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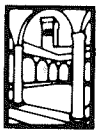

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Integration Through Law

Europe and the American Federal Experience

A Series under the General Editorship of

Mauro Cappelletti · Monica Seccombe · Joseph Weiler

Volume 4

Legal Harmonization and the Business Enterprise

Corporate and Capital Market Law Harmonization Policy in Europe and the U.S.A.

by

Richard M. Buxbaum and Klaus J. Hopt

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General Editors' Foreword

The Florence Integration Through Law Series is the product of a research project centered in the Law Department of the European University Institute, and as such it reflects the research interests of the Department: it is a contextual examination of European legal developments in comparative perspective. In the general introduction to the Series (published in Book One of Volume I), we explained fully the philosophy, methodology and scope of the Project. Here we wish merely to recapitulate some of the principal themes of special relevance to this Volume on Enterprise Law.

The European Legal Integration Project set out to examine the role of law in, and the legal impact of, integration in Europe, using the United States federal system as a comparative point of reference. The Project was conceived and executed in two parts. In Part One (published in Volume I entitled "Methods, Tools and Institutions"[1] a number of teams of American and European scholars examined a wide range of legal techniques and mechanisms for integration and undertook an overall general analysis of law and integration. The first book of Volume I ("A Political, Legal, and Economic Overview") establishes the comparative and interdisciplinary context, providing background studies on the political, legal and economic implications of integration in Europe and America and including studies on other federal systems (Australia, Canada, Germany and Switzerland) to add comparative perspective. The second book ("Political Organs, Integration Techniques, and Judicial Process") analyzes the pre- and post-normative stages, examining the decision-making and implementation problems, and the role of political techniques available in a federal or supranational context.

The third and final book of Volume I ("Forces and Potential for a European Identity") focusses on how the law can be harnessed to promote the governmental or integrational objectives of union. It isolates for consideration some substantive goals (foreign policy, free movement of goods and persons, human rights protection and legal education), in order to elucidate the ways in which law has been or can be used to promote substantive objectives. This approach is more fully developed in the studies in Part Two of the Project which deals in greater detail with substantive areas of federal/transnational policy and is open-ended. To date, in addition to the present volume on enterprise law, monographs have been written in the following four areas: environmental

[1] Published by Walter de Gruyter (Berlin/New York) in January 1986.

policy,[2] consumer protection,[3] energy policy,[4] and regional policy.[5] It is hoped that further studies may be undertaken in the future.

No justification is needed for the choice of corporate law and capital market harmonization as a topic to be included among the five substantive studies. One of the great benefits the Common Market was to yield was to be the easing of transnational enterprise and entrepreneurship. Indeed, the United States was often cited as a model of a non-unitary legal order in which companies could nevertheless operate as if in a single market with all the advantages of size, and in which investors and creditors would receive federal protection. In fact the Community has often been accused of "pandering" to the interests of the business community to the exclusion of other societal sectors. The fact is that harmonization of enterprise law has proved to be a much greater task than was originally envisaged. Obstacles of a legal, political and economic nature have impeded the desired transformation, and at a deeper level the very philosophy and alleged gains have come under strict scrutiny.

The authors of this study capture the totality of the debate. The theoretical grounds of transnational enterprise law are re-examined and then confronted with the complex reality of the two legal orders. The conclusions, as the reader will discover, are often startling. Thus we find, to give but one example, that a principal objection to harmonization may be not so much that the substantive contents of a compromise directive are unacceptable, but the fact that once a measure is "Communitarized," the tortuous EC decision-making structure might consign it to almost automatic obsolescence given the difficulties in passing new amending legislation. Transnationalism might thus be impeded by the very success of the initial Community process.

Corporation law as a topic for legal analysis has, of course, already elicited a substantial amount of scholarly attention. Why then present this new examination? First and foremost is the value of a fresh analysis by the distinguished authors of this volume. But in addition, it is our belief that the Integration Project provided a special context for specific and unique insights. Most obvious is the comparative context: this study presents a tight comparative analysis of the European and American experiences. Through this comparative

2 E. REHBINDER & R. STEWART, *Environmental Protection Policy* (Vol. 2 *Integration Through Law*) was published by Walter de Gruyter (Berlin/New York) in December 1985.

3 T. BOURGOIGNIE & D. TRUBEK, *Consumer Law, Common Markets and Federalism in Europe and the United States* (Vol. 3 *Integration Through Law*) was published by Walter de Gruyter (Berlin/New York) in December 1986.

4 T. DAINTITH & S. WILLIAMS, *The Legal Integration of Energy Markets* (Vol. 5 *Integration Through Law*) was published by Walter de Gruyter (Berlin/New York) in March 1987.

5 Y. MENY & B. DE WITTE, *Regionalism and Federalism: The Challenge of Regions in National and Transnational Polities* (Vol. 6 *Integration Through Law*) (forthcoming).

analysis we gain a better understanding not only of the problems associated with the specific subject of transnational enterprise law but also of the workings of the transnational/federal system of governance in general. There is as much to be learnt from this volume on the process of integration and its problems as there is to be learnt on the legal dimensions of corporate life and capital markets.

The Project has invited, however, more than the comparative contribution. The Florence Integration Through Law Series is dedicated to the concept of Law in Context: the examination of legal problems in their political, economic and social setting. There has been much pontification in recent years about the value of interdisciplinarity. Implementation of this value, however, often falls short of much hallowed theoretical expectations. In this regard our claims were modest: We did not ask our contributors to bring the full scientific paraphernalia of, say economics or political science to bear on their subject; we simply asked that the legal analysis be situated in, and be sensitive to, the implications of the socio-economic and political context. The present volume is, in our view, an extraordinarily successful example of this approach.

The European Integration Project follows on from an earlier wide-ranging research project which was carried out at the European University Institute – the Florence Access-to-Justice Project. Access to Justice was not only concerned with an examination and, indeed, extension of the procedural and institutional mechanisms for the vindication of rights in contemporary society. It was an approach which sought to emphasize that in legal study an analysis of the normative content of legal rules and policies – while still central – can give only a partial picture of the function and shortcomings of the law in its societal context. Normative analysis is but one layer of analysis: the effective (or otherwise) reach of the law, its implementation and enforcement, its accessibility to subjects to whom it is addressed as a source of rights and duties, is a second no less important layer. This approach has been a constant guideline to all contributions to the European Integration Project.

Problems of implementation and enforcement are notorious in the field of multinational corporations. They are aggravated in the European transnational system which has its own inherent difficulties of supervision and compliance – though this context offers the only real hope of coming to grips with the multinational corporate body. This study deals in depth with this dimension, and is one of the first of its kind in the European context.

If the Access-to-Justice philosophy postulated the addition of this post-normative layer in the analysis of law, the institutional and procedural character of the Integration Project postulated the addition of yet another layer – a pre-normative layer. Both in the first general methodological part of the Project and in its second substantive part we have given considerable attention to the decision-making process by and through which norms emerge. The necessity of this addition is so clear as to obviate any lengthy explanation. Not only is decision-making an essential component in the analysis of the system as a

whole, but it also gives, particularly in the context of the European transnational concordance of interests, an insight into the normative outcome and, as explained throughout the Project, into the very problems of implementation, application and enforcement. All studies in Part Two of the Project, have adopted what one may call a "total" approach to legal analysis. Certainly the normative, "black letter" dimension of the law is explored; but this normative analysis is sandwiched between the pre- and post-normative phase. The volume explores fully the process of policy-making, the difficulty it encounters and the political context against which normative compromises are reached.

The Integration Through Law Series represents a collective effort over a long period of time. At its inception we believed that the first methodological part of the Project would be the setting against which the subsequent substantive parts, such as this study on corporate law and capital markets would be written. Things often do not turn out as they were planned. The two parts of the project in fact evolved simultaneously, and while the Part Two studies undoubtedly did rely on the general methodological background studies of Part One, the studies in Part One equally drew upon the analysis contained in the concrete substantive studies of Part Two. In this process of cross-fertilization Professors Buxbaum and Hopt played a much appreciated part. In particular their insights into the economic dimensions of transnational processes were instructive to many other contributors. Their collegiality and cooperation with the editors significantly facilitated our task. We are truly grateful to them.

Florence, December 1986

Mauro Cappelletti
Monica Seccombe
Joseph Weiler

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List of Abbreviations

AcP	Archiv für die civilistische Praxis
ADHGB	Allgemeines Deutsches Handelsgesetzbuch
AfA	Absetzung für Abnutzungen
AG	Aktiengesellschaft, Die Aktiengesellschaft
AJIL	American Journal of International Law
AktG	Gesetz über Aktiengesellschaften und Kommanditgesellschaften auf Aktien
Am. Bar Found. Res. J.	American Bar Foundation Research Journal
Am. J. Comp. L.	American Journal of Comparative Law
Am. J. Leg. Hist.	American Journal of Legal History
BB	Der Betriebs-Berater
BFH	Bundesfinanzhof
BG	Bundesgerichtshof
BGBl.	Bundesgesetzblatt
BGH	Bundesgerichtshof
Bost. Coll. L. Rev.	Boston College Law Review
BTDrucks.	Drucksachen des Deutschen Bundestages
Bull. EC	Bulletin of the European Communities
Bus. Hist. Rev.	Business History Review
Bus. Law.	Business Lawyer
BVerwG	Bundesverwaltungsgericht
Cal. L. Rev.	California Law Review
Ch.	Chapter
C.M.L.R.	Common Market Law Reports
C.M.L. Rev.	Common Market Law Review
Colum. L. Rev.	Columbia Law Review
Comp. L. Yearbook	Comparative Law Yearbook
Cong.	Congress
Conn. Bar J.	Connecticut Bar Journal
Const.	Constitution
Corp. L. Rev.	Corporation Law Review
DB	Der Betrieb
DBW	Die Betriebswirtschaft
Doc. COM	Commission Document(EC)
EC	European Community/Communities
E.C.R.	Reports of the European Court of Justice
Ecol. L. Q.	Ecology Law Quarterly
EEC	European Economic Community
EUI	European University Institute

EuR	Europarecht
Eur. L. Rev.	European Law Review
F.2d	Federal Reporter, Second Series
F. Supp.	Federal Supplement
GebrMG	Gebrauchsmustergesetz
Geo. L. J.	Georgetown Law Journal
Giur. comm.	Giurisprudenza commerciale
GmbH	Gesellschaft mit beschränkter Haftung
GmbHG	Gesetz betreffend die GmbH
GmbH-Rdsch.	Rundschau für GmbH
GRUR	Gewerblicher Rechtsschutz und Urheberrecht
GWB	Gesetz gegen Wettbewerbsbeschränkungen [Kartellgesetz]
Harv. J. Legis.	Harvard Journal on Legislation
Harv. L. Rev.	Harvard Law Review
HGB	Handelsgesetzbuch
H.R.	House of Representatives (US)
I.C.L.Q.	International & Comparative Law Quarterly
Int'l Enc. Comp. L.	International Encyclopaedia of Comparative Law
Int'l Leg. Materials	International Legal Materials
J. Am. Hist.	Journal of American History
J.C.M. Stud.	Journal of Common Market Studies
J. Comp. Bus. & Cap. Mkt. L.	Journal of Comparative Business & Capital Market Law
J. Comp. Corp. L. & Sec. Reg.	Journal of Comparative Corporation Law & Securities Regulation
J. Econ. Hist.	Journal of Economic History
J. Econ. Lit.	Journal of Economic Literature
J. Int'l Bus. L.	Journal of International Business Law
J. Law, Econ. & Org.	Journal of Law, Economics & Organization
J. Leg. Studies	Journal of Legal Studies
J.O.	Journal Officiel
JöR n.f.	Jahrbuch des Öffentlichen Rechts der Gegenwart, neue Folge
J. World Trade L.	Journal of World Trade Law
Law & Contemp. Prob.	Law & Contemporary Problems
Law & Soc'y Rev.	Law & Society Review
Law & Policy Int'l Bus	Law & Policy in International Business
L.Q.R.	Law Quarterly Review
Mich. L. Rev.	Michigan Law Review
Minn. L. Rev.	Minnesota Law Review
MitbestG	Gesetz über die Mitbestimmung der Arbeitnehmer
Mod. L. Rev.	Modern Law Review
N.C.L. Rev.	North Carolina Law Review
Netherlands Int'l L. Rev.	Netherlands International Law Review

NJW	Neue Juristische Wochenschrift
Notre Dame Law.	Notre Dame Lawyer
N.Y.U. L. Rev.	New York University Law Review
O.J.	Official Journal (of the EC unless otherwise stated)
Ore. L. Rev.	Oregon Law Review
Oxf. J. Leg. Studies	Oxford Journal of Legal Studies
P.2d	Pacific Reporter, Second Series
Pas. Belge	Pasicrisie Belge
PatG	Patentgesetz
Pub. Ad. Rev.	Public Administration Review
Pub. L.	Public Law
Q.B.	Queen's Bench, Law Reports (England)
RabelsZ	Rabels Zeitschrift für ausländisches und internationales Privatrecht
Rev. crit. droit int'l privé	Revue critique de droit international privé
Rev. soc.	Revue des sociétés
Rev. trim. droit comm. et droit écon.	Revue trimestrielle de droit commercial et de droit économique
RGBl.	Reichsgesetzblatt
RG	Reichsgericht
RGZ	Entscheidungen des Reichsgerichts in Zivilsachen
R.I.D.C.	Revue internationale de droit comparé
Riv. soc.	Rivista delle società
RIW/AWD	Recht der Internationalen Wirtschaft/Außenwirtschaftsdienst des Betriebs-Beraters
R.T.D.E.	Revue trimestrielle de droit européen
S. Ct.	Supreme Court Reporter
SEC	Securities & Exchange Commission
Sec. Reg. L.J.	Securities Regulation Law Journal
Sess.	Session
Stan. L. Rev.	Stanford Law Review
Sup. Ct. Rev.	Supreme Court Review
Supp.	Supplement
U. Chi. L. Rev.	University of Chicago Law Review
UCLA L. Rev.	University of California, Los Angeles Law Review
U. Pa. L. Rev.	University of Pennsylvania Law Review
U.S.	United States Supreme Court Reports
U.S.C.(A.)	United States Code (Annotated)
UWG	Gesetz gegen den unlauteren Wettbewerb
Va. L. Rev.	Virginia Law Review
WPg	Die Wirtschaftsprüfung
Wis. L. Rev.	Wisconsin Law Review
WM	Zeitschrift für Wirtschaft- und Bankrecht (Wertpapier-Mitteilungen)

Wm. & Mary L. Rev.	William and Mary Law Review
WRP	Wettbewerb in Recht und Praxis
WuR	Wirtschaft und Recht
WZG	Warenzeichengesetz
Yale L. J.	Yale Law Journal
ZaöRV	Zeitschrift für ausländisches öffentliches Recht und Völkerrecht
ZfA	Zeitschrift für Arbeitsrecht
ZGesKW	Zeitschrift für das gesamte Kreditwesen
ZGR	Zeitschrift für Unternehmens- und Gesellschaftsrecht
ZHR	Zeitschrift für das gesamte Handelsrecht und Wirtschaftsrecht
ZKW	Zeitschrift für das gesamte Kreditwesen
ZRG Germ. Abt.	Zeitschrift der Savigny-Stiftung für Rechtsgeschichte, Germanistische Abteilung
ZVerglRW	Zeitschrift für vergleichende Rechtswissenschaft
ZZP	Zeitschrift für Zivilprozeß

Chapter One

Introduction: Models of Inquiry

This is a study of legal integration in the field of company law, with some extension into the larger field of enterprise law. It begins, as do parallel substantive field studies in the "Integration Through Law" Series, with the search for principled criteria providing an appropriate guide to the division of all three governmental powers – legislative, judicial and executive – between federal (Community) and state (Member State) governments, insofar as this division of powers affects the latter's respective roles in the development and implementation of company or enterprise law. The description and critical evaluation of the American struggle to develop those criteria will reveal primarily the results of two hundred years of political developments; the European study will reveal more the result of the current, and somewhat more explicit, bureaucratic as well as political struggle over this agenda.

Scholars who look or hope for rational decision-making criteria are victims of the illusion that principle and motive are synonyms. Nevertheless, and whether one focuses on the American or on the European experience, a first effort to develop rational criteria for that jurisdictional purpose is essential.

I. The Search for a Rational Division of Powers

This search implies a need for data and for models. The review of American and European experience which follows reveals the prevalence of the simple criteria of enterprise size and corporate form as determinants for state versus federal location of company law, but suggests little in the way of underlying theories or reasons for those choices. The potentially interesting theories about the division of powers which do emerge are mainly general in character and not specific to corporate or enterprise law. Two that are reasonably specific, one prescriptive and one predictive, are elaborated in some detail below and used in the substantive chapters that follow. Others, more general in nature, are more sketchily introduced; their use in the substantive chapters is more in the way of provocative illumination than as systematic explanations or hypotheses.

A. Quantitative Criteria

The following chapters reflect the considerable attention which has been paid in both legal systems to the identification of appropriate criteria by which to distinguish enterprise activity safely left to local regulation from enterprise activity which it is necessary to subject to federal, or in European terms to Community level, regulation. Questions of corporate size, and especially operational definitions of size appropriate to the various regulatory purposes, have occupied legislatures on both sides of the Atlantic for some time. It is theoretically intriguing and practically convenient to use such criteria to establish the division of legislative competence over corporations both at the state/federal and at the Member State/Community level in each set of jurisdictions. Certainly the American experience with investor protection regulation suggests such a correlation and, in a yet different sense, the European debates about the disclosure of enterprise information and the imposition of labor codetermination requirements confirm this focus on size-related criteria as the jurisdictional dividing line.

Nevertheless, this approach has both practical and theoretical inadequacies. Simply from an institutional perspective the issue, what specific size should trigger jurisdictional consequences, cannot be answered in principle but becomes enmeshed in expediency, political bargaining and administrative expertise. At the least, these are all problems which disable the courts from providing leadership in evolving appropriate rules and, by the same token, mandate the involvement of legislative institutions. The very existence of the latter at this stage of the European Community's development, let alone their ability, in terms of political legitimacy, to generate and install such norms, is still precarious. The evidence of the last decade concerning the struggle over company law directives in these sensitive fields demonstrates the problem,[1] at least as to the Council of Ministers, and indirectly even as to the European Parliament.

Perhaps even more significant is the functional problem: To what end is a size criterion desirable?[2] The elements of size relevant to investor protection relate primarily to dispersal of share ownership; the elements primarily relevant to codetermination concern the number of employees; whereas the elements relevant to antitrust concerns are totally external and bear more on

[1] See SCHNEEBAUM, "The Company Law Harmonization Program of the European Community," 14 *Law & Policy Int'l Bus.* 293 (1982); TIMMERMANS, "Die europäische Rechtsangleichung im Gesellschaftsrecht, Eine integrations- und rechtspolitische Analyse," 48 *RabelsZ* 1 (1984). For the history to 1970, see the definitive study of E. STEIN, *Harmonization of European Company Laws* (Indianapolis 1971).

[2] See on this issue R. BUXBAUM, "The Formation of Marketable Share Companies," in *Int'l Enc. Comp. L.*, Vol. XIII, *Business and Private Organizations*, ch. 3 (A. Conard ed., Tübingen n.d. [1974]).

market occupancy than on company criteria. Regulation of disclosure of information for both investor and public purposes, a critical matter in current European discussions, would depend upon size criteria partaking of all of these elements and perhaps of yet others. The theoretical poverty of these discussions is well illustrated by the German solution to the development of criteria triggering disclosure obligations of enterprises other than those organized in the form of a corporation: elements of employee number, asset size, and turnover size are cumulated in the legislation, which triggers disclosure obligations whenever any two of the three criteria, at levels established by law, are met by the particular enterprise.[3]

B. Formal Criteria

These inadequacies render focus on size-related criteria less fruitful than may have appeared originally. In addition, the desirability of imposing at least information requirements on certain types of enterprises which applying all criteria would fall below triggering levels has currently led policy-makers and commentators back to a focus on the traditional criterion of corporate form. The German experience with regulatory legislation of various types, which to a considerable degree is based on corporate form, has thus become particularly relevant to the European debate over the proper division of competence in the field of corporation law.[4] In Germany, the principal regulatory criterion has been the incorporation of the enterprise in the form of an *Aktiengesellschaft* (AG); the size of any other form of enterprise has been an independent triggering criterion only for certain very large entities (in the case of imposition of information requirements before 1986, for example, a GmbH with, *inter alia*, more than 5,000 employees).

In this one case the correlation of form with regulatory purpose may be suitable for general adoption, though this results from the more or less accidental circumstance that in most European countries other than Germany the public corporation form (AG, SA, NV) in fact is chosen by most companies, even small ones, and certainly by those large enough to be of interest to the regulators. In the cases in which this is not so – particularly in Germany, where a substantial percentage of large scale enterprise activity is carried out in close corporation or noncorporate form – a supplemental criterion of functionally specific size does turn out to be necessary. Indeed, the absence of this additional jurisdictional hook in present Common Market rules has in fact meant that some German entities escape Community-level regulation when similarly positioned enterprises in other Member States are subject thereto.[5]

3 See Ch. 3, § I.B.1.c *infra* at p. 185.

4 See Ch. 3, § I.B.1.d *infra* at pp. 185-87.

5 As to these problems of the GmbH & Co., see Ch. 3, § I.B.1.d *infra* at p. 187; § III. B.1.e, at pp. 240-41; § IV. A.1.a.ii at p. 252.

Further, even in the case of the other Member States of the European Community one has to recall that, as in the United States, all large enterprise may be engaged in supranational commerce, but not all actors in that arena are large enterprises.[6] For the time being this has not been a sensitive enough problem to generate yet other criteria for the imposition of supranational regulatory norms. At least to date, the Commission of the European Community has met this problem of different national use of the various corporate organizational forms by providing in its harmonization directives an actual catalogue of such forms in any situation in which the regulatory purpose dictates the coverage of all (particularly German) companies engaged in certain types of economic activity. The American experience with the focus on the stream of commerce itself as the essential triggering criterion for federal regulation, however, suggests that in time this functional attribute may come to dominate all others previously identified.

C. The Relevance of Constitutional Text and Context to the Choice of Criteria

At the direct textual level the constitutional acts are similar. The American Commerce Clause places in the federal government the power "to regulate commerce among the several states";[7] Article 3(h) of the Treaty of Rome, authorizing legislation "to the extent necessary for the functioning of the Common Market," is made operational by the direction of Article 100 to the Community organs to achieve approximation of national laws through directives as to matters which have a "direct incidence on the functioning of the Common Market."[8] Furthermore, each organic act contains a "necessary and proper" clause.[9] As texts, neither is adequately honored by absolute, all-or-nothing criteria such as levels of size or types of forms. Rather, each suggests the need for jurisdictional criteria that focus not on enterprise-specific elements but on the direct object of the jurisdictional grant, the concept of interstate commerce. The antitrust law offers the closest analogy: not size of company, not form of company, but the impact of the questioned activity on the relevant market and on trade between the (member) states, an external touchstone, is the significant substantive criterion.

6 See Ch. 2, § II *infra* at pp. 26-28.

7 U.S. Const. art. I, § 8; see text *infra* at p. 30.

8 No such direct incidence is needed under the very important new Art. 100A (as of 1987): see EHLERMANN, "The Internal Market Following the Single European Act," 24 *C.M.L. Rev.* 361, at 381 et seq., 385 (1987). See also EEC Treaty art. 220, authorizing inter-state negotiation of common provisions concerning mergers and transfer of corporate seat transactions; see STEIN, *supra* note 1, at 41-45.

9 U.S. Const. art. I, § 8, cl. 18; EEC Treaty art. 235.

This formal similarity, however, only suggests the common starting point for the division of powers within each of the two legal systems. The distance each system travels along the road identified by this focus on interstate commerce is not and cannot be a function of logic or of economic rationality. It is a matter of political commitment to, and legitimation of, the central authority vis-à-vis the single states or nations voluntarily relinquishing original sovereign authority to that center. It needs no demonstration here to assert that this critical commitment was different at the inception of the American union from that at the inception of the three European Communities.

A related, perhaps even more important, causative factor in determining the distance which either system travels along the road to significant harmonization or centralization of its component units' economic law is the accidental factor of the time as of which the effort begins. The American federal experiment had the happy and fortuitous advantage of beginning when the existing structure of economic activity was still so localized that it created little immediate pressure for, and thus little immediate reaction to, centralization of legal rules and institutions.[10] Commerce itself in fact was not yet interstate in character, and the embryonic federal legal system had time to test itself and grow against modest pressures which did not overwhelm its modest initial capabilities. The European experiment, by contrast, was fated to begin *in medias res;* it has required from the outset more political strength than it has in fact been allotted to achieve even minimally necessary legal harmonization.

Finally, the significance of institutional differences between the two systems, and in particular the relative predominance of the judicial role in the American as against the legislative role in the European system cannot be ignored as a third causative factor explaining the depth of the centralizing and harmonizing impulses at work in each system. Courts operate on a case-by-case, single-issue basis; their participation in the evolution of the particular legal regime assures flexibility, reversibility, opportunity to experiment.[11] Courts operate with a rhetoric of authoritative persuasion, not of authoritative apodictic fiat.[12] This permits relatively open use of economic motivations and rationales, and in this way aids the achievement of efficiency. For both reasons courts can help the legal regime within which they have their place develop its legitimacy vis-à-vis the centrifugal systems from which it is siphoning sovereign power. In the historical American setting this tendency was augmented by the fact that all of these factors operated through the federal courts. While the same institu-

[10] See Ch. 2, § III. B.2 *infra* at pp. 31-32.

[11] We believe it is common ground today that this describes Civil as well as Common Law adjudication, at least at the level at which the distinction between the legislative and the adjudicative process is relevant here.

[12] See, e.g., FISS, "The Supreme Court, 1978 Term, Foreword: The Forms of Justice," 92 *Harv. L. Rev.* 1, 13 (1979); HORN, "Rationalität und Autorität in der Juristischen Argumentation," 6 *Rechtstheorie* 145 (1975).

II. Economic Considerations Underlying the Division of Powers in the Field of Corporate and Enterprise Law

The foregoing discussion suggests that any formal dividing line between federal and state competence in this field stems primarily from the extrinsic, societal concept of "national commerce" or "common market." The particular enterprise-related criteria actually found in specific federal legislation are only reflections of this overriding "constitutional" criterion.

Whatever historical or institutional differences exist between the two systems, and whatever the textual differences between the constitutions of each federal system, in any federal system the division of competence has to be related in some satisfactory fashion with this underlying division between interstate and local commerce. If this is so, it is now appropriate to consider the major autonomous variable with similar explanatory potential, the economic variable. We beg the initial but unresolvable question whether economic reality preordains political reality or vice versa, or whether the two realities reciprocally influence each other. We prefer to introduce the simpler question whether economic theory provides another basis for modelling the appropriate reach and intensity of federal legislation in our field of concern, in order to see whether economic theory provides the survey benchmarks for the division of powers within the American and European federal systems.

We do not intend thereby to neglect other explanatory or prescriptive models derived from political economy or political science. Indeed, a major current debate in the political economy literature, concerning the correlation between economic organization and the political concept of federalism, is used as a sounding board for recent American constitutional developments in the next chapter.[16] This debate, however, which is essentially a debate over neo-mercantilism or "mixed economy" characterizations, is mainly relevant to the legal issues posed by the division of powers in a descriptive sense. It provides no prescriptive guidelines for the development or ranking of a legal agenda or for the testing of legal arguments. Other, less fully elaborated generalizations about actual historical developments, briefly described in the final chapter,[17] are not yet directly useful as explanations of a specifically legal history and do not claim normative qualities. One which does is the effort to apply the Musgravian categories of governmental functions[18] to a federal system;[19] but as both

[16] See its explanation in MUELLER, "Public Choice: A Survey," 14 *J. Econ. Lit.* 395 (1976). The description of public choice therein suggests that the use of the concept in the next-cited works is on a somewhat less rigorous analytical level.

[17] Chapter 4 *infra* at p. 274.

[18] See R. MUSGRAVE & P. MUSGRAVE, *Public Finance in Theory and Practice*, esp. chs. 1, 29, 30 (3d ed., New York 1980).

[19] *Id.;* see also W. OATES, *Fiscal Federalism* (New York 1972); BUXBAUM, "Federalism and Company Law," 82 *Mich. L. Rev.* 1163 (1984).

tional factors operated to some degree in favor of state courts which often fostered a competing localizing philosophy, the latter were by definition locked in an unequal contest due to the *Kompetenz-Kompetenz* early arrogated to the federal judicial system by the decision in *McCulloch v. Maryland.*[13]

The law-making institutions of the European Community, by contrast, are concentrated in the hybrid Council of Ministers, as supplemented by some autonomous and some derived powers of the Commission; only relatively recently has the now-elected European Parliament begun to question its constitutional inability to initiate legislation rather than to review it.[14] Partly because of this institutional distinction, partly for reasons of political legitimacy and expediency, the operation of these Community organs has demonstrated a certain degree of generality and rigidity, without thereby avoiding political compromise as to substance. It displays relative inflexibility of course correction, and relatively little articulation of even the rationale let alone the motivation of many of its laws, regulations and directives.[15] To the extent that the Court of Justice could function as the American federal court system has just been described as functioning, it has done so; but it sits at a distance from and without a systematic connection to the Member State appellate, let alone Member State trial, court systems. Thus, not only is its determination of its competence vis-à-vis that of the Member State courts less pervasive than that of the American Supreme Court, because of their different constitutional underpinnings, but in addition, it lacks the aid of an own subordinate hierarchy of European Community courts in this context.

These three types of differences between the American and the European federalizing experiments do not make a comparison of their respective experiences useless. They do, however, help to explain differences in those experiences; not only in the experience of deriving formal criteria for the division of powers within each system, but also in the experience with economic and political models and values as sources of appropriate criteria, to which we now turn.

13 17 U.S. (4 Wheat.) 316 (1819). On the struggle of the European Court of Justice (ECJ) to fashion supremacy without a supremacy clause, see STEIN, "Lawyers, Judges and the Making of a Transnational Constitution," 75 *AJIL* 1, 10 (1981); WAELBROECK, "The Emergent Doctrine of Community Pre-Emption – Consent and Redelegation," in 2 *Courts and Free Markets* 548 (T. Sandalow & E. Stein eds., Oxford 1982); CAPPELLETTI & GOLAY, "The Judicial Branch in the Federal and Transnational Union: Its Impact on Integration," in I/2 *Integration Through Law* 261 (New York/Berlin 1986).

14 See the description by WEILER, "The European Parliament and Its Foreign Affairs Committees," in 2 *Control of Foreign Policies in Western Democracies* 22-30 (A. Cassese ed., Padua 1982). *Cf.* also the 1987 version of Art. 149 of the EEC Treaty.

15 See Ch. 3, § III. B.1 *infra* at pp. 242-43. For a more optimistic (and early) picture of articulate, persuasive and well-prepared decision-making, by an insider, see still WIRSING, "Probleme Internationaler Wirtschaftsverwaltung," in *Staat und Wirtschaft im nationalen und übernationalen Recht* 130, esp. 134-37 (Berlin 1964).

the original and the federal versions thereof speak only to fiscal policies, their relevance to corporation and enterprise law (private and regulatory) is too indirect to permit their direct application to this project. Only in the structural economic literature do we find two models that appear suitable for our particular purposes, and they are the subject of this section as well as a reference point throughout this entire study.

A. The Public Choice Approach

One modern model is attractive because of its specific focus on this essentially politico-legal question of division of powers, particularly on its appearance in the form of the federal preemption of subject matter otherwise within the exclusive or at least the concurrent competence of the member states. This is the theory of public choice, a modern extension of the structural conditions of competition to non-market areas,[20] which *Kitch* recently elaborated in this same federal context.[21] It posits that competition between legal regimes of different (but coequal) sovereigns will itself generate the efficient allocation of resources within the market comprised of that group of competitively collaborating sovereigns, and will do so with less cost than will a harmony of law imposed on that same market from the federal center. The competitive, capital- and employment-seeking pressure exerted by each sovereign on the other, in a federation in which no one sovereign can dictate the terms of the others' laws, itself will suffice to generate the harmonization or approximation of the same laws that are the main concern of the federal agenda.

Operational consequences of this model, assuming its validity, are directly relevant to the subject of this chapter. There would be no need for federally imposed harmonization, let alone unification, of company laws or even of some broader, yet to be defined field of "enterprise laws": the market would see to that process. Indeed, the model has even broader implications; but in those broader implications also lie the reasons for doubting the adequacy of using it to test present developments or predict future ones, let alone to prescribe them.

Not only company laws could dispense with centrally imposed harmonization. The tariff walls themselves, and everything in between them and com-

[20] See particularly J. BUCHANAN, *The Demand and Supply of Public Goods* (Chicago 1968), building on R. MUSGRAVE, *The Theory of Public Finance* (New York 1959) in a legal and political direction.

[21] KITCH, "Regulation and the American Common Market," in *Regulation, Federalism and Interstate Commerce* 9 (D. Tarlock ed., Cambridge 1981). See also WINTER, "State Law, Shareholder Protection, and the Theory of the Corporation," 6 *J. Leg. Stud.* 251 (1977); and the interesting effort to test these "competition-of-laws" hypotheses in ROMANO, "Law as a Product: Some Pieces of the Incorporation Puzzle," 1 *J. Law, Econ. & Org.* 225 (1985).

pany law, should fall in time to this process. Nor is the set of sovereigns exposed to the process limited to one already loosely bound together by law, proximity or language.[22] Albania and Zimbabwe, and every sovereign between, is subject to these levelling tendencies; it is less questions of law than questions of degree and time that distinguish them from the thirteen colonies or the twelve Member States. The model claims too much, and if cut down to more modest claims by reasons of judgment or expediency, itself reopens the original issue of fixing the division of powers on the basis of other, typically and explicitly more political, independent variables.

Applied only to federal systems in which some formal division of powers already has occurred, it meets a further, explicitly political countervailing objection: the process it postulates would cause the individual states to throw out the public law baby with the private law bath-water. Societal pressure for various forms of public law protection – let us simply name investor and labor protection – would be directed at the federal level of the system. That federal center in turn might respond favorably to such regulatory demands, in which case it would need to develop a stronger political base than at least initially would have been assigned to it. Alternatively, it might respond negatively, and thus tend toward a corporatist form of government. This presumably would be politically unacceptable to those member states whose configuration makes them sympathetic to the regulatory pressures while constrained by their federal membership from acting on their desires.[23] If these options are politically unavailable or unacceptable as a starting point for a federal union or economic community, they should be equally unacceptable as a consequence of such political organization.

The public choice analysis does have a legitimate and powerful basis, but that lies rather in its implicit call for prudence, judgment and modesty in the definition and implementation of a federal law agenda. That is an important reminder and an important value, but not one that is really necessary in a setting like that of today's European Community where political considerations already provide more counsel of prudence than may be prudent. Paradoxically, it may have more persuasive power as a check on federal aggrandizement in the name of free-market or efficiency criteria, which in the United States today is leading to the imposed dismantling of state legislation, at least in certain areas of securities regulation.[24]

The foregoing, of course, are reactions to the prescriptive or normative aspects of this federal public choice argument. The descriptive or predictive

[22] Money, after all, is a solvent that can erode national as well as state boundaries.

[23] Morale (or civic culture), ideology and relative strength in natural and human resources may provide a nation or a state with some immunity for some time – and how much, for how long and why are fascinating questions – but not categorically and probably not over the long run.

[24] See Ch. 2, § V.c *infra* at p. 130 et seq.

aspects of the argument are another matter; and it is one of the ancillary if not principal purposes of the later review of the American experience with federalism as an element of corporation and enterprise law to test those descriptive aspects. We leave to the concluding chapter our own evaluation of that test.

B. The Productivity of Integration Approach

An older, less exorbitant but more general economic theory may have more power as a modelling technique for the division of powers in the field of enterprise law and even, at quite operational levels, for the specific content of that law, whether by way of unification or of approximation of state laws. This is the modern common market variant of the classic concept of comparative advantage in international trade, a variant associated principally with the already classic work of *Scitovsky*.[25] The classic theory which underlies free trade models assumes a substantial comparative advantage (from production specialization) because the three natural advantages whose exploitation provides signals to output-reallocation decisions – natural endowments, productivity and transportation costs – vary substantially among nations. These are not, however, significantly different among countries as close, as similar and as developed as are the member states of the American union or of the European Community, even granting the distance between Germany and Greece or Mississippi and New York. Therefore, the reallocation of productive factor resources incident to the removal of national barriers to commerce within a new common market is not likely to increase productivity of these component units significantly.

Scitovsky then postulated the existence of other economic bases in justification of economic integration of contiguous markets evidencing reasonably similar levels of industrialization. Changes in production methods and behavior are another element in the achievement of productivity gains, changes ranging from attitudes towards competition to styles of workforce behavior. However, for reasons allied to those identified as imposing limits on the first element – that of productive factor resources reallocation – *Scitovsky* asserted that these changes, too, cannot be expected to generate substantial pro-

[25] T. SCITOVSKY, *Economic Theory and Western European Integration* (London 1958; repr. w./intro. 1962). An equally important and influential work is that of B. BALASSA, *The Theory of Economic Integration* (London 1962), focussing more generally on "dynamic" aspects of integration. For a critique of these and other theoretical works from within the economic discipline, see KRAUSS, "Recent Developments in Customs Union Theory: An Interpretative Survey," 10 *J. Econ. Lit.* 413, esp. 419-21 (1972). See also D. SWANN, *The Economics of the Common Market* 179-81 (4th ed., Harmondsworth 1978).

ductivity increases – with one important exception. To the extent that changes in competitive structure and behavior of producers are included within this element, the pressure a common market would exert in favor of more fully competitive structure and behavior would expectably increase productivity. This would occur less as an indirect consequence of changing the general mixture of structural and behavioral components of production (i.e., its technological, bureaucratic, work-ethos or other components), than in direct consequence of the mentioned change in competitive structure and behavior.

The final element influencing productivity identified by *Scitovsky,* and the only long-run one, is the changes in the volume, nature and pattern of investment produced by the development of a common market. Since they can take effect only at the margin, through new investment, not by drastic wholesale conversion of existing investment, they will be significant only by accretion over time, but are none the less important to support and induce for all that.[26] Here, too, however, the model posits eventual significant change in investment increase and pattern, though again less as a general consequence of integration than as a direct consequence of improved competitive structure and behavior which provides positive investment signals. In short, of all factors influencing productivity, the improved mobility of the factors of production – be they goods, services, capital or labor – are less important as either causes or consequences of integration than as handmaidens to the increase in competition within a newly integrated market.

This conclusion does not imply the disregard of public good (or distributive justice) considerations relevant to any of these factors, particularly the employment factor, or their mindless subservience to the goal of increased competition. On the contrary, the social costs of full labor mobility are built into the *Scitovsky* analysis as an externality to be booked against the gross gains from competition and reduce their net value.[27] The model does, however, suggest certain implications about the priorities, weight and attention to be paid to federal support and control of factor mobility if those factors are seen in this subsidiary role rather than in some assumed primary role in the ongoing development of a common market. In the same sense, the model's attention to competition as the principal benefit, and therefore justification, of integration carries implications for the importance of federal insistence on that competition and on the removal of local law barriers inhibiting its development.[28]

[26] The substantial foreign investment in new production capacity, however, was not accorded sufficient importance in this description of new investment "at the margin."

[27] See particularly the discussion in SCITOVSKY, *supra* note 25, at 40 ff, 92 ff.

[28] See Ch. 4, § II.C *infra* at p. 280 et seq.

C. The Nature of the State and the Unification of Law

The latest contribution of economics to the search for a rational division of powers is that of *Bernholz* and *Faber*.[29] The main thesis of their normative economic theory of the unification of law is that rules of the "*Rechtsstaat*" or night-watchman state should be uniform in principle, whereas within the "*Versorgungsstaat*" or welfare state law should be unified only to a limited extent and under certain conditions.[30] They see three advantages in any unified substantive economic (framework) policy (which they contrast to process-oriented policy): unification contributes to securing the freedom of the individual, it increases the certainty and the knowledge of laws, and it improves the efficiency of economic organization.[31]

While this may be a valid plea for leaving the regulation of public goods and public services at the level of the Member States, it is too loose a concept for most private as well as company and commercial law. Taken as stated, the authors' main thesis would imply full-fledged integration of practically all these areas of law since they are not unique functions of the welfare state, however the latter may be defined.[32] The common law at the American state level would be incompatible with such a thesis. If one looks beyond the main thesis to investigate the reasons given to support it – freedom, certainty and efficiency – the picture becomes blurred. More freedom and protection for the individual of course can be an important contribution of centralized law, as examples in the United States[33] as well as in the European Community[34] show. But not all corporate and capital market law is concerned with investor and creditor protection, and the freedom argument could also be invoked on behalf of the entrepreneur who may prefer to do business under his own local state law or to use one of the choices offered by the various member states' laws. The certainty argument is probably economically the one most commonly used. Certainty in interstate commerce is vital, but it is an open question whether certainty is not equally provided by a set of state laws which offer different choices (without setting up legal barriers for out-of-staters). The efficiency argument is the most tangible but at the same time the most troubling. It may be obvious that a common market leads to efficiency gains, but there is a question-begging element to the assertion that the unification of certain

[29] BERNHOLZ & FABER, "Überlegungen zu einer normativen ökonomischen Theorie der Rechtsvereinheitlichung," 50 *RabelsZ* 35-60 (1986).

[30] *Id.* at 58.

[31] *Id.* at 41.

[32] See the authors' fine distinctions between "*Versorgungsstaat*," "*Sozialstaat*," and "*Wohlfahrtsstaat*," *id.* at 40, all of which might be rendered in English as "welfare state" or "social welfare state."

[33] See Ch. 2, § III.C *infra* at p. 36 et seq., esp. § III.C.3, at pp. 43-54.

[34] See Ch. 3, § II.A.3.c.i *infra* at p. 201.

rights, concepts and institutions in private law leads to the improved efficiency of economic organizations. At least when stated as a principle of general application for all rules of the *Rechtsstaat* this is an assertion which would need considerably more substantiation.

In their review of the so-called dynamic aspects of unification, the authors seem to make a full turn. They introduce the additional postulate of the need for free experimentation on a trial and error basis for the legal, social and political institutions of a politico-economic system.[35] Private property, private forms of organizations and free markets should be restricted as little as possible. This dynamic view not only is reminiscent of Justice Brandeis' famous reference in 1932 to the states in a federal system as "laboratories" of social experimentation,[36] but also resembles the public choice approach (without expressly mentioning its American progenitors). Approximation of law, if it occurs at all, should be the outcome of competition between various privately developed legal systems.[37] Yet the authors reserve certain safeguards for legislation and unification which make it safe to treat their thesis as a milder variant of the *Kitch* thesis. They accept that [only] in the case of serious defects the state should influence the emergence, development and elimination of markets and they maintain that compulsory law should be employed [only] to avoid the abuse of rights.[38]

The premises of this approach are open to the same criticisms as the public choice approach discussed earlier.[39] Even *Bernholz* and *Faber*'s milder version of that approach, while meeting some of our objections, is still far from providing clear enough guidance, let alone presenting a blueprint for devising a rational division of legal powers in the area of capital market law. As sometimes happens, allowing exceptions to or otherwise mitigating a theory makes that theory to a certain degree even more vulnerable, or at least opens new flanks to attack. A first difficulty with this version of the public choice argument is one of basic consistency. If competition is, as many say, really an independent process of discovery ("*Wettbewerb als Entdeckungsverfahren,*" according to *Hayek*[40]), it is difficult to see why this should be true in some but not in certain other cases. This objection lies at the heart of the criticism of modern legal-economic competition theory as the basis for a rational antitrust legisla-

35 BERNHOLZ & FABER, *supra* note 29, at 47.

36 New State Ice Corp. v. Liebmann, 285 U.S. 262, 311 (1932) (dissenting opinion): "It is one of the happy incidents of the federal system that a single courageous state may, if its citizens choose, serve as a laboratory; and try novel social and economic experiments without risk to the rest of the country."

37 BERNHOLZ & FABER, *supra* note 29, at 52.

38 *Id.* at 52, 60.

39 *Supra* at pp. 8-10.

40 VON HAYEK, "Die Anmaßung von Wissen," 12 *Ordo* 26 (1975); F. VON HAYEK, *Die Theorie komplexer sozialer Phänomene* (Tübingen 1972).

tion, and there is by no means unanimity in answering the problem, either in the United States or in those European countries which have a developed antitrust law.[41] But no economic theory which purports to apply competition concepts to legal institutions and legal harmonization can afford to ignore or refuse to take a stand on this admittedly quite technical discussion.

A second difficulty is not only how but on what basis to define "serious defects of markets," "abuse of rights" or other paraphrases used by the two authors to justify accepting central unified law-making. It could be objected that this is a merely practical difficulty found commonly in laws and legal concepts. Yet it seems to us that the major problem to be overcome is precisely the rational drawing of this demarcation line, and under this perspective the practical difficulty may turn out to be a deep-rooted theoretical one.

A third unsolved question is the relationship in the *Bernholz* and *Faber* study between the postulates of the first and those of the second part; that is, the relationship between the static and the dynamic economic viewpoint. Opening the door to the dynamic aspects of change and evolution not only adds a new dimension to the harmonization problem, but poses apparent or actual contradictory postulates as to unification or non-unification of member state law. Again, if this objection is met with the argument that the different postulates must be balanced in order to obtain the reasonable legal mix of federal and state laws in a given area such as capital market law, the unavoidable question resurfaces: Who is to make the final choice in this balancing process, and on what reasonable economic grounds?

Whether the various implications derived from this understanding of an economic justification for a common market suffice to allow us to generate operational rules for the appropriate division of powers for the enterprise law sector in an American or European common market polity, let alone to generate actual federal or state legislation in that field, is another matter. The preceding reference to the social cost of economically coerced labor mobility itself suggests that other values, filtered through still nationally-based political processes, are relevant to this quintessentially constitutional task of defining the respective sovereign competence of federal and member state law-makers in the field of enterprise law. In the concluding chapter we attempt a brief ordering of the particular normative-political factors that the following study identifies as important. At this introductory stage it should be enough to point to the difficulties inherent in the use either of economic models or of political guidelines at the present stage of European law-making.

[41] For a good overview of the different theories see W. MÖSCHEL, *Recht der Wettbewerbsbeschränkungen* § 3 & § 11.I (Cologne/Berlin/Bonn/Munich 1983).

III. The Political Frame of Reference

A. The European Political Frame of Reference

"The Europe of the businessman" is a criticism, not a definition. While as a criticism it simplifies and distorts a complex reality, it does usefully remind us that the Treaty of Rome is not confined to economic goals. The Community should not, and of course cannot, define its mission and its problems only as economic ones. The issue of choice of social values and their implementation cannot be avoided any more than it can be answered pursuant to the foregoing, or indeed any, economic models.

For some, integration as such is a value. We doubt, however, whether economic or cultural integration, not to mention the range of political and social integration possibilities lying between those two, is *eo ipso* better than diversification without a definition of and consensus about values underlying that conclusion. Certainly at the level of cultural integration there would be no intuitive choice to abandon richness and diversity of experience, let alone to assume that these losses in fact would be balanced by gains of harmony, peace, justice or other social virtues.

To the extent law is an element of a nation's culture, legal integration, too, should be valued for its functional purposes, not as an end in itself. The proper questions are whether, for example, an accepted value – such as a given level of consumer protection, environmental preservation or labor codetermination – is better served by a more centripetal or more centrifugal policy. The following sketch of the political frame of reference within which the main part of this study can then be set might best be viewed, therefore, as bearing on the instrumental question of how these underlying values can be identified and made to play their proper role in the determination and testing of the legal agenda.

It is still unclear whether any existing economic or political theory of integration is already able to offer a fully developed, operational model of how to draw rational dividing lines between federal and state regulation of company and capital market law. It is clear that in the European Community of today the institutions responsible for the harmonization of law have not yet even taken up those bits and pieces of any theory which might be helpful to that effort. Instead, they explicitly understand themselves to be political actors, rather than social engineers, and seem more inclined to reach politically feasible compromises at the outset rather than to construct a theoretically optimal dual legislative system in this field.[42]

So far as the Council of Ministers is concerned this fact of life is hardly surprising, given the Council's composition as an aggregate of politically responsi-

[42] See Ch. 3, § IV.B *infra* at pp. 259-262.

ble Member State ministers or sub-ministers and its explicit political mandate under the Treaty of Rome. The European Parliament, the final law-making political instance under the Treaty, is slowly gaining in legitimacy, but it has not yet been developed, nor is it presently being developed, as a full-scale legislative body in the sense of the United States Congress. Even the Commission of the European Community, however, shies away from preparing proposals for harmonization in this field on the basis of economic criteria appropriate to the optimal division between federal and state subject matters, though it occasionally in rather formal and almost *pro forma* terms will mention some theoretical arguments for its activity. The broad language of the Treaty provisions authorizing harmonization of laws permits dispensing with the need to justify a harmonization approach in any given field in other than the most general terms. When the Commission provides some kind of justification on a given topic, it does so mainly in rationalization of what has already been reached as an expectably acceptable political compromise in the informal preparation stage of the proposed directive or regulation.[43]

In this context the Luxembourg Agreement, requiring the Community to proceed on the basis of unanimity,[44] has had extremely negative consequences for the work of the Commission. The result of the Agreement was to force the Commission to identify and deal with potential political objections from any Member State at the beginning of any harmonization task; thus, any fundamental legal objection brought forward at the political level needs to be built from the outset into the construction of the harmonized rule that the Commission is attempting to develop. This fact of life does little to provide an incentive for the Commission to consider either theoretical or empirical information in developing even a given substantive rule, let alone in developing a rationale for a more general division of competence in this field. On the contrary, given in addition the possible theoretical flaws of any model, the financial drain of embarking on a search for empirical data, and not least the uncertainty whether the outcome of a theoretical or empirical effort in fact would strengthen the institutional quest for harmonization, the situation is rather such as to discourage European law-making agencies from engaging in these efforts. What these institutions then provide is an explicitly politicized law-making process under certain institutional and organizational framework limitations.

In this process the Commission of course has traditionally seen itself as the advocate of more centripetal forces, albeit a politically sensitized advocate; and as such it naturally comes under attack from those other forces which are centrifugal in not only political but also technical law-making orientation. Most articulate in this context in recent years have been the English courts,

[43] See Ch. 3, § III.B.1.c *infra* at p. 236. As to Art. 100A (as of 1987) see *supra* note 9.

[44] The situation has changed under the Single European Act. See EVERLING, "Gestaltungsbedarf des Europäischen Rechts," 22 *EuR* 214, at 232-35 (1987).

which have contested much of what the Commission is doing in the area of harmonization of laws.[45] Even here, however, the battle is waged on explicitly political or legal "turf" grounds.[46] Even if it would make sense for Member State actors to rely on economic theses such as that of *Kitch*, which basically favors the political stance of reserving maximum jurisdiction to state law-making bodies, their positions tend to be articulated rather in explicit political terms. Specifically, these groups tend to argue in favor of restricting harmonization to the least and absolutely necessary extent, of respecting national legal traditions and positions because they predate the new traditions and positions being proposed as alternatives, and finally and simply of encroaching as little as possible upon national sovereignty. In short, the reality of present European harmonization activity, whether seen from the perspective of the federal or of the state actor, is that of explicit political thrust and counterthrust.

The political reality described here concerning the present state of the harmonization and integration process in the fields of company law and capital market law sets the scene for the comparative studies undertaken in this work. The study on the European Community cannot at this point of development already come up with an economic or political operational structure from which a sound federal-state division of the legislative agenda could be drawn. Apart from the difficulties, perhaps the impossibility, of establishing any such operational model on more than an extremely tentative basis, such an effort would remain totally theoretical, with too little relation to what are the actual moving forces for harmonization in this field in present day Europe. At this stage of development it seems preferable to take an approach that is more concerned, instead, with the political realities and functional processes of European harmonization and integration programs.

Such an approach implies the need for a critical evaluation of the current EC situation through four separate steps. First it seems necessary to map out the major differences in company and capital market law as they presently persist between the Member States. It is of course unnecessary, not to mention uninteresting, simply to describe the current law of the Member States on specific aspects of company law and capital market law. Many governmental and academic studies have done this to a greater or lesser extent, and it is in any event more appropriate as a preliminary task for the staff of the Commission whenever it tackles a specific subset of these fields.[47] It is more important

[45] An interesting example, though it may well have led to a correct result, is the judgment of the Court of Appeal of 10 Mar. 1981, Phonogram Ltd. v. Lane, [1982] Q.B. 393, [1982] 3 C.M.L.R. 615. See also Ch. 3, § II.B.2, *infra* at p. 205 et seq.

[46] For an interesting challenge to this legal irredentism, see the decisions of the European Court of Justice as to direct applicability of directives, see Ch. 3, § III.B.1.d *infra* at pp. 237-38.

[47] As it has done, e.g., in the field of codetermination; see EC COMMISSION, "Employee Participation and Company Structure," *Bull. EC*, Supp. 8/1975 ("Green Paper"). See also Ch. 3, § IV.B, *infra* at pp. 259-262.

to identify the major current systematic differences in the various national company and capital market laws, and to understand their roots in the long historical development of those national laws since the beginnings of the nineteenth century. It will be seen in the European part of the study below that – contrary to the situation in the United States – these legal systems were not exposed to persistent contact with each other, whether by way of commercial intercourse or by way of a legal profession with a common background in an even partial political federation.[48]

Against this background the second step of fruitful present research is to identify the aims given to and followed by the Commission and the Council of Ministers in harmonizing modern company and capital market law. These aims are derived not only from the Treaty of Rome, understood as a legal instrument, but also from the specific incomplete federal structure which was adopted as a political compromise and endowed with various discretionary jurisdictional formulas. This compromise and these formulas together comprise the structural and behavioral framework conditions which any harmonization of law experiment, particularly one in company and capital market law, must honor if it is to come up with viable substantive results.

Once a realistic scope of the aims that the European Community institutions should and do follow in harmonizing this field has been defined, the focus then should shift to the methods and tools available to these federal actors for the achievement of these aims. In the study of the United States experience, this search turns out to focus basically on a court-made federal as well as state law, overlaid by a court-made structure of federal supersession of state law in the case of unacceptable conflicts. The European study identifies a more complex present situation, since the normal instrument of harmonization is the Community Directive, which needs to be transformed into national law primarily by the Parliaments of the respective nations, a process leaving these legislatures, at least in theory, substantial discretion in the formulation of the particular national law. In consequence the role of the courts is a much more interstitial and supplemental one than in the American setting. The European process of harmonization and integration of laws in this field can only be fully appreciated as to its actual functioning and its possibilities of development, if this ends-means relationship is understood in its complexity and reciprocity of influence.[49]

The fourth step properly taken in any further study is to provide a synoptic view of the present level of company and capital law harmonization in the EC. This can be achieved rather summarily and easily through a straightforward tabular survey of the various directives now in force, proposed and envisaged, as well as of the several instruments for harmonization that are being used or at least being contemplated by the European Community institutions involved

[48] See Ch. 3, § I.B *infra* at p. 174 et seq.; Ch. 4, § II.D *infra* at pp. 281-82.

[49] To this understanding the work of STEIN, cited *supra* note 1, is still essential.

in this process.[50] Legal details which would be of specific interest to practitioners are beyond the scope of this work, but can easily be found in the sources referred to in our study. The prospects for European harmonization and integration in this field can be sketched by briefly identifying the areas of company and capital market law which the Commission plans to harmonize in the years to come.

A more important last inquiry, however, may be to look at the actors other than the Commission and Council which either already exist or should be created to participate in this process: actors such as courts, regulatory agencies, professional groups and other clienteles.

Our Conclusion suggests, as our research presumably demonstrates, that prospects for the efficient implementation of appropriate harmonization policies in the company law and capital market law fields are relatively dim.[51] Of course, in time the law of the Member States will adapt to a reasonable degree to comply with the harmonization compromises presently or soon to be reached at the European level.[52] It is quite another question whether this degree of harmonization will have significant effects in the near future on overall corporate structure and business behavior as these bear on the developing integration of the national markets and legal institutions serving the Common Market. From the perspective of this integration drive, it may very well be that the overall result of this study is to open up new questions rather than to resolve old ones. Nevertheless, even this result is a step forward; a proper current understanding of the legal and political forces at work in the present EC, and of their scope in terms of aims and activities, should help make comprehensible why harmonization of company and capital market law is not more advanced than it is. It also should help to identify what further legal, economic and political research is still necessary for the revitalization and achievement of sound integration policy in this field of law. If the contradiction between interventionist policy and fledgling integration is as troubling as recent studies in political economy suggest,[53] it should come as no surprise that, in certain key areas such as codetermination or the law of groups of com-

50 See Ch. 3, § IV.A *infra* at p. 250 et seq.

51 *Cf.* Ch. 3, § II.C.1 *infra* at pp. 212-18.

52 But *cf. supra* note 46.

53 See the discussions in "Symposium, The European Community Past, Present and Future," 21 *J.C.M. Stud.* 1-244 (1982), especially ZIEBURA, "Internationalization of Capital, International Division of Labour and the Role of the European Community," *id.* at 127, and HAGER, "Little Europe, Wider Europe and Western Economic Integration," *id.* at 171. See also the larger study of HELLER & PELKMANS, "The Federal Economy: Law and Economic Integration and the Positive State – The U.S.A. and Europe Compared in an Economic Perspective," in I/1 *Integration Through Law* 245-412 (New York/Berlin 1986).

panies, the effort to harmonize or unify even the private, let alone the public, law aspects of company and capital market law should be at a near standstill at the present time.

B. The American Political Frame of Reference

By definition, of course, there is no American analogy to this picture of European law-making reality. The American political system is in place; its political legitimacy survived the test of fire over one hundred years ago; its changes are the incremental ones captured by *Talcott Parsons'* model of systemic challenge and adaptation.[54] It is, to be sure, true that the conscious direction of the national economic market which evolved in the last decades of the nineteenth century did not itself evolve until economic realities required the achievement of that centrally located consciousness. In *Wiebe*'s terms, the United States on the eve of that change was still a collection of polities without central consciousness let alone central direction.[55] But even that development is long behind us; what was not yet accomplished under the pressure of World War I arrived with the Great Depression.

A self-assured federal authority can afford to be transparent and articulate in debating and persuading when a further centripetal decision is under consideration. That self-assurance not only is a function of the complete nature of the federal union in formal constitutional terms, as contrasted with the incomplete federalism of the European Community, a formal structure buttressed by the plenary sovereign attributes of fiscal and police powers which the American system of division of powers provides the federal government alone. It is equally a function of history; in two hundred years a lot of initially fragile institutions mature if they survive at all.

Nothing illustrates this so well as the present contrast between European and American issues centering on the critical commerce clause of their respective constitutions. In Europe the struggle still is to define a minimally adequate positive commerce clause in support of legislative and administrative extensions of federal competence to act.[56] In the United States the struggle is that of a judiciary, of absolute and plenary authority, to define autolimitations on its free use of the negative Commerce Clause – on the use, that is, of the constitutional grant of authority, standing alone and unexercised, to forbid state

[54] See particularly T. PARSONS & N.J. SMELSER, *Economy and Society* (Glencoe 1956).

[55] R. WIEBE, *The Search for Order 1877-1920*, esp. at xiii (New York 1967).

[56] See WEILER, "Community, Member States and European Integration: Is the Law Relevant?," 21 *J.C.M. Stud.* 39 (1982); W.-H. ROTH, *Freier Warenverkehr und staatliche Regelungsgewalt in einem Gemeinsamen Markt – Europäische Probleme und amerikanische Erfahrungen* (Munich 1977). A new chapter may have begun with the 1986/87 European efforts towards completing the internal market by 1992. See Ch. 3, § II.A.1 *infra* at pp. 194-95.

incursions into this unposted territory.[57] A power not yet completely within the grasp of the strongest European central political authority is in the United States left to the politically least involved (if not therefore least powerful) branch of government, to extend or not extend at will. Much of the following report of the American setting is therefore devoted to the evolution and unprincipled potential of that Commerce Clause, for nothing so well demonstrates the political distinctions between the recent European experiment and its American forerunner.[58]

From that experience further impulses derive that should be useful to the overall purpose of this project to suggest principled and socially and politically realistic operational rules of federal and of state competence in the fields of company law and capital market law. Before that agenda can be developed in detail, studies like the following are necessary: studies that illuminate, in part by a review of legal and institutional history, in part by analysis and criticism of current doctrine, and in part by an inventory and status report on positive law, the experience of both federal legal systems in the subject fields to date. The choice of items to discuss, and the choice of tools for discussion, are of course themselves informed by the preceding economic and political considerations. This, however, is not meant in the sense of full-blown application of social science models to the data, but only in the sense that some assumptions or preconceptions of what is relevant are always necessary in order to shape and order even the most mundane compilation of information.

IV. Conclusion

We reserve to the concluding chapter the more difficult question whether, in light of the knowledge gathered and summarized in the body of this chapter, a fruitful detailed agenda of further research and of further policy prescriptions can be proposed; and whether these indeed would be based on any of the models here sketched, on yet others, or on none but typical and perhaps adequate muddle and improvisation.[59]

[57] See Ch. 2, § III.c *infra* at pp. 40-62.

[58] *Id.*.

[59] This evolution of ends through immersion of human activity in means is as much an aspect of the political as of the legal process; see, e.g., both LINDBLOM, "The Science of 'Muddling Through'," 19 *Pub. Ad. Rev.* 79 (1954) (especially as used in C. SCHULTZE, *The Public Use of Private Interest* 88-90 (Washington 1977)) and E. LEVI, *An Introduction to Legal Reasoning*, ch. 1 (Chicago 1949). Nor is this inconsistent with rational-actor views of organizational theory; *cf., e.g.*, H. WILENSKY, *Organizational Intelligence* 75-81 (New York 1967).

Before embarking on the following analysis of European and American experience with divided competence over company and capital market legislation, one obvious objection to the entire proceeding has to be addressed. To what degree can it make sense to compare the developments and problems of two jurisdictions which just on this issue of division of powers are so fundamentally different as are Europe and the United States? Is it not a commonplace that the European Community, despite all political effort to date, still and perhaps permanently remains a set of nation states with carefully preserved sovereignty, and with a supranational sphere of activity that is seen as an exception and requires narrow definition? The contrast with a federation that began on the basis of a nation deriving its sovereignty from the people and not from the individual states, and has arrived at its current form after a march of two centuries that include one bitter internal war, is overwhelming and seems to suggest the futility of comparison.

One answer, but possibly too easy an answer, is that the entire Project of which the present study forms a part is intended to face this very problem and that the venture, therefore, is by definition a legitimate undertaking. The overall title of the Project, however – "European Integration in the Light of the American Federal Experience" – suggests only a very loose comparability.

A better defense may be specific to the subject matter we are treating, although we hope it is of some relevance to the entire undertaking. Despite all the differences which exist between the two systems, suggested by the foregoing and if anything emphasized by the following detailed studies, there are two points which may make the effort worthwhile. The first is that in the field of company and capital market law there are in a very general sense quite similar economic conditions in Europe and in the United States, since both are highly developed modern industrial societies with a high degree of interstate and international commerce already in place. The second point is that no matter how difficult it may be to identify the best division of competence within each federal system, and no matter how different that line may turn out to be in the American and in the European systems in view of their different traditions, developments and needs, the problems demanding that some line be drawn and resulting in the development of a substantial jurisprudence on those issues are similar in both settings.

It is not inconsistent with our preceding assertion that political and institutional realities are important to this effort – an assertion which emphasizes the different political realities of Europe and the United States – now to assert that economic and even certain noneconomic political pressures to develop rational and sensible accommodation of state and federal competence over the subject matter are equally important and can be aided by a comparative study. This similarity of needs, if not of settings, should make the following two case studies of evolved and planned harmonization in the same field of law useful, even if they are two patterns which differ not only in the time sequence of their development but also in being the outcome of different historical, political and

social variables relevant to any integration process. If following this study certain lessons can be drawn that are helpful, either positively or negatively, to that ongoing integration effort, the task will have been worthwhile.

Chapter Two

The American Experience

I. Introduction

The following is a mixture of description, chronological explanation and, particularly as current issues are approached, critical analysis. It is critical, however, only in an immanent and not in a transcendent sense. It delves again into subjects better and more comprehensively treated in several of the earlier studies in this Project; that is particularly true of its foray into American Commerce Clause and Supremacy Clause issues.[1] This seemed appropriate because of the need to consider exactly this material more specifically in the context of corporation law and capital market law. One obvious cost, however, is that of repetitiveness, in particular of the treatment in the *Kommers* and *Waelbroeck* study[2] of Commerce Clause matters. A further cost is that, as compared with the *Heller* section of the *Heller* and *Pelkmans* study[3] of the legal-economic interaction of integration, the following is more a work within but not about the paradigms.[4] Our concern may, therefore, be less social-theoretical, but this itself may provide a useful contrast with that and similar studies.[5]

1 For the text of these Clauses see *infra* pp. 30-31.

2 KOMMERS & WAELBROECK, "Legal Integration and the Free Movement of Goods: The American and European Experience," in I/3 *Integration Through Law* 165 (Berlin/New York 1986).

3 T. HELLER & J. PELKMANS, "The Economic Impact of Transnationalism/Federalism: The Mutual Impact of Legal and Economic Integration – Part I" (by T. HELLER) (EUI, Doc. IUE 280/81 Col. 67, Florence, Dec. 1981); HELLER & PELKMANS, "The Federal Economy: Law and Economic Integration and the Positive State – The U.S.A. and Europe Compared in an Economic Perspective," (§§ I & II), in I/1 *Integration Through Law* 245, 245-317 (Berlin/New York 1986).

4 *Cf.* WIETHÖLTER, "Begriffs- oder Interessenjurisprudenz – falsche Fronten im IPR und Wirtschaftsverfassungsrecht," in *Internationales Privatrecht und Rechtsvergleichung im Ausgang des 20. Jahrhunderts – Festschrift Kegel* 213, 263 (A. Lüderitz & J. Schröder eds., Frankfurt 1977); see also A. FIELD, *Nabokov: His Life in Part* 263 (New York 1977).

5 There is also some overlap, at least in description, with several of the studies in *Courts and Free Markets* (T. Sandalow & E. Stein eds., Oxford, 2 vols. 1982).

II. The Factual Setting for the State Regulation of Trans-State and Transnational Company Activities: An Introduction and Census

In a federal system like that of the United States, let alone that of the European Community, the legitimacy of federal rather than state governance of any given economic institution or activity would seem to depend upon the extent to which that activity or institution crosses state boundaries or affects other states than its own. Local activity may have transborder consequences, of course, but some starting position, below which federal assertion of jurisdiction is politically and legally unacceptable, does exist everywhere and should be identified.

In the United States, at least, economic activity is carried out primarily in corporate form. While a substantial proportion of property holdings is in partnership form (and these mainly as limited partnerships, for tax-related investment purposes), mining, manufacturing and commercial activity is predominantly corporate as is much of the financial services sector. Therefore, information on the activity of corporations can stand as an indicator of economic activity, and by the same token governance of corporations as institutions may be an important mode of governance of economic activity. It is important, of course, also to respect the constitutional and statutory ground rules concerning state and federal involvement in the governance of economic activity, for those ground rules should determine the legitimate extent and division of powers to govern the formal corporate institution. To that understanding, however, a sense of factual context is indispensable.

A recent census[6] discloses that in 1981 there existed approximately 2,800,000 corporations sufficiently active to file federal corporation income tax returns;[7] in 1960 the number was 1,140,000,[8] in 1950 570,000[9] and in 1940 414,000.[10] The largest 200 corporations (in gross assets) over $ 250 million (less than 0.01% of the total number) owned in 1981 over 60% of all corporate assets

6 For an earlier study with considerable interpretative material, which can still be consulted with profit, see G.H. EVANS, *Business Incorporations in the United States 1800-1943* (New York 1948). It is especially interesting on early incorporations under special chartering statutes.

7 BUREAU OF THE CENSUS, U.S. DEP'T OF COMMERCE, *Statistical Abstract of the United States 1985,* No. 871, p. 517 (Washington, D.C. 1984).

8 BUREAU OF THE CENSUS, U.S. DEP'T OF COMMERCE, *Statistical Abstract of the United States 1977,* No. 948, p. 566 (Washington, D.C. 1976).

9 BUREAU OF THE CENSUS, U.S. DEP'T OF COMMERCE, *Historical Statistics of the United States, Colonial Times to 1970,* Part 2, Series V, Nos. 108-140, pp. 924-25 (Bicentennial ed., Washington, D.C. 1975).

10 *Id.*

(of almost $ 5.5 trillion).[11] This compares with 600 corporations with gross assets over $ 250 million (less than 0.05% of the total number) which owned 46% of total assets (of $ 1.2 trillion) in 1960[12] and the 700 (0.1% of the total) with assets over $ 100 million, which owned 50.8% of all corporate assets (of $ 598 billion) in 1950.[13] Of all corporations approximately 1,600 were large and active enough, with a sufficiently large number of shareholders, to be listed on the New York Stock Exchange (at the end of 1986).[14] With approximately another 800 listed on the American Stock Exchange (as of mid-1986)[15] and with another 4,600 (as of the end of 1986) sufficiently widely held to be eligible for purchase on margin,[16] a rough total of 7,000 companies can be identified which are publicly held and which therefore may also be assumed to be engaged in interstate economic activity.[17]

The converse, however, is not true. As a 1964 Congressional study, summarizing an analysis of state corporate tax reform, said:[18]

> Clearly big business is in interstate commerce but all interstate commerce is not big business. There are in the United States 120,000 companies, at the very least, which sell goods across state lines. [On the other hand, of] these, a great many and probably most have annual sales volumes under $ 1 million; indeed, a very substantial number have volumes under $ 500,000.

These data focus on asset size, sales activity and shareholder numbers. Other indicators can be signposts to legitimate concerns of governance as well; obvious ones are number of employees and profitability, less obvious ones are sector distribution and location. The latter are difficult to come by except in relatively crude terms; though the highly refined Standard Industrial Classification (SIC) provides narrow sector data, it operates aggregatively and not by company or company location.[19] The former (employees and income data) are available,[20] but their distribution turns out not to vary significantly from

11 BUREAU OF THE CENSUS, U.S. DEP'T OF COMMERCE, *supra* note 7, No. 886, p. 522.

12 *Id.*; actually, $ 4.5 trillion in assets of non-financial firms.

13 BUREAU OF THE CENSUS, U.S. DEP'T OF COMMERCE, *Statistical Abstract of the United States 1976,* No. 842, p. 515 (1975).

14 NEW YORK STOCK EXCHANGE, INC., *Fact Book 1987,* at 24 (New York 1987).

15 AMERICAN STOCK EXCHANGE, *American Stock Exchange Guide [C.C.H.]* 1261-83 (New York 1986).

16 NATIONAL ASSOCIATION OF SECURITIES DEALERS (NASD), *The NASDAQ Securities Fact Book* 24 (New York 1984, with supplemental information).

17 See also M. EISENBERG, *The Structure of the Corporation* 38-43 (Boston 1976).

18 HOUSE COMMITTEE ON THE JUDICIARY, *Report of the Special Subcommittee on State Taxation of Interstate Commerce, H.R. Doc. No. 1480,* 88th Cong., 2d Sess. S93 (Washington, D.C. 1964).

19 OFFICE OF MANAGEMENT & BUDGET, EXECUTIVE OFFICE OF THE PRESIDENT, *Standard Industrial Classification Manual* 9-12 (Washington, D.C. 1972).

20 See, e.g., BUREAU OF THE CENSUS, U.S. DEP'T OF COMMERCE, *supra* note 7, at 569; BUREAU OF THE CENSUS, U.S. DEP'T OF COMMERCE, *supra* note 9, at 687-88, 938.

that of the described indicators, which thus can be taken as sufficiently representative for this brief survey.

This preliminary review already suggests some corrections to the later discussion of the governance of corporations in a state-federal context. If company size turns out to be a reasonable warrant for the division between local and border-crossing economic activity, it may then also be a reasonable warrant for the division of jurisdiction between state and federal governance, not only in formal legal terms but also in political terms. This would minimize concentration on corporate form and, indeed, minimize concern with company law as such. That approach is already familiar in various subsets of legal institutions both in the US and the EC; witness the "small offering" and "private offering" exemptions from federal securities regulation in the American Securities Act on the one hand,[21] and the "small enterprise" exceptions from codetermination requirements in both the German statute[22] and the Draft of a Fifth Directive of the EC[23] as well as the similar provision in the draft of the *Societas Europaea*,[24] on the other.[25]

III. The American Constitutional Framework of Corporation Law

A. Introduction

Though today state corporation law is fairly uniform among the states and its content is, generally, "enabling," it displays enough variation that a brief review of its history, which explains much of the variation, will be useful. That history is further useful to help explain the division of jurisdiction between the

21 Securities Act §§ 2(4), 4(1), 3(b), 15 U.S.C. §§ 77b(4), d(1), c(b) (1980). For full discussion of these exemptions and their recent expansion, see R. JENNINGS & H. MARSH, *Securities Regulation – Cases and Materials* 298-345 (6th ed., Mineola 1987).

22 For a succinct review of this and other aspects of the Codetermination Act of 1976 [*Mitbestimmungsgesetz*], see MERTENS & SCHANZE, "The German Codetermination Act of 1976," 2 *J. Comp. Corp. L. & Sec. Reg.* 75 (1979).

23 The modified draft Directive is conveniently reprinted in *Bull. EC*, Supp. 6/1983.

24 The modified draft Statute is conveniently reprinted in *Bull. EC*, Supp. 4/1975.

25 For the "Green Paper" of the Commission, "Employee Participation and Company Structure," see *Bull. EC*, Supp. 8/1975.

The separate issue whether any codetermination law of a Member State is compatible with EEC Treaty Art. 54 is discussed in LUTTER, "Mitbestimmungsprobleme im internationalen Konzern," in *Festschrift für Konrad Zweigert zum 70. Geburtstag* 251, 260 ff (H. Bernstein, U. Drobnig & H. Kötz eds., Tübingen 1981).

various states and the federal government, a division which not only manifests itself in the differing subject matter of those respective legal regimes but even in the structure of corporation law itself. In other words, to identify states as involved primarily with corporation law and the federal government as involved primarily with securities regulation, labor, antitrust, environmental protection and bankruptcy is correct but inadequate. The federal Constitution permits federal involvement in corporation law, and some state involvement in the public law catalogue; and history is important to an understanding of present reciprocal involvement and future possibilities.

American corporation law today is thus an amalgam of federal law and state law, and as to each of common law and statutory law. It could be otherwise; and what could be helps provide an understanding of what is. The constitutional delimitation of the respective powers of the federal and the state sovereigns is not by any means the element providing the most explanatory power of past, present and prospective corporation law rules and institutions, but it is the element providing the framework within which the play of economic, social and political forces that shapes those rules and institutions takes place.

B. Division of Powers

The following two citations are appropriate introductions to a discussion of that constitutional framework:

> [The] uncertainty and incoherence of doctrine regarding the constitutional status of the corporation reflects the confusion of hopes and fears in American thought generally regarding the social utility of the corporate device.[26]
>
> [The] decisions of one period continue to have important effects on law and practice long after they have been ignored or even repudiated by the [Supreme] Court. For this reason the Supreme Court's decisions in *Bank of Augusta v. Earle* (1839) and *Paul v. Virginia* (1869), decisions highly questionable under today's constitutional doctrines, go far to explain the structure of the modern statutory law of corporations, banking, and insurance regulation.[27]

The division of powers within the federal union is not, of course, the only constitutional constraint on governmental involvement with the business corporation. Both sovereigns are subject to certain limits concerning uncompensated deprivation of property, unreasonable classification of law and, perhaps, unreasonable interference with rights of participation in civic and political life as these are enjoyed by corporations. Of growing importance today, these latter

[26] F. FRANKFURTER, *The Commerce Clause Under Marshall, Taney and Waite* 65-66 (Chapel Hill 1937).

[27] KITCH, "Regulation and the American Common Market," in *Regulation, Federalism, and Interstate Commerce* 9, 22 (D. Tarlock ed., Cambridge 1981).

civil rights nevertheless cannot well be described outside the context of the federal system, and it is this division of powers which will be addressed first.

That first question is furthermore important in its own right. The Project of which this study is a part seems to proceed from an assumption that, in Europe, the fragmentation of sovereign power among the Member States of the European Communities is antithetical to economic progress; whether to progress on the generally accepted basis of a mixed economy or to progress on the basis of "as much market as possible, as much state as necessary."[28] The question, whether the American experience provides a variety of useful positive and negative lessons for the hopes for European legal integration, is indeed a conscious one infusing the entire Project. Within this assumption, however, lies dormant another issue (though it, too, may be subject to some differences between the two economic systems). *Kitch*, the source of the second introductory citation above, has posed the challenging thesis that the monopolization of legislative power by one federal sovereign may be less conducive to the goal of economic progress under at least the maximum free market model than the alternative of competition among several coequal legislative sovereigns.[29] For this cross-economic (if not cross-cultural) thesis to be tested, some preliminary emphasis on the nature of that American division of powers also is essential.

1. The Texts

a. Article I, Section 8: The Congress shall have the power . . .

. . .

[cl. 3] To regulate Commerce with foreign Nations, and among the several States, and with the Indian Tribes;

. . .

[cl. 18] To make all Laws which shall be necessary and proper for carrying into Execution the foregoing Powers, and all other Powers vested by this Constitution in the Government of the United States . . .

. . .

b. Article I, Section 10[1]: No State shall . . . pass any . . . Law impairing the Obligation of Contracts . . .

. . .

c. Article III, Section 2[1]: The judicial Power shall extend to all Cases, in Law and Equity, arising under this Constitution [and] the Laws of the United States . . . [and] to Controversies . . . between Citizens of different states . . .

d. Article IV, Section 1: Full Faith and Credit shall be given in each State to the public Acts, Records, and judicial Proceedings of every other State. . . .

[28] A remark attributed, by hearsay, to Finance Minister Professor Schiller of the Federal Republic of Germany. But it has antecedents; see SCHMIDT-RIMPLER, "Wirtschaftsrecht," in 12 *Handwörterbuch der Sozialwissenschaften* 686, 702 (Tübingen 1965): ". . . die Faustregel: 'so viel Freiheit wie möglich, so viel Lenkung wie nötig.'"

[29] KITCH, *supra* note 27, at 10, 19, 44-45.

e. Article IV, Section 2[1]: The Citizens of each State shall be entitled to all Privileges and Immunities of Citizens in the several States.

f. Article VI, Section 2: This Constitution, and the Laws of the United States which shall be made in Pursuance thereof . . . shall be the supreme Law of the Land . . .

g. [Amendments (1791), Article I]: Congress shall make no law . . . abridging the freedom of speech . . .

h. [Amendments (1791), Article V]: No person shall be . . . deprived of life, liberty, or property, without due process of law; nor shall private property be taken for public use, without just compensation.

i. Amendment [Article] XIV [1868], Section 1: . . . No State shall make or enforce any law which shall abridge the privileges and immunities of citizens of the United States; nor shall any State deprive any person of life, liberty, or property, without due process of law; nor deny to any person within its jurisdiction the equal protection of the laws.

2. The General History

After the American Revolution and during the earliest part of the nineteenth century, the mercantilistic understanding of corporate activity overshadowed jurisdictional questions. Manufacturing was not understood as commerce in constitutional terms until a century later; thus, state incorporation of the few manufacturing corporations created before the Jacksonian era generated no intergovernmental jurisdictional conflicts. As for the larger number of corporations clearly engaged in commerce – the canals, turnpikes, bridges and ferries – both state and federal policy endowed them with monopolistic franchise attributes; their incorporation and their formal internal relations elements were trivial appendages of their quasi-public mission and status.[30]

The Jacksonian era and its insistence on general incorporation statutes, generally though erroneously understood as a reaction to the purchased legislative charters of the wealthy few,[31] still brought relatively few jurisdictional conflicts. There was no national – interstate – market for most manufactures, and the federal courts' development of the interstate Commerce Clause as a preemptive tool (thus) lay some decades in the future.

Early doctrine, reflecting early political reality, also defined interstate commerce narrowly (a narrowness reflected in the narrow purposes clauses of most early corporations). Not only manufacturing companies but even transportation companies, if their lines did not actually cross a state border, were deemed to be engaged in local commerce only. If incorporated, they were understood to exist only in the state of incorporation, and only "the easily destructible basis of comity" required another state to suffer their presence within its

[30] See generally M. HORWITZ, *The Transformation of American Law, 1780-1860*, at 109 ff (Cambridge 1977); 2 J. DAVIS, *Essays in the Earlier History of American Corporations*, esp. chs. 3 & 4 (Cambridge 1917).

[31] See the discussion of this question *infra* at pp. 113-16.

borders.[32] It is conceivable, though the issue did not come up for decision, that such corporations might not even have been permitted to invoke the protection of the Commerce Clause against another state's law under circumstances in which an individual merchant could have done so.[33]

On the other hand, after a brief period of indecision during the time of the Revolution, it was early agreed that the federal government could use the Commerce Clause to enact federal incorporation statutes for corporations whose inherently interstate activity made the foregoing vulnerability unacceptable.[34] Any such move was politically unrealistic because it would have been seen as a maneuver in the battle over the establishment of a national bank,[35] and this in fact rendered the use of federal incorporation almost moot; but the constitutional issue was more or less settled.

3. The Question of Diversity of Citizenship

a. Introduction and History

The number of corporations established by the beginning of the Civil War, and the cumulative scope of their individually modest activity, brought about pressure to regularize their status outside of their home states at least for purposes of access to the federal court system under diversity jurisdiction.[36] This

[32] E.M. DODD, *American Business Corporations Until 1960,* at 157 (Cambridge 1954).

[33] *Id.* at 157 n.11.

[34] See DAVIS, *supra* note 30, at 12-16; Dodd, *supra* note 32, at 30-34. For the resolution of the debate in the later 19th century, see R. HEISLER, *Federal Incorporation* 10 ff (Boston 1913).

[35] For a discussion of the specific political debate concerning the establishment of a federal bank, which underlay much of the doctrinal discussion, see B. HAMMOND, *Banks and Politics in America from the Revolution to the Civil War* 114-22 (Princeton 1957); DAVIS, *supra* note 30, at 12-16.

[36] The following discussion was materially aided by extensive use of G. HENDERSON, *The Position of Foreign Corporations in American Constitutional Law* (Cambridge 1918). This lucid and closely reasoned study (by a law student) seems to have captured most later students of both private and public law interests. See, e.g., the comments ranging from FRANKFURTER, *supra* note 26, at 64 n.34, to A. NUSSBAUM, *Principles of Private International Law* 137 n.47 (New York 1943). The work is all the more remarkable when one considers the depth of perspective on what then was in great part exceedingly recent legal history, a perspective which retains its validity to this day.

The Supreme Court's control of the diversity jurisdiction was a powerful institutional medium through which the politically inexorable judicial arrogation of power over the national market question was achieved. See James Willard HURST, *The Legitimacy of the Business Corporation in the Law of the United States 1780-1790,* at 143 (Charlottesville 1970):

> The record prompts the question, why did Congress make only limited and piecemeal use of its potential power over corporations in interstate commerce, while the Court made national authority felt over a broad range of the states'

legal institution is even today not directly relevant for European experience since it arises from the existence of a full parallel federal court system that includes trial and intermediate appellate courts as well as a supreme court. It is in particular the problem of access to the trial court system under a constitutional rule limiting access to that bench – the problem of "complete diversity" between all plaintiffs and all defendants – which was exacerbated by the appearance of the corporation as a party litigant.

The original expectation of the courts, in developing certain fictions equating the corporation to a physical being for purposes of diversity jurisdiction, was that this would assure the ability of others to hale the corporation into federal court, in its "home" state, as a party defendant, and thus to avoid the state judiciary of that corporation's domicile.[37] *Dodd* states that the Supreme Court "seems to have been influenced mainly by the desire to provide nonresident plaintiffs who had claims against corporations with a tribunal which was less likely to be prejudiced in favor of the corporation than judges and juries of the state of the corporation's domicile."[38] The role of the Clause as a shield protecting foreign corporate litigants from local state courts and juries emerged at a later date.

The simplest fiction was the one now enshrined in the Judiciary Code: The corporation is deemed a citizen of the state of its incorporation.[39] That particular jurisdictional fiction, however, first established in 1844, only became necessary as corporations began to develop an interstate character – or better, a multistate character – through the process of capital formation; in other words, as their shareholders began to be recruited from more than one state. Before that time the easier but more limiting fiction that corporate diversity jurisdiction existed if but only if all shareholders were diverse in citizenship from their (its) adversaries[40] had functioned well enough to withstand the

> involvement with corporate business. The contrast derived from the structure of national legal agencies rather than from different attitudes towards the corporation. The political environment in which we created our federalism inhibited early, bold use by Congress of its potential powers. The principal relevant judicial power conferred by the federal Constitution ran only to cases arising under the Constitution or laws of the United States. . . . The only avenue which federal courts could take to contribute by their own force to positive law establishing corporation structure or powers was their further jurisdiction over controversies between citizens of different states.

Cf. also CURRIE, "The Constitution in the Supreme Court: The Powers of the Federal Courts, 1801-1835," 49 *U. Chi. L. Rev.* 646, 671 ff (1982).

37 See also CONARD, "Federal Protection of the Free Movement of Corporations," in 2 *Courts and Free Markets, supra* note 5, at 275, 363, 364.

38 DODD, *supra* note 32, at 154-55.

39 Louisville R.R. Co. v. Letson, 43 U.S. (2 How.) 497 (1844).

40 Bank of United States v. Deveaux, 9 U.S. (5 Cranch) 61 (1809); for the procedural setting of this set of cases, see HENDERSON, *supra* note 36, at 54-56.

strain of the growing diversity of citizenship among corporations' shareholders.[41] By the 1840's that no longer was the case and the rule changed (though the contemporary doctrinal perception of the change was muddy for at least a decade).

b. Debatable Aspects of Corporate Citizenship

The shift to a fiction of corporate personality in the context of "citizenship," however, carried the risk of other, then still-unwanted consequences. Just five years earlier, in the important case of *Bank of Augusta v. Earle*,[42] a foreign bank, denied access in Alabama to the business of purchasing bills of exchange from their holders, claimed that the Privileges and Immunities Clause of the Constitution prohibited such denial of access. Under that provision, for example, Alabama could not have prohibited physical persons who were citizens of another state to engage in commercial activity in Alabama which it permitted its own citizens to conduct. The Bank unsuccessfully contended that the corporate diversity citizenship fiction extended to allow it to claim the protection of this Clause.

Exactly this fear of extended consequences had led *Marshall,* already in the first of the original fiction cases, the already-mentioned 1809 decision known as *United States v. Deveaux*,[43] to reject the full corporate fiction in favor of the above-mentioned less radical "aggregate" shareholder citizenship fiction. *Henderson*[44] attributes this directly to

> the fear that to ascribe citizenship to a corporation would give it rights, under the privileges and immunities clause, which would place corporations above the state. . . . To say that a corporation is a citizen, probably meant to the court to put it on a parity with individual citizens, with the same privileges of egress and ingress, of trade and commerce. . . . To persons familiar with the political passions which the [national] bank controversies had aroused, it must have been apparent that such a doctrine would have seriously imperilled the Union.

That this fear still held sway in 1839 is clear from the following important dicta of *Taney* in *Bank of Augusta*, which at the same time reveal that more modern concerns had begun to develop:[45]

41 The requirement of complete diversity in the case of joint plaintiffs had just been established, in Strawbridge v. Curtiss, 7 U.S. (3 Cranch) 267 (1806); a casual last paragraph of *Deveaux,* 9 U.S. (5 Cranch) at 91, suggested that in the case of corporations this was a pleading formality only, and so it came to be understood. Even in *Deveaux* it was undoubtedly a fiction.

42 38 U.S. (13 Pet.) 519 (1839).

43 9 U.S. (5 Cranch) 61 (1809).

44 HENDERSON, *supra* note 36, at 56-57.

45 38 U.S. (13 Pet.) 519, 585 (1839).

But the [*Deveaux*] principle has never been carried any farther than [its procedural context] . . .

If . . . the members of a corporation were to be regarded as individuals carrying on business in their corporate name, and therefore entitled to the privileges of citizens in matters of contract, it is very clear that they must at the same time take upon themselves the liabilities of citizens, and be bound by their contracts in like manner. The result of this would be to make a corporation a mere partnership in business, in which each stockholder would be liable to the whole extent of his property for the debts of the corporation. . . . [Anything else] would . . . give the citizens of other states far higher and greater privileges than are enjoyed by the citizens of the state itself. Besides, it would deprive every state of all control over the extent of corporate franchises proper to be granted in the state; and corporations would be chartered in one to carry on their operations in another. It is impossible upon any sound principle to give such a construction to the article in question.

Given this background, the mentioned fear that the 1844 shift to the total "corporate citizen" fiction would erode this 1839 barrier to corporate mobility becomes comprehensible, and explains the 1853 reversion by the Supreme Court to yet another, less radical, version of corporate diversity citizenship: "The persons who act [as a corporation] may be justly presumed to be resident in the state which is the necessary *habitat* of the corporation, and where alone they can be made subject to suit; and should be estopped in equity from averring a different domicil . . ."[46] For our purposes it is not necessary to trace this tortuous journey further; it is enough to recognize that it can be understood only in the context of the political struggle, surprisingly well articulated in the contemporary cases, to steer the Union through its sectionally exacerbated economic development. *Henderson*, who does explore the doctrinal labyrinth fully, concludes that it reveals, and is explained by two things:[47]

[a] strong conviction that the spirit and purpose of the Constitution required [the court] to give corporations the rights of citizens in the federal courts; and a profound aversion [for a great variety of high political reasons including the already roiling slavery controversy] to reaching such a result by the simple and direct method of calling a corporation a citizen. . . . Between [these poles] no rational reconciliation seemed at that time possible.

Of course, as *Henderson* also points out,[48] the quoted passage does not address the soon more pressing question, whether a state could bar foreign cor-

[46] Marshall v. Baltimore & Ohio R.R. Co., 57 U.S. (16 How.) 314 (1853). This statement makes explicit what had been implicit in the original version of this fiction in *Deveaux,* 9 U.S. (5 Cranch) 61 (1809); see also *supra* note 41.

[47] HENDERSON, *supra* note 36, at 62-63. For an interesting, more institutional discussion of this doctrinal evolution in its political context, see C. SWISHER, "The Taney Court 1836-64," in *History of the Supreme Court of the United States* 457-70 (New York 1974).

[48] HENDERSON, *supra* note 36, at 101 ff.

porations though it allowed its own citizens to conduct the business at issue in corporate form. That question was answered at the last possible moment before the already impending move to general incorporation laws, and answered in a way that probably was available only because many incorporations still were "privileges" granted by special legislative charter.

C. The Search for a Substantive Rationale of Federal Supremacy

1. The Tension Between the Privileges and Immunities Clause and the Commerce Clause[49]

a. The Rejection of Privileges and Immunities Protection for Corporations

Paul v. Virginia,[50] decided in 1868, involved a Virginia statute that required foreign insurance companies to secure their exposure on local insurance policies through a bonding system which was not imposed on local companies, a statute challenged under the Privileges and Immunities Clause. On the merits the discrimination might well have been justified on such analogies as *judicatum solvi* requirements imposed on foreign but not domestic litigants, and the like. The court, however, went further:[51]

> The corporation being the mere creation of local law, can have no legal existence beyond the limits of the sovereignty where created. . . . Having no absolute right of recognition in other States, but depending for such recognition . . . upon their assent, it follows, as a matter of course, that such assent may be granted upon such terms and conditions as

[49] Since this is more a legal-doctrinal than a political study, the focus is more on the formal, "internal" corporation law regulations and their inhibition through constitutional controls than on the substantive, "external" public law regulations of corporate transactions and their inhibition through constitutional controls. The latter would have to take account of the march from impairment of contract doctrine to substantive and later procedural due process and equal protection doctrine; and in doing so, would implicate the long, intense and still unresolved debate concerning the role of the judiciary during various stages of the 19th century and early 20th century in the evolution of the economy and particularly its large corporation manifestation. That is not our purpose, even though an occasional and unsystematic stray into that arena is inevitable. For an introduction to the debate, see HURST, "Old and New Dimensions of Research in United States Legal History," 25 *Am. J. Legal Hist.* 9 (1979). For the connection of these larger historical issues with the specific problem of federalism, see SCHEIBER, "Federalism and the Economic Order, 1789-1910," 10 *Law & Soc'y Rev.* 57 (1975). And for the proper placement (at least in our view) of the following survey in the evolution of the larger legal-doctrinal debates surrounding the public law treatment of corporate activity, see MCCURDY, "Justice Field and the Jurisprudence of Government-Business Relations: Some Parameters of Laissez-Faire Constitutionalism, 1863-1897," 61 *J. Am. Hist.* 970 (1975).

[50] 75 U.S. (8 Wall.) 168 (1868).

[51] *Id.* at 181.

those States may think proper to impose. They may exclude the foreign corporation entirely. . . . The whole matter rests in their discretion.

That the result rests upon the Court's preconception of a corporate charter as a privilege is properly emphasized by *Henderson*,[52] and is apparent in another passage from the opinion which he highlights:

> Now a grant of corporate existence is a grant of special privileges to the corporators . . . If the right asserted of the foreign corporation . . . were even restricted to such business as corporations of those [other] States were authorized to transact, it would still follow that those States would be unable to limit the number of corporations doing business therein. They could not charter a company for any purpose, however restricted, without at once opening the door to a flood of corporations from other states to engage in the same pursuits. They could not repel an intruding corporation, except on the condition of refusing incorporation for a similar purpose to their own citizens; and yet it might be of the highest public interest that the number of corporations in the state should be limited . . .[53]

To *Henderson*, writing in 1916, the decision was inapplicable to the burgeoning world of corporations in fact, because "the era of freedom of incorporation had already definitely arrived."[54] It was inapplicable normatively because such entities were not creatures of privilege: "Incorporation under a general law . . . is a general right open to all."[55] This led him, and continues to lead others,[56] to deny the continued authority of *Paul v. Virginia* in the modern era.

[52] HENDERSON, *supra* note 36, at 64.

[53] 75 U.S. (8 Wall.) at 181-82.

[54] HENDERSON, *supra* note 36, at 67. [55] *Id.* at 68.

[56] See, e.g., KITCH, *supra* note 27, at 22; EULE, "Laying the Dormant Commerce Clause to Rest," 91 *Yale L.J.* 425, 454 (1982). See also VARAT, "State 'Citizenship' and Interstate Equality," 48 *U. Chi. L. Rev.* 486 (1981), arguing for the use of the Privileges and Immunities Clause as the proper second prong of federal supremacy with the Commerce Clause and thus arguing, as a necessary condition, for the overruling of *Paul v. Virginia*. But *cf.* W.C.M. Window Co., Inc. v. Bernardi, 730 F.2d 486 (7th Cir. 1984) (Clause still unavailable to corporations and unincorporated associations).

The Privileges and Immunities Clause continues to play a minor role that nevertheless merges institutional (e.g., commerce) with personal (e.g., "anti-discrimination") policies. See, e.g., Supreme Court of New Hampshire v. Piper, 105 S. Ct. 1271 (1985), invalidating a New Hampshire attorney residency requirement challenged by an otherwise qualified Vermont resident living near state border. Perhaps the provision's most interesting recent use and the clearest indication of its relation with commerce questions has been in the invalidation of some state and local "job reservation" ordinances favoring employment of local residents. Thus, compare White v. Massachusetts Council of Constr. Employers, Inc., 460 U.S. 204 (1983) with United Building & Constr. Trades Council v. Mayor and Council of City of Camden, 465 U.S. 208 (1984); *cf.* also South-Central Timber Dev., Inc. v. Wunnicke, 467 U.S. 82 (1984) and *W.C.M. Window*, 730 F.2d 486 (1984), reaching the same end under Commerce Clause analysis.

Whether this position is correct or not, the issue is almost moot. The details are not necessary, but the same facts of life which led to general incorporation laws led to the development of other federal doctrines which overpowered such uses of the exclusion or expulsion power as the states were inclined to exercise under the freedom granted them by *Paul v. Virginia*. In the order of their arrival and expansion, these are the Due Process and Equal Protection Clauses of the Fourteenth Amendment and the "new" Commerce Clause.

b. The Interim Role of the Fifth and Fourteenth Amendments

For forty years, well into the first decade of this century, state legislatures continued to protect local – even local corporate – activity by barring or otherwise handicapping foreign corporations.[57] Particularly in service sectors such as banking and insurance, but also in commercial sectors impinging on local small business (the growth of retail chains, for example), such restrictions were common. As just explained, the Privileges and Immunities Clause did not stand in their way. This "pure" exclusion of foreign corporations could be mandated. What began to be successfully attacked, however, was entry (or continuation) under discriminatory conditions: e.g., curtailment of recourse to federal courts, taxation of otherwise unreachable (foreign) income, or other discriminatory regulation of the foreign business activity of the incoming foreign corporation.[58]

Whether these cases demonstrated that corporations were granted genuine protection under due process or equal protection criteria, or whether they were better understood as indirectly involving interstate commerce criteria was and remains debatable.[59] All of the challenged state regulations involved decisions by enterprises to accept those rules as conditions of entry, and thus in form were consensual though in fact economically coerced. An early analytical effort distinguished those state rules which also affected the rights of third parties or the public generally from those which seemed to impinge only on the rights of the corporation.[60] Exaction of the promise to eschew recourse to federal courts was an example of the former (even if the third party was only the

[57] See generally HENDERSON, *supra* note 36, at ch. 6.

[58] See *id.* at ch. 7.

[59] Compare EULE, *supra* note 56, with TUSHNET, "Rethinking the Dormant Commerce Clause," [1979] *Wis. L. Rev.* 125.

Only recently the Supreme Court indicated its willingness to hear Commerce Clause arguments against state efforts to toll prescriptive periods against unqualified foreign corporations in that state, while rejecting equal protection classification arguments: see G.D. Searle & Co. v. Cohn, 455 U.S. 404 (1982). *Cf.* also Andover Savings Bank v. Commissioner of Revenue, 439 N.E.2d 282 (Mass. 1982).

[60] See HENDERSON, *supra* note 36, at ch. 8, esp. at 142-46.

federal judicial system and its honor), and was properly subject to prohibition. Exaction of the promise to pay taxes on otherwise non-taxable income was an example of the latter, and might properly be permissible. Had the Supreme Court followed this distinction throughout this entire period, as it seemed to do at its beginning around 1875-1900, it would have been appropriate to argue that the personal rights of the corporation as such were not what was being vindicated. Since the Supreme Court did not hold to this distinction, however, but soon struck down both types of state action, it became entirely possible to assert, with *Henderson*, that:[61]

> What the Supreme Court has really done is to abandon the traditional doctrine that a foreign corporation can be excluded at the will of the state. . . . [When] a state is no longer allowed to get what price it can for the privilege of doing business within its borders, this means that the privilege is no longer within its control.

That, however, goes too far. Not due process but interstate commerce considerations explain this transitional struggle, as a brief consideration of the nature of business activity at the time should demonstrate. These state restrictions are reactions to a particular flow of commerce which, not yet protected by an "interstate" characterization, seemed to be hostage to such state attack.

The provision of services such as banking and insurance and the retail distribution of commodities illustrate the point. So long as the typical insurance company or manufacturing plant, incorporated in one state, entered a second state only through the establishment of second "home office" headquarters or plants there, the blunt exclusion thereof was a century ago and continues today to be perfectly legitimate; here the continuing unavailability of the Privileges and Immunities Clause to corporations still prevails.

But insurance can be advertised in local newspapers and insurance contracts transmitted by mail; and foreign-produced goods can be shipped to other states and there sold by mail order or through local retail channels. Furthermore, such transactions generate rights and liabilities and lead to lawsuits in the receiving state. If because of *Paul v. Virginia* these goods and services were not free to travel as objects of interstate commerce, corporations wishing to launch them into the stream of commerce might have to request permission to enter those other states and thereby subject themselves to the discriminatory entry conditions that in fact led to the Supreme Court's newer jurisprudence. And if those same corporations, though permitted to provide their goods and services in this manner, could not litigate to secure rights arising therefrom in foreign state courts without at least at that point seeking entry and subjecting themselves to these conditions, then "foreign" commerce as well as "foreign"

61 *Id.* at 147.

investment would be for practical purposes subject to local protective barriers.[62]

This was the situation in the last quarter of the 1800's, and it was untenable. Whatever the doctrinal bases of the inconsistent and confusing blizzard of Supreme Court opinions of that era, it was corporate participation in the irresistibly developing national market that provided the motive force behind those judicial developments. This economic function of corporations grew to be perceived as legitimate, and their participation in this interstate market came to be perceived as a property right with a claim to an undefined equal protection and due process shield[63] – unless and until the more appropriate expansive modern understanding of the Commerce Clause supplanted such blunt tools.

2. The Commerce Clause

a. Introduction

The first step in making the Commerce Clause available to corporations challenging state barriers to entry had to be the formal one of standing. It is a minor historical irony that this occurred in the very case denying corporations the benefit of the Privileges and Immunities Clause, *Paul v. Virginia*.[64] To reach (and reject) the proposition that the issuance and transmittal of an insurance policy was a transaction in interstate commerce, the Supreme Court had to accept the proposition that the constitutional grant of regulatory power to the Congress was not limited to commerce carried on by individuals but included commerce carried on by corporations. In modern terms this question of constitutional interpretation would follow the standing question, but it is clear from the opinion that this issue was subsumed under the issue of interpretation: "There is . . . nothing in the fact that the insurance companies . . . are corporations to impair the force of the [commerce] argument . . ."[65]

62 To the foregoing description see G. PORTER & H. LIVESAY, *Merchants and Manufacturers*, esp. chs. 9-11, 14 (Baltimore 1971); MCCURDY, "American Law and the Marketing Structure of the Large Corporation, 1875-1890," 38 *J. Econ. Hist.* 631 (1978). *Cf. also* KOMMERS & WAELBROECK, *supra* note 2.

This distinction between establishing a presence in the state and sending articles of commerce into the state survives in the analogous field of constitutional limitations on state taxation. See National Bellas Hess v. Dep't of Revenue, 386 U.S. 753 (1967).

63 See 2 D. WATSON, *The Constitution of the United States* 1635 (Chicago 1910), implying that a foreign corporation might claim the benefit of the Equal Protection Clause of Amend. XIV: "Any private corporation within the State or any foreign corporation organized for any legal purpose and doing business within a State and thereby subjecting itself to the jurisdiction of the State would be within the meaning of the word 'person' [as used in the Fourteenth Amendment]."

64 75 U.S. (8 Wall.) 168 (1868).

65 *Id.* at 183.

On the merits, however, the modern expansive interpretation of the Commerce Clause still lay in the future. While already the *Marshall* Court[66] had implied the existence of the so-called "negative" or "dormant" Commerce Clause – "the doctrine that the commerce clause, by its own force and without national legislation, puts it into the power of the Court to place limits upon state authority"[67] – the role of the Clause understandably was limited to the conflict between state franchises and the physical flow of goods: dams or low bridges over major navigable ocean inlets, ferry monopolies across state boundary rivers or, as in *Gibbons v. Ogden*, state monopolies on river (not road) traffic. The still fragile coexistence between Union and state claims of competence, the politically divisive commercial-agrarian sectionalism, and the implications of the Commerce Clause for the institution of slavery all combined to render an expansive understanding of the Clause unwise if not unthinkable.[68]

b. The Preemptive Effects of the Commerce Clause

One point should be made before embarking upon more extended discussion of the dormant Commerce Clause. The dormant Commerce Clause is important for an understanding of American doctrine governing individual state control of corporations within the boundaries of corporation law as previously defined – company law, securities regulation, aspects of labor law and aspects of creditors' remedies. Whether it is or may become directly relevant for an understanding of EC doctrine in that field we cannot say. That will depend upon the degree to which persons affected by Member State legislation have the possibility to claim that such legislation violates Treaty of Rome provisions which have not been implemented by EC regulations or decisions (the directive is another though related matter). It does seem clear that the jurisprudence of the Court of Justice relating to "direct applicability" of Treaty norms is an element in resolving the "dormant Commerce Clause" issue but is by no means itself the resolution. Nevertheless, on the assumption that the problem will if it does not now exist in the EC, we suggest that the following discussion may have some direct comparative utility, not only the indirect utility of making the end result of American doctrine – the present and potential division of legislative power in this field between national and state sovereigns – interesting as comparative experience.[69]

66 Gibbons v. Ogden, 22 U.S. (9 Wheat.) 1 (1824). That this power of the Court could be applied against state regulation was confirmed in Cooley v. Board of Wardens of the City of Philadelphia, 53 U.S. (12 How.) 299 (1851). See thereto most recently D. CURRIE, *The Constitution in the Supreme Court* 168, 174-81, 230-34 (Chicago 1985).

67 FRANKFURTER, *supra* note 26, at 18.

68 See, e.g., 2 C. WARREB, *The Supreme Court in United States History* 173-74 (rev. ed., Boston 1926); and more generally, SWISHER, *supra* note 47, at ch. 18, esp. at 359 ff.

69 See as to competition questions E. MESTMÄCKER, *Europäisches Wettbewerbsrecht*, chs. 1 & 2 (Munich 1974).

It is the dormant Commerce Clause which most concerns us, but it is the more aggressive use of the Commerce Clause as the constitutional predicate of congressional power to regulate commerce of even local nature that defines the former's reach.[70] After all, the more that previously intrastate commerce is recharacterized as interstate commerce, the more frequent the occasion for challenging state involvement in the remaining space under the dormant Commerce Clause.[71]

Its early use was a reaction to state efforts to regulate through price, rate or entry controls the traditional and theretofore unregulated channels of interstate commerce.[72] In the same climate in which that effort was struck down, however, demands for federal regulation of those channels arose and were accepted. These dormant Commerce Clause decisions striking down state regulation of railroad rates did not cause the arrival of federal regulation – that was already in the air[73] – but they were "a powerful spur to the passage of the Interstate Commerce Act."[74]

The next step in the march of both aspects of the Commerce Clause was the characterization of potentially separate intrastate components of a stream of commerce as being so vitally enmeshed in the overall interstate stream as to prohibit state regulation of the former (including, of course, let us remind ourselves, regulation in the form of entry qualifications otherwise permitted by *Paul v. Virginia*). That development, in a general sense, accompanied the emplacement of the first generation federal regulatory apparatus over natural monopolies in interstate commerce which had begun with the Interstate Commerce Act of 1887, and both were substantially completed by 1914.[75]

The next stage in the development was a product of the Great Depression and the New Deal and is characterized by deep, if partly transitory, involvement of the federal government in the manipulation of a wide variety of input and output factors of industry generally – labor relations, investor protection,

[70] See G. GUNTHER, *Cases and Materials on Constitutional Law* 182 (10th ed., Mineola 1980).

[71] See also the discussion of Edgar v. MITE Corp., 457 U.S. 624 (1982), *infra* at pp. 137-48. See also now CTS Corp. v. Dynamics Corp., 107 S.Ct. 1637 (1987), *infra* notes 427 & 458.

[72] For a brief history of these decisions see GUNTHER, *supra* note 70, at 124 ff, 133 ff; the cases are also adequately reviewed in HENDERSON, *supra* note 36, at ch. 7.

[73] See, e.g., KITCH, *supra* note 27, at 39-41.

[74] FRANKFURTER, *supra* note 26, at 100. They also were a powerful spur to the federal judiciary's arrogation of further authority; see MERKEL, "The Origins of an Expanded Federal Court Jurisdiction: Railroad Development and the Ascendancy of the Federal Judiciary," 58 *Bus. Hist. Rev.* 336 (1984).

[75] This is briefly but well reviewed in FRANKFURTER, *supra* note 26, at 97-109; in doctrinal terms the development is usually described as stemming from the Supreme Court decision in Pensacola Tel. Co. v. Western Union Tel. Co., 96 U.S. 1 (1877).

production limitation, subsidization and so forth.[76] The first requirement of legitimacy, of course, was the abandonment of the formalism of the *Sugar Trust* case of 1895 that "[c]ommerce succeeds to manufacture, and is not a part of it."[77] That accomplished in 1937,[78] the rest was easy. Under the *Jones & Laughlin* holding that an activity having a "substantial economic effect" upon interstate commerce was a proper object of federal regulation, and the further procedural holding that a congressional finding to that effect would be upheld if resting on a rational basis, no significant barrier to the use of the Commerce Clause as a sword for federal legislation remained or remains. Indeed, totally intrastate activity, if it can be said to become a supply or demand factor in an interstate market, is now subject to congressional regulation even if, taken by itself, it could not be of more than trivial weight in that exchange relation, so long as taken cumulatively items of that class might have the requisite impact.[79] From this doubly extended reach of the active Commerce Clause little local activity could remain immune.

That such a development has a powerful preemptive effect upon state regulation which collides with congressional enactment of such "aggressive" legislation goes without saying; much litigation involves just that kind of preemption problem. Even more important, however, as well as more debatable, is the impact of this development upon the role of the dormant Commerce Clause in controlling state regulation of commercial articles and commercial actors. An understanding of states' competence to enact anything other than simple enabling rules in the field of corporation law requires a prior analysis of this question. This analysis, it turns out, cannot itself be complete unless we first identify the values inherent in the concept of a national market, in the sense of the social theory – or at least the premises of political economy – that shape our view of that concept.[80]

3. Institutional and Economic Values Shaping the Concept of a National Market

The disturbing arrival of the corporation in the political arena via the Free Speech Clause, already briefly mentioned, is a separately important question that requires a different analysis and will be treated in some detail below. Nevertheless, as the foregoing review already has suggested, in the long run the Commerce Clause is the federal rock on which the corporation, though nominally a creature of the individual state, has been allowed to rest immune above the waves of local control. This is the point of departure for any Euro-

[76] See generally GUNTHER, *supra* note 70, at 132-48, 157-67, 171-82.

[77] United States v. E.C. Knight Co., 156 U.S. 1, 12 (1895).

[78] NLRB v. Jones & Laughlin Steel Corp., 301 U.S. 1 (1937).

[79] The highwater mark is generally taken to be Wickard v. Filburn, 317 U.S. 111 (1942).

[80] See especially T. PARSONS & N. SMELSER, *Economy and Society*, ch. 1 (Glencoe 1956).

pean interest in the American federal experience and the American federal analogy.[81]

a. The Commerce Clause as Institutional Rather Than Personal Protection

One overriding legal consequence derives from this emphasis on the Commerce Clause. In a vague but important sense, the corporation's freedom to function in a national market is not a primary right but a derivative one that rests on the federal government's decisions about appropriate divisions of legislative competence between itself and the states. The Constitution permits prudential – i.e., political – legislative judgment in this matter.

One need not subscribe to Marxist or to mercantilist political theory to appreciate that a federal legislature may and perhaps should in turn appreciate the importance of efficiency criteria in making these judgments. But efficiency is not a right, only a necessity and not the only necessity. The private corporation may be a messenger of efficiency but that does not constitutionally mandate any particular location of the boundary between federal and state competence to govern corporate existence and activity. It can even be argued that federal preemption and efficiency criteria in fact are not correlated, that efficiency-inhibiting regulation in fact follows more readily from federal law-making monopoly than from individual states' competitive and conflicting exercise of that shared legal dominance.[82] Certainly it can be argued that this may happen. In short, for whatever reason, to the corporation the Commerce Clause is borrowed armor. It can be recalled.[83]

Yet one cannot take this conclusion too far. First, even in a formal sense it can be argued that the Commerce Clause supplies corporations with the same level of protection which the Privileges and Immunities Clause should provide but for *Paul v. Virginia*: "The language of 'citizenship' in the privileges and immunities clause has at times obscured the common concern of that clause and the antidiscrimination portion of the commerce clause with the problem of state discrimination against individuals or businesses domiciled in one of the other states."[84] And this formal, historical argument is buttressed substantively by the willingness of the courts to look to the Equal Protection Clause to strike down just such local discrimination in those rare instances when neither of the first two clauses can apply:

> Ordinarily, there are three provisions of the Constitution under which a taxpayer may challenge an allegedly discriminatory state tax: the Commerce Clause; . . . the Privileges

[81] See also CONARD, *supra* note 37, at 370.

[82] See KITCH, *supra* note 27.

[83] See also J. CHOPER, *Judicial Review and the National Political Process* 175 (Chicago 1980) (no individual right reviewable by the federal judiciary under his analysis, if it is clear that one of the sovereigns in a federal system properly may exercise authority).

[84] VARAT, *supra* note 56, at 489.

and Immunities Clause . . . and the Equal Protection Clause. . . . This case assumes an unusual posture, however, because the Commerce Clause is inapplicable to the business of insurance . . . and the Privileges and Immunities Clause is inapplicable to corporations. . . . Only the Equal Protection Clause remains as a possible ground for invalidation of the California tax.[85]

From these two constitutional strands an obvious message emerges. Corporations, like other persons, have a primary, direct right to challenge state laws which at least by intent if not even only by effect discriminate against out-of-state persons in favor of local persons. Federal political decisions about the proper balance between state and federal regulation of commerce cannot erode that protection. Recourse to the Equal Protection Clause – a demand for rational classification of laws – as a surrogate for the Privileges and Immunities and Commerce Clauses gives the game away and probably also robs *Paul v. Virginia* of its remaining power to justify *discriminatory* state legislation.[86]

The question whether the Equal Protection (or Due Process) Clause also directly protects corporations from non-discriminatory state legislation which simply and even-handedly burdens all commerce carried on by corporations,

[85] Western & Southern Life Ins. Co. v. State Bd. of Equalization, 451 U.S. 648, 655-56 (1981) (footnotes and citations omitted); see also the already cited argument of EULE, *supra* note 56, at 455, preferring the use of the Privileges and Immunities Clause to the Commerce Clause in this situation. On the impact of *Western & Southern* on the equal protection/interstate commerce interplay, see Note, "Taxing Out-Of-State Corporations After *Western & Southern*: An Equal Protection Analysis," 34 *Stan. L. Rev.* 877 (1982), and especially the telling comments in the recent decision of Metropolitan Life Ins. Co. v. Ward, 470 U.S. 869, 880 (1985):

> The State argues . . . that it is impermissible to view a discriminatory tax such as the one at issue here as violative of the Equal Protection Clause. This approach, it contends, amounts to no more than 'Commerce Clause rhetoric in equal protection clothing.' . . . [T]he State's view ignores the differences between Commerce Clause and equal protection analysis and the consequent different purposes those two constitutional provisions serve. Under Commerce Clause analysis, the State's interest, if legitimate, is weighed against the burden the state law would impose on interstate commerce. In the equal protection context, however, if the State's purpose is found to be legitimate, the state law stands as long as the burden it imposes is found to be rationally related to that purpose. . . . The two constitutional provisions perform different functions in the analysis of the permissible scope of a State's power – one protects interstate commerce and the other protects persons from unconstitutional discrimination by the States.

In turn critical of this effort at unbundling the doctrines is COHEN, "Federalism in Equality Clothing: A Comment on *Metropolitan Life Insurance Company v. Ward*," 38 *Stan. L. Rev.* 1 (1985).

[86] See L. TRIBE, *American Constitutional Law* 408-12 (Mineola 1978) for a more extended analysis of the "personal" vs. "institutional" aspects of the Privileges and Immunities Clause as a partial surrogate for the Commerce Clause.

both intrastate and interstate, is, however, a more difficult and complex one. Not only would this possibility influence the question of interpretation when the reach of the dormant Commerce Clause is at issue; it might even suggest limits to the right of the federal government to exercise its Commerce Clause power. Taken to its logical conclusion, in short, this assertion would complete the rebuttal of the argument that the corporation's right to conjure with the Commerce Clause was simply a byproduct of institutional considerations of federalism.[87]

b. The Economic Philosophy Supporting the Commerce Clause

This problem can only be discussed from the starting point of the standard doctrine under which such non-discriminatory "burden" statutes are reviewed. Its recent formulation stems from *Pike v. Bruce Church, Inc.*:[88] "Where the statute regulates evenhandedly to effectuate a legitimate local public interest, and its effects on interstate commerce are only incidental, it will be upheld unless the burden imposed on such commerce is clearly excessive in relation to the putative local benefits." Whether such a balancing test or a recently suggested "disproportional impact" test[89] is proclaimed, it still is necessary to identify the values underlying the national commerce concept in order to use such doctrine. One writer recently provided the following analysis of the question:[90]

> In the commerce clause context, selecting between competing approaches . . . ought to pose no serious dilemma. The Framers unquestionably rejected free trade as a constitutionally protected value. Invalidation of state commercial legislation can only, therefore, be done on some basis other than its interference with the 'right' of an individual or corporation to engage in interstate trade unhindered by government restriction. Two alternatives immediately suggest themselves. The legislation may be invalidated because its burdensome nature 'invades or nullifies federal prerogatives' or because its discriminatory or protectionist nature represents a breakdown of the mechanism of democratic government. [The latter is an important test of discriminatory laws but is irrelevant in the case of non-discriminatory but burdensome state legislation. The former is irrelevant as a source of a constitutionally mandated underlying value judgment.]
>
> . . .

87 *Id.*

88 397 U.S. 137, 142 (1970). An exhaustive critique of any general balancing test recently has been produced by REGAN, "The Supreme Court and State Protectionism: Making Sense of the Dormant Commerce Clause," 84 *Mich. L. Rev.* 1091 (1986); see also SMITH, "State Discriminations Against Interstate Commerce", 74 *Calif. L. Rev.* 1203 (1986).

89 EULE, *supra* note 56, at 443; see also O'FALLON, "The Commerce Clause: A Theoretical Comment," 61 *Ore. L. Rev.* 395 (1982) basing a similar assertion on his concept of "representation."

90 EULE, *supra* note 56, at 434-35.

Congress' authority under the commerce clause is plenary and includes within it the power to regulate free trade as well as to burden it, to encourage commercial intercourse or to prohibit it. . . . Because the Constitution does not protect free trade or a national market, the Court's current role as the trumpeter of these values can only be viewed as that of congressional spokesman.

The same conclusion is reached by a writer who finds a "free market" value in the Commerce Clause:[91]

To my mind, the most satisfactory explanation of the [dormant] commerce clause cases is that the Supreme Court is fashioning federal common law on the authority of the commerce clause. That clause embodies a national, free-trade philosophy which can be read as requiring the Court, in limited circumstances, to displace state-created trade barriers. . . . I do not see why the Court is not making constitutionally inspired common law. The ultimate source of judicial lawmaking authority is the constitutional text; and . . . the . . . cases are wholly subject to congressional revision.

The first important point for present purposes is that under either view of the underlying philosophy, the courts are involved in articulating policy which the legislature may confirm, modify or overrule. Under an implicit "free market" model, however, they (if not the legislature as well) operate under a different and more intensive guideline than would be the case under a plurivalent model. The critical question then becomes whether a difference in individual outcomes can be predicted from these different starting points.

This perspective highlights a further ideological danger. The practice of leaving what is essentially a legislative judgment to the Court is to make it the legislature. This is true less in the formal sense – that the nature of its judgment or the breadth of a decision's consequences is legislative – than in a more political sense. The Congress can correct the Court's judgment only by explicit disavowal thereof. Passage of substantive legislation occupying the space theretofore occupied by the dormant Commerce Clause will not do the job (unless it simply adopts the challenged state regulation); for reasons discussed below, the preemptive effect given congressional enactments also is in the hands of the Supreme Court and normally will be held to confirm rather than contradict the dormant Commerce Clause analysis.[92] The enactment of substantive legislation by Congress is rarely coupled with an explicit declaration that preexisting and continuing state regulation of the subject is compatible with that enactment.[93] And naked federal legislation simply overruling

[91] MONAGHAN, "Foreword: Constitutional Common Law," 89 *Harv. L. Rev.* 1, 17 (1975).

[92] See text *infra* at pp. 137-54.

[93] Such savings clauses are by no means unknown; just in the field of securities regulation they are important. Their treatment by the courts, however, often is rather cavalier; see Edgar v. MITE Corp., 457 U.S. 624, 630 ff (1982) (White, J., on this point concurring).

the Court's dormant Commerce Clause decision is almost unheard of. The famous battle over state control of traffic in liquor[94] and the analogous episode surrounding congressional "reversal" of the Supreme Court's ruling that insurance was interstate commerce subject to the Sherman Act[95] remain unique and controversial exceptions.

An even more important reason for the Supreme Court's squatter sovereignty over this arena lies in the political realities structuring the legislative process. Interest group participation in the legislative process usually favors the prevention of law enactment;[96] thus a state's interest in overturning a centralizing decision faces an uphill battle by definition. If, in addition, the Supreme Court supports the unspoken assumption that the national market is equated with a *laissez-faire* philosophy, then business interests, assuming they resist regulation in the particular instance, are in the happy position of having to invest relatively little energy in the safeguarding of the judicial decisions their litigation has brought about. In short, the Supreme Court's role in the national market development process, coupled with its unspoken (and perhaps logically necessary) economic philosophy, has brought about a unique variation, perhaps distortion, of the normal political process. In this major sector the structural self-interest of the private economy is spared its customary exposure to that process, and to the latter's attendant demand that these interests continually justify themselves to the larger polity.

This perspective suggests some interesting further perspectives or lines of inquiry, which can only be hinted at here in very simple form. The first extension already is suggested by the earlier comment that the "space" occupied through the power of the dormant Commerce Clause looks quite different now that many sectors of economic activity are pervasively if randomly infused with federal-level regulation – not only traditional types such as labor and antitrust regulation but newer types such as environmental, safety and subsidization regulation. Are the preemption decisions of the Court in these settings as automatically final as were those of the era during which the states in-

94 In Leisy v. Hardin, 135 U.S. 100 (1890) the Supreme Court voided an Iowa statute prohibiting the sale of liquor, on Commerce Clause principles, while pleading for "remedial" legislation. The Congress responded with the Wilson Act of 1890, 27 U.S.C. § 121, authorizing the states to regulate the importation of intoxicants. The Supreme Court upheld the statute; *In re* Rahrer, 140 U.S. 545 (1891). For general (especially psycho-historical) background, see, e.g., N. CLARK, *Deliver Us from Evil*, esp. ch. 5 (New York 1976); see also, though primarily on a slightly later period, the political history in P. ODEGARD, *Pressure Politics: The Story of the Anti-Saloon League* (New York 1928).

95 See DOWLING, "Interstate Commerce and State Power – Revised Version," 47 *Colum. L. Rev.* 547, 555-58 (1947); and generally GUNTHER, *supra* note 70, at 352-57.

96 See CHOPER, *supra* note 83, at 25-28; but *cf.* Jackson, J., in Duckworth v. Arkansas, 314 U.S. 390, 400 (1941) (if the Court upholds state statute, "inertia" in Congress favors local not national interests).

truded into a hitherto unregulated sector? Is the whole argument still attractive when business interests may find it sensible to weigh the respective costs and benefits of a specific substantive variety of state regulatory regimes against a particular federal regulatory regime?[97]

Another inquiry is the comparative one. The Treaty of Rome seems to make its partial versions of the Commerce Clause inherently constitutional; i.e., Court of Justice decisions against Member State intrusions are not subject, certainly not to the extent of the American practice, to Council revision.[98] Is that or can that become a factor, among other factors, in generating for the Court of Justice a different, perhaps a more restrained view on the necessary congruence of Common Market and *laissez-faire* values? Is the United States Supreme Court more readily committed to economic liberalism because it is in theory subject to correction through the legislative – political – process? If so, how should one understand and evaluate its posture in light of the above-described critical divergence of theory from practice? Whatever the outcome of further study of these issues, it does seem clear that present constitutional doctrine harbors a substantial ideological component, one all the more important for being little articulated within this doctrinal structure.[99] It may be that the recent and more visible grant by the Supreme Court of direct political legitimacy to the business corporation via the Free Speech Clause, analyzed below,[100] though itself only partly articulated in that important *Bellotti* decision,[101] will provide the occasion for a more meaningful debate of this parallel and equally problematical situation.

State law regulating hostile takeovers will be discussed in the substantive review that makes up the second part of this Chapter.[102] The recent case invalidating a prototypical state tender offer law, *Edgar v. MITE Corporation*,[103] is, however, worth considering already now because of the clue it provides to this ideological point. The Supreme Court's plurality opinion first tests the Il-

97 See the discussion of environmental and energy issues, respectively, in E. REHBINDER & R. STEWART, *Environmental Protection Policy* (vol. 2 of *Integration Through Law*, Berlin/New York 1985); and T. DAINTITH & S. WILLIAMS, *The Legal Integration of Energy Markets* (vol. 5 of *Integration Through Law*, Berlin/New York 1987).

98 See WAELBROECK, "The Emergent Doctrine of Community Pre-Emption – Consent and Re-Delegation," in 2 *Courts and Free Markets, supra* note 5, at 548; SMIT, "The Court of Justice," in vol. 4, sec. 4, *The Law of the European Economic Community*, at §§ 173.03, 173.08, 173.09, 177.08, pp. 5-373 ff, 5-458.1 ff (H. Smit & P. Herzog eds., New York, looseleaf 1976 –).

99 *Cf.* also Comment, *"Hood v. Dumond*: A Study of the Supreme Court and the Ideology of Capitalism," 134 *U. Pa. L. Rev.* 657, 687 ff (1986).

100 First Nat'l Bank of Boston v. Bellotti, 435 U.S. 765 (1978); and see discussion *infra* at pp. 155-63.

101 *Id.*

102 See text *infra* at pp. 130-54.

103 *Supra* note 71.

linois statute against the possible preemptive sweep of the Williams Act,[104] federal legislation whose effectiveness could be compromised by the continued application of such state regulation (though only two justices join the opinion writer in finding such a preemption under the Supremacy Clause). Then it turns to an analysis of the state law under the dormant Commerce Clause, and identifies two grounds for invalidation. The first is itself questionable but is irrelevant for present purposes: A state statute should be invalidated if it directly, not only incidentally, purports to regulate interstate commerce.[105]

It is the second, the balancing test under *Pike v. Bruce Church, Inc.*,[106] that is applied in a provocative fashion:

> The effects of allowing the Illinois Secretary of State to block a nationwide tender offer are substantial. Shareholders are deprived of the opportunity to sell their shares at a premium. The reallocation of economic resources to their highest-valued use, a process which can improve efficiency and competition, is hindered.[107]

To this recourse to classical welfare economics can be added one more suggestive bit of evidence. Speaking of the *Wabash Railway* case[108] – which, it was argued, concerned direct, not merely incidental state control of interstate commerce – *Frankfurter* said:[109] "Here was a matter that demanded single, unified control. The interests of interstate movement could not be left to the individual policies of the states. If Congress chose not to regulate, *laissez faire* was the regulator."[110]

That was the message during the heyday of unregulated business activity, in 1886, and it is the message lurking in the quoted *MITE* opinion of 1982. The continuity, however, is more apparent than real; this is a case of pouring new wine into old bottles. Enlightened *laissez-faire* principles, dressed in securities

[104] See Securities Exchange Act of 1934, §§ 14(d)-(f), added by Pub. L. No. 90-439 (1968).

[105] Essentially superseded by later case-law and always difficult to operationalize.

[106] *Supra* note 88.

[107] 457 U.S. at 644. See also the concern – in the context, however, much more understandable and defensible – with efficiency considerations in Pike v. Bruce Church, Inc., 397 U.S. 137, 145 ff (1970) ("[T]he Court has viewed with particular suspicion state statutes requiring business operations to be performed in the home state that could more efficiently be performed elsewhere."). REGAN, *supra* note 88, at 1278-83, argues that *Edgar v. MITE* in fact does not apply the *Pike* test in any meaningful way.

[108] Wabash Ry. Co. v. Illinois, 118 U.S. 557 (1886).

[109] FRANKFURTER, *supra* note 26, at 100; *cf.* also BROWN, "The Open Economy: Justice Frankfurter and the Position of the Judiciary," 67 *Yale L.J.* 219, 237-38 (1957).

[110] As to the Common Market, see the coincidental yet exact echo in the formulation by VER LOREN VAN THEMAAT, "Die Rechtsangleichung als Integrationsinstrument," in *Zur Integration Europas, Festschrift Ophüls* 243, 252 (W. Hallstein & H.-J. Schlochauer eds., Karlsruhe 1965): "Interessant ist . . . dass gerade die Herstellung

regulation policy of "full disclosure," still may exist and be appropriate in that specific field of takeover bids. But in general, public regulation of private enterprise now exists to a degree unknown a century ago. Today the highways of interstate commerce are riddled with the potholes of federal regulation. Is it still meaningful to insist on keeping the interstices free of state-created ditches under such a vision of the values underlying the dormant Commerce Clause?

Is it even possible? When *laissez-faire* was the national policy, state intrusion into an otherwise "free" market at least could be measured more or less predictably: against the stable federal boundary of inaction. Modern governmental involvement in that market, however, not only is prevalent and creates discontinuities and turns in that critical boundary; it is also, as formulated by administrative agencies under broad legislative delegation of power, flexible, reversible and now and then perhaps even a touch arbitrary. Even in earlier times it was a common theme of praise or criticism that in this field the Supreme Court always and avowedly had chosen to rise above principle: that the justices were acute in "their realization that practical considerations, however screened by doctrine, underlie resolution of conflicts between state and national power," as *Frankfurter* put it;[111] or, with *T.R. Powell*,[112] that their jurisprudence could be described as holding that "the states may interfere with interstate commerce but not very much." Is even that much of a conclusion possible today, or do we not have a more important shift: that in an era of governmental regulation of production, labor and credit factors, centralization is a bureaucratic imperative? If productive activity is too important to be left

eines freien gemeinsamen Marktes mit unverfälschtem Wettbewerb die bei weitem umfangreichsten Rechtsangleichungsarbeiten fordert. Man ist hier wohl weit entfernt von der These, dass Freiheit bedeutet 'laisser faire, laisser passer.'"

See also the more explicitly political argument, that excessive dedication to free market principles may harm the flexibility or readiness to compromise of EC Member States (especially given the absence of robust political debate), made in J. STEENBERGER, G. DE CHERCQ & R. FOGUÉ, *Change and Adjustment: External Relations and Industrial Policy of the European Community* 119 (Deventer 1983).

111 FRANKFURTER, *supra* note 26, at 34.

112 As quoted in BLACK, "Perspectives on the American Common Market," in *Regulation, Federalism, and Interstate Commerce, supra* note 27, at 59, 62. It is a widely-held article of faith that in the original statement Powell went on to say: "How much is too much is beyond the scope of this paper." But if POWELL, "Supreme Court Decisions on the Commerce Clause and State Police Power 1910-1914 (Part I)," 21 *Col. L. Rev.* 737 (1921) is the source, he only said (at 744):

> To the factually-minded person this means that the states may regulate interstate commerce some but not too much. Most of the cases remaining for consideration are concerned with drawing the line between the points where 'some' leaves off and 'too much' begins.

Se non è vero è ben trovato.

to the marketplace, it may be too important to be left to the weaker member of a dual sovereignty.[113]

That perception, incidentally, also may soften the paradox arising from the fact that the extreme proponents of the public choice model do not leave regulatory competition to the marketplace when that competition turns out to be painful. The rationale, justifying the invalidation of state takeover statutes in the teeth of a model that would leave the erosion of such state efforts to competition, given by *Winter*[114] and accepted without further reflection by *Kitch*,[115] is surprisingly offhand and unpersuasive. To force freedom onto the unconvinced may hurry history along, but fits into a Buñuel film more readily than into the public choice model. It is more appropriate to recognize the development as nothing other than the Supreme Court's retention of its traditional prerogative to tailor the states' agenda to its understanding of the national agenda. It can and should be criticized if, as seems the case, the Court's substantive agenda is more *laissez-faire* than a highly differentiated industrial and service society can use; but criticism at that substantive level cannot itself resolve the separate and to some extent autonomous issue of federalism and of the division of powers in this segment of economic law. The question posed at the end of the preceding paragraph still has to be faced, and we return to it in the last chapter; but it has to be faced on grounds of political and bureaucratic-organizational conflicts and imperatives, not on grounds of economic theory.

[113] See the reference to recent theoretical writings challenging the compatibility of mercantilist or interventionist sovereign behavior with regional integration, in Symposium, "The European Community, Past, Present and Future," 21 *J.C.M. Stud.* 1-244 (1982), and the discussion thereof *supra* Ch. 1, § II.A at p. 8 ff, and *infra* Ch. 3, § II.A.3.c at pp. 200-04. For a full review of the background to this issue, see PELKMANS, in HELLER & PELKMANS, "The Federal Economy," *supra* note 3, at § III, esp. at 321-23, 327-31.

[114] WINTER, "State Law, Shareholder Protection, and the Theory of the Corporation," 6 *J. Legal Studies* 251, 268, 287 ff (1977): "Unlike most corporate code provisions, however, takeover statutes have an extraterritorial effect. . . . [268] Because . . . they apply even when all shareholders reside elsewhere [?] or are scattered among the states, the competition for charters is not the significant factor in the state legislative judgment. . . . Politically, legislators in A may believe they have little to lose by protecting local management, while B cannot make significant gains in revenues from chartering by the absence of takeover provisions because its corporation code appears to be overridden by A's takeover legislation." [287-88] The revised version of this paper does not elaborate or refine this argument; see R. WINTER, *Government and the Corporation* 42-44 (Washington, D.C. 1978). For a critical evaluation of the WINTER analysis, see BUXBAUM, "Federalism and Company Law," 82 *Mich. L. Rev.* 1163 (1984).

[115] KITCH, *supra* note 27, at 41-42.

At first glance the situation in the incomplete federation of Europe would be just the opposite: Where the nation-state has not (yet) spoken, *laissez-faire* is the regulator – at the Community level. This comports with the argument of a substantial body of political economists, that in an era of pervasive intervention in privately organized production and trade, let alone in an era of straight-out mercantilism, the interaction of sovereigns is on a national (state) not a regional level.[116] It comports even with the argument of those liberal economists who have attempted to adapt the comparative advantage model of classic free trade to this interventionist overinvolvement of the welfare state.[117] Here too the revised model puts the external costs of fettered trade onto the national (Member State) sovereign which alone possesses the fiscal power, and not onto the federal (Community) unit which in this sense is not autonomous and therefore in no position to carry this financial burden.

In fact the reality is somewhat less clear-cut than this. The explicit creation of such special regimes in the Rome Treaty as agriculture and transportation, regimes that are to a degree exempt from the competitive general regime otherwise given primacy, signifies that as to a substantial part of just this mentioned interventionist agenda the federal government does enjoy the right and does possess the political power and legitimacy to play a large part in this sovereign involvement with market processes. Outside of these special sectors, however, and outside of a few special situations (e.g., shipbuilding, textiles), the argument that managed economies and regional politics are incompatible does find support in the experience of the Community.

The significance of this contradiction, however, be it a theoretical or a practical contradiction, is for our purposes limited. The division of powers resulting therefrom is a part of life, not a normative prescription. To recognize it is simply to suggest that for the time being there will not be the aggressive capture of exclusive legislative competence by the organs of the EC, whether by judicial exploitation of a negative commerce clause or otherwise, that marked (and is again marking) the American federal experience.

Thus, the extensive review of the American debate on the negative Commerce Clause may be not so much a foretaste of recent European developments, nor a warning against excessive current European centralization, as simply a review of the substance of the regulatory package that each of the two industrialized societies have to consider and put into place, at whatever level. If, however, the economic climate or philosophy again puts a premium on liberal economic organization, the American version of this federal-state

[116] See ZIEBURA, "Internationalization of Capital, International Division of Labour and the Role of the European Community," 21 *J.C.M. Stud.* 127 (1982).

[117] COOPER, "U.S. Policies and Practices in International Trade," in *International Trade and Industrial Policies* 118 ff (S. Warnecke ed., New York 1978).

struggle over the enterprise law package should again become more directly relevant to European legal development.[118]

c. Excursus: The State as Proprietor

A partial answer to that rhetorical question lies in a yet undiscussed strand of Supreme Court doctrine, in a field particularly relevant to the subject of corporation law – the immunity from the reach of the dormant (and perhaps even the active) Commerce Clause of direct state involvement in economic activity as proprietor rather than as regulator.

South Dakota, a state known for its continuation of the Progressive legacy of the turn of the century, has owned and operated a cement plant since 1920. In 1978, faced with increasing demand, the state Cement Commission decided to supply South Dakota customers first, then to honor out-of-state contract commitments, and to allocate the remaining volume on a first come, first served basis. In *Reeves, Inc. v. Stake*,[119] a Wyoming building supplier, which had been purchasing the overwhelming percentage of its cement needs from this plant but had never signed a requirements contract, sued to enjoin the implementation of the policy, arguing that the Commerce Clause prohibited this state action. The Supreme Court rejected the argument:[120]

> The basic distinction . . . between States as market participants and States as market regulators makes good sense and sound law. . . . [T]he Commerce Clause responds principally to state taxes and regulatory measures impeding free private trade in the national marketplace. . . . There is no indication of a constitutional plan to limit the ability of the States themselves to operate freely in the free market. . . . The precedents comport with this distinction.
>
> Restraint in this area is also counseled by considerations of state sovereignty, the role of each State 'as guardian and trustee for its people,' . . . and 'the long recognized right of trader or manufacturer, engaged in an entirely private business, freely to exercise his own independent discretion as to parties with whom he will deal.' . . . Moreover, state proprietary activities may be, and often are, burdened with the same restrictions imposed on private market participants. Evenhandedness suggests that, when acting as pro-

[118] It is not likely, however, that European legal developments would, let alone should, then recapitulate the intensive and close judicial scrutiny of the legitimacy of the "junior" sovereignty's intrusive laws, and particularly of their motivation as an element of their legitimacy. That attitude, which of course underlies and explains the much-remarked political nature of the Supreme Court's Commerce Clause decisions (see *supra* text accompanying note 111), arose because of specifically 19th century and probably specifically American realities of state legislative behavior as mercantilism evolved into liberalism. See, though not on this federal aspect as such, MCCURDY, *supra* note 49; and more generally, SIEGEL, "Understanding the *Lochner* Era: Lessons from the Controversy Over Railroad and Utility Rate Regulation," 70 *Va. L. Rev.* 187, 260 (1984).

[119] 447 U.S. 429 (1980).

[120] *Id.* at 436-37.

prietors, States should similarly share existing freedoms from federal constraints, including the inherent limits of the Commerce Clause. . . . Finally, as this case illustrates, the competing considerations in cases involving state proprietary action often will be subtle, complex, politically charged, and difficult to assess under traditional Commerce Clause analysis. Given these factors, . . . as a rule, the adjustment of interests in this context is a task better suited for Congress than for this Court.

Another remark in the case is interesting for what it reveals about the economic philosophy underlying such an exception to the supremacy of federal principles under a dormant Commerce Clause analysis:[121]

In its last argument, petitioner urges that, had South Dakota not acted, free market forces would have generated an appropriate level of supply at free market prices for all buyers in the region. Having replaced free market forces, South Dakota should be forced to replicate how the free market would have operated under prevailing conditions.

This argument appears to be to us simplistic and speculative. The very reason South Dakota built its plant was because the free market had failed adequately to supply the region with cement. . . . There is no indication, and no way to know, that private industry would have moved into petitioners market area, and would have insured a supply of cement to petitioner. . . . Indeed, it is quite possible that petitioner would never have existed . . . had it not been for South Dakota cement.

That is not much of an economic response to the plaintiff's economic argument, but it is a complete response to the assertion that efficiency considerations should shape the outcome of what is primarily an issue of intergovernmental line-drawing rather than of due process or other direct private right. It is particularly on this point that the strong dissent of four justices is interesting:[122]

The application of the Commerce Clause to this case should turn on the nature of the governmental activity involved. If a public enterprise undertakes an 'integral operatio[n] in areas of traditional governmental functions,' the Commerce Clause is not directly relevant. If however the State enters the private market and operates a commercial enterprise for the advantage of its private citizens, it may not evade the constitutional policy against economic Balkanization.

This distinction derives from the power of governments to supply their own needs, . . . and from the purpose of the Commerce Clause itself, which is designed to protect 'the natural functioning of the interstate market'. . . . [W]hen a State itself becomes a participant in the private market for other purposes, the Constitution forbids actions that would impede the flow of interstate commerce. These categories recognize no more than the 'constitutional line between the State as government and the State as trader.' . . .

The Court holds that South Dakota, like a private business, should not be governed by the Commerce Clause when it enters the private market. But precisely because South Dakota is a State, it cannot be presumed to behave like an enterprise 'engaged in an entirely private business.' . . . A State frequently will respond to market conditions on the

121 *Id.* at 445-46.

122 *Id.* at 449-51. See also the critique of REGAN, *supra* note 88, at 1195-1200.

basis of political rather than economic concerns. . . . In that situation, it is a pretense to equate the State with a private economic actor. State action burdening interstate trade is no less state action because it is accomplished by a public agency authorized to participate in the private market.

Only recently the Supreme Court again confirmed the power of this proprietor-regulator distinction, when it upheld the right of a state to reserve employment on public works projects for its citizens against a Commerce Clause argument.[123] This ambiguous but fertile distinction between the state as regulator and the state as market participant bids well to become the successor, in the states' rights debate, to the faltering and now repudiated "fundamental attributes" gambit next discussed.[124]

d. Excursus: The "Fundamental Attributes" of States' Rights and the Commerce Clause

Indeed, another struggle is subsumed within the struggle over this exception, one that explicitly emphasizes the states' rights issue. Only a few years previously, the same Supreme Court, again by a bare majority but of different alignment, decided that considerations of federalism might thwart even direct congressional legislative intrusion upon the states through the asserted preemptive power of the Commerce Clause. In *National League of Cities v. Usery*,[125]

[123] White v. Massachusetts Council of Constr. Employers, 460 U.S. 204 (1983), rejecting a Commerce Clause attack on a local ordinance which reserved a percentage of local government construction jobs to local residents, based this approach on the proprietor-regulator distinction. (It may well be asked, of course, if the Court's most recent expression of diffidence about its competence to distinguish traditional from modern state missions, discussed *infra* at p. 59-60, in time will impinge upon its treatment of such fairly analogous problems as were at issue in *White*).

Barely decided, *White* was distinguished in United Building & Constr. Trades Council v. Mayor of Camden, 465 U.S. 208 (1984), also involving a municipal work-protection ordinance, because the attack this time was based on the Privileges and Immunities Clause. There, said the Court, the proprietor-regulator distinction has no bearing:

> This concern [of the Clause] with comity cuts across the market regulator-market participant distinction that is crucial under the Commerce Clause. It is discrimination against out-of-state residents on matters of fundamental concern which triggers the Clause, not regulation affecting interstate commerce.

Id. at 1028.

[124] See *infra* note 137 on the antitrust analogy. The case following *White* in the reports is EEOC v. Wyoming, 460 U.S. 226 (1983), reversing a holding based on *National League of Cities* and finding the application of federal age discrimination rules at least to state game wardens (if not yet to the police, e.g.) to be a constitutional use of the affirmative Commerce Clause.

[125] 426 U.S. 833 (1976).

the Court held that a federal statute extending minimum wage and maximum hour provisions to almost all public employees of the states and their political subdivisions could not be validly enacted under the Commerce Clause in the face of long-recognized concepts of intergovernmental immunity:[126]

> It is one thing to recognize the authority of Congress to enact laws regulating individual businesses necessarily subject to the dual sovereignty of the government of the Nation and of the State in which they reside. It is quite another to uphold a similar exercise of congressional authority directed, not to private citizens, but to the States as States. We have repeatedly recognized that there are attributes of sovereignty attaching to every state government which may not be impaired by Congress, not because Congress may lack an affirmative grant of legislative authority to reach the matter, but because the Constitution prohibits it from exercising the authority in that manner. . . .
>
> [The] dilemma presented by the minimum wage restrictions may seem not immediately different from that faced by private employers who have long been covered by the Act and who must find ways to increase their gross income if they are to pay higher wages while maintaining current earnings. The difference, however, is that a State is not merely a factor in the 'shifting economic arrangements' of the private sector of the economy, . . . but is itself a coordinate element in the system established by the Framers for governing our Federal Union.

The problem interesting from our perspective, of course, is the possible extension of this immunity to the type of state activity illustrated by *Reeves*. The *National League of Cities* opinion is suggestive also on that point. The Court was faced with a New Deal decision, *United States v. California*,[127] that held federal railroad safety regulations applicable to a state-owned railroad which, under then evolving expansive notions of interstate commerce, could be said to be engaged in such commerce. Particularly the following passage, though only dictum, was inconsistent with the doctrine now being promulgated:[128]

> [W]e look to the activities in which the states have traditionally engaged as marking the boundary of the restriction upon the federal taxing power. But there is no such limitation upon the plenary power to regulate commerce. The state can no more deny the power if its exercise has been authorized by Congress than can an individual.

This language proved sufficiently troublesome to the majority to require the overruling of an intermediate case which had used the quoted paragraph as the dispositive ground for its holding.[129] As to *United States v. California* itself, however, the *National League of Cities* majority opinion adds the following critical footnote:[130] "The holding of *United States v. California*, as opposed to the language quoted in the text, is quite consistent with our holding today.

[126] *Id.* at 845, 848-49.
[127] 297 U.S. 175 (1936).
[128] *Id.* at 185.
[129] Maryland v. Wirtz, 392 U.S. 183 (1968).
[130] 426 U.S. at 854 n.18.

There California's activity to which the congressional command was directed was not in an area that the States have regarded as integral parts of their governmental activities."

Against this distinction *Tribe* provides the following criticism:[131]

> [C]ongressional interference with state activities of a routine, proprietary sort – such as operating a railroad for profit – was expressly excluded from the scope of the state autonomy protected by *National League of Cities*. Yet if the 'right' being protected in *National League of Cities* is a state's claim to fiscal autonomy, it is difficult to see why interference with a state's proprietary functions would be any less intrusive or destructive of the 'right' than would interference with the 'traditional governmental functions' held sacrosanct in the opinion. Further, any special status that attaches to a function by virtue of the state's deliberate decision to perform it . . . would seem to attach as clearly . . . in the case of discretionary, proprietary functions as in the case of essential, classical public services.

This criticism enjoys some support from a later, ambivalent footnote comment of uncertain reach in *Reeves*:[132]

> Considerations of sovereignty independently dictate that marketplace actions involving 'integral operations in areas of traditional governmental functions' . . . may not be subject even to congressional regulation pursuant to the commerce power. [*National League of Cities* . . .]. It follows easily that the intrinsic limits of the Commerce Clause do not prohibit state marketplace conduct that falls within this sphere. Even where 'integral operations' are not implicated, States may fairly claim some measure of a sovereign interest in retaining freedom to decide how, with whom, and for whose benefit to deal.

Only shortly after making this pronouncement, however, the Supreme Court drew back from this broad interpretation and reaffirmed its intention to maintain the line between night-watchman and proprietary functions of state government as the operative distinction between illegitimate and legitimate congressional incursion, on state action, under the Commerce Clause. Thus, in *United Transportation Union v. Long Island Railroad Company*[133] the Court held the regulation of the labor disputes of a state-owned railroad operating in interstate commerce preempted by federal railway labor legislation: "It is thus clear that operation of a railroad engaged in interstate commerce is not an integral part of traditional state activities generally immune from federal regulation under *National League of Cities*."[134] The Court applied its new test from *Hodel v. Virginia Surface Mining & Reclamation Association, Inc.*:[135]

131 TRIBE, *supra* note 86, at 311 (footnotes omitted).
132 447 U.S. at 438, n.10.
133 456 U.S. 678 (1982).
134 *Id.* at 685.
135 453 U.S. 264 (1981).

[I]n order to succeed, a claim that congressional commerce power legislation is invalid under the reasoning of *National League of Cities* must satisfy *each* of three requirements. First, there must be a showing that the challenged regulation regulates the 'States as States.' . . . Second, the federal regulation must address matters that are indisputably 'attributes of state sovereignty.' . . . And third, it must be apparent that the States' compliance with the federal law would directly impair their ability 'to structure integral operations in areas of traditional functions.'[136]

This half-way position promised continuing doctrinal conflict, and perhaps even cast a new shadow on the long-established immunity of state-mandated private enterprise behavior from federal antitrust sanctions, an issue of renewed and current dispute.[137] This position also presaged a diminution of *National League of Cities'* effort to create a special regime for state regulation within the shadow of the Commerce Clause.

That prediction now has come to pass. In 1985, in *Garcia v. San Antonio Metropolitan Transit Authority*,[138] the Court proclaimed *National League of Cities* to be a totally unmanageable doctrine, and, abandoning it, abandoned the states to their fate in the political arena of the federal Congress. Nothing, however, is ever simple and one-sided, and so it turns out here. The central reason for the abandonment contains the seeds for a concurrent retreat by the Court from its arrogation of legislative power in the dormant Commerce

[136] *Id.* at 286-88; see also EEOC v. Wyoming, 460 U.S. 226 (1983). Some commentators presciently recognized in this turn the end of the *National League of Cities* experiment; thus, see Note, "The Repudiation of *National League of Cities*: The Supreme Court Abandons the State Sovereignty Doctrine," 69 *Cornell L. Rev.* 1048, 1049 (1984):

> [The] state sovereignty doctrine has no further vitality and thus *National League* represents nothing more than an anomaly in commerce clause litigation.

[137] A separate problem arising from these doctrinal changes concerns the continuing validity and stability of the "state action" doctrine in antitrust law – whether the Sherman Act will continue not to preempt state-mandated anti-competitive entrepreneurial behavior. This doctrine, based on Parker v. Brown, 317 U.S. 341 (1943), has come under increasing scrutiny from various perspectives; see, e.g., POSNER, "The Proper Relationship Between State Regulation and The Federal Antitrust Laws," 49 *N.Y.U. L. Rev.* 693 (1974); AREEDA, "Antitrust Immunity for State Action After *Lafayette*," 95 *Harv. L. Rev.* 435 (1981); Note, "*Parker v. Brown*: A Preemption Analysis," 84 *Yale L. J.* 1164 (1975); and, explicitly in this federalism context, EASTERBROOK, "Antitrust and the Economics of Federalism," 26 *J. Law & Econ.* 23 (1983).

A flurry of recent and not altogether reconcilable cases has sharpened interest in this issue. See particularly New Motor Vehicle Bd. of California v. Orrin W. Fox Co., 439 U.S. 96 (1978); California Retail Liquor Dealers Ass'n v. Midcal Aluminum, Inc., 445 U.S. 97 (1980); Community Communications Co. v. City of Boulder, 455 U.S. 40 (1982); and Town of Hallie v. City of Eau Claire, 471 U.S. 34 (1985).

[138] 469 U.S. 528 (1985).

Clause framework, and particularly from its too-ready confusion of specific economic ideology with constitutional doctrine. We introduce this prediction with the following quotation from *Garcia*:[139]

> We rejected the possibility of making immunity turn on a purely historical standard of 'tradition' in *Long Island*, and properly so. The most obvious defect of a historical approach to state immunity is that it prevents a court from accommodating changes in the historical function of States, changes that have resulted in a number of once-private functions like education being assumed by the States and their subdivisions. At the same time, the only apparent virtue of a rigorous historical standard, namely, its promise of a reasonably objective measure for state immunity, is illusory. . . .
>
> A nonhistorical standard for selecting immune governmental functions is likely to be just as unworkable as is a historical standard. [A] possibility would be to confine immunity to 'necessary' government services, that is, services that would be provided inadequately or not at all unless the government provided them. . . . The fact that an unregulated market produces less of some service than a State deems desirable does not mean that the State itself must provide the service. . . . It also is open to question how well equipped courts are to make this kind of determination about the workings of economic markets.
>
> We believe, however, that there is a more fundamental problem at work here, a problem that explains why . . . an attempt to draw [a governmental/proprietary distinction] with respect to federal regulatory authority under *National League of Cities* is unlikely to succeed. . . . The problem is that neither the governmental/proprietary distinction nor any other that purports to separate out important governmental functions can be faithful to the role of federalism in a democratic society. The essence of our federal system is that within the realm of authority left open to them under the Constitution, the States must be equally free to engage in any activity that their citizens choose for the common weal, no matter how unorthodox or unnecessary anyone else – including the judiciary – deems state involvement to be. Any rule of state immunity that looks to the 'traditional,' 'integral,' or 'necessary' nature of governmental functions inevitably invites an unelected federal judiciary to make decisions about which state policies it favors and which ones it dislikes. . . . [T]he States cannot serve as laboratories for social and economic experiment . . . if they must pay an added price when they meet the changing needs of their citizenry by taking up functions that an earlier day and a different society left in private hands.

That explanation suggests the actual decision of the Court may signal a more rather than a less restrained exercise of dormant Commerce Clause power in the future. It is, of course, the affirmative Commerce Clause power of Congress, not the dormant Commerce Clause power of the courts, that is involved in this *National League of Cities/Garcia* excursion. But if the Court can say, "We doubt that courts ultimately can identify principled constitutional limitations on the scope of Congress' Commerce Clause powers over the States,"[140] it can hardly pretend to rediscover "principled constitutional limitations" when the

[139] *Id.* at 543-46.
[140] *Id.* at 548.

Court's Commerce Clause power turns out to be at issue. Nor can the *deus ex machina* to whom the states now have to turn – the explicitly politically operating Congress – descend from the flies in dormant Commerce Clause cases; the Supreme Court emphasizes its non-elected status in *Garcia* itself.[141] That, too, it seems to us, speaks against rather than for a continued exorbitant use of the dormant Commerce Clause; in Dean *Choper*'s words, it counsels diffidence, rather than deference, when state action is examined under dormant Commerce Clause standards in the future.

e. Conclusion

This ends the recapitulation of text bearing on the trends that might be considered to run counter to traditional doctrine involving either aspect of the preemptive power of the Commerce Clause. It now remains to integrate these somewhat inconsistent themes and, most importantly, to utilize them in testing the ability of the states to regulate corporate affairs by focusing on the formal attributes of corporateness.

It is helpful to begin by recognizing what it is that the doctrines do not do. Since a free market in neoclassical welfare economy terms is not posited by these constitutional underpinnings, considerations concerning the efficient allocation of resources are not dispositive of rules or results; nor, despite the contrary intimation in *Edgar v. MITE*,[142] should they be. The Common Market approach of legislating neutral and equal starting positions for enterprise activity within its state-divided territory finds no echo in American doctrine. Only in some of the state taxation of interstate commerce cases, which we have not separately discussed, do rudimentary efforts at factor analysis provide some implicit though hardly explicit guides to decisions.[143] In all other areas of state regulation or control of the medium, the products or the actors of interstate commerce, the most that is apparent is a recognition that intrastate commerce and interstate commerce are not hermetically separated, tangentially touching circles of activity.

That particular "separate spheres" formalism, moreover – repudiated by *Marshall* in his first commerce cases, resurrected as a meaningless rationalization to cover a clear though bitterly disputed political vision of federal-state relations a generation later, and again rejected during the "realist" advance accompanying the first and second periods of federal regulatory activity – even if viable would provide no principled basis for decision-making.[144] Instead, as

[141] *Id.* at 546.

[142] *Supra* note 71.

[143] For a good review see TRIBE, *supra* note 86, at 344-69; *cf.* also BROWN, *supra* note 109.

[144] This sequence of doctrinal efforts is vividly if briefly recapitulated in LINDE, "Transportation and State Laws Under the United States Constitution: The Evolution of Judicial Doctrine," in 1 *Courts and Free Markets, supra* note 5, at 139; see also FRANKFURTER, *supra* note 26, at 12-24, 97-101.

has been consistently shown, political considerations, perhaps masquerading as process-oriented considerations, govern the field.[145] In the case of explicitly discriminatory state regulation, this is explicitly recognized by reference to the dangers of parochial attack on politically unrepresented foreign interests. In the case of non-discriminatory state activity that unavoidably and perhaps differentially burdens interstate commerce, however, the process approach is less persuasive. While non-representation may still exist, it is by definition not troublesome, at least not so troublesome as when it accompanies intentional discrimination. Nevertheless, even here the type of burden imposed on the state to justify its regulation – the burden of demonstrating that a legitimate local purpose is being effected by the means least onerous to the legitimate interests of interstate commerce – suggests the operation of at least a weakened version of the process model, a version attentive to the danger that non-parochial concerns may even inadvertently be overlooked by the state government.[146] Related to this model, and justifying the political-process concern, is of course the underlying value, often stated but hard to apply instrumentally, of preserving the states as laboratories for legal experimentation.[147] Its role in the present analysis is that of unquantifiable "softener" of otherwise rigorous centralizing tendencies. Undoubtedly, this is a significant if intangible value to recollect and honor just in this economic law arena; but it does not alone provide an answer to a specific conflict.

More doctrinal coherence than that the American jurisprudence does not provide. And even beyond this modicum, the conflicting if not overriding recognition that the sovereign attributes of the state may stretch to cover entrepreneurial activity also needs to be considered and integrated within this political representation process model.

IV. Division of Powers and Traditional Corporation Law

A. The Conflict of Laws

1. Law of the State of Incorporation or Law of the Siège Social?

Private international law everywhere distinguishes between the law applicable to the internal affairs of the corporation and the law applicable to a corpora-

[145] See EULE, *supra* note 56.

[146] *Id.;* see also O'FALLON, *supra* note 89. But *cf.* the Supreme Court's willingness to approve state taxation of foreign entities under "unitary tax" methods in the face of this representation problem, discussed *infra* at note 482.

[147] New State Ice Co. v. Liebmann, 285 U.S. 262, 311 (1932) (Brandeis, J., dissenting).

tion's various relations with third parties. Only the former interests us here. The phrase "internal affairs of the corporation" may be specifically Anglo-American,[148] but its meaning – the relations of the entity with its own shareholders, of the entity with its directors or other formal management hierarchy, and of the shareholders with one another – is uniform.[149] These relations – these internal affairs – are not limited to those arising from contract but include all manner of delictual obligations; all, however, arising from the original contractual relation that brings the entity into being and the individual members, directors and officers thereof to their common arena of operations.

The conflicts rule universally applicable in all American state jurisdictions to these internal affairs is that they are governed by the law of the state of incorporation.[150] That rule itself already reflects the specifically American influence of federalism (though the exact degree to which that influence determined the rule remains speculative);[151] to wit, the already-discussed early nineteenth century preoccupation with corporate citizenship.[152] The question of capacity to sue elsewhere was first and easily handled on this territorial basis. The problem interesting in the present context, however, is the choice of governing law once the corporation began to appear elsewhere in the "active" sense of making contracts, committing or suffering torts and finally, and

148 See, e.g., G. GRASMANN, *System des internationalen Gesellschaftsrechts* 66-67 (Herne 1970).

149 We do not intend hereby to ignore the fact that Continental private international law doctrine, in contrast to Anglo-American doctrine, still purports to apply the same governing law to the relations of the entity to third parties, under a "capacity" principle, as applies to the relations of the internal components of the entity with each other. For both a restatement and thorough critique of this approach, see GRASMANN, *supra* note 148, at 68-91; compare *Restatement (Second), Conflict of Laws* § 301 (1971), and the important recent review of this difference, in a comparative context, in First Nat'l City Bank v. Banca para el Comercio Exterior de Cuba, 462 U.S. 611, 627 (1983).

150 *Restatement (Second), Conflict of Laws* § 302 (1971). See BAADE, "Multinationale Gesellschaften im Amerikanischen Kollisionsrecht," 37 *RabelsZ* 5 (1973), for a review of the concept in the context of exploring (and denying) the need for separate principles to govern the multinational corporation.

151 It is known that the territoriality of the corporate concession led naturally to characterizing that juristic person as having been created by the state of incorporation; see the discussion in GROSSFELD, "Die Entwicklung der Anerkennungstheorien im Internationalen Gesellschaftsrecht," in *Festschrift für Harry Westermann* 199, 200-03 (W. Hefermehl, R. Gmür & H. Brox eds., Karlsruhe 1974).

152 Thus, the first edition of J. STORY, *Commentaries on the Conflict of Laws* (Boston 1834) contained no discussion whatsoever of the conflict-of-laws principles applicable to corporations, whereas the first edition of 2 J. KENT, *Commentaries on American Law* 215 ff (New York 1827), already discussed foreign corporations, but only as to their capacity to hold property and to sue and be sued in other states.

critically, raising capital. It is in the context of this chronologically later stage that the debate about the alternative or cumulative role of the law of the *siège social* and of the place of incorporation should be understood; and in this context the often quoted but often challenged thesis of *Rabel* that "[t]he requirement of domicil is additional to that of incorporation and does not by any means replace it" deserves more credit than it is generally given.[153]

Today, admittedly, it is customary to explain the preference for the law of the state of incorporation on other grounds. As the *Restatement (Second), Conflict of Laws* puts it:[154]

> Application of the local law of the state of incorporation will usually be supported by those choice-of-law factors favoring the needs of the interstate and international systems, certainty, predictability and uniformity of result, protection of the justified expectations of the parties and ease in the application of the law to be applied.

These considerations, however, are equally important to other legal systems which have chosen the law of the corporate *siège* as the law governing the internal affairs of the corporations; and more to the point, are equally satisfied by that law.[155] They do not explain why the law of the state of incorporation is

153 2 E. RABEL, *The Conflict of Laws – A Comparative Study* 38, 39 (2d ed., U. Drobnig ed., Ann Arbor 1960). It is in this context, too, that the "*Überlagerungstheorie*" of SANDROCK finds its validity; see esp. SANDROCK, "Ein Amerikanisches Lehrstück für das Kollisionsrecht der Kapitalgesellschaften," 42 *RabelsZ* 227 (1978) and, more generally, SANDROCK, "Die multinationalen Korporationen im Internationalen Privatrecht," in *Internationalrechtliche Probleme Multinationaler Korporationen* 169 (Vol. 18, Berichte der Deutschen Gesellschaft für Völkerrecht, Heidelberg 1978). For criticism of the theory as to certain instrumental aspects thereof, and especially as to some problems of its operationalizability, see, e.g., 1 H. WIEDEMANN, *Gesellschaftsrecht* 790-91 (Munich 1980).

For a discussion of the acceptance, under a *lex mercatoria*-influenced conflicts rule of the *siège social,* of a company's voluntary submission to the law of a second seat (still different from the place of incorporation), see the fascinating case of Comité de défense des actionnaires de la Banque ottomane c. La Banque ottomane, Cour d'appel Paris, 3 Oct. 1984, in 74 *Rev. crit. droit int'l privé* 526 (1985).

154 *Supra* note 150, at 309, Comment on Subsection (2). See also the European Convention on the Mutual Recognition of Companies of 1968, English version in *Bull. EC,* Supp. 2/1969 (see also the translation in E. STEIN, *Harmonization of European Company Laws,* Annex II (Indianapolis 1971), which makes the *siège* concept an exception, declared as such by a ratifying state, to the otherwise governing law of the state of incorporation). See also the drafts and conventions discussed *infra* at note 172.

155 *Cf.* also the full discussion in SANDROCK, "Die multinationalen Korporationen im Internationalen Privatrecht," *supra* note 153; as to the role of this *Überlagerungs* theory in the 1968 Convention, see *id.* at 203 ff. Public law issues also may influence a state's characterization of the "nationality" of (especially multinational) corporations, of course. For a recent analysis of this aspect, see L. LEVY, *La nationalité des sociétés* (Paris 1984).

to be preferred over the latter, and thus other explanations need to be considered.

It seems the explanation is found in three elements that happen to be relevant to current discussions of European legal integration as well:

(1) The American state-created corporations engaged in out-of-state commercial transactions (not investment transactions) at an earlier time than did European nation-created companies because around the time of the Congress of Vienna the internal borders of the American Union obviously were easier to cross than were the national borders within Europe.

(2) That mobility began at a time when conceptual characterization of the new private corporation phenomena was still governed by the mystical fictions characteristic of and, more important, useful to the mercantile era's concession theory.[156]

(3) Specific political considerations, already discussed, made the continued use of these fictional concepts convenient until relatively late in the nineteenth century, well into the time of full mobility of large corporations.

One explanation may be related to different conceptual understandings or characterizations of the corporation in the Anglo-American and the Civilian systems. It is apparent that older English and American cases, not to mention commentators, speak of the corporation in vividly mystical terms that are alien to the later Continental arsenal of characterizations: "that mere artificial being, invisible and intangible."[157] But they are not so alien to earlier Continental descriptions, and are not enough in themselves to explain the different choices of governing law.

Rather, the purpose of such pathos-ridden phrasing needs to be recalled; the most important word in the quoted phrase is "mere." The issue debated in all of these early American cases, as above explained, was the right of the corporation to use the federal court system in a jurisdiction outside of its incorporating state: its *"aktive Parteifähigkeit"* or *"activité juridique"* in the German and French parlance.[158] Since this right, under constitutional mandate, required a finding of diversity of citizenship, attention was focused upon this attribute alone. Indeed, since the concept of complete diversity made recourse to the citizenship of the corporation's owners the less feasible the more states were

[156] This connection was elegantly made in MAITLAND, "Moral Personality and Legal Personality," in 3 *The Collected Papers of Frederic William Maitland* 310 (H.A.L. Fisher ed., London 1911), in the context of the medieval aphorism, *"Solus princeps fingit quod in rei veritate non est."*

[157] Bank of the United States v. Deveaux, 9 U.S. (5 Cranch) 61 (1809) and repeated as late as 1839 (but only to avoid its consequences) in Bank of Augusta v. Earle, 38 U.S. (13 Pet.) 517, 588 (1839).

[158] See HENDERSON, *supra* note 36, at 42 for this context.

represented among the domiciles of those owners, it was natural that the corporation's citizenship should become the point that mattered.

Had other constitutional rights of citizenship been open to corporations – aspects related to their functional rather than their formal recognition[159] – it still would have been possible to look to other single-location attributes (i.e., *siège*) as fixing the applicable law. But the extreme hostility of the Supreme Court during the critical 1800-1870 era, as already demonstrated, centered on prevention of just this danger, with the result that the very notion of a corporate seat outside the state of incorporation was unnecessary.

It should also be noted that until out-of-state shareholders became common, there would have been little occasion for a choice-of-law inquiry. (The fact of there being out-of-state directors might have sufficed occasionally to generate litigation in their out-of-state forum, but not necessarily to generate a choice-of-law inquiry; that still would have depended on the nature of the action and remedy.) The few very early American cases involving foreign corporations either dealt with formal capacity problems such as the capacity to sue and be sued or to hold property, or with their contract or tort relations with third parties. Of the former, capacity to hold property typically was a problem of characterization that would have arisen only when unusual entity forms were involved, which needed to be "recharacterized" pursuant to the law of the forum in order to fit them within that law's catalogue of entities enjoying the right to hold and convey property.[160]

The purer but more common question of capacity to sue and be sued[161] has a somewhat more complex American history, in part because of the federal-state court system separation. The earliest state cases treat the matter of capacity to sue as one of comity and look, when appropriate, to the underlying action and its possible conflict with foreign policy. Thus the analysis, when one was made, tended to move from the correlation of the corporation to a natural person, and the consequent recognition of such a person's rights to sue in another state, directly to a choice-of-law or a public policy issue bearing more on the nature of the action than on the capacity question. This is best illustrated in an early Virginia case, *Bank of Marietta v. Pindall*:[162]

[159] *Cf.* HENDERSON, *supra* note 36, at 42; GRASMANN, *supra* note 148, at 437-47.

[160] The best example of this problem is Hill-Davis Co. v. Atwell, 215 Cal. 444, 10 P.2d 463 (1932) (also cited and used by GRASMANN, *supra* note 148, at 437), involving the right of an Illinois entity formed under its obsolete statute governing partnerships organized on shares (a variation of the *commandite* organization) to qualify to convey lands under California law.

The purer but more common question of capacity to sue and be sued (2 RABEL, *supra* note 153, at 72) has a somewhat more complex American history, in part because of the federal-state court system separation. For a recent example (treatment of a Liechtenstein *Anstalt*), see Cohn v. Rosenfeld, 733 F.2d 625 (9th Cir. 1984).

[161] 2 RABEL, *supra* note 153, at 4 ff, 72.

[162] 23 Va. (2 Rand.) 394, 396-97 (1824).

But, the appellants, as artificial persons in Ohio, had, according to the laws of that State, the same capacity to contract and acquire rights, in their corporate name and character, as if they had been natural persons. [The Court then moves directly to the issue of the propriety of suing on a contract which, if made in Virginia, would have been in violation of forum law; its discussion of conflict-of-laws and especially comity principles goes to that question rather than separately to the question of capacity.] . . .

Every argument in favor of entertaining, in our Courts, suits by the American confederation, applies with double force to corporations of our sister States. It is rendered doubly necessary by the intimacy of our political union, and by the freedom of commercial intercourse.

Other courts, particularly in the Northern commercial states, took even less pains with the issue. Thus, in what is apparently the first case of a foreign corporation bringing action against a debtor in a state forum, the Court simply assumed the propriety of the action from the point of capacity.[163] Not until the well-known case of *Silver Lake Bank v. North*[164] was it deemed necessary to demonstrate this right. By 1825, the right of a foreign corporation to sue was already taken for granted.[165]

The capacity of a foreign corporation to be sued in a forum state developed much later, for the understandable reason that the forum's writ, in service-of-process terms, typically did not extend beyond the boundaries of the state. It was not until later in the nineteenth century that *in personam* jurisdiction

[163] Bank of United States v. Haskins, 1 Johns. Cas. 132 (N.Y. 1799). (It should be noted, however, that the Bank of the United States was incorporated federally, as it was intended to be the early equivalent of a federal reserve system; see HAMMOND, *supra* note 35, at 205. This may have made a difference even to a state court's perception of the Bank as a local person, or at least a person at home everywhere, rather than as a foreign person.)

[164] 4 Johns. Ch. 370 (New York 1820).

[165] See New-York Fireman Insurance Co. v. Ely & Parsons, 5 Conn. 560 (1825); *cf.* Portsmouth Livery Co. v. Watson, 10 Mass. 91 (1813); President, Directors & Company of Union Turnpike Road v. Jenkins, 2 Mass. 37 (1806); Williamson v. Smoot, 7 Mart. (n.s.) 31 (La. 1819).

Modern questions of capacity to sue in the federal courts (other than those bearing on the limited nature of federal diversity jurisdiction, see text *supra* at pp. 32-36) are governed by Fed. R. Civ. P., Rule 17(b), "federalizing" the capacity issues. Again, this is primarily a problem for special types of partnerships, real estate investment trusts and the like, not corporations.

For a more modern statement of the need to subordinate theoretical choice-of-law considerations as to capacity to sue to the commercial dictates of an interstate economy, see First Title & Securities Co. v. United States Gypsum Co., 211 Iowa 1019, 233 N.W. 137 (1930); GRASMANN, *supra* note 148, at 439. For a rare modern survival of an explicit forum requirement of reciprocal comity as a condition of granting a foreign corporation the capacity to sue, see the now-repealed Georgia Code § 22-1501, as applied in Textile Banking Co. v. Colonial Chem. Corp., 285 F. Supp. 824 (N.D. Ga. 1967).

concepts based upon the flow of commerce became acceptable; in the early decades local plaintiffs' efforts had to be based on cumbersome local attachment statutes, especially on third party debt (to defendant) attachments, and these typically failed for lack of explicit statutory extension to this situation.[166]

The few very early American cases involving the contract or tort relations of foreign corporations with third parties dealt with quite different governing law issues, such as *lex contractus* and *lex locus delicti*.[167] In short, and solely to explain the recourse to incorporation rather than *siège* reference points, American law at the critical stage did not allow the type of foreign corporation intrusion into host states that it is the function of the *siège* notion to render harmless. Recourse to the state of incorporation to identify the governing law was perfectly safe, given this limited right of mobility. A brief look at the general European concept of the *siège social* as the place whose law governs the internal affairs of the corporation will help demonstrate how these three elements explain the two different choice-of-law rules.[168]

The concept of the *siège social* is a creation of and a reaction to the already existing transborder mobility of corporations. It does not predate but follows the time when particularly French private corporations began to invest and do business in other countries, specifically in Belgium.[169] It is the invention of theorists of a host state, not of a chartering state.[170] Indeed, when with Gladstone's 1844 law England briefly became a European Delaware, and

166 See, e.g., Middlebrooks v. Springfield Fire Ins. Co., 14 Conn. 301 (1841), where a summons left with the secretary of a Massachusetts corporation at its Connecticut office was held insufficient to confer jurisdiction on the Connecticut court.

167 See, e.g., Day v. Essex County Bank, 13 Vt. 97 (1841) (a contract case); and Libbey v. Hodgdon, 9 N.H. 394 (1838) (permitting a foreign corporation to be sued within the state if effective service could be made upon its agent or property, without a discussion of the substance of plaintiff's claim).

168 The text is based in part on material analyzed in LATTY, "Pseudo-Foreign Corporations," 65 *Yale L. J.* 137, 166-71 (1955), although he does not use the materials for quite the following purpose. See the speech of the Procureur in Soc. La France c. Tongre-Hambursin, [1847] Pas. Belge 398 (as cited in HENDERSON, *supra* note 36, at 4 n.1).

169 See VERAGHTERT, "Participations Françaises aux Sociétés Anonymes Belges 1830-1870" (Leuven, Centrum voor Economische Studien, *Report No. 7301*, n.d. [1974]) (a reference we owe to Dr. J. STEENBERGEN of the European Court of Justice); see generally R. CAMERON, *France and the Economic Development of Europe 1800-1914* (Princeton 1961).

170 See the discussion of the decision of 8 Feb. 1849 of the Belgian Cour de Cassation, [1849] Pas. Belge, in F. RIGAUX & G. ZORBAS, *Les Grands Arrêts de la Jurisprudence Belge* (Brussels 1981); see also C. LOEB, *Legal Status of American Corporations in France* 45 (Paris 1921). The latter author also discusses the Belgian Law of 1855 which required separate authorization of the Government to permit a foreign incor-

French corporations tried to take advantage of it by incorporating in France but choosing a foreign seat, the doctrine was amended to forbid the nomination of any but the statutory seat; i.e., to forbid turning the state of incorporation into its own "pseudo-foreign state" enclave in matters of corporation law.[171] Furthermore, the later French corporation code of 1867, which required the charter to designate the corporate seat, had been preceded by a special law of 30 May 1857, which by its own terms was at first limited to the French-Belgian conflict in order to prevent French corporations from obtaining Belgian incorporation and then returning to France![172] This connection in effect made the law of the country of incorporation the standard rule to govern the internal affairs of the normal, non-migratory corporation.

If Belgium was an example, by analogy, of a southern American state which wanted to resist the intrusion of foreign corporate activity claiming to be governed by corporation laws other than Belgium's own, France in the next era became the example of a commercial state resisting the external organization of its own domestic capital under lax foreign enabling laws. Not only does the mentioned requirement of the "statutory seat" so demonstrate; so does the even more extreme French reaction when local capital, seeking to benefit from the new "statutory seat" requirement, began to incorporate in England and in its English charter nominated London as the "statutory" seat. Again French doctrine responded and, essentially adopting the Belgian formula, required that as to foreign incorporations the nominal seat be real – i.e., French.[173]

porated entity to have a legal existence and to do business in Belgium. As to the French statutory reaction of 1857, see J.P. NIBOYET, *Cours de Droit International Privé* 330, 803 (Paris 1946); on its gradual exfoliation into a general conflicts rule, see P. MAYER, *Droit International Privé* 709 (Paris 1977).

171 See LATTY, *supra* note 168, at 166 n.130.

172 See C. LYON-CAEN & L. RENAULT, *Traité de Droit Commercial* 909, & n.1096 (5th ed., Paris 1929); see also LOEB, *supra* note 170, at 44.

The approach of the text seems confirmed by the role of the state of incorporation and the subsidiary role of the state of the central seat played in art. 152 of the Swiss Draft Federal Law on Private International Law of 30 June 1978; see hereto MCCAFFREY, "The Swiss Draft Conflicts Law," 28 *Am. J. Comp. L.* 235, 282 (1980). See also the "Montevideo Convention" (Inter-American Convention on Conflicts of Law Concerning Commercial Companies), reprinted in 18 *Int'l Leg. Materials* 1222 (1979), arts. 2, 5 & 7 with their state of incorporation, *siège* and forum *ordre public* exception rules, to be applied in that order.

173 See LATTY, *supra* note 168, at 169-70; see also 2 RABEL, *supra* note 153, at 38 & n.20G. The Belgian-French collision is more fully described, from a point of view at least analogous to that in the text, in GROSSFELD, "Zur Geschichte der Anerkennungsproblematik bei Aktiengesellschaften," 38 *RabelsZ* 344, 350-56 (1974). A recent critical analysis of the *siège* problems, in part from the above perspective, is that of SANDROCK, *supra* note 155; see also NEUMAYER, "Betrachtungen zum internationalen Konzernrecht," 83 *ZVerglRW* 129, 139 ff (1984).

In short, one can make the argument that the law of the state or country of incorporation is normally the law governing the internal affairs of European as well as American corporations. The concept of the *siège social* is designed for the special case only; and not for the special case of simple corporate mobility in the sense of interstate business activity but for the special case of pseudo-foreign corporate distortion (local capital claiming foreign status). The concept of the corporate seat is the precursor of the more recent American effort (statutory, following the failure of twentieth century common law evolution) to apply selected substantive corporation law rules of the "true" and only host jurisdiction to the affairs of a local corporation foreign in name only.[174]

2. The Domestic Mobility of American Capital and Its Legal Consequences

It now becomes important to inquire into that failure of the American common law to develop similar choice-of-law principles at a similar time in history. One explanation is historical. While Belgium already had to suffer the mobilization of its capital and the invasion of foreign capital by French corporations in the 1840's, and develop choice-of-law rules at least in order to tame foreign enterprise to local standards, companies incorporated in the northeastern United States were active in southern and western states less for the purpose of mobilizing local capital than for the doing of local business on the basis of their home capital.[175] The control those host states had to exercise was not control over investment (and thus control over the internal affairs of the corporation) but control over the doing of business; and that control, we have seen, was feasible until after the Civil War and the full flowering of a national market and of its handmaiden, the Commerce Clause.[176]

In addition, charter mongering in the United States was a relatively late phenomenon. Not until 1875 did one state, New Jersey, set itself up as the England of American jurisdictions in the sense of adopting a simplified enabl-

[174] See the discussion *infra* pp. 88-90.

[175] There was, of course, considerable capital formation (and dissipation) by land companies already before the beginning of the 19th century and certainly before the Civil War, and by railroad companies, again before the Civil War. These, however, typically either were unincorporated, or incorporated in the state in which they were sinking their investments. Thus, these transactions also did not give rise to choice-of-law problems. See generally S. LIVERMORE, *The History of Early American Land Companies – Their Influence on Corporate Development* (New York 1939); G. TAYLOR, *The Transportation Revolution, 1850-1860* (New York 1951); see also SCHEIBER, "The Transportation Revolution and American Law: Constitutionalism and Public Policy," in INDIANA HISTORICAL SOCIETY, *Transportation and the Early Nation* 1 (Bloomington 1982), and, more generally, DAVIS, *supra* note 30.

[176] For a full discussion of commercial activity suggesting the validity of this description, see L. HARTZ, *Economic Policy and Democratic Thought: Pennsylvania, 1776-1869* (Cambridge 1948).

ing act,[177] and not until about 1890 did it consciously hold itself out as a comfortable home for migrant corporations.[178] By then, its attraction was primarily for the large national corporation whose financial and administrative center may have been New York but whose business activities were nationwide and, most significantly, whose shareholders also by now were nationally dispersed.[179] The New Jersey approach did not generate a "pseudo-foreign" corporation syndrome; it is hard to characterize New York, for example, as a "host state" in the Belgian sense. Its own earlier role had been too ambivalent to make that shift of mood easy, and its new financial capital prominence made any sensitive reaction equally unlikely.

At the outset of the move towards national capital formation by investment in national corporations, corporations were still being incorporated in New Jersey and in the states with the largest local capital formation base – New York, Massachusetts, Ohio and Pennsylvania.[180] Those states, and particularly New York, then developed as financial centers of intermediation between savers and users of surplus. For these and related reasons having to do with location advantages in transportation and communication, they then, understandably, also became the administrative headquarters of most newly national corporations; not only of those already previously in New York but also of those whose enterprise activity had been in the Pittsburgh basin, in the Ohio Valley, in the Massachusetts mill areas and so forth. Until 1890 these corporations existed comfortably under New Jersey or New York law and, indeed, under the company law of any commercial state. At least among commercial states, harmonious coexistence was understandable and there was no real occasion to subject foreign corporations to local company laws (as distinguished from local "domestication" laws).

This is marvellously illustrated by an opinion of New York's highest court, *Merrick v. Van Santvoord*,[181] written in 1866, the first possible date as of which the sense of the irresistible move towards a national market and its attendant need of full corporate mobility could have been articulated. The case is separately important for its intimations about the scope of the internal affairs

[177] J. CADMAN, *The Corporation in New Jersey*, esp. ch. 5 (Cambridge 1949). See KEASBY, "New Jersey and the Great Corporations," 13 *Harv. L. Rev.* 198, 205 ff (1899) (Keasby was then the New Jersey Secretary of State, responsible for formal incorporation control).

[178] See BUXBAUM, "The Relation of the Large Corporation's Structure to the Role of Shareholders and Directors: Some American Historical Perspectives," in *Law and the Formation of the Big Enterprises in the 19th and Early 20th Centuries* 243, 249 (N. Horn & J. Kocka eds., Göttingen 1979).

[179] The location of their stock trading meeting place may have been concentrated in one state – in the New York Stock Exchange – but their individual domiciles, of course, were appropriately varied.

[180] See EVANS, *supra* note 6, esp. Table 16, p. 48, and ch. 3.

[181] 34 N.Y. 208 (1866)

rule as conflicts doctrine, but at this point it is the underlying attitude towards the mobile role of corporations that deserves extended quotation:[182]

The only contract ever made by Van Santvoord, which has any bearing on the present issue, was that which he made on becoming a party to the Connecticut charter. . . . The fact is found, that his contract was that of a corporator, with immunity from personal responsibility. Even if the charter had been silent, he would not have been liable for the debts of the company, either there or here, unless by force of some statute depriving him of his exemption. . . . The boats of the company were not his boats. Its debts were not his debts. In the case of *The Bank of Augusta v. Earl* [sic], the Chief Justice said: 'Whenever a corporation makes a contract, it is the contract of the legal entity of the artificial being created by the charter, and not the contract of the individual members.' (13 Peters, 587.) In Connecticut the defendant was clearly entitled to protection. How does it happen that on one side of the State line he owns the property, which on the other belongs to the company, or that by crossing the New York boundary he assumes all the liabilities of the corporation? . . .

No warrant for such a proposition can be found in our general statutes. We exercise the right, which exists in all sovereignties, to regulate and restrain foreign corporations in doing business here under charters from other governments. . . . These various regulations and restrictions imply the validity of the exercise here, of powers granted by other governments; but we have other statutes expressly recognizing the rights of foreign corporations as contracting parties and litigants, except so far as they are limited by the tenor of their own charters, or abridged by the force of our local laws. (2 R.S., 457 §§ 1, 2; Code, § 437.) These acts of the law-making power operate as a recognition, not only of the legal existence of such corporations under charters from other States, but of the rights and immunities conferred on the corporators. Except so far as these are cut down by our own legislation, they are perfect and absolute, until they are revoked or annulled in the State from which they were derived.

. . . We think the recognition, in our State, of the rights hitherto conceded in our courts to foreign corporations, is neither injurious to our interests, repugnant to our policy, nor opposed to the spirit of our legislation. Ours is peculiarly a commercial country. . . .

In no other country has so much been achieved, by the association of capital and labor, through corporate organization. It has enabled the many, whose means were limited, to contribute to the accomplishment, and participate in the benefit of great undertakings, which were beyond the compass of individual resources and enterprise. It has taken, without let or hindrance, the direction to which it was invited by the general law of supply and demand. The same enlightened policy has prevailed in every portion of the country. All have welcomed labor from abroad, and invited the free investment of capital. Hitherto, corporate enterprise has not been trammeled by unfriendly legislation. No jealousy of competition, or rivalry of adverse interest, has been permitted to convert State lines into barriers of obstruction to the free course of general commerce. Its avenues have been open to all.

In this country our material interests are so interwoven that the union of the States is due, in its continuance, if not in its origin, as much to commercial as to political necessity. . . .

[182] *Id.* at 211-18, 220-21.

A corporate charter is in the nature of a commission from the State to its citizens, and their successors in interest, whether at home or abroad. Each government, in the exercise of its own discretion, determines the conditions of its grant. It is free to impose or omit territorial restrictions. It cannot enlarge its own jurisdiction, but it can confer general powers, to be exercised within its bounds, or beyond them, wherever the comity of nations is respected. For the purposes of commerce, such a commission is regarded, like a government flag, as a symbol of allegiance and authority; and it is entitled to recognition abroad until it forfeits recognition at home.

Under such commissions, New York has sent forth its citizens from time to time with corporate franchises and immunities, to gather wealth from the coal mines of Pennsylvania, the silver mines of Mexico, and the gold mines of California; to establish lines of inland navigation on the Orinoco and the Amazon; to plant forest trees beyond the Mississippi; to fish in the northern and southern oceans; to found christian missions in Asia, and to colonize freedmen on the coast of Africa. In many of these cases the franchises were, by the terms of the charter, to be exercised in foreign territory. . . . In the act of 1827, incorporating 'The New York South American Steamboat Association,' it was provided that the annual elections should be held in the city of New York, but there was no requirement that any of the officers should be residents; and the company was authorized, in terms, to navigate its vessels 'upon any water or waters *not within the jurisdiction of New York.*' (Laws of 1827, 308.) The Panama Railroad Company was organized, under a charter from this State, to construct and maintain a railway 'across the isthmus of Panama, in the republic of New Grenada.' The only act which the charter requires to be done in this State, is the annual election of its officers; . . . Other illustrations of our legislative construction of the rules of national comity, will be found in the acts incorporating the 'North Carolina Gold Mining Company,' the 'Orinoco Steam Navigation Company,' the 'Pacific Mail Steamship Company,' the 'California Inland Steam Navigation Company,' the 'African Civilization Society,' and the 'American Forest Tree Propagation and Land Company.' (Laws of 1828, 211; *id.*, 1847, 513; *id.*, 1848, 396; *id.*, 1850, 627; *id.*, 1864, 758; *id.*, 1865, 360).

. . .

We think the policy of this State is in harmony with that of the country, and that it would be neither provident nor just to inaugurate a rule which would unsettle the security of corporate property and rights, and exclude others from the enjoyment here of privileges which have always been accorded to us abroad. Our national commerce is but the aggregate of that of the States, and every needless restriction, by the operation of local laws, is unjust and calamitous to all. We suppose the rules of comity, on which we have heretofore acted, to be generally accepted and approved. We see no reason why a southern State may not grant, to a corporation of its planters, the right to erect mills for the manufacture of their cotton in New England; nor why the legislature of Massachusetts may not authorize a company of Lowell millers to raise cotton in South America, or on the Sea Islands. The State of Illinois touches neither the Atlantic nor the Pacific; but if it should organize a company of its citizens to transport produce on the ocean, with its office in the city of New York, and its business conducted by managers, elected annually in Chicago, the rights of the corporation would be recognized wherever the obligations of national law are respected.

The rules of comity are subject to local modification by the law making power; but, until so modified, they have the controlling force of legal obligation. The franchises and immunities which they secure, it is the duty of the courts to respect, until the sovereign

sees fit to deny them. The rights of a foreign suitor or defendant, so far as they are unabridged by legislation, are as imperative and absolute as those of the citizen. These rules have their place in every system of jurisprudence. As there are certain conservative powers not derived from grant, but inherent in every government because essential to its existence, so there are certain obligations, springing from the necessities of national intercourse, and recognized by all civilized communities in the law of general comity. They have been uniformly acknowledged and enforced by the courts of this State. . . . Their authority is fortified by repeated adjudications in our federal tribunals. . . .

The rights of foreign corporations have been protected in the English courts on the same general principle of public law. . . . Indeed, the law of international comity in the interest of commerce, which has so long prevailed in that country, is recognized in a provision of *Magna Charta*; which elicited from Montesquieu the encomium, that the English have made the protection of foreign merchants one of the articles of their own liberty.

The theory on which the Supreme Court held the defendant Van Santvoord liable, was, that he was a member of an absconding corporation; that it has migrated from Connecticut to New York; and that, by such migration, it had lost its corporate character, except for the single purpose of charging its shareholders with personal liability, on the contracts made here by its officers. In these views we cannot concur. . . .

. . .

In this case we think the Supreme Court erred in assuming, that the exercise by the corporation in another State, through officers and agents residing there, of the powers with which it was endowed at home, was an act of corporate migration, even if it was capable of such migration. . . . Its domicile was not controlled by the place where its office was kept, where its books and papers were deposited, or where its business was done. Its powers had no territorial limitation; and it fully complied with the only local requirements in its charter, which were limited to its original organization, and the annual election of its managers. The grant of franchises without restriction is equivalent to a specific authority, to exercise them wherever the company might find it convenient or profitable, whether within or without the limits of the State of Connecticut. (*Bank of Augusta v. Earle,* 13 Pet. 588; per *Taney,* Ch. J.)

The decisions of the other States, the course of New York legislation, and the general usages of the country, are all opposed to the theory on which this case was decided. From the centralizing tendencies of commerce, the transferable character of corporate stock, and the necessities of domestic and foreign intercourse, the principal offices of many of our most important corporations in the inland States are kept in our seaboard city. It would be equally disastrous to the citizens of our own and of other States, if judicial innovations were permitted in applying the rules of general comity.

The conscious migration of corporations to New Jersey can be dated to 1890, had quite a different cause, and was limited to large, national corporations typically with a New York seat if not also there incorporated.[183] The New Jersey statute, already since 1875 a "modern" one in a non-controversial enabling sense, was amended to permit a corporation to own stock in other corporations. This was intended to protect the continuing concentration of corpora-

[183] To this and the immediately following text, see BUXBAUM, *supra* note 178.

tions theretofore united through the trust device, in avoidance of the prohibitions of the Sherman Anti-trust Act of 1890. It was an enactment devised by the attorney for the Rockefeller Standard Oil Trust, and attractive to the New Jersey legislature because of the franchise fee income it would generate. To the New York corporations New Jersey was happily also attractive since, "just across the river," it was least inconvenient if minor administrative changes like location of records and of shareholders' meetings unavoidably followed a change of the state of incorporation. This motive for domicile transfer was not one which would or did upset New York State courts when disputes concerning internal affairs of such corporations arose; host states' objections to this charter mongering had a fiscal motive, the loss of franchise revenue, not the motive of local shareholder protection.[184]

The less industrialized states from which that kind of objection could have been expected at that time (1865-1900) had no occasion to express it. Before the internal affairs of a corporation, and with them the objectionable law of a foreign jurisdiction, could be a local issue there had to be present local investors and local directors and officers. By definition these were not being supplied in significant numbers in these states. Physical facilities of eastern corporations existed there and generated third party litigation, but that had nothing to do with company law except in the special category of corporate capacity to engage in a particular line of activity – the *ultra vires* problem.

In short, both formal and substantive considerations of federalism on the one hand, and the particular American history of national corporation development on the other, combined to make recourse to the admittedly convenient law of the place of incorporation acceptable.

B. The Twentieth Century Struggle Against Traditional Conflicts Doctrine

The early acceptance of the primacy of the law of the state of incorporation should not be taken as proof of the absence of intracorporate problems. Promoters' enthusiasm, if not fraud, had led to massive investment losses even before the Civil War, when state government-inspired overdevelopment of

[184] See, e.g., J. DILL, *Trusts: Their Uses and Abuses* 6-7 (New York 1901); U.S. INDUSTRIAL COMMISSION, *Preliminary Reports on Trusts and Industrial Combinations, H.R. Doc. No. 93*, 56th Cong., 1st Sess. 1080-82 (Washington, D.C. 1899-1900) (testimony of Mr. James B. Dill).

uneconomical railroad segments flourished.[185] The arrant railroad investment frauds of the 1860's and 1870's are legendary,[186] and the ruins of salted gold and copper mines began to show up in the reported cases well before the turn of the century.[187] Nevertheless, these events had little to do with choice-of-law problems. Overvaluation and overcapitalization, the issuance of watered stock, was not originally dependent on any particular compliant or lax state corporation law,[188] except in the general, though itself quite interesting, sense that, unlike the European case, state control of the capitalization process never has been a feature of American company law.[189]

Certainly intracorporate disputes existed; the earliest published case apparently dates from 1807.[190] Certainly foreign corporations appeared as plaintiffs or defendants in host state (or federal) courts – the earliest case apparently being one in 1799[191] – but in third-party, not shareholder disputes. The two strands do not come together until considerably later in the century, and in their joint course thereafter lies not only the obvious development of the

185 For the general history, including some of these problems, see TAYLOR, *supra* note 175; and more specifically to the state debt and repudiation problem, S. BRUCHEY, *The Roots of American Economic Growth, 1607-1861: An Essay in Social Causation* 133 ff (New York 1965). On the later railroad finance problems (of the 1850's), see C. DUNBAR, *Economic Essays* 265 ff (New York/London 1904), as reviewed in HAMMOND, *supra* note 35, at 709 ff.

On the role of British private investors in the involuntary subsidization of this infrastructure development, see the vividly described history in L. JENKS, *The Migration of British Capital to 1875* (London 1927), esp. ch. 4 and its quotations from the Sydney Smith "petition" to Congress, *id.* at 104-05.

186 For an early contemporary discussion, see C.F. ADAMS & H. ADAMS, *Chapters of Erie and Other Essays* (New York 1886); see also *High Finance in the 60's* (F. Hicks ed., Port Washington 1929).

187 The first classic gold mine case seems to be Cross v. Sackett, 16 How. Pr. 62 (N.Y. Super. Ct. 1858).

188 This is not to say, of course, that specific and differing common law or statutory treatment of the overvaluation of property by directors of new corporations did not make a difference; thus, see V. MORAWETZ, *Treatise on the Law of Private Corporations* §§ 825-829 (2d. ed., Boston 1886) and, as to the view from a couple of decades later, WICKERSHAM, "The Capital of a Corporation," 22 *Harv. L. Rev.* 319 (1909).

189 See R. BUXBAUM, "The Formation of Marketable Share Companies," in *Int'l Enc. Comp. Law*, Vol. XIII, *Business and Private Organizations*, ch. 3 (A. Conard ed., Tübingen, prov. ed. n.d. [1972]); on the doubtful utility of this distinction, *cf. id.* at 20-22.

190 Gray v. Portland Bank, 3 Tyng. (Mass.) 384 (1807), a preemptive rights case; see also Tippets v. Walker, 4 Tyng. (Mass.) 595 (1808) and the factually and historically interesting case of Currie v. Mutual Assurance Soc'y, 14 Va. (4 Hen. & M.) 315 (1809).

191 Bank of the United States v. Haskins, 1 Johns. Cas. 132 (1799). It should be recalled, however, that the Bank of the United States was a federal corporation; see *supra* note 163 for the significance of this distinction. See also the discussion in DAVIS, *supra* note 30, at 34-108, esp. 50-52.

modern "internal affairs" rule. More significantly, there can also be found the proper understanding of the constitutional limits, measured by the Full Faith and Credit Clause, of state freedom to escape the confines of that conflicts rule and to reassert, within the outer limits of Commerce Clause and due process considerations, more restrictive company law norms than those lax norms which corporations have been able to choose by choosing their state of incorporation.

1. The Origin and Definition of the Concept of "Internal Affairs"

If until now the emphasis has been on identifying the law which governs the internal affairs of a corporation, it is now time to define that concept itself more precisely. According to the *Restatement (Second), Conflict of Laws* § 192, Comment a: "[A] corporation's internal affairs are involved whenever the issue concerns the relations *inter se* of the corporation, its stockholders, directors, officers or agents." That, however, not only is a problematic definition in the light of modern efforts to capture within corporation law the significant (if not all) aspects of a corporation's relations with its investors in their entering and exiting roles, with its creditors, and with its employees (*Unternehmensrecht*). It also obscures the evolution of the internal affairs doctrine, and thereby a proper understanding of its purpose, even when that purpose is narrowly defined.

Two types of cases show up frequently in the early reports. The first and earliest concerns the already mentioned challenge to the capacity of the corporation to enter into the contract it now sues upon, the *ultra vires* question. Though typically a third party action – a suit by a foreign corporation to collect a debt – it necessarily involves the construction of the company charter; which, in the days of incorporation by special law, was as much as saying the construction of a foreign law. That a reference to the foreign charter is necessary is self-evident by definition; such a reference hardly rises to the dignity of a choice-of-law rule.[192]

Indeed, the earliest courts saw the matter more as an issue of remedies. The defense was not in the typical case a meritorious one; on the contrary, it was typically raised by a third party whose misuse of the shareholders' decision not to go into the challenged business only further damaged them, by preventing recovery of the corporate assets which had, perhaps illegitimately, been loaned to the defendant in the first place. Under those circumstances, the judicial reaction to treat the whole matter as properly a matter for the courts of the corporation's home state was fully understandable, even if the most celebrated of

[192] This is to be distinguished, of course, from the question of the effects of an *ultra vires* transaction (or a question of the specific power of a corporation to effect an *intra vires* purpose by dubious means, such as guaranteeing the debt of another corporation); this would be determined by a conscious and explicit reference to foreign governing law.

those first cases, *Silver Lake Bank v. North*, later was taken as one progenitor of the internal affairs rule:[193]

> Another objection is [the *ultra vires* point], that the plaintiffs had no right to take a mortgage concurrently with the loan, in order to secure it, and that their charter only authorized them to take mortgages for 'debts previously contracted.' If this objection was strictly true, in point of fact, I should not be readily disposed to listen to it. Perhaps it would be sufficient for this case, that the plaintiffs are a duly incorporated body, with authority to contract and take mortgages and judgments; and if they should pass the exact line of their power, it would rather belong to the government of *Pennsylvania* to exact a forfeiture of their charter, than for this Court in this collateral way, to decide a question of misuser, by setting aside a just and *bona fide* contract.

This strand of early internal affairs case-law in any event evaporated relatively early, as the *ultra vires* point became unavailable as a defense to a corporate claim and, of course, as corporate purposes and powers clauses, and their construction, grew ever more generous.[194]

The second and probably more significant early strand of the doctrine concerns disputes that nominally were between the corporation and its members but in fact concerned either recurrent contract disputes or creditors' remedies, both of which required uniform treatment in order to prevent chaos among large numbers of potential claimants.[195] Many early insurance companies were organized as mutual companies, with each insured party becoming a member (shareholder) by virtue of purchasing, or in order to purchase, an insurance policy.[196] Many early corporations, indeed in the case of banking corporations even into this century, provided for the double liability of shareholders, calling for their assessment in the event of corporate insolvency of as much again as

193 4 Johns. Ch. 370, 373 (N.Y. 1820).

194 To the beginnings of such curative doctrines as early as the first decade following the Civil War, see A. GREEN, *A Treatise on the Doctrine of Ultra Vires* (Am. ed. of S. BRICE, *same*, New York 1875); as to the current state of affairs, see R. JENNINGS & R. BUXBAUM, *Corporations – Cases and Materials* 116-135 (5th ed., St. Paul 1979). A brief but enlightening discussion of the fate of the doctrine between early regulation and growing judicial adoption of *laissez-faire* values is provided in KELLER, "Public Policy and Large Enterprises. Comparative Historical Perspectives," in *Law and the Formation of the Big Enterprises, supra* note 178, at 521 ff.

195 An early comprehensive discussion is that in Bank of Virginia v. Adams, 1 Pars. Eq. 534 (Com. Pl. (Phila.) Pa. 1850), involving a direct suit by the creditors of the foreign corporation on defendant's unpaid subscription to that corporation; see particularly the concern, at 547 ff, that no complete remedy would be had because the foreign entity was not in court.

196 For a still useful European perspective and analysis of this "doubled" relationship, see S. RIESENFELD, *Das Problem des gemischten Rechtsverhältnisses im Körperschaftsrecht unter besonderer Berücksichtigung der Versicherungsvereine auf Gegenseitigkeit* (Vol. 19, Gesellschaftsrechtliche Abhandlungen, A. Nussbaum ed., Berlin 1932).

they had originally subscribed for.[197] Both types of situations spawned litigation which, for reasons that need not be detailed here, had to be resolved in a unitary fashion (typically, because of the danger that otherwise there would be a race among creditors or a multiplicity of potentially inconsistent actions raising havoc with premium assessment procedures and the like). This led to a predictable series of cases misleadingly labeled *forum non conveniens* but more accurately described as cases finding a derogation clause in favor of the foreign state of incorporation to be implicit in the foreign corporation's charter.[198]

On the other hand, when that foreign corporation itself (or its receiver) sued a shareholder in the local forum to recover on an unpaid subscription, as part of its marshalling of the assets of the corporation, the forum court typically had no problem accepting jurisdiction, since there would be no danger of chaotic remedial competition. By the same token, however, it would apply the law of the state of incorporation to this liability, even if the forum state rule on the merits was different.[199]

From such procedural or remedial considerations there was thus derived a more general choice-of-forum rule that disputes concerning the internal affairs of a corporation should be brought before the courts of the state of incorporation. It was, however, at all times a rule embedded in the practical recognition that (as long-arm jurisdiction and imperfect joinder and interpleader rules then stood) the host state forum simply was in no position to do justice among all

[197] See the relatively recent discussion of this issue in Anderson v. Abbott, 321 U.S. 349 (1944); Comment, "Corporations – Liability of Stockholder of Bank Stock Holding Company for Statutory Assessment on Bank Stock," 36 *Mich. L. Rev.* 1336 (1938).

This "doubled" shareholder liability derives from the right usually granted early banks by special chartering statutes to generate liabilities up to twice the amount of their capital stock. See DAVIS, *supra* note 30, at 105-06. It originated in a New York constitutional provision of 1846 making stockholders liable for again the amount of their stock and faded from the scene about the time of enactment of the Glass-Steagall Act; see HAMMOND, *supra* note 35, at 559.

[198] See, e.g., Note, "Forum Non Conveniens and the Internal Affairs of Foreign Corporations," 33 *Col. L. Rev.* 492 (1933).

Good early examples of this construction of both special statutory and general charters to infer a derogation clause in favor of the courts of the state of incorporation, include, in addition to the next quoted cases, Bank of Virginia v. Adams, 1 Pars. Eq. 534 (Com. Pl. (Phila.) Pa. 1850); Redmond v. Enfield Mfg. Co., 13 Abb. Pr. (n.s.) 332 (N.Y. 1872); Chase v. Vanderbilt, 37 N.Y. Super. (5 Jones & Spencer) 334 (1874); North State Copper & Gold Mining Co. v. Field, 64 Md. 151, 20 A. 1039 (1885); State *ex. rel.* Richardson v. Swift, 12 Del. (7 Houst.) 137, 158 (1885); Smith v. Mutual Life Ins. Co. of N.Y., 96 Mass. (14 Allen) 336 (1867).

[199] Thus, in what is probably the earliest reported case in this area, Merrimac Mining Co. v. Levy, 54 Pa. 227 (1867), the court accepted jurisdiction on this basis.

affected parties, as the following two quotations – the first from one of the earliest true internal affairs cases and still focusing on remedial issues, the second a classic newer and more abstract description of the problem – demonstrate:

[i] The plaintiffs, claiming to be the owners of bonds and common stock of the Chicago and Northwestern Railway Company, ask an injunction against the defendants, to restrain them from paying a stock dividend declared by them on the preferred and common stock. The dividend was to be paid to each class of stockholders, in the same kind of stock as that held by them. The plaintiffs claim that the company has no authority to make stock dividends, and if they have, that the distribution is unequal in giving preferred stock to one class and common stock to the other; and they also claim that the company is bound by a previous resolution, adopted by them, not to issue any preferred stock beyond the amount at that time in existence. . . .

. . .

There are, however, other considerations which, in my judgment, should have a controlling influence in the decision of these questions. This corporation derives its existence from the legislation of other states than that of New York. No part of its road or franchise is exercised within this state, and we can in nowise reach the corporation, except by attaching property within the state. Some of its directors reside here, and they may be forbidden to act, but such an injunction can be rendered nugatory at any moment by a resignation and substitution of others in their places. A disobedience of the order of the Court can be obviated by keeping the office of the company, and appointing directors living in other states. . . . It is the duty of the state to provide for the collection of debts from foreign corporations, due to its citizens, and this has been done; and it is the duty of the state to protect its citizens from fraud, by all the means in its power, whether against domestic or foreign wrongdoers. This, however, does not authorize the courts to regulate the internal affairs of foreign corporations. The courts possess no visitorial power over them. We can enforce no forfeiture of charter for violation of law; nor can we remove directors for misconduct. These powers all properly belong to the courts of the state from which they derive their existence. It is for these reasons I think there is no propriety in enjoining the defendants, in the present case.[200]

[ii] We have thus stated at greater length than usual, the material allegations of this bill in order that its scope and purpose may be clearly seen. As far as our comprehension goes, it makes a case of a contest between the complainant and other *bona fide* stockholders of the corporation on the one side, and those claiming to be stockholders and president and directors on the other. This is clearly a controversy relating to the *internal management* of the corporation, and the validity of the acts of those who claim to be, and indeed are admitted to be *de facto,* its president, directors and stockholders. Now if this were a Maryland corporation there could be no question as to the jurisdiction of a Maryland Court over the subject, but such is not the case. This corporation was created under the laws of another State, and it seems to us that all such controversies must be determined by the Courts of the State by which the corporation was created. Our researches have enabled us to find no case in which the Courts of another State have ever assumed jurisdiction over a controversy like this, and we think none can be found.

[200] Howell v. Chicago & North Western Ry. Co., 51 Barb. 378, 379-80, 382-83 (1872).

Indeed, it would be a strange anomaly in our system of jurisprudence if the Courts of one State could be vested with the power to dissolve a corporation created by another, and assume control over its property for the purpose of distributing it among those claiming to be its stockholders.

But assuming that a Maryland Court has jurisdiction in this case for any of the purposes stated in this bill, we think it clear that the corporation itself is an essential party to the suit.[201]

As this sequence of passages suggests, the rigorous forum derogation rule over time was bound to collapse into a more general and more discretionary *forum non conveniens* doctrine,[202] albeit a version more attuned to administrative and institutional than party-convenience considerations. This shift can be traced, at a surprisingly late date, by contrasting the two Supreme Court opinions in *Rogers v. Guaranty Trust Co.*[203] and *Koster v. Lumbermens Mutual Casualty Co.*[204] Though the former spoke in general terms of the trial court's inherent discretion to refuse jurisdiction, it was as concerned with what it called "the management of the internal affairs of a [foreign] corporation [by] the courts"[205] as it was with the problem of applying foreign law.[206] As then Justice *Stone*'s dissent clearly demonstrates,[207] this approach seriously overestimated the degree of interference with management even potentially involved in the typical dispute. By 1947, however, in *Koster*, and after an important interim decision that had adopted a much more modern and relaxed view of

201 Wilkins v. Thorne, 60 Md. 253, 258 (1883). See also the interesting middle, or transitional situation in Smith v. Mutual Life Ins. Co. of N.Y., 96 Mass. 336, 343 (1867):

> [W]e regarded as within the province of this court, sitting as a court of equity, in its discretion, to decline to exercise jurisdiction in such cases, referring parties to the tribunals of the state upon whose laws their relations and rights peculiarly depend, and where they alone can be effectually and properly administered. This course is especially appropriate in the case of a foreign corporation, when the proceeding is such as not merely to affect its external relations but also to involve its organic laws, which are necessarily local, and require local administration.

The English jurisprudence also reveals exactly this distinction between retention and rejection of jurisdiction on the basis of remedial completeness and harmony. Thus, *compare* Sudlow v. Dutch Rhenish Ry. Co., 21 Beav. 43 (1855) *with* Lewis v. Baldwin, 11 Beav. 153 (1848) and esp. Pickering v. Stephenson, 14 L.R.-Eq. 322 (1872).

202 See generally A. EHRENZWEIG, *The Conflict of Laws* 135 (St. Paul 1962). The following passages are based substantially on BUXBAUM, "The Origins of the American Internal Affairs Rule in the Corporate Conflict of Laws," in *Festschrift für Gerhard Kegel* 75, 82 ff (Munich 1987).

203 228 U.S. 123 (1933).

204 330 U.S. 518 (1947).

205 228 U.S. at 130.

206 *Id.* at 132.

207 *Id.* at 133, 145 ff.

the "interference" typically involved in these situations,[208] the Supreme Court simply put the matter into the hands of the trial courts and their more or less unfettered discretion.[209]

The same trend was apparent even earlier at the state court level, a development all the more interesting in that several state statutes explicitly, if obscurely, renounced any legislative intention "to regulate the . . . internal affairs of a [foreign] corporation."[210] With perhaps one exception,[211] which has been described as an anachronistic reaction,[212] the courts simply collapsed this mandate as well into the general stream of the discretionary exercise of jurisdiction.

2. From Choice-of-Forum to Choice-of-Law Rules

Until such a derogating choice-of-forum rule was abandoned there could hardly, it is obvious, develop a choice-of-law rule. It seems equally obvious that the later choice-of-law rule would evolve fairly unreflectively from that choice-of-forum rule, and still show its origin in these same practical and remedial considerations.[213] Just as the first cases deciding to take jurisdiction over a

208 Williams v. Green Bay & W. R. Co., 326 U.S. 549 (1946).

209 Where it still plays a role; see, e.g., Horwitz v. South West Forest Industries, Inc., 612 F. Supp. 179, 183 (D. Nev. 1985): "It is only when the courts must exercise continuing supervision over corporate affairs, *e.g.*, through a court-appointed receiver, that a foreign court might have trouble enforcing its orders."

210 These statutes are discussed in KAPLAN, "Foreign Corporations and Local Corporate Policy," 21 *Vanderbilt L. Rev.* 433, 457-59, 471-72 (1968).

211 Plum v. Tampax, 399 Pa. 553, 160 A.2d 549 (1960).

212 EHRENZWEIG, *supra* note 202, at 135.

213 The first such case seems to have involved a forum shareholders' claim against locally found directors of a foreign corporation for what today would be called breach of fiduciary duties; Griffith v. Scott, unreported, paraphrased in *Howell, supra* note 200, at 384. Note how its use in *Howell* clearly points to the remedial problem as the critical issue:

> There has been a wrong impression entertained since the decision [in *Griffith*] that the court intended in that case to hold that we had jurisdiction and should exercise it, in all cases, over foreign corporations. That case warranted no such conclusion. There the charge was a fraudulent contract between individuals who were directors of two companies at the west, by which the stockholders in one of the companies would have been deprived of all interest therein, and would be without redress. Those directors lived in New York and others here were connected with them, in the arrangement, who were only to be reached by proceedings here.

In Redmond v. Hoge, 3 Hun. 171 (N.Y. Sup. 1874), the appointment of a receiver for a foreign corporation was ordered by the court on behalf of shareholder as well as director interests, essentially on the grounds that the state of incorporation would have even less "useful" jurisdiction since all assets and all officers were New York residents and thus New York could enforce any remedy granted.

shareholder's complaint about the acts of directors of that corporation justified this step by stressing their ability to grant complete relief, so did the choice of the law of the foreign state of incorporation rest in part on the fear that a different choice might not be honored by that foreign state whose later cooperation might have been essential in the matter. The close sequencing of the following case excerpts is significant in this regard:

[i] [T]he basis of an action for an accounting and restoration against offending officials of a corporation is the trust relation which such officials bear to the corporation and to its stockholders. This gives a court of equity jurisdiction of the subject-matter wherever it can obtain jurisdiction of the persons of the defendants, even though the subject-matter might be real estate situate without the state . . ., which is not the fact here. The right of the plaintiffs, as stockholders, to compel a restoration by the officers to the corporation, is co-extensive with the right of the corporation itself. Surely, the corporation would not be confined to the courts of the state which created it, but could pursue its officers in whatever jurisdiction it might find them; otherwise, it would be remediless if those officers remained without the state. The learned judge, however, was of opinion that this action . . . was, in effect, an action to control the internal management of the corporation itself. Of an action of the last character he was of opinion that the corporation could only be called to account in the tribunals of the state which created it. We are not prepared to admit the correctness of the proposition as broadly as stated by the learned justice. If the illegal acts of the directors or of the corporation offended solely against the majesty of the state to which it owed its life, – in other words, constituted only public wrongs, – the proposition is probably correct; for we are not compelled to, nor should we, entertain actions simply to redress the outraged dignity of foreign governments. But, if such illegal acts also cause injury to the property rights of individual stockholders who are citizens of this state, we cannot see why they are not entitled to obtain full relief in our courts, so far as such relief can be accomplished by acting directly on the persons of the defendants.[214]

[ii] When a judgment against a foreign corporation would not be effectual without the aid of the courts of a foreign country or the sister state, and it may contravene the public policy of the foreign jurisdiction, *or rest upon the construction of a foreign statute, the interpretation of which is not free from doubt*, – as where the subject-matter of the litigation and the judgment would relate strictly to the internal affairs and management of the foreign corporation, – the court should decline jurisdiction, because such questions are of local administration, and should be relegated to the courts of the state or country under the laws of which the corporation was organized.[215]

3. The Beginning of Tension Between Host State and Home State Law

Nevertheless, though it is understandable that local corporation law thus was more or less automatically thought inapplicable to the internal affairs of a foreign corporation, from the earliest date that a choice-of-law rule even became relevant – i.e., from the day that the derogating choice-of-forum rule

[214] Ernst v. Rutherford & Boiling Springs Gas Co., 56 N.Y. Supp. 403, 406 (1899).
[215] Hallenberg v. Greene, 66 App. Div. 590, 73 N.Y. Supp. 403, 408 (1901).

eroded – pressures to disregard the undesired application of the foreign enabling act in the host forum also developed and to some degree were honored.

One early, fruitfully ambivalent local response was procedural: The forum provided an action, typically by interpretation of a general statute, that may or may not have been available under the law of the state of incorporation. The 1904 New York case of *Miller v. Quincy* is instructive.[216] Plaintiff, a director of a New Jersey corporation with its seat in New York, sued a former director to recover for the corporation monies allegedly converted to his own use. While similar to a derivative action, it was in fact based upon a New York statute that allowed only the people, a creditor, a trustee or a director or officer of the corporation to sue a corporation's officers or directors for an accounting or for restoration of property taken by them, lost or wasted.

The statute was construed to apply also in the case of a foreign corporation, without consideration of the possible conflict of laws problem but with full consideration of the danger that the recent wave of New Jersey incorporations otherwise would pose to New York interests (certainly including shareholder interests):[217]

> It is a matter of common knowledge that hundreds of corporations in this state are organized under the laws of New Jersey, or some adjoining state, but the business and all the operations of the corporation are conducted here, except possibly, once a year, there may be a meeting of the stockholders in the state creating the corporation for the purposes of a new election. In all other respects these corporations stand upon the same footing as though organized here under the laws of this state; and what reason can be given for denying to a director of such a corporation the right to bring an action such as might be brought and maintained by a director of a domestic corporation? The distinction between the two classes of corporations in this respect is simply arbitrary and rests upon no sound reason, or any principle of public policy.

Of course, a forum's statutory choice of law would bind that forum, subject to outer constitutional limits, but this kind of recourse to a remedial rule can only by courtesy be called such a statutory choice-of-law mandate. Nevertheless, it is in exactly that vaguely statutory arena that the forerunners of current host state choice-of-law rules are to be found; specifically, in the 1915 New York case of *German-American Coffee Company v. Diehl*,[218] which permitted a derivative action, available only under a New York forum statute, to recover a dividend distribution illegal under both New York law and the law of New Jersey, the state of incorporation. While a number of jurisdictions have interpreted certain procedural provisions of forum statutes to apply to foreign corporations' shareholder-management disputes – inspection of corporate records, prohibition on the voting of illegitimately obtained shares and the

[216] 179 N.Y. 294, 72 N.E. 116 (1904).
[217] 179 N.Y. at 300.
[218] 216 N.Y. 57, 109 N.E. 875 (1915).

like[219] – true "common law" cases choosing forum law, in the sense that they find in the general differences between the chartering and host states' substantive corporation codes a call to apply the forum's code, are almost non-existent.[220]

[219] E.g., McCormick v. Statler Hotels Delaware Corp., 30 Ill. 2d 86, 195 N.E. 2d 172 (1963) (inspection of shareholder list); Lonergan v. Crucible Steel Corp. of America, 37 Ill.2d 599, 229 N.E.2d 536 (1967) (enjoining acquisition of shares for voting purposes).

It should be emphasized, however, that many state statutes explicitly provide for inspection of the books of foreign corporations, so that this is less clearly a judicial choice-of-law issue. See, e.g., the California statute recently upheld against, of all things, a Commerce Clause attack in Valtz v. Penta Inv. Corp., 139 C.A.3d 803, 188 Cal. Rptr. 922 (1983).

[220] See the case analysis in KAPLAN, *supra* note 210, an important study of this entire field; and the full study by BARAF, "The Foreign Corporation: A Problem in Choice-of-Law Doctrine," 33 *Brooklyn L. Rev.* 219 (1967), the first of the theoretical analyses influenced by LATTY, *supra* note 168. A full study of this subject, challenging these "revisionist" conflicts theories under the compulsion of *MITE (supra* note 71), has recently appeared: KOZYRIS, "Corporate Wars and Choice of Law," [1985] *Duke L.J.* 1; and even more recently, DEMOTT, "Perspectives on Choice of Law for Internal Corporate Affairs," 48 *L. & Contemp. Prob.* 161 (1985). See also *infra* note 458, last paragraph.

One interesting more recent harbinger of a "contact" choice-of-law analysis even in internal affair questions is Greenspan v. Lindley, 36 N.Y.2d 473, 330 N.E.2d 79 (1975), involving a Massachusetts business trust, in which the following dicta appeared:

> We conclude, therefore, in the circumstances of this case that reference must be made to the [Massachusetts] authorities. . . . In deciding this case as we do, however, we expressly leave open what law we might apply were there proof from which it could properly be found, in consequence of significant contacts with New York State, that this investment trust, although a Massachusetts business trust, was nonetheless so 'present' in our State as perhaps to call for the application of the so-called 'internal affairs' choice-of-law rule, under which the relationship between shareholders and directors of a business corporation would be governed by the law of the State in which the business entity was formed.
>
> Similarly we do not reach the question of what significance we would accord the explicit agreement of the parties that their rights are to be governed by Massachusetts law, were we disposed, entirely without reference to that provision of the declaration of trust, to apply the law of New York or the law of some State other than Massachusetts. (330 N.E.2d at 80 ff).

The later memorandum decision of Skolnik v. Rose, 55 N.Y.2d 964, 434 N.E.2d 251 (1982) suggests that the New York courts are not going to find the existence of the necessary local contacts too readily:

> [Plaintiff] does not contend, and indeed, could not on this record, that the party's express choice of the laws of Massachusetts should not be enforced because

Kaplan has canvassed this run of cases thoroughly,[221] and perhaps it is essentially a vain undertaking to try to derive a generic common law sense of appropriate conflicts doctrine from a field that is, after all, in its substantive dimensions a codified field. The judicial role lies rather in the concretization of those uniform and uniformly vague statutory norms mandating a fiduciary level of care and honesty for directors and officers.[222] Any subtle differences that a close analysis of different states' jurisprudence might reveal more likely would not even be identified by any given forum court; rather, its own perception of the "national" meaning of any such phrase would more likely be in the nature of "moral data," in *Ehrenzweig*'s terms:[223] a kind of pre-characterization assumption based on Aristotelian notions of right results achieved by the right reasoning of the right people.

In effect, we can classify the situations other than explicit statutory choice of local law mandates in two basic categories: (1) the grant of forum remedies unavailable in the state of incorporation, in disregard of their typical characterization as elements of substantive corporation law; and (2) forum concretization of the content of a vague statutory (or occasionally only common law) norm defining directors' or controlling owners' behavioral duties in ways not compatible with those of the ostensibly governing law of the state of incorporation. At least the first of these should not surprise Civilian lawyers; their traditional characterization of procedure and remedies as public law categories should lead them to a similar result in any event, even if by different reasoning. Whether the result of *Hausman v. Buckley*[224] be correct or not, its converse

> the trust does not have any contacts with that State. In our view the factors alleged do not invoke any overriding policy consideration under the laws of New York and do not provide a compelling reason or justification for disregarding the express agreement of the parties that their rights under the trust should be governed by the laws of Massachusetts, the State where the trust was founded. (434 N.E.2d at 252).

Nevertheless, as the later developments cited *infra* notes 224 & 226 suggest, this basic "contacts" approach has generated considerable support. *Cf.* also Zion v. Kurtz, 50 N.Y.2d 92, 405 N.E.2d 681 (1980) and Norlin Corp. v. Rooney, Pace, Inc., 744 F.2d 255, 263 (2d Cir. 1984) (applying New York law to the issue whether a Panamanian corporation could vote shares of its parent which it "owned").

221 KAPLAN, *supra* note 210.

222 This is a common feature of cases in federal diversity jurisdiction, in the sense that federal courts often use sources from many states in identifying the ostensible substantive law of the state whose rules are dispositive in the given cause.

223 1 A. EHRENZWEIG & E. JAYME, *Private International Law* 77-79 (Leyden 1967) for both the general statement and its application to corporation law.

224 299 F.2d 696 (2d Cir. 1962), involving a vain effort to persuade a New York federal forum to entertain a derivative suit against (on behalf of) a Venezuelan corporation, whose law does not know the concept. Whether substantive or procedural in characterization, the right to bring a derivative suit was to be governed by the law

would not follow: no European court is likely to invent a foreign state of *siège* (or incorporation) institution like the derivative suit, unknown to the forum, just because it is part of the "substantive" corporation law of the home state, applicable to the litigation under some version of the internal affairs doctrine.[225] And even the second category, illegitimate as it may seem when so highlighted, is common at least at a subliminal level – otherwise why is there so much nonuniform interpretation of uniform laws?

The more radical step of finding a hidden choice-of(-forum)-law rule in the existence of a strong substantive statutory rule of corporation law, as in the case of a statutory mandate of cumulative voting, for example, is very seldom taken.[226] The same New York case that firmly established the right of the forum to hear a typical derivative suit involving a foreign corporation made this clear:[227]

The complaint is drawn inartificially. The pleader seems to have labored under the idea that *the statutes of this state regulating the increase of capital stock*, the contracting of debt, the issuing of bonds, and the execution of mortgages control the action of foreign cor-

of the state of incorporation; compare German-American Coffee Co. v. Diehl, 216 N.Y. 57, 109 N.E. 875 (1915), permitting a derivative action not available under the law of the state of incorporation, and, despite (and not mentioning) *Hausman,* Norlin Corp. v. Rooney, Pace, Inc., 744 F.2d 255 (2d Cir. 1984). For a thorough analysis see KAPLAN, *supra* note 210 at 461-64, and, as to *German-American Coffee*, at 451. Compare also H.F.G. Co. v. Pioneer Publishing Co., 162 F.2d 536 (7th Cir. 1947) with Kreindler v. Marx, 85 F.R.D. 612 (N.D. Ill. 1979).

An interesting interpretation issue arises if the forum state by (typical) statute explicitly authorizes derivative actions brought on behalf of foreign corporations. See, e.g., N.Y. Bus. Corp. Law § 626 in connection with § 1319(a)(2), and the use of the latter in Goldberg v. Meridor, 567 F.2d 209, 220 (2d Cir. 1977) to avoid *Hausman v. Buckley.*

225 This is part of the so-called "substitution" problem in European conflicts doctrine; see, e.g., P.H. NEUHAUS, *Die Grundbegriffe des IPR* 351 ff (2d ed., Berlin 1976).

226 The well-known case of Mansfield Hardwood Lumber Co. v. Johnson, 268 F.2d 317 (5th Cir. 1959) might be taken as a rare modern example. Compare its analysis in KAPLAN, *supra* note 210, at 452, with that of RESSE & KAUFMAN, "The Law Governing Corporate Affairs: Choice of Law and the Impact of Full Faith and Credit," 58 *Col. L. Rev.* 1188 (1958). More recently if also more casually, an Ohio case firmly adopts this approach on a common law basis; see Gries Sports Enterprises, Inc. v. Modell, 15 Ohio St. 3d 284, 473 A.2d 807 (1984); and see the discussion of similar cases *supra* note 220.

Indirectly, through the investor protection element inherent in a statutory mandate of cumulative voting, the responsible state regulatory agency may appropriate the substantive statute for choice of local law purposes; see the discussion *infra* at p. 102.

227 *Ernst v. Rutherford*, 56 N.Y. Supp. 403, 406 (1899). Since the litigant (and litigator) was the (later) well-known Morris L. Ernst, one may speculate that the pleadings did not refer to the "wrong" governing law through inadvertence.

porations. That such an idea is entirely unfounded, and that the statutory law of this state can neither have extraterritorial effect nor can be presumed without proof to prevail in other states, requires the citation of no authority.

4. The Development of Statutory and Partial Choice-of-Law Rules

While a few isolated and inconclusive examples of teasing a choice-of-law rule out of a particular corporation code provision of the forum exist,[228] this approach failed to take root. Neither the fact that the corporation might be a pseudo-foreign corporation, local in all but name, nor the availability in other contexts of the public order exception to otherwise applicable choice-of-law rules helped American courts over this hurdle[229] (although it should be noted that the public order exception, needed to "correct" any formal two-stage conflicts analysis, traditionally has enjoyed little support in United States law).[230] Indeed, an effort of a state court to apply that exception, in order to prevent a foreign mutual insurance company from collecting additional assessments from local defendants, led to the first of that short line of cases, discussed below,[231] which conjured with the Full Faith and Credit Clause of the Constitution to force unwilling states into a uniformity dictated by the state of incorporation.

Instead, attention turned to statutory choice-of-law enactments, spurred by Dean *Latty*'s important criticism of the ability of local incorporators to choose their substantive corporation law by choosing a foreign state of incorpora-

228 Such as, e.g., Mansfield Hardwood Lumber Co. v. Johnson, 268 F.2d 317 (5th Cir. 1959), and International Ticket Scale Corp. v. United States, 165 F.2d 358 (2d Cir. 1948), a tax case. Judge Cardozo's early opinion in *German-American Coffee Co.*, 216 N.Y. 57, 109 N.E. 875 (1915), might be cited as a progenitor; and *cf.* even Miller v. Quincy, 179 N.Y. 294, 72 N.E. 116 (1904).

For the limited role of general statutory phrasing of the opposite sort, prohibiting intrusion into the internal affairs of foreign corporations, see KAPLAN, *supra* note 210, at 470-72.

229 What has helped, or should help, is the partial loosening of the strict "internal affairs equals law of state of incorporation" connection made in the *Restatement,* in favor of its generic reference to the law of the state of the more significant relationship in the "unusual case"; see the formulations in its §§ 302-310.

It should also be remembered that the "police power" concept, mandating the application of specific local law, can fulfill some of the functions of the *ordre public* exception; see, e.g., E.C. Warner v. W.B. Foshay Co., 57 F.2d 656 (8th Cir. 1932).

230 See, e.g., NUTTING, "Suggested Limitations of Public Policy Doctrine," 19 *Minn. L. Rev.* 468 (1935), reacting to the first *Restatement, Conflicts,* and supported in KAPLAN, *supra* note 210, at 468. For the same antipathy in the private international law arena, see KATZENBACH, "Conflicts on an Unruly Horse: Reciprocal Claims and Tolerances in Interstate and International Law," 66 *Yale L.J.* 1087 (1956).

231 Supreme Council of the Royal Arcanum v. Green, 237 U.S. 531 (1915); see *infra* pp. 103-06.

tion[232] and by his simultaneous effort to turn his proposals into law at the state level through the 1955 revision of the North Carolina Business Corporation Act.[233] This, according to him, was "perhaps the first in any state designed to discourage incorporation under the laws of states with lax corporation laws for the purpose of evading the local law."[234] While this segment of the overall revision was not adopted by North Carolina, a weakened version of it did become a feature of the New York revision of 1961.[235] *Latty* originally intended to make a large number of the protective features of the new code applicable to those corporations which under the code's definition were essentially North Carolina enterprises: the stringent directors' indemnification provisions; liability for forbidden dividends, share repurchases and loans; the new fiduciary standards and more.[236] The New York provision, as finally adopted, was less ambitious but did provide for the application of certain remedial sections to all foreign corporations, rather than only to pseudo-foreign corporations as, again, originally proposed by its drafters.[237] Indeed, the statute makes directors and officers of all foreign corporations liable for distributions by way of dividends or share repurchases that violate New York law,[238] and even can be construed to permit actions against such persons for violations of New York's standards of prudence and loyalty governing directors' and officers' conduct generally.[239]

This particular move towards specific conflict rules tied to specific substantive rules of the forum has culminated for now in the much reviewed § 2115 of the California Corporations Code,[240] which first carefully limits its defini-

232 LATTY, *supra* note 168.

233 *Id.;* see also HENN, "The Philosophies of the New York Business Corporation Law of 1961," 11 *Buffalo L. Rev.* 439, 455 n.109 (1962).

234 LATTY, POWERS & BRECKINRIDGE, "The Proposed North Carolina Business Corporation Act," 33 *N.C.L. Rev.* 26, 50 (1954).

235 LATTY, "Some General Observations on the New Business Corporation Law of New York," 11 *Buffalo L. Rev.* 591, 608 (1962).

236 *Id.* at 610-12.

237 Note, "Particular Problems Under the New York Business Corporation Law," 11 *Buffalo L. Rev.* 615, 680-84 (1982).

238 N.Y. Bus. Corp. L. § 1317; *cf.* Note, *supra* note 237, at 681.

239 Inapplicability of New York law to "pseudo-foreign" corporations whose shares are listed on a national exchange is provided by § 1320, but this "inapplicability" does not extend to derivative actions on behalf of foreign corporations – under § 626; see *supra* note 224 – and this may mean that substantive New York law governing fiduciary duties also can be applied. While the statutory duty of care (§ 717) would not necessarily apply, the "loyalty" issues may come in via § 626 and the remedial § 720. *Cf.* the inconclusive discussion in Note, *supra* note 237, at 682.

240 See the full though slightly tendentious analysis in HALLORAN & HAMMER, "Section 2115 of the New California General Corporation Law – The Application of California Corporation Law to Foreign Corporations," 23 *UCLA L. Rev.* 1282 (1976).

tion of foreign corporation to reach only those with substantially more contact with California than with any other jurisdiction; and then catalogues the substantive provisions applicable to such corporations:

- annual election of directors
- removal of directors without cause
- [grounds for] removal of directors by court proceedings
- filling of director vacancies [to ensure early shareholder involvement therein]
- [aspects of] directors' and shareholders' liability for unlawful distributions [by way of dividends and share repurchases]
- indemnification of directors and officers
- limitations on distributions by way of dividends or share repurchases
- requirements for annual shareholders' meetings and remedies for breach
- cumulative voting
- limitations on sale of assets, reorganization and merger transactions
- dissenters' rights following corporate reorganization
- reporting obligations and inspection rights
- action by Attorney General to redress violations of certain rights.

Again, these provisions are rendered inapplicable by certification of the Commissioner of Corporations if the company involved has its securities listed on a national exchange, but so far at least, sparing use has been made of this power.[241]

C. The Constitutional Debate: Conflicts of Obeisance and the Role of the Full Faith and Credit Clause

The statutory extension of forum law to such elements of the internal affairs of a foreign corporation eventually needs to fit within the constraints imposed by that forum's existence within a federal system. In the United States that test is administered not by the Commerce Clause, but by the more specific Full Faith and Credit Clause, set forth in full above (§ III.B.1.d). The degree to which the Clause mandates any given choice-of-law rule of a member state, and specifically the internal affairs rule in corporation law, is not completely settled, though at least as to the type of collision generated by the New York and California statutes the lines are fairly clear.

[241] See Wilson v. Louisiana-Pacific Resources, Inc., 138 Cal. App. 3d 216, 187 Cal. Rptr. 852 (1982), the first reported case upholding the constitutionality of § 2115 (contrary to the assumptions of the litigants and court, there had been no certification of the stock exchange).

1. Conflict Characterization of Substantive Corporation Law: Introduction

European literature, directed to an analogous problem in the area of antitrust law, at one time distinguished between conflicting rules that create two hurdles, with the lower one not inconsistent with the demands of the higher,[242] and conflicting rules that create genuine conflicts of obeisance, with one mandating what the other forbids.[243] While it is an incomplete and inadequate analogy, one can say, roughly, that it is the function of the Full Faith and Credit Clause to prevent excessively costly collisions of the latter kind. To the extent that, in the first example, the lower hurdle is a creation of the central, rather than a sister jurisdiction, and reflects a belief that the person subject to that lower hurdle should not be subject to a higher one, it would be the function of the Commerce Clause to give effect to that belief. That effect, however, cannot legitimately be imposed in the case of differing (as against absolutely conflicting) legislative or judicial policy judgments – hurdles – of coequal sovereign states.[244] In other words, while the Full Faith and Credit Clause may well be

[242] See the description in KOCH, "Das Verhältnis der Kartellvorschriften des EWG-Vertrages zum Gesetz gegen Wettbewerbsbeschränkungen," 14 *Betriebs-Berater* 241 (1959), where the concept, in its modern use, originated. On its subsequent transformation see W. MÖSCHEL, *Recht der Wettbewerbsbeschränkungen*, para. 133, pp. 89-90 (Cologne 1983).

[243] See BUXBAUM, "Securities Regulation and the Foreign Issuer Exemption: A Study in the Process of Accommodating Foreign Interests," 54 *Cornell L. Rev.* 358, 372 (1969); *cf.* 3 A. EHRENZWEIG & E. JAYME, *Private International Law* 27-29 (Leyden 1977), placing the concept in its general private international law context.

[244] During the New Deal period a somewhat more aggressive role was envisaged for the Full Faith and Credit Clause, as is clear from the classic address by [Justice] JACKSON, "Full Faith and Credit – The Lawyer's Clause of the Constitution," 45 *Colorado L. Rev.* 1, 17 (1945): "[The Full Faith and Credit Clause] was placed foremost among those measures which would guard the new political and economic union against the disintegrating effects of provincialism in jurisprudence. . . . "

The amendment of the Judiciary Act of 1790 in 1949 to include "public acts" (i.e., statutes) in the catalogue of respected state actions, 28 U.S.C. § 1738, was taken by some at that time to confirm this strong role. Thus, see CHEATHAM, "A Federal Nation and the Conflict of Laws," in *Lectures on the Conflict of Laws and International Contracts* 193, 197 (Ann Arbor 1951; repr. Buffalo 1982). This view, which was explicitly tied to Commerce Clause considerations in HOROWITZ, "The Commerce Clause as a Limitation of State Choice-of-Law Doctrine," 84 *Harv. L. Rev.* 806 (1971), still informs the analysis of KOZYRIS and DEMOTT, *supra* note 220.

See also HAY, "Full-Faith-and-Credit and Federalism in Choice of Laws," 34 *Mercer L. Rev.* 709, 723 (1983), speaking of a full faith and credit problem: "Federalism implies a mutual deference among the states, not only vertical deference." See the similar argument, in a non-uniform trademark law context, of A. VON MÜHLENDAHL, *Territorial begrenzte Markenrechte und einheitlicher Markt* 219-48

a more specific, more sharply focused constraint on exorbitant forum choice-of-law adventures than the Commerce Clause, that latter Clause under at least some circumstances could come into play and invalidate state legislation even in this field of corporation law when the same state law would not violate the Full Faith and Credit Clause.

Before exploring this basic question in more detail, it is necessary to review the mentioned typical corporation code choice-of-law rules to categorize them properly according to the degree to which they can generate even the two-hurdle let alone the conflict-of-obeisance problem. And before doing this, it is necessary to recall already here a fact of life to be examined in more detail later: As to many substantive provisions there is already so much uniformity among the states that what differences remain can be ascribed more readily to the accident of the date of the most recent recodification effort than to purposeful differentiation. The difference this fact makes to the analysis will be evident in the following detail.

2. Conflict Characterization: The Peripheral Problems

Most of the substantive rules applied via the choice-of-law provision do not rise even to the dignity of the first type. Code provisions granting shareholders rights of information and of inspection of records, and providing techniques and remedies to implement those rights, may create trivial management costs to the corporation but not problems of company law policy. No corporations code trumpets a managerial right to silence or a prohibition on shareholders' inspection rights. Rather, the differences, to the degree they are not simply inadvertent or related to the opportunity or lack of opportunity to develop some meaningful interpretive jurisprudence, are at the most due to relatively minor differences in cost-benefit judgments. Whether all or only a certain size of corporations should provide audited rather than unaudited statements might be as substantive a difference as this type of provision can reflect,[245] and that is hardly the kind of difference which can be dignified even with a burden analysis under the Commerce Clause let alone with the dilemma analysis necessary under the Full Faith and Credit Clause.[246] This conclusion is all the

(Cologne 1981). See also generally HAY, LANDO & ROTUNDA, "Conflict of Laws as a Technique for Legal Integration," in I/2 *Integration Through Law* 161, 208-32 (Berlin/New York 1986).

[245] See, e.g., the detailed prescription in Calif. Gen. Corp. Law § 1500(a), (d).

[246] This assumes, *arguendo*, that, however attenuated, a link between something like a shareholder's inspection right and an effect on interstate commerce can be conceived. *Cf.* G.D. Searle & Co. v. Cohn, 455 U.S. 404 (1982), for a current sense of the outer reach of the Commerce Clause argument in the case of technical corporation law provisions (in that case even discriminatory ones); *Valtz v. Penta*, 139 C.A.3d 803, 188 Cal. Rptr. 922 (1983).

more warranted if the local rule – an information requirement, for example – only applies if a substantial number or even majority of shareholders are residents of the aggressive forum, as is the case, for example, with § 2115 of the California Corporations Code.[247]

Even a "procedural" burden of this sort can be based upon a purpose that goes beyond the bounds of the kind of enlightened free enterprise philosophy which is adorned rather than impeded by a "full disclosure" requirement. The inspection right, for example, might be granted to creditors or employees. While not everyone would call this socialism, such a grant could generate at least the kind of "efficiency" debate which state takeover legislation has generated. To this issue, too, then, the implications of the recent Supreme Court opinion in *Edgar v. MITE Corporation* might be relevant.[248] While these are discussed in detail below,[249] it should be obvious even now that those implications – i.e., those Commerce Clause considerations – do not cloud the right of states to impose the kind of local information rules that exist today, given their minimal variation from those of any other jurisdiction.

Another type of local provision fits within this "minimal burden" group – the availability of a particular legal process, the derivative suit, to the shareholders of even a foreign corporation. Part of the reason for this conclusion, again, is based on the fact that every American jurisdiction knows and provides this action.[250] The differences, if they exist, are at highly refined levels of detail: who may bring the action; the formal prerequisites to its maintenance; when, if ever, is the plaintiff required to give security for costs; the formal conditions under which the directors may compromise and settle or approve dismissal of an already instituted action; etc. Some of these elements are procedural ones, which under general conflicts principles are subject to the law of the forum.[251] Others, though generally called substantive, or at least outcome-determinative under the special choice-of-law analysis used by federal

247 BUXBAUM, "The Application of California Corporation Law to Pseudo-Foreign Corporations," 4 *Calif. Bus. L. Rptr.* 109, 112 (1983).

248 *Supra* note 71.

249 See *infra* pp. 137-48.

250 And equally to the point, typically specifically authorized suits on behalf of foreign corporations – probably on the justified assumption of uniformity. See *supra* note 224, and *cf.* 2 *Model Business Corporation Act Annotated,* Commentary to § 7.40 (ABA Committee on Corporate Laws, 3d ed., St. Paul 1986).

251 See, e.g., Kaufman v. Wolfson, 136 F. Supp. 939 (S.D.N.Y. 1955) (contemporaneous ownership). The problem arises most frequently in the context of federal diversity jurisdiction because of the specific impact of Fed. R. Civ. P., Rule 23.1. *Cf.* Picard v. Sperry Corp., 120 F.2d 328 (2d Cir. 1941); HFG Co. v. Pioneer Publishing Co., 162 F.2d 536 (7th Cir. 1947). See generally "Developments in the Law – Multiparty Litigation in the Federal Courts," 71 *Harv. L. Rev.* 874, 950 (1958); Note, 40 *Calif. L. Rev.* 433 (1952); see also the discussion *infra* text accompanying note 262.

courts exercising diversity jurisdiction,[252] again do not reflect such significant philosophical differences among the states as to engender even a burden let alone a dilemma analysis. It is one thing, with *Hausman v. Buckley*,[253] to refuse to entertain a derivative action on behalf of an alien corporation not otherwise significantly connected with New York, when the law of its state of incorporation does not even recognize the *actio pro socio* in the first place.[254] It is another to find even in that case a policy sufficient to override a New York statutory command to make the procedure available in such a situation[255] – and as it happens, such a statutory command exists[256] and has been used.[257] Again the reverse hypothesis is instructive: The derivative suit concept is not so substantive that in a case involving a foreign corporation a forum court would have to make it available by reason of the internal affairs conflicts rule were it otherwise unknown to the law of the forum.

The only problem that these derivative suit code sections really can cause in cases involving foreign corporations is rather more subtle, and is better seen as part of the third group of conflicting laws, that involving a substantive dif-

252 The leading case still is Cohen v. Beneficial Industrial Loan Corp., 337 U.S. 541 (1949).

253 *Supra* note 224; but *cf.* Hirshhorn v. Hirshhorn, 112 N.Y.S.2d 841 (N.Y.A.D. 1952).

254 This aspect is discussed in KAPLAN, *supra* note 210, at 461-64; the most assertive statement of the point is that of 2 A. EHRENZWEIG & E. JAYME, *Private International Law* 127 (Leyden 1973); and see the recent historical review of this "local procedure" issue in FASSBERG, "The Forum: Its Role and Significance in Choice-of-Law," 84 *ZVerglRW* 1, esp. at 9 ff. (1985).

255 To the extent that *Hausman v. Buckley* rests on a *forum non conveniens* argument, that prudential ground for dismissal would remain available to the New York court unless itself explicitly countermanded by statute. *Cf.* the general discussion in Panama Processes, S.A. v. Cities Service Co., 650 F.2d 408 (2d Cir. 1981) (direct suit between alien and American corporate parents of Brazilian subsidiary dismissed, over persuasive dissent, on *forum non conveniens* grounds). But *cf.* Rocha Toussier y Asociados, S.C. v. Rivero, 457 N.Y.Supp. 2d 798 (A.D. 1983), accepting local derivative suit despite doubtful foreign association receiver's status; and see the analogous cases cited *supra* note 220.

For recent discussion of the FNC concept generally, see Comment, "Forum Non Conveniens and American Plaintiffs in the Federal Courts," 47 *U. Chi. L. Rev.* 373 (1980). It can be argued, perhaps ironically, that the resurgent use of the *forum non conveniens* notion to avoid difficult choice-of-law issues, *per* Piper Aircraft v. Reyno, 454 U.S. 235 (1981), amounts to a full circle return to the origins of the internal affairs doctrine as a forum derogation method; *cf.* KAY, "Theory Into Practice: Choice of Law in the Courts," 34 *Mercer L. Rev.* 521, 584 (1983).

256 N.Y. Bus. Corp. Law § 1319(a)(2)(1963).

257 *Norlin v. Rooney*, 744 F.2d 255 (2d Cir. 1984). While the 1963 statute purportedly tracks the old law in part, it is more explicit on this derivative suit point (a difference which may explain the different outcome from that in *Hausman v. Buckley*, 299 F.2d 696 (2d Cir. 1962).

ference though not yet a true conflict of obeisance. A prime example of this group is the already mentioned interpretation of the New York rule which might apply local standards of care and loyalty in cases involving foreign corporations.[258] Loyalty cases – i.e., conflict-of-interests cases – not cases of actionable negligence, are the typical ones; and the most important issue in these cases is the (increasingly statutory) procedure by which a board of directors can convert a self-interested into a disinterested decision, typically either by delegating the decision to a smaller group of disinterested directors or by permitting its proponents to prove that the challenged decision is "fair" in a sense somewhat more stringent than that applicable under the so-called "business judgment rule" to fully disinterested decisions. The substantive law of loyalty increasingly is subsumed within this procedural context; and thus, to the extent that that procedure is explicitly applied to litigation involving foreign corporations, the local substantive law of "fairness" applies in such cases.[259]

At present, this situation has resulted in an oddly bifurcated set of rules in derivative litigation involving a foreign corporation. If no special conflicts rule governs derivative suits as such, the only recourse to local standards governing conflict-of-interests decision-making would reside in this separate curative statute. These, however, generally do not apply to foreign corporations.[260] A statutory or common law curative rule of the forum, that converts interested into disinterested decision-making by delegating the right to decide either horizontally to a smaller group of disinterested directors or vertically to (disinterested) shareholders,[261] would not itself be directly available in this situation. Yet in an indirect but more important sense this rule is available, if the forum court reads its derivative suit statute – which does apply to foreign corporation cases[262] – to permit the thwarting of such actions if an analogous independent decision to block the suit was made by similarly situated directors or shareholders of the foreign corporation. The converse, it is true, does not

[258] See *supra* 89.

[259] See to this merger problem BUXBAUM, "Conflict-of-Interests Statutes and the Need for a Demand on Directors in Derivative Actions," 68 *Cal. L. Rev.* 1122 (1980). An indirect recognition of this conjuncture, and an instrumental rule honoring it, recently was provided for the important Delaware-incorporated entity in Zapata Corp. v. Maldonado, 430 A.2d 779 (Del. 1980). Both the Second and Third Circuits since then have applied this approach in cases nominally subject to other state or federal law; see Joy v. North, 692 F.2d 880 (2d Cir. 1982) and Lewis v. Curtis, 671 F.2d 779 (3d Cir. 1982). More recently, however, the Delaware Supreme Court has undercut its own innovation, at least indirectly, in Aronson v. Lewis, 473 A.2d 805 (1984).

[260] Indeed, this seems to be the case throughout. These statutes are collected and analyzed in BULBULIA & PINTO, "Statutory Responses to Interested Director Transactions: A Watering Down of Fiduciary Standards?," 53 *Notre Dame Law.* 201 (1977).

[261] These are two of the three approaches made alternatively available by these statutes.

[262] See *supra* note 251.

necessarily hold. If forum rules would permit the action to proceed despite such a decision, it could conceivably still founder when the merits are reached and the actual similarly effected transaction decision is judged, under the law of the state of incorporation, under the more lenient business judgment rule.[263]

This assertion is based on the possibility that the forum court would interpret the forum derivative suit statute's express application to foreign corporations to supply also the standards by which such management blocking tactics should be evaluated. In fact, all courts that have dealt with such transactions have collapsed the analysis and applied the "substantive" foreign law concerning directors' decisions blocking the maintenance of derivative suits.[264] It is important to distinguish from the foregoing the preexisting, also uniform requirement that a shareholder seeking to institute a derivative suit make a demand on the board of directors to bring the action directly or plead specifically why the demand should be excused (typically, if "futile," because of the self-interest of the *sued* directors to respond negatively to that demand). The rules governing the meaning of "futility" or "excuse of demand," again, could be characterized as procedural under the compulsion of the forum's derivative suit statute, but in fact often are silently deemed substantive and taken from the jurisprudence of the state of incorporation.[265]

The other curative mechanism of these substantive conflict-of-interests statutes is for the proponents of the transaction to meet the burden of proof that the challenged transaction is "fair" or some similar term of art suggesting a standard higher than that of actionable imprudence in business judgment

263 As would be the case in a Delaware forum if the "judicial business judgment" exercise required under *Zapata, supra* note 259, came to a result different from, and thus overriding, the "independent directors' business judgment" to block the suit.

264 See the recent analysis (of what is still a fluid situation) in AMERICAN LAW INSTITUTE [ALI], *Principles of Corporate Governance and Structure: Restatement and Recommendations,* Annot. to § 7.03 ("Termination of Derivative Action on the Basis of Board or Shareholder Action"), pp. 295-350 (Tentative Draft No. 1, Philadelphia 1982).

265 See, however, the more complex or at least more confused situation in federal diversity jurisdiction, *supra* text at pp. 84-88 and notes 251 & 252; and the following recent statement from Susman v. Lincoln American Corp., 550 F. Supp. 442, 446 n.6 (N.D. Ill. 1982) (on the issue of the standing of a shareholder of a company disappearing in a merger):

> To bring state-law-based derivative claims in federal court, it is entirely possible that Susman must satisfy the standing requirements of both Rule 23.1 and Delaware law. After all, Rule 23.1 could be viewed as a federal procedural question, while the Delaware statute could require standing as a matter of substantive law. But cf. Schilling v. Belcher, 582 F.2d 995 (5th Cir. 1978) (reserving judgment on whether the issue of derivative standing is governed by federal or state law).

terms. In this situation it is more common and more understandable to derive the substantive meaning of "fairness" from the jurisprudence of the state of incorporation. This happens to be a common law jurisprudence. While almost no state has codified a definition of the fiduciary duty of loyalty, all jurisdictions have generated some case-law fleshing out the content of that duty, at least as applicable in various recurring transaction categories such as ordinary self-dealing, usurpation of corporate opportunities, sale of control and so forth. As a result, however, each court tends to see its case-law as reflective of uniform substantive rules in *Ehrenzweig*'s "moral data" sense,[266] and to yield to the rules of the state of incorporation only in rare instances. Most uses of a forum's curative statute, under either the "disinterested decision" or the fairness prong thereof, can thus be expected to lead to use of the forum's substantive law.

3. Conflict Characterization: Substantive Disputes

At the present stage of forum choice-of-law claims in corporation law, then, it is not the relatively rare claim of application of local derivative suit procedures that matters, given their rarity and the availability of fairly similar procedures in all jurisdictions. It is, rather, the much more prevalent choice-of-forum-law rule hidden in these common curative statutes; and there, in turn, it is the potential for the application of substantively different definitions of "fairness" that matters, not the relatively unproblematic possibility that forum law allowing different formal curative procedures might be applied to the internal affairs of a corporation whose home state law recognizes no such possibility. In short, it is a forum's application of its more (or less) stringent substantive law of fiduciary managerial duty to the decisions of a foreign corporation that typifies this third group and deserves separate treatment.

If that forum law imposes a higher standard of loyalty (or care) on the management of a foreign corporation, a genuine two-hurdle situation is created. It is, however, only a two-hurdle case, not a dilemma case; the home state's law certainly poses no problems to a management honoring the foreign forum's standards, or subject to injunctive relief or even a judgment for damages because of a derivative suit brought by a shareholder there at the instance and for the benefit of the corporation. What is involved, rather, is a question of burden. We have asserted and assumed, above,[267] that burden issues, when caused by the differing actions of coequal state sovereigns, are not disruptive enough to trigger federally imposed harmony via the Full Faith and Credit Clause; that, at most, they might cause a superior sovereign entity within a federal system statutorily to preempt inferior bodies' inconsistent legislation

[266] *Supra* note 223.
[267] See *supra* pp. 91-92.

under federal supremacy principles. Whether that is a correct or defensible reading *de lege lata* will be considered below; for the moment it is enough to identify the category.

The two-hurdle or burden issues can, however, in extreme cases generate Commerce Clause arguments,[268] and thus should be scrutinized within some framework of values in the sense of the earlier discussion.[269] The possibility that *laissez-faire* values animate the Commerce Clause and its preemption of regulatory state law obviously will be relevant to this analysis as well. Even so it seems clear that variously stringent definitions of fiduciary standards can be propounded by statutes all of which share a common underlying adherence to a free market economy. The most that could be said against such stringent standards is not that any given one is incompatible with the efficient allocation of resources – for that concept depends upon and does not dominate a given set of legal rules – but that the uncertainties created by the potential application of differing fiduciary standards to management muddy investment decisions somewhat and make investment signals harder to hear clearly. Whether that categorical objection can rise to a level of pathos triggering constitutional relief is best left to a discussion of those more serious conflicts among substantive rules found in the fourth group, the group of true conflicts of obeisance.[270]

4. Conflict Characterization: The Classic Case of Cumulative Voting

The most important and perhaps only example of that group stems from California's application of its own mandatory rule of cumulative voting for the election of directors to those corporations within the definition of "pseudo-foreign" entities under § 2115.[271] This happens, at the same time, to be the substantive rule at issue in the only American decisions that have considered the implications of the Full Faith and Credit Clause in a modern company law context, the well-known and often-analyzed case of *Western Airlines, Inc. v. Sobieski*[272] and the more recent *Wilson v. Louisiana-Pacific Resources, Inc.*[273]

Cumulative voting by shareholders is a version of proportional representation attaining results similar to those available under the *d'Hondt* method used

[268] See the good discussion of this point in *Wilson v. Louisiana-Pacific*, 138 Cal. App. 3d 216, 187 Cal. Rptr. 852 (1982).

[269] *Supra* pp. 43-62.

[270] See *supra* note 243.

[271] *Supra* pp. 89-92.

[272] 191 Cal. App. 2d 399, 12 Cal. Rptr. 719 (1961); its sequels are Western Airlines, Inc. v. Schutzbank, 258 Cal. App. 2d 291, 66 Cal. Rptr. 293 (1968) and People v. Western Airlines, Inc., 258 Cal. App. 2d 286, 66 Cal. Rptr. 316 (1968). For discussion see KAPLAN, *supra* note 210, at 453-55.

[273] 138 Cal. App. 3d 216, 187 Cal. Rptr. 852 (1982).

in Europe for political balloting. Each shareholder has as many votes available as equal the product of the number of shares held times the number of directors' seats at issue, and may cast them all for one candidate or disperse them among as many as is desired.[274] Unit voting, on the other hand, permits only the casting of so many votes as equal the shares owned, a voting process repeated for each vacancy (or – it would make no difference on the issue we are discussing – cast once for a slate of candidates). Under cumulative voting some level of minority representation on a board of directors is possible; unit voting on the other hand permits the holder(s) of 51% of the voting shares to elect 100% of the board of directors.

For a company potentially subject to both rules of voting, a conflict of obeisance arises in two senses. First is the formal problem that the same election, the same event, may be subject to conflicting mandates; it is not possible to vote both ways at the same time in the sense of obtaining congruent results.[275] Either directors A through G are elected or A through D plus H, I and J or some variant thereof. By contrast, a management transaction valid under the more stringent of two rules also is valid under the less stringent. In short, the cumulative voting dilemma cannot be treated as a two-hurdle problem.

In the second place, both the efficiency and the fairness considerations which may be trivialized in the prior examples cannot be shrugged off so lightly in this case. The expectations of a major shareholder that full domination of the board can be achieved with at least 51% of the share ownership if not, practically, with even less, are certainly disappointed in a significant sense once the local forum's rule of mandatory cumulative voting is applied to a foreign corporation. The state of incorporation's unit voting rule may or may not represent a conscious policy choice of majoritarianism; it is enough that a hypothetical investor may place more weight, more expectations, in that rule than is the case with the less serious groups of conflicts previously discussed.

But disappointed investor expectations do not rise to the level of constitutional claims unless they involve the taking of property without due process of law or the denial of the equal protection of the laws. Since the abandonment of substantive due process scrutiny as well as of rigorous equal protection scrutiny in the area of shareholder property rights within the corporate structure, these claims have been unsuccessful. For historical reasons this special case of intrusion on shareholder expectations through the statutory change of governance ground rules was analyzed as an impairment of contracts problem,

[274] See generally C. WILLIAMS, *Cumulative Voting for Directors* (Cambridge 1951); JENNINGS & BUXBAUM, *supra* note 194, at 275-87.

[275] See the transactions in Arden-Mayfair, Inc. v. Louart Corp., 385 A.2d 3 (Del. Ch. 1978) and Palmer v. Arden-Mayfair, Inc., 47 U.S. Law Week (Gen.) 2055 (Del. Ch. 1978).

a problem eliminated with the adoption of the so-called "reserve power" in state constitutions after the *Dartmouth College* case.[276] It is not the particular investor but the protected institution, be it private investment or the private enterprise economy, or be it the non-contentious functioning of courts, legislatures and agencies in a dual sovereign system, whose claims can even trigger an analysis under the more institutionally oriented Full Faith and Credit Clause and possibly, lurking behind it, the Commerce Clause.

This situation should not be confused with the survival or resurrection of constitutional protection of the *corporation's* right to exercise powers granted with the charter, and attacked by later conflicting state action. Though *Dartmouth College* characterized this relationship, too, as a contract (and thus subject to "reserve power" control), the ascription of personhood to the corporation for Fourteenth Amendment purposes, culminating but not commencing with *Santa Clara County v. Southern Pacific Railroad*,[277] prerrode this approach to retaining state police power control over undesirable exercises of corporate power.[278]

[276] Trustees of Dartmouth College v. Woodward, 17 U.S. (4 Wheat.) 518 (1819). For a full discussion of the impact of this reservation of power on the expectations of shareholders in the sense discussed in the text, see the two classic judicial expositions, McNulty v. W. & J. Sloane, Inc., 184 Wisc. 835, 54 N.Y. Supp. 2d 253 (1945) and Bove v. Community Motel Corp., 105 R.I. 36, 249 A.2d 89 (1969). See also the recent thorough review in CARNEY, "Fundamental Changes, Minority Shareholders, and Business Purposes," 1980 *Am. Bar Found. Res. J.* 69.

[277] 118 U.S. 394 (1886).

[278] See the recent interesting analysis of the transition from the Contract Clause to due process and equal protection as the doctrinal vehicle for this change in outlook, in KAINEN, "Nineteenth Century Interpretations of the Federal Contract Clause: The Transformation From Vested to Substantive Rights Against the State," 31 *Buffalo L. Rev.* 381, 461 ff (1982).

It is worth noting here, if only for the historical analogy, that at least before the Civil War not all states followed the federal courts' (and other states') "inevitable" use of the Contract Clause to protect corporations from early use of state police power control. See in particular the following passage from L. LEVY, *The Law of the Commonwealth and Chief Justice Shaw* 279-80 (Cambridge 1957):

> When the work of the Shaw Court in relation to the contract clause is considered as a whole, the fact that astonishes is the limited serviceability of that clause as a bulwark to vested rights. If there was a link between capitalism and constitutionalism, it was the contract clause as construed by the Supreme Court, whether under Marshall or Taney. Brookes Adams once commented that the 'capitalist . . . regards the constitutional form of government which exists in the United States, as a convenient method of obtaining his own way against a majority . . .' [BROOKES ADAMS, *The Theory of Social Revolutions* (New York, 1914), p. 214]. Before the substantive interpretation of due process of law – an interpretation rejected by Shaw – the contract clause was the chief

There has been a minor revival of the Impairment of Contracts Clause, Article I, Section 10(1) ("no State shall . . . pass any . . . Law impairing the Obligation of Contracts . . .") recently, in transactions which possess some minor analogy to the type of transactions here at issue.[279] The cases, however, seem to add nothing substantively to the rules derived from the other constitutional provisions discussed herein,[280] although in its own terms this new jurisprudence does suggest that the Supreme Court is toying with "substantive due process" considerations even in economic affairs – a development once thought to be long abandoned but apparent in other areas as well as this one.[281]

Western Airlines, Inc. v. Sobieski[282] is the prototype of this fourth group of transactions. A corporation originally incorporated in California had many years previously reincorporated in Delaware (under circumstances permitting an argument that it had accepted the continuing jurisdiction of the California Blue Sky Agency in a manner perhaps not binding upon other foreign corporations). Almost thirty years later it proposed a shareholder vote to eliminate cumulative voting, mandatory in California but permissive rather than mandatory in Delaware. The Department of Corporations properly asserted that this change in the rights, preferences and privileges of the shares constituted a sale under the extremely broad definition contained in the California Corporate Securities Law;[283] that was not subject to dispute, being a simple question of statutory interpretation. The Commissioner of Corporations then denied Western Airlines' application for a permit on the ground that the change to unit voting was not "fair, just and equitable" in the terms of the then

> repository of doctrines of constitutional limitations upon the majorities' power to regulate the economy. Constitutional law at the federal-court level in the antebellum years was littered with the corpses of state enactments impaled on the contract clause. But not in Massachusetts. So far as the Shaw court is concerned, the 'basic doctrine of American constitutional law,' contrary to Professor Corwin, ["The Basic Doctrine of American Constitutional Law," in vol. 1 of *Selected Essays on Constitutional Law*, p. 101] was not the doctrine of vested rights. It was the doctrine of plenary police power.

279 See particularly United States Trust Co. v. New Jersey, 431 U.S. 1 (1977) and Allied Structural Steel Co. v. Spannaus, 438 U.S. 234 (1978); *cf.* "The Supreme Court – 1977 Term," 92 *Harv. L. Rev.* 1, 86-99 (1978).

280 See *infra* pp. 103 ff; see generally (and provocatively) POWE, "Populist Fiscal Restraints and the Contracts Clause," 65 *Iowa L. Rev.* 963 (1980).

281 For an interesting suggestion that the Commerce Clause jurisprudence may be the best analytical analogue for the inquiry "into the fairness and comity of an act of an interested state" under the Full Faith and Credit, Due Process or Equal Protection Clauses, see WEINBERG, "Choice of Law and Minimal Scrutiny," 49 *U. Chi. L. Rev.* 440, 446 n.31 (1982); *cf.* also HAY, *supra* note 244.

282 *Supra* note 272.

283 See now Calif. Sec. Law (Corp. Code) § 25017(a).

applicable and still governing statutory term of art governing the grant of the permit to "issue" shares. By doing so, the Commissioner in essence applied California's mandatory cumulative voting law to the internal affairs of this Delaware corporation, on policy grounds that, of course, had to do with the substantial (though by no means predominant) connection of the company to California. The Commissioner's action was upheld by an intermediate appellate court, again on the basis of the (misleadingly designated) pseudo-foreign character of the company; no full-faith-and-credit argument concerning the refusal of the court to apply the law of the state of incorporation to this transaction was debated.

It is clear, of course, that this was in essence a common law choice-of-law decision. The Corporate Securities Act contained no choice-of-law provision of its own at the time,[284] and the Commissioner's decision to promulgate a regulation so interpreting the act[285] was no more compelled than a common law judicial decision would have been. At the most, judicial deference to administrative interpretation of a delegation of authority contained in a statute for which that agency has administrative responsibilities is a minor factor distinguishing this instance from the classic case. This, then, is a situation in which the company was refused permission to conduct the shareholders' election of the board of directors in a manner which the law of the state of incorporation would have permitted.

It is not, however, a case in which the law of that state mandated unit voting. That mandate either would spring from a specific statutory prohibition of cumulative voting,[286] or from a judicial decision interpreting the permissive law and the charter choice thereunder of that specific voting method as mandating unit voting. In the field of corporation law only the latter situation has arisen so far,[287] and it is this situation – the involvement of the courts and

[284] It did and does have outer limits of applicability, of course, such as those limiting regulatory scrutiny to sales transactions in the state; see, e.g., Calif. Sec. Law (Corp. Code) § 25110, as defined in § 25008. These, however, do not bear on the character of the corporation but of the investment transaction.

[285] At the time, Calif. Adm. Code, § 367.1, Tit. 10, *reprinted in* CCH Blue Sky Law Rptr., para. 8617.

[286] See, e.g., (and perhaps only) the statute so interpreted in State *ex rel.* Kearns v. Rindsfoos, 161 Ohio St. 60, 118 N.E.2d 138 (1954).

[287] The impairment of contracts doctrine was used to this effect in State *ex rel.* Swanson v. Perham, 30 Wash. 2d 368, 191 P.2d 689 (1948). It was overruled, however, on modern "reserve power" concepts (see *supra* note 276) in Seattle Trust & Savings Bank v. McCarthy, 94 Wash. 2d 605, 617 P.2d 1023 (1980). That Court made the additional observation, relevant to the discussion of the full faith and credit issue in the text immediately following, that no shareholder not directly owning a majority of the voting stock had any right in the expectation of coalition voting that rose even to the level of a claim whose defeat would need the heavy artillery of the reserve power argument; *id.* at 1026 n.2.

therefore the judgments of two sovereign states – which provides an opportunity for analysis of current federal constitutional doctrine.[288]

D. The Constitutional Issue

1. The Precedents and Their Significance

The corporation law full-faith-and-credit cases are few and according to current consensus no longer fully respectable.[289] The broader full-faith-and-credit doctrine, fruitfully confused if not enriched by a major recent Supreme Court opinion,[290] has moved away from many of the assumptions underlying these few and older special cases.

[288] It also provides an opportunity for critical reexamination of the position of the *Restatement (Second), Conflict of Laws* on its own § 302, paragraph (2) of which does allow common law intrusion of the law of the state with the "more significant relationship" into the monopoly of the law of the state of incorporation. Comment (a) thereto (p. 307) extends this possibility to a range of internal affairs including cumulative voting; but Comments (e) and (g) (at pp. 309-12) then take most – not all, see Illustration 2 – of this freedom away, but with the assertion that,

> [i]n addition, many matters involving a corporation cannot practicably be determined differently in different states. Examples of such matters, most of which have already been mentioned in Comment *a*, include . . . methods of voting including any requirement for cumulative voting. . . .

See also, in this mode, YOUNG, "Federal Corporate Law, Federalism, and the Federal Courts," 41 *Law & Contemp. Prob.* 146, 148 (Summer 1977). See also *infra* note 458, last paragraph.

From the private law perspective of interstate and international conflict of laws, see the respective criticisms of this approach in KAPLAN, *supra* note 210, at 440-41 and SANDROCK, *supra* note 155, at 200 n.64, 226-27. *A fortiori*, the apotheosis of such a rule through constitutional dictates should be viewed even more sceptically.

[289] See the full and still valid historical and analytical discussion in WEINTRAUB, "Due Process and Full Faith and Credit Limitations on a State's Choice of Law," 44 *Iowa L. Rev.* 449 (1959), *reprinted* in revised form as ch. 9 of R. WEINTRAUB, *Constitutional Limitations on Choice of Law* 495-547, esp. at 529-30 (2d ed., Mineola 1980); see also KAPLAN, *supra* note 210, at 446.

[290] Allstate Ins. Co. v. Hague, 449 U.S. 302 (1981). For discussion, see, e.g., "Symposium," 10 *Hofstra L. Rev.* 1 ff (1981); BRILMAYER, "Legitimate Interests in Multi-State Problems," 79 *Mich. L. Rev.* 1315 (1981); HAY, LANDO & ROTUNDA, *supra* note 244, at 212-15.

All of these early cases – and they are only four in number[291] – concern exactly the type of "incomplete remedy" problem which led originally to the development of the internal affairs doctrine as a forum derogation clause. They concern mutual insurance companies, not ordinary corporations, and the problem of inconsistent state court reaction to bylaw changes or directors' resolutions bearing on the financial rights and obligations of the insured company members. A single quotation from the first of these cases should suffice to demonstrate both the source and the limits of the Court's concern that led it here to enshrine the "internal affairs" choice-of-law rule in the Full Faith and Credit Clause:[292]

> The contradiction in terms is apparent which would rise from holding on the one hand that there was a collective and unified standard of duty and obligation on the part of the members themselves and the corporation, and saying on the other hand that the duty of members was to be tested isolatedly and individually by resorting not to one source of authority applicable to all but by applying many divergent, variable and conflicting criteria.

Weintraub, who has provided the still authoritative doctrinal explanation of these cases, characterized this particular line as properly concerned with the question of the need for a uniform application of law in certain situations:[293]

> In many crucial areas there is need for national uniformity of conduct. . . . It is submitted then, that in order to determine whether the full faith and credit clause places a further limitation on a state's choice of law than is imposed by the due process clause, the interest of the state which gives it the reasonable contact essential under due process is to be weighed against the need for national uniformity in the solution of the particular controversy being litigated.

While this concept of uniformity, replacing an older "weighing" or "balancing" test, now has become accepted Supreme Court dogma,[294] it should be apparent that in and of itself it answers nothing concerning our particular problems of conflicting state law. It should by now be equally apparent that procedural and remedial concepts, particularly questions of preclusion of parties and issues, are at the heart of any individualized, properly discriminating dif-

[291] Supreme Council of the Royal Arcanum v. Green, 237 U.S. 531 (1915) (*supra* note 231); Modern Woodmen of America v. Mixer, 267 U.S. 544 (1925); Sovereign Camp of the Woodmen of the World v. Bolin, 305 U.S. 66 (1938); and Order of United Commercial Travelers of America v. Wolfe, 331 U.S. 586 (1947). These are presented and discussed in WEINTRAUB, *Constitutional Limitations, supra* note 289, at 524-30.

[292] *Supreme Council of the Royal Arcanum*, 237 U.S. at 542.

[293] WEINTRAUB, *Constitutional Limitations, supra* note 289, at 528.

[294] *Allstate*, 449 U.S. 302 (1981). Indeed, WEINBERG, *supra* note 281, suggests that not even this issue of "necessary uniformity" underlies current Supreme Court doctrine, but that only the relaxed standard of "minimal scrutiny" of rational purpose now exists.

ferentiation between truly intractable interstate conflicts and lesser though still unsettling problems of conflicting mandates. The cumulative voting transaction permits a demonstration of these points in sufficient detail. If a California court, properly and first seized of the action, held that forum law rather than the law of the state of incorporation governs the question of the manner of shareholder election of directors, and ordered a forthcoming election to be held under cumulative voting procedures, the only possible awkwardness that could arise would be a conflicting decision of a Delaware (or federal) court ordering unit voting. It is just this kind of *second* conflicting decision which the Full Faith and Credit Clause in this case bars Delaware from handing down, since the Clause applies preeminently to the judgments of a sister state, whatever the extent to which it applies to its statutes and records.[295] The critical question, in other words, is not whether two statutes or two judicial decisions require inherently incompatible action from a corporation, but whether such mundane requirements as *res judicata* or collateral estoppel exist and preclude a second inconsistent interpretation which might escape the otherwise preclusive effect of the Full Faith and Credit Clause. In this field, at least, the Clause is no more than a constitutional adjunct to ordinary problems of civil procedure; a recent Supreme Court opinion has amply reconfirmed this observation.[296]

The preceding discussion assumes a conflict between a common law conflicts rule of the state of incorporation (that the law of the state of incorporation governs the internal affairs of the corporation) and a statutory conflicts rule of the forum state (that the law of a state with certain significant relationships with the corporation governs certain internal affairs of the corporation). The discussion further assumes that a court of the "statutory" state first adjudicates a given dispute, and that the courts of the "common law" state then are bound by the Full Faith and Credit Clause to award that decision party-preclusive effect. The analysis is no different if either or both variables are reversed: if the state of incorporation statutorily mandates application of the law of the state of incorporation to the internal affairs of such a corporation, or if a court of the state of incorporation is first seized of a given cause. Were Delaware to codify its choice-of-law rule it would add nothing to a Delaware court's right to have its first judgment honored in California, or to its legal inability to ig-

[295] Despite the dissenting argument of WALKER, "A Criticism of Prof. Weintraub's Presentation of Full Faith and Credit to Laws," 57 *Iowa L. Rev.* 1248 (1972), this is the prevailing understanding of the statutory change in the phrasing of the 1949 implementing legislation, 62 Stat. 947, 28 U.S.C.A. § 1738, adding "acts" to the previous list of items deserving of full faith and credit (see *supra* note 244).

[296] *Allstate*, 449 U.S. 302 (1981). While critical of the development, the recent comprehensive analysis of the impact of *Allstate* in KOZYRIS, *supra* note 220, agrees (at 32) with this description. For a similar perception (that *Allstate* limits full-faith-and-credit analysis to "procedural due process"), see FASSBERG, *supra* note 254, at 42 ff.

nore an earlier California court's judgment. Conversely, a California court would be as bound by an earlier Delaware judgment (when the same parties relitigate an issue there that would be caught by *res judicata* or collateral estoppel principles were it relitigated before the earlier-seized court) as in the prior, "reverse" example.

There is one interesting though narrow escape from this preclusion argument just in the field of corporation law. It is possible that a state administrative agency, not involved in the first judicial hearing of a given transaction, may claim the right to reopen the transaction and, of course, to reach a different substantive result. An example would be a state securities regulation office reviewing the legitimacy of a transaction such as a merger or other structural decision effected under ordinary corporation law enabling provisions and already tested in a first judicial proceeding in a state other than that of the agency.[297]

It is obvious that a race to the courthouse is a potential and potentially ugly aspect of this element of the American federal system. Indeed, the competitive litigation problem is even more aggravating than this, since certain types of remedies may preclude the second state forum from ever having the opportunity to tackle a given matter so far as the particular corporation is concerned. For example, if the first action combines a request for a declaratory judgment with a request for a mandatory injunction that all elections for directors of the target corporation thereafter be held under a cumulative (or under a unit) voting regime or for a negative injunction that the disfavored mode not be used, that first court's action may be permanently preclusive on all other courts under full-faith-and-credit principles. In short, either a certain degree of chaos, if the race is run time and time again, or a certain degree of arbitrary victory depending upon the outcome of the first race, is an inescapable component of the mutual sovereign system. It is not, however, a reason for recourse either to the Full Faith and Credit Clause or to the Due Process Clause; it can be accepted as a bearable cost of legitimate dual (perhaps even multiple) state sovereignty within a federal system.

[297] For a recent suggestion that even such an agency might be blocked under full faith and credit, see Underwriters National Assurance Co. v. North Carolina Life & Accident & Health Insurance Guaranty Ass'n, 455 U.S. 691 (1982); *cf.* BUXBAUM, *supra* note 247. This would depend upon the offensive or defensive use of a non-mutual collateral estoppel claim; see ALI, *Restatement (Second), Judgments* § 29 (1980); *cf.* the recent review in Allesandra v. Gross, 453 A.2d 904 (N.J. Super. 1982).

The role of state law issue preclusion rules in federal litigation was recently reviewed, and honored, in Migra v. Warren City School District, 464 U.S. 548 (1984).

2. The Relationship Between Substantive Reach and Procedural Reach

This limited role of the Full Faith and Credit Clause now can be illustrated by application of the *Allstate* case.[298] Once the right of the state court to exercise jurisdiction over the appropriate defendants, itself a mixture of party and institutional concerns,[299] has been established, and assuming that previously discussed considerations do not call for dismissal or transfer under the "internal affairs" version of the *forum non conveniens* rule, consideration of the choice of law is in order. It is common ground between the two major competing approaches to this issue that here, too, both personal and institutional concerns are involved; there is some dispute whether both are best subsumed within a full-faith-and-credit analysis or whether the former should be analyzed under some, perhaps unique, version of due process.[300] For present purposes it is not necessary to discuss this aspect, but the following quotation from a proponent of the latter approach does help focus the discussion on the specific corporation law sector of this constitutional debate:[301]

> [T]wo separate questions must be answered. First, does the Full Faith and Credit Clause *require* Minnesota, the forum State, to apply Wisconsin law? Second, does the Due Process Clause of the Fourteenth Amendment *prevent* Minnesota from applying its own law? The first inquiry implicates the federal interest in ensuring that Minnesota respect the sovereignty of the State of Wisconsin; the second implicates the litigants' interest in a fair adjudication of their rights.

Analyzing the first issue, Justice *Stevens* stated what is today a consensus:[302]

> [I]n view of the fact that the forum State is also a sovereign in its own right, in appropriate cases it may attach paramount importance to its own legitimate interests. Accordingly, the fact that a choice-of-law decision may be unsound as a matter of conflicts law does not necessarily implicate the federal concerns embodied in the Full Faith and Credit Clause. Rather, . . . the Clause should not invalidate a state court's choice of forum law unless that choice threatens the federal interest in national unity by unjustifiably infringing upon the legitimate interests of another state.

At this point an accounting of the category and intensity of the forum's interest typically follows, and typically leads, as it did in *Allstate*, to validation of the forum's choice of law.[303]

298 *Supra* note 290.

299 See also this aspect of discussion of due process limitations on state claims of *in personam* jurisdiction in the recent leading case of World-Wide Volkswagen Corp. v. Woodson, 444 U.S. 286 (1980); but *cf.* Insurance Corp. of Ireland, Ltd. v. Compagnie des Bauxites de Guinée, 456 U.S. 694, 699 n.10 (1982).

300 This is the point at issue between the plurality and concurring opinions in *Allstate*, 449 U.S. 302 (1981).

301 *Id.* at 320 (Stevens, J., concurring).

302 *Id.* at 323.

303 WEINBERG, *supra* note 281, at 442.

While *Stevens* does not similarly explain the nature of the second, due process analysis, his approving citation of *Weintraub*'s discussion thereof provides sufficient information:[304] it is the "unfair surprise" to a party of having forum law applied to its dispute. Specifically, it is the "unfair surprise" to its earlier plans and dispositions, the confounding of its justified expectation that a chosen or predictable law important to its decision as to its use of its resources would apply to that decision. The examples are those of insurance companies which issue policies and set premiums in situations in which the choice of law is material in actuarial terms.

So understood, the reciprocal influence of institutional and private concerns each on the other and thus on the application of either a unitary or a two-pronged full-faith-and-credit/due-process test is clear. A very interesting scissors effect emerges. On the one hand, the more autonomy a party has to choose the applicable law, the more it can conjure with the unfair surprise element. On the other hand, the more it uses its autonomy to remove itself to the periphery of the region on which its transactions impact, the less surprise can it claim when the force of gravity emanating from that center pulls the transactions back to that center's orbit. In short, only if there is no legitimate gravitational pull – if the forum's level of connection with the transaction is so low that its choice of its own law would violate private international law principles in the way that a forum's jurisdictional claims might violate parallel principles applicable to jurisdiction – can either the party's personal claims or the federal system's institutional claims overcome the forum's claims. Specifically, the federal context adds almost nothing to the equation that otherwise applies to the competition of coequal sovereigns.[305]

If this is the case in contract law despite the countervailing value inherent in the direct interaction of the contracting parties' autonomous will, how much more should it be expected in corporation law where that expression of will is diluted to the point of invisibility by the mediating institutional realities of corporate investment and shareholding, and of the shareholder-director-officer hierarchies involved in corporate governance and decision-making.

[304] *Allstate*, 449 U.S. at 327 n.16, *citing* WEINTRAUB, "Due Process," *supra* note 289, at 457-60.

[305] See also Note, "Comparative Impairment Reform: Rethinking State Interests in the Conflict of Laws," 95 *Harv. L. Rev.* 1079, 1091-92 (1982):

> Although policy-oriented theorists have seen policy analysis and territoriality as mutually exclusive approaches to conflict-of-laws adjudication, consideration of territorial contacts is in fact a means of assessing the existence and quantum of state interests. . . . [S]ome kind of consideration of territorial contacts is essential in order to specify which states are interested in a given transaction. But to identify precisely which territorial contacts are relevant, a court must look to the class of transactions a state desires to affect, rather than searching vainly for some 'touchstone' contact.

An interesting *forum non conveniens* internal affairs case, *O'Brien v. Virginia-Carolina Chemical Corp.*,[306] permits the integration of these various doctrinal and contextual strands and the application of the result to the foreign corporation choice-of-law problem. Plaintiff, a New Jersey resident and holder of a small number of preferred shares in defendant, a moderately large Virginia corporation, had dissented from a typical recapitalization plan approved by a majority of that class, a plan which called for elimination of a substantial arrearage of cumulative dividends by their partial capitalization in an exchange of the prior stock for a new class. She brought suit in New Jersey; its courts had personal jurisdiction over the corporation because it had qualified to do (a minor amount of) intrastate business there though it had no other connection with the state under any of the traditional major tests of shareholder residence, plant and employee location or sales. The merits of the dispute involved the interpretation and possibly the (federal or state) constitutionality of an arguably retroactive amendment of the Virginia corporation law on which the corporation's recapitalization plan rested, complicated by the effect of a summary but potentially plenary Virginia administrative review of the new share issuance under its blue sky regulation.

Reversing the lower court, the New Jersey Supreme Court properly decided that an action with so much internal Virginia law detail, also entailing the risk that the forum state court might find it necessary to declare a sister state law unconstitutional, was best heard before a Virginia court and dismissed the action under appropriate protective conditions.[307] It emphasized, too, those factors which made New Jersey an inconvenient forum; they were, of course, the same elements which would have made a New Jersey choice of local law questionable to the point of constitutional infirmity under the above-described conditions: few New Jersey shareholders to protect, and no significant connection of the Virginia enterprise with New Jersey in the sense of localizing it sufficiently there to justify application of local law to a locally "seated" person under a "nationality principle."

The justified expectations of the Virginia corporation are not central to this point, except in the sense that application of forum law would have been close to whimsical and therefore surprising. Everything, in short, turns on the degree of interest of a state in the actions of the foreign corporation, and that

306 87 N.J. 25, 206 A.2d 878 (1965); *cf.* its discussion in GIBSON & FREEMAN, "A Decade of the Model Business Corporation Act in Virginia," 53 *Va. L. Rev.* 1396, 1405 ff (1967). See also the "home" case concerning the same transaction, O'Brien v. Socony Mobil Oil Co., 207 Va. 707, 152 S.E.2d 278 (1967).

307 This modern use of the original "internal affairs" doctrine, as a remedially and factually oriented *forum non conveniens* concept, of course does and should retain some vitality. See, e.g., the overly broad but in the context understandable comments in Langfelder v. Universal Laboratories, Inc., 293 N.Y. 200, 56 N.E.2d 50 (1944) and Prescott v. Plant Industries, Inc., 88 F.R.D. 257, 261 (S.D.N.Y. 1980).

in turn depends upon the degree of connection (as categorized, for instance, by the elements of California's § 2115[308] though not necessarily by those specific numbers). The important point remains that articulated by the Supreme Court in a quite analogous insurance regulation case: "Nothing in the Constitution requires a state to nullify its own protective standards because an enterprise regulated has its headquarters elsewhere."[309]

3. Multiplicity of State Claims

The only significant borderline problem recurrent in, though not unique to, corporation law lies in the question whether a state may define the degree of connection of the foreign enterprise, justifying application of all or selected local law, in terms that would permit other states to make similar assertions. Does this possibility of multiple potentially applicable corporation law rules distinguish the corporate setting from other settings?

The major aspect of the problem has already been discussed in the choice-of-forum context and, one hopes, satisfactorily put to rest with the prior suggestion that appropriate rules of preclusion of parties to relitigate given transactions are adequately responsive to the constitutional concerns there. The same preclusion concept adequately responds to the choice-of-law problem, with one important distinction, illustrated by the distinction between *Western Airlines* and *O'Brien*.

Precedent, not *res judicata*, is the important countervailing consideration to an exorbitant use of a forum's freedom to choose local law, at least in corporation law. When a given decision – preclusive as to this corporation and this transaction – is itself primarily transaction-focussed, its permissible disregard as precedent by later courts is not critical. If forum law concerning the fiduciary duty of directors is applied to hold them liable as to a given transaction, disregard of that precedent in a subsequent charter-state court hearing a different fiduciary claim, whether involving a different or the same corporation, again is not significant. The reliance of these later hypothetical defendants on the lesson of the earlier holding is not qualitatively different from or more deserving of deference than reliance on any precedent of another or even of the same jurisdiction. That choice-of-law considerations lead to "overruling" of precedent raises no greater constitutional issue, in and of itself, than does the overruling phenomenon generally.

At the other end of the scale are cases like the cumulative voting case, in which (unlike the actual *Louisiana-Pacific* case) a declaratory judgment is sought in the first tribunal establishing the "rule" of voting for that corporation not only for the first disputed election but also for the future. If the procedural context of the case was such as to bind all current shareholders –

[308] See *supra* pp. 89-90.

[309] Hoopeston Co. v. Cullen, 318 U.S. 313, 320 (1943).

perhaps even all future shareholders – then such a ruling indeed may require full faith and credit as to future elections in that corporation. The only difficult cases are the few middle range cases such as *O'Brien*, when the transaction at issue can only be characterized as comprising both transaction-specific and status elements. A construction of the corporation's charter under Virginia law to permit retroactive elimination of a dividend arrearage by a Virginia corporation technically is only "precedent" if the same corporation is used in New Jersey to prevent a later arrearage from being disposed of in the same way. It might be possible, however, for the first court, under class action procedures, so to structure the relief as to give it "status" consequences in rule-stating or contract-interpreting terms. If so, its holding may be preclusive as to the corporation. Even so it would only be "precedent" in the event other though similarly situated Virginia corporations come to court. In short, in choice of law as in choice of forum, if preclusion rules of civil procedure are fully operative, the problem is only one of good judgment, not one of constitutional dimensions. Extremes of misjudgment, of exorbitant local law claims, can be corrected under the Full Faith and Credit Clause just as extremes of exorbitant personal jurisdiction claims can be corrected under the Due Process Clause, but categorical constitutional rules are no more needed in the field of corporation law than in such fields as contracts, torts, or family law or in their public law analogues of consumer protection, health and safety regulation or custody rules.

V. Voluntary and Substantive Uniformity Among State Corporation Laws: "Harmonization from Below"

A. Introduction and Early History

Already by the turn of the century the inevitable practical unification of traditional corporation law codes under the inexorable spurs of a national marketplace and of the Commerce Clause was being heralded. Indeed, many writers around the turn of the century felt that the unification would take place under federal auspices, and either pleaded for that approach or argued that it was the only legitimate one.[310]

[310] See, e.g., HENDERSON, *supra* note 36, at 123:

> Despite the Commerce Clause, a state retains a certain degree of control over its own corporate creatures, even though they are engaged in interstate or foreign commerce. It has power to provide for the security of its stockholders,

On the other hand, already in 1832 the first text on American corporation law could say: "The competency of the legislative power of a State to create corporations, with powers which are not repugnant to the constitution of the United States and the acts of Congress, and which do not conflict with the powers of the general government, nor with the constitution of the State, is so clear, so generally admitted, and has been so long and so often claimed and exercised, that it is unnecessary to offer any arguments or authorities to establish it."[311] In fact state laws have tended to become uniform, but the process was not substantially completed until the 1960's, and centrifugal tendencies continue to exist here as they do in the more substantive fields of state economic regulation of enterprise activity.

1. Individual State Experimentation

The road to modern enabling acts has three parts. The first departure from legislative chartering of individual corporations was a New York statute of

> for the details of corporate management, for the suability and solvency of the corporation. This is an anomaly which will remain till by federal incorporation the national interest in these matters is vindicated.

Other writers went further; as it was put in F. HENDRICK, *The Power to Regulate Corporations and Commerce* 66 (New York 1906):

> The power of regulating the formation of corporations is as natural to the province of the national government as it is in theory, and has proved in practice, incapable of effective exercise by the States.

His motivation, however, was to assure more effective control of corporations ("the hydra-headed beast") than states were able to provide; *id.* at 107-10. See also, generally, HEISLER, *supra* note 34.

311 J. ANGELL & S. AMES, *Treatise on the Law of Private Corporations Aggregate* 41 (Boston 1832). Uniform state legislation was the foreseeable result of these contending trends, and it is no coincidence that by the turn of the century a commercial publication compiling the corporation law codes of all states was feasible. See *The Annotated Corporation Laws of All the States* (R. Cumming, F. Gilbert & H. Woodward eds., New York 1899). That this legislation was already then enabling rather than controlling of corporate forms of the exercise of economic power is a separate matter. On the turn of the century expectation that state corporation law could serve as a regulatory barrier to those share-structured mergers and holding-company cartels which the Sherman (Antitrust) Act could not reach because of the Supreme Court's restrictive definition of interstate commerce, see N. LAMOREAUX, *The Great Merger Movement in American Business, 1893-1904*, at 162 ff (Cambridge 1985).

1811[312] which, however, neither was exclusive nor provided sufficient flexibility in terms of duration, purpose or capitalization to be useful.[313] As a result, even in New York most corporations continued to be formed by special legislative charter.

While the next step, the move to more accommodating and particularly to exclusive general incorporation statutes, usually is credited to the Jacksonian era and its middle-class populist response to Whig privileges,[314] the first product of that reaction was enacted late in the period – the Connecticut statute of 1837.[315] Measured by late nineteenth century standards it, too, was still a timid and inadequate approach. Indeed, even the later common amendment of statute or state constitution to permit incorporation only under the general law was ineffective to achieve this goal of automatic incorporation, in part because these provisions typically still permitted incorporation by special charter if the objects of incorporation were not obtainable under the general law.[316]

Much has been claimed for this statute, as a well-known statement of the major historian of the Jacksonian era demonstrates (though it is a statement almost offhand in terms of the author's larger concerns):[317]

[312] 1811 N.Y. Laws 67, briefly discussed in DODD, *supra* note 32, at 198 (1954); see also HAAR, "Legislative Regulation of New York Industrial Corporations 1800-1850," 22 *New York History* 191 (1941).

An interesting contemporary evaluation of the statute is contained in Slee v. Bloom, 19 Johns. Cas. 456, 473-74 (N.Y. 1822):

> There is nothing of an exclusive nature in the statute; but the benefits from associating and becoming incorporated, for the purposes held out in the act, are offered to all who will conform to its requisitions. There are no franchises or privileges which are not common to the whole community. In this respect, incorporations under the statute differ from corporations, to whom some exclusive or peculiar privileges are granted. The only advantages of an incorporation under the statute over partnerships . . . consists [*sic*] in a capacity to manage the affairs of the institution, by a few and select agents, and by an exoneration from any responsibility beyond the amount of the individual subscriptions.

The concept of general incorporation was known earlier, but limited to specific types of corporations; see DAVIS, *supra* note 30, at 16-19 (referring, among others, to a 1799 Massachusetts statute permitting the incorporation of water companies). See more generally DODD, "American Business Association Law 100 Years Ago and Today," in 3 *Law: A Century of Progress, 1835-1935,* at 269 ff (New York 1937).

[313] See LIVERMORE, *supra* note 175, at 270-71.

[314] See Liggett v. Lee, 288 U.S. 517, 541 (1933) (Brandeis, J., dissenting); R. LARCOM, *The Delaware Corporation* 2-3 (Baltimore 1937).

[315] The Act and the story of its passage are described in DODD, *supra* note 32, at 416-17.

[316] For a tabulation of these constitutional directions to require incorporation to be under general incorporation statutes only, see EVANS, *supra* note 6, at 11, Table 5.

[317] A. SCHLESINGER, *The Age of Jackson* 336-37 (Boston 1953).

The main Jacksonian proposal, however, was to attack the monopoly character of banking by enacting general laws of incorporation; and this reform was quickly adapted for the whole corporate system. Incorporation by special charter had little to recommend it, except for people who already had their own charters and wanted to keep out competitors. It was a prolific source of legislative corruption as well as a system of special privilege hardly consistent with democracy. . . . The radical Democrats thus advocated . . . general laws of incorporation which would extend corporate exemption to all business groups satisfying certain requirements, instead of limiting it, on a basis of legal 'monopoly,' to those able to cajole, bully or bribe state legislatures.

In fact it has been fairly persuasively demonstrated that the road to general (and mandatory) incorporation statutes was neither as simple nor as attributable to Jacksonian politics as this quotation would suggest. An early, comfortable use of unincorporated associations and equally comfortable social acceptance of business activity was followed, during the earliest post-Revolution decades (in part because of the Bank controversy and in part because of early conflicts between Federalists and Democrats) by legislative crippling of special charters, so that the drive for general incorporation coincided not only with egalitarian principles but with the general desire for a reliable and stable charter basis.

After the turn of the century, corporation primacy was threatened by the growing tendency on the part of legislators to impose disabilities on the corporation, even while they continued to grant those particular legal advantages which set it apart from the association. . . .

That the leading legislatures should have embarked on this restrictive policy after 1800 seems to have been due fundamentally to a recurrence of familiar 18th Century fear of the corporation's monopoly position. The 'monster of special privilege' was brought out of the political storeyard to frighten voter and legislator. The rise of the Jeffersonian party was a contributing influence. More and more, legislators were permitted to insert crippling clauses into charters, many of them just prior to final passage on the floor of the assemblies.

This trend toward hamstringing the corporate body after 1800 is deserving of far more attention than it has yet received, for undoubtedly dissatisfaction with the vacillation of the legislatures in Massachusetts and Connecticut was a potent force in bringing about the general acts governing incorporation, which in effect took the unincorporated association under the wing of the state.[318]

[318] LIVERMORE, *supra* note 175, at 260-61; but *cf.* the argument that LIVERMORE underestimated the broad use and value of even the earliest general statute, in KESSLER, "A Statistical Study of the New York General Incorporation Act of 1811," 48 *J. Pol. Econ.* 877, 878 (1940). See generally HURST, *supra* note 36, at 27 ff. See also the important related demonstration that at least in the case of the transformation of American merchant-adventurers to manufacturers (an important American case), ingrained partnership habits, particularly the ability to live with potentially unlimited personal liability, lessened business pressure for general incorporation enabling statutes, in P. COLEMAN, *The Transformation of Rhode Island 1790-1860*, esp. at 113 ff (Providence 1963).

Nevertheless, when all is said and done, the Connecticut statute was the single most significant break with tradition and was soon emulated at least in those other Eastern jurisdictions which before the Civil War evidenced substantial capital formation activity.[319] Indeed, its proponents later claimed that even Gladstone's 1844 reform was influenced by and borrowed from the Connecticut statute.[320]

The first modern enabling act, in the sense not simply of exclusive general incorporation procedures but of its internal details, was the New Jersey enactment of 1875.[321] Why New Jersey was the first to move in this direction, and why then, is still not clearly understood; at that early stage it was not yet in the charter mongering business though it was already known as seeking the business of the neighboring New York corporations, a plan characterized by some as part of a general effort to derive employment and fiscal benefits from its proximity to New York.[322] Judging by the descriptions of the law provided by its proponents at the time, considerations of ease of formation and of later capital augmentation, more than accommodation of managerial autonomy or majoritarian rule, were primary.[323] Certainly its shareholder voting procedures were not less stringent in terms of minority protection than those then prevailing, for instance, in New York or Massachusetts; and in its first version it did not yet provide those specific substantive features that made it both a forerunner of managerialist statutes and the first entrant in the race to lure foreign corporations to a hospitable state of incorporation.

That development started in earnest around 1890 when, as already mentioned, *James Dill*, then counsel for Rockefeller's Standard Oil Trust, persuaded New Jersey's governor to recommend adoption of an amendment to the code

[319] For the New Jersey 1846 statute, see CADMAN, *supra* note 177, at 118 ff. For the Massachusetts 1851 statute, see DODD, *supra* note 312, at 317 ff; and W. RAPPARD, *Les Corporations d'Affaires au Massachusetts* 69 ff (Paris 1908).

[320] Note, "General Corporation Acts – Their Origin," 20 *Am. L. Rev.* 757 (1886).

[321] The statute was preceded by a constitutional provision of the same year prohibiting special charters of incorporation (a common state development of the time, see EVANS, *supra* note 6); see CADMAN, *supra* note 177, at 183-97. For a discussion of the statute itself, see KEASBY, *supra* note 177.

[322] See CADMAN, *supra* note 177, at 174-80 (174):

> There are indications that from very early years it had been the conscious policy of New Jersey legislators to attract capital into their relatively poor state by grants of special favor. In individual incorporation acts passed for the benefit of out-of-state petitioners, New Jersey was willing to give terms more attractive to businessmen than any that would have been approved in general laws in the middle years of the 19th Century. Since the New York constitution of 1846 made it difficult for promoters to obtain special acts of incorporation in that state, New Jersey maintained a competitive advantage in the field of chartering by retaining its system of special acts of incorporation.

[323] See KEASBY, *supra* note 177.

that would permit a New Jersey corporation to own shares in another company.[324] While unsuccessful in attaining its original purpose of allowing corporate combinations to avoid the then-pending Sherman Act, this provision became the cornerstone of intercorporate partial integration and allowed such phenomena as the utility holding company pyramids of the 1920's and even the development of the conglomerate affiliated enterprise systems of today. This particular provision was one of the few that can be said collectively to distinguish flexible enabling statutes from differentially more stringent corporation codes during the period from that 1890 start to the 1960's; and these are discussed further below.[325]

New Jersey had the dubious distinction of remaining the pioneer in this race until Governor Woodrow Wilson, a strong foe of the entire development, forced the legislature to change course around 1906.[326] With his removal to the Presidency in 1914 the path was clear for New Jersey to renew its old ways, which it did in 1916; but by then the vacuum caused by its temporary absence from the arena was being filled by other states. Delaware had already entered the lists in 1899, impelled, even more than New Jersey had been in 1888, by the vision of reaping sufficient revenues from even modest corporate franchise taxes to allow it, a state of small population and equally small public needs, to leave its people otherwise unburdened by taxation.[327]

2. Uniformity by Design

Even so, until 1960, these states remained alone in the choice of this lax type of enabling statute. While individual states, mostly Eastern ones, adopted one or the other specific code provision of this sort, as described below, none adopted an across-the-board statute of this type.[328] On the contrary, such movement towards uniform laws as there was rather consciously chose the op-

[324] To the following see BUXBAUM, *supra* note 178.

[325] See text *infra* at pp. 119 ff.

[326] BUXBAUM, *supra* note 178, at 249.

[327] For a discussion of the Act of 1899 and this background, see LARCOM, *supra* note 314, at 7-10. Interestingly, the original impulse for its enactment was as much revulsion against corrupt practices in a legislature still accustomed to using special incorporation statutes as a source of private revenue as it was these other advantages; these, however, immediately became apparent.

[328] The one exception, West Virginia, was considered *déclassé* and lost out in the race to attract foreign corporations; for this characterization, see particularly, and not surprisingly, DILL, *supra* note 184. As to other states of this ilk, see Brandeis, J., dissenting in Louis K. Liggett Co. v. Lee, 288 U.S. 517, 557 n.34 (1933).

posite direction.[329] An early effort of the National Conference of Commissioners on Uniform State Laws, a private codification effort subsidized by state governments,[330] to promulgate a uniform corporations code, begun in 1928,

[329] See, however, N. MACCHESNEY, *Uniform State Laws* 23 (Chicago 1916) (Presidential address to Illinois State Bar Association):

> The legal theory has been that all local or domestic concerns should be controlled by the State, while matters of National concern were within the jurisdiction of the National Government.
>
> The facts, however, have been at war with this legal theory. So far as commerce has been concerned, State lines have been wiped out and the investor has sought to place his money where it would bring him the best return. This has resulted in vast aggregations of capital doing an interstate business, outside of the power of the Federal Government to regulate, and beyond the power of the State Governments to control.
>
> Until the recent past, the business interests have encouraged this condition of our law, because many of them believe that the lack of regulation was all to their advantage. To an extent this was true, however detrimental to the community as a whole not interested in such enterprises. But in the present decade there has been a change in attitude and the great business interests are at least nominally in favor of uniform state laws, as they come to see that it is the only way to avoid almost destructive conditions of regulation in the various jurisdictions.

This contemporaneous view of the failure or inability of the states to pick up the regulatory gauntlet, thrown to (or left with) them by the Supreme Court's jurisprudence blocking federal regulatory extension, casts some doubt on the thesis of MCCURDY, "The *Knight* Sugar Decision of 1895 and the Modernization of American Corporation Law, 1869-1903," 53 *Bus. Hist. Rev.* 304 (1979), that the Supreme Court assumed that the states would appropriately regulate business activity. *Cf.* also LAMOREAUX, *supra* note 311; UROFSKY, "Proposed Federal Incorporation in the Progressive Era," 26 *Am. J. Leg. Hist.* 160 (1982).

[330] The National Conference grew out of an 1889 resolution of the American Bar Association to appoint a Committee on Uniform State Law. Soon thereafter, however, following the lead of New York, the governors of the various states appointed commissioners to do this work and present its results to the mentioned ABA Committee for endorsement. As MACCHESNEY, *supra* note 329, goes on to say:

> This connection with the American Bar Association has given to the work of the National Conference the great weight of the influence of the American Bar Association in furthering the cause of uniformity of law, but in some respects the companionship has tended to make the work of the National Conference itself less well-known, as it has been over-shadowed by the larger and better known organization, and though acting under an official authority of the respective State Governments, and therefore an official legislative body, it has often been thought of . . . a branch or Committee of the American Bar Association.

Id. at 32. See also the history of the Conference provided in each annual volume of its Proceedings.

was unsuccessful in attracting converts.[331] Work on a new entrant began in 1943 by a small committee of the American Bar Association (ABA), which was staffed by members who had in part been involved in drafting and understandably were influenced by the quite stringent Illinois law of the 1930's.[332] Their model act, accepted by the ABA in 1946,[333] had a fairly successful early adoption record and easily outstripped the Conference Model Act with its five state adoptions;[334] the latter therefore declared this act to be superseded by the ABA Act in 1957.[335]

In time, this committee became what is now the Committee on Corporate Laws of the ABA Section on Business, Commercial and Banking Law. That Committee, responsible for the maintenance and constant refinement of what has become known as the Model Business Corporation Act, slowly over the years following 1955 and then with a vengeance with its major recodification of 1969, went over to the other camp and provided a model matching the Delaware law in its majoritarian and managerialist characteristics.[336] Nor was it alone; all major states' postwar recodifications – New York's of 1961,[337]

331 *Handbook of the National Conference of Commissioners on Uniform State Laws and Proceedings of the Thirty-Eighth Annual Meeting* 78 (1928) [hereinafter cited as *Handbook NCCUSL*].

332 ABA SECTION ON CORPORATION, BANKING & MERCANTILE LAW, "Background of Our Section," 1 *Bus. Law.* 3 (1946).

333 EISENBERG, "The Model Business Corporation Act and the Model Business Corporation Act Annotated," 29 *Bus. Law.* 1407 (1974).

334 *Handbook NCCUSL, 67th Year,* 287 (1958).

335 *Id.* at 341, 342.

336 For a critical analysis of this evolution see EISENBERG, *supra* note 333; compare, for an insider's view (at least of the 1984 revision procedure), HAMILTON, "Reflections of a Reporter [on the Revised Model Business Corporation Act]," 63 *Texas L. Rev.* 1455 (1985).

The important 1984 revision and recodification of this Model Act continues the enabling tradition, which reached a current highwater mark with Delaware's move, adopted in 1986 and already imitated (out of necessity) by other jurisdictions, to authorize the limitation of directors' personal liability for breach of duty by way of charter amendments; see WANDER & LECOQUE, "Boardroom Jitters: Corporate Control Transactions and Today's Business Judgment Rule," 42 *Bus. Law.* 29, 40 n.57 (1986).

337 See HENN, *supra* note 233; and esp. LATTY, *supra* note 235, at 601 ff (612):

> Using the abused word 'liberal' in a Delaware corporation law sense, one may say that New York's new Business Corporation Law is a conservatively liberal act.
>
> If [it] is, first of all, an 'enabling' act that furnishes the motive power [with power steering] and leaves it to the courts to put on the brakes at the instance of the vigilant, that reflects the complacent spirit of the time in corporation law. . . . On the other hand, the Business Corporation Law does not completely

Delaware's of 1967,[338] even California's of 1975 in great part[339] – either adopted the Model Act as such or took a similar route in all essential characteristics. In this they recognized the view which many had come to declare already in the 1920's: that so long as a corporation could choose its governing law by choosing its state of incorporation, any effort at stringent control was vain. In fairness, however, it should be said that the official and unofficial legislative history accompanying these major recodifications usually embraces the flexible enabling code policy justifications as its own rather than as an unavoidable evil.

B. The Major Components of the Majoritarian and Managerialist Enabling Act

1. Corporate Finance and Capacity Issues

The first element has already been mentioned:[340] the right of the corporation to acquire and hold shares of another entity. To this should be added the right, first developed (against an ongoing minority view) at common law and only late in the nineteenth century by statute, to reacquire its own shares, either then to cancel them or to hold them as treasury stock.[341] Not only was this an important power in the sense of increasing the range of options for asset distribution (otherwise limited to current or liquidating dividends) but more generally in the sense of increasing the range of legitimate capitalization options such as the issuance of redeemable preferred stock. It also, of course, carried with it the possibility of abuse, particularly because of the illegitimate promotional practice of offering "money back" corporate guarantees as an inducement to investment.[342]

reflect the spirit of complacency to the extent of exhibiting an attitude that management can or will do no wrong, which is one source of complacency in corporation law.

338 See FOLK, "Some Reflections of a Corporation Law Draftsman," 42 *Conn. Bar J.* 409 (1968).

339 See MARSH, "Introduction [to Symposium: The New California General Corporation Law]," 23 *UCLA L. Rev.* 1035 (1976).

340 See *supra* p. 116.

341 See the early and thorough review in LEVY, "Purchase by a Corporation of its Own Stock," 15 *Minn. L. Rev.* 1 (1930). For the typical more restricted view of this power at the start of the major enabling act codifications of the turn of the century, see MORAWETZ, *supra* note 188, at 220 ff (the leading late 19th century American treatise).

342 See the critical analysis of the problem in H. BALLANTINE, *Ballantine on Corporations* 613-14 (rev. ed., Chicago 1946). It was also used, abusively, to permit the pretense of capitalization vis-à-vis credit extenders and regulators; see the condemnation of analogous practices already in Sawyer v. Hoag, 84 U.S. (17 Wall.) 610 (1873).

The second major element bore on the initial capitalization function, and especially on the promotional practice of bringing in assets in kind, rather than money, in exchange for shares, and then raising monetary capital by reference to the asset value of the corporation as measured by that earlier or contemporaneous contribution in kind. In its earlier days a common promoters' fraud, it became a more respectable practice at the turn of the century when it accompanied the consolidation of existing companies and the writing-up of their consolidated asset values as a prelude to the flotation of major primary and secondary stock issues.[343] The best-known and most spectacular example is the creation of the United States Steel Corporation by J. P. Morgan in 1900, which was accompanied by a $ 750 million write-up of the assets of the three companies consolidated in US Steel beyond the sum at which they were carried on the prior entities' books.[344]

To accommodate this practice the earlier New Jersey code section which had granted the directors of a company the right to set the value of in-kind assets contributed for securities was amended to make their judgment conclusive in the absence of actual fraud. The important change was the adjective: by so limiting judicial supervision, the danger that "constructive fraud" – objectively reckless but subjectively (at least arguably) honest overvaluation – might be attached to such financial creativity was all but eliminated. It is interesting, however, that while the first element – right of acquisition of one's own as well as another company's shares – became a normal component of all modern statutes, this more dubious enabling provision to this day has remained a hallmark of the charter mongering states. It was not, for example, picked up by the ABA Committee as a feature of its Model Act.[345] Even where picked up, of course, it has undergone quite varied transformation at the hands of the variously unsympathetic judiciaries; at the least, it has been disrespectfully treated when old-fashioned behavioral fraud has been suspected.[346] In that treatment, incidentally, lies a lesson as to the doubtful ability of any code to legislate a standard to govern behavior that varies in both subjective and objective manifestations depending on the myriad possible factual constellations. At least in this field the judge has remained the legislator of the event, and the narrower and more biased (in whatever direction) the general rule intended to govern the event, the less possible and the less likely that a fact-oriented judiciary can or will honor it.[347]

[343] To the following text see BUXBAUM, *supra* note 178.

[344] See W.Z. RIPLEY, *Trusts, Pools and Corporations* 197 ff (rev. ed., Boston 1916).

[345] Thus, *compare* Model Business Corp. Act § 19, para. 3 [now § 6.21], *with* Del. Code. Ann., Tit. 8, § 152 (1967).

[346] See BUXBAUM, *supra* note 178.

[347] *Cf.* BUXBAUM, "The Dissenter's Appraisal Remedy," 23 *UCLA L. Rev.* 1229, 1254 (1976); JENNINGS & BUXBAUM, *supra* note 194, at 201, 443, 515.

The third major capacity element is the authorization of no par stock.[348] Discussed as early as the 1890's, it was not seriously considered until taken up by Wall Street lawyers around 1906, and first became law with a New York amendment in 1911. It, too, is now a standard feature of all corporation codes and has no current connotation of manipulation or abuse. Indeed, the most modern codifications, including even the recent Model Act revision, make no par stock the only form of permitted capitalization. Its history, however, is not quite so innocuous, for however originally rationalized it was frequently used as a supplemental vehicle in the creation of watered stock. On the one hand, as argued by its proponents, it may have diverted the average investor from excessive focus on the stated par value of stock which, in the case of stock promotions that involved earlier issues of stock for overvalued assets, usually was an illusory yardstick. At the same time it aided just such stock watering promotional frauds, since it also eliminated the ability of shareholders and creditors to rely on the (implied) statutory promise of the promoter, to pay in the equivalent of par value, as an automatic remedy. With the later advent of low par stock, which permitted only a minimal portion of the consideration to be ascribed to the par component of the issue, with the balance attributed to an initially contributed surplus, the role of the statutory promise to pay par in any event was essentially eliminated. It could function as a summary remedy only so long as par value equalled the promised capital payment. Of course the courts never were hindered from granting a remedy to relying parties in the case of a clear "speaking" fraudulent overvaluation, but just that requirement of reliance in the case of creditors, and, in the case of corporate (or shareholder) efforts to recoup, problems of waiver and inadequacies of class actions often made that traditional remedy useless and thus increased early reliance on the now-destroyed automatic statutory par payment remedy.

All three of these enabling characteristics of the early modern statutes, and especially the first and third, lost their dubious importance, at least in the case of large companies, with the advent of federal securities legislation in 1933. To some degree they had already been attacked by state securities regulation known as blue sky laws, beginning with the Kansas statute of 1911.[349] These, however, were so circumscribed in their reach of extraterritorial securities issuance[350] and in their after-the-fact remedial approach as to be substantially compromised in their effectiveness.[351] While this particular field of corporation law remains to be separately discussed below,[352] it can be said here that only preregistration and preclearance procedures, like those long the law in

[348] The text of the following paragraph is adapted from BUXBAUM, *supra* note 178.

[349] See L. LOSS & E. COWETT, *Blue Sky Law* 5 (Boston 1958) (their discussion includes historical review of some partial predecessor efforts).

[350] *Id.* at 197 ff.

[351] *Id.* at 86; R. JENNINGS & H. MARSH, *supra* note 21, at 1604 ff.

[352] See text *infra* at p. 132 ff.

California,[353] promise to rival federal securities regulation in their analogous effect on the capitalization behavior of the smaller companies.

Additional important elements of this set of statutory provisions include (1) the authorization of non-voting stock, which in the 1920's, according to *Berle*,[354] was a major prop of abusive maintenance of corporate control by promoters who did not contribute capital commensurate with that control, though today used mainly as a conventional flexible financing mechanism; and (2) redeemable, not only occasionally repurchasable stock (used, today, even as an employee stock ownership device).[355] On the side of asset distribution as contrasted with capital acquisition, early important elements of uniform legislation included the statement of limits, based upon creditor and preferred stockholder protection, within which distributions by way of dividends or share repurchases would be permitted.[356] While minor variations in these protective levels exist, and are used as one of the litmus tests distinguishing lax from conservative corporation laws, they neither permit significant variations nor predominate in the face of other, more conservative regulation indirectly imposed by accounting principles and securities regulation.[357] The major distinction developing today, in fact, has little to do with these earlier characterizations, but involves the legal recognition of modern financial conventions that emphasize not formal capital and surplus positions but liquidity and asset-to-liability ratios as the first line of creditor and preferred shareholder protection.[358] Among major states only California so far has moved to this position,[359] although the recent renovation of just these financial sections of the Model Business Corporation Act suggests that a new wave of partial codifications of state statutes is imminent.[360]

353 Cal. Corp. Code §§ 25000 ff (1968).

354 See A. BERLE, *Studies in the Law of Corporation Finance* 41 (Chicago 1928).

355 Thus, compare the modern approach of Lewis v. H.P. Hood & Sons, Inc., 331 Mass. 670, 121 N.E.2d 850 (1954) with the older approach exemplified by Starring v. American Hair & Felt Co., 21 Del. Ch. 380, 191 A. 887 (1937).

356 See the discussion of [the now deleted] Model Business Corp. Act § 66 on this point in 2 *Model Business Corporation Act Annotated, supra* note 250, (2d ed. 1971) at 303 ff.

357 See generally D. HURWITZ, *Business Planning* 422 ff (Mineola 1966); and J. BURTON, R. PALMER, & R. KAY, *Handbook of Accounting and Auditing* 45-23 to 45-25 (Boston 1981).

358 See generally BUXBAUM, "Preferred Stock – Law and Draftsmanship," 42 *Cal. L. Rev.* 243, 255 ff (1954).

359 Cal. Corp. Code § 500(b) (1968); see generally ACKERMAN & STERRETT, "California's New Approach to Dividends and Reacquisitions of Shares," 23 *UCLA L. Rev.* 1052 (1976).

360 ABA COMMITTEE ON CORPORATE LAWS, "Changes in the Model Business Corporation Act – Amendments to Financial Provisions," 34 *Bus. Law.* 1867 (1979); see now ABA COMMITTEE ON CORPORATE LAWS, *1984 Revised Model Business Corporation Act – Exposure Draft* § 6.40 ("Distributions to Shareholders") (tent. ed. 1984, Chicago).

2. Managerialist and Majoritarian Issues

One major element of state codes was not substantially unified until the 1960's – the adoption of simple majority voting as adequate for all major structural corporate decisions which are reserved to the shareholders rather than the directors.[361] While a decision to augment capital or to liquidate always has been understood as an inherent element of corporate life since the days of the first enabling acts, other similar structural changes were not so recognized. For instance, a decision to merge or consolidate two corporations initially was characterized as so foreign to the original essence of any given corporation as to require unanimity among shareholders to achieve it.[362] While the matter is not free from doubt,[363] some have asserted that the first dissenters' appraisal remedy, an 1861 Pennsylvania enactment, was promulgated in order to obtain judicial acquiescence in mergers voted by a (super) majority of shareholders.[364]

A more modern, enabling approach to these structural combination and fragmentation decisions did not occur until the 1890's, when the already compliant New Jersey statute was further modified to achieve just these ends; even then, however, only if a classified majority of shares, including each class of otherwise nonvoting shares, approved these transactions by a two-thirds vote.[365] That approach – enfranchising voteless shares and requiring extraordinary majorities – then became the model for other modern codifications, usually coupled with dissenters' appraisal remedies coextensive with these majoritarian enabling procedures.[366] This situation continued until the further modernization wave of the 1960's, when ordinary majority voting, coupled in some but not all cases with the disenfranchising of otherwise also nonvoting shares, supplanted the earlier forms.[367] At the same time the special problem of interstate mergers, in practice achievable even without enabling laws by various expedients such as reincorporation in one and the same state, was explicitly resolved, first by Delaware and then generally.[368]

361 On the following see particularly EISENBERG, *supra* note 17, at 215-32.

362 See BALLANTINE, "Questions of Policy in Drafting a Modern Corporation Law," 19 *Cal. L. Rev.* 465, 481 (1931).

363 See the persuasive criticism in EISENBERG, *supra* note 17, at 75-76.

364 See particularly the argument of MANNING, "The Shareholder's Appraisal Remedy: An Essay for Frank Coker," 72 *Yale L.J.* 223, 246 ff (1962). But see LEVY, "The Rights of Dissenting Shareholders to Appraisal and Payment," 15 *Cornell L.Q.* 420 (1930); BALLANTINE, *supra* note 342, at 683 ff.

365 Corporations Act § 105 (enacted 1896), in *Compiled Statutes of New Jersey 1709-1910* (Newark 1911).

366 See BALLANTINE, *supra* note 342, at 685 ff.

367 See the brief review of these changes in 2 *Model Business Corporation Act Annotated, supra* note 250, at 364-65; this evolution is criticized in EISENBERG, *supra* note 17, at 234-35 and *passim*.

368 See generally BALLANTINE, *supra* note 342, at 706-08.

The mentioned question of dissenters' appraisal rights has been more debated and less uniformly treated.[369] Its legitimacy has long been questioned at least in the case of companies whose shares are traded on an adequate stock exchange;[370] and in part as a result the catalogue of incidents subject to the remedy to this day varies substantially among states which otherwise display similar flexible enabling and majoritarian policies. Not only does that catalogue range from all transactions "affecting the rights, preferences and privileges" of shares in New York[371] to mergers only in Delaware,[372] and from all listed or unlisted companies in the newest Model Act revision[373] to those smaller companies which do not enjoy at least over-the-counter trading support in California.[374] In addition some states, notably Delaware, long have judicially permitted transparent evasion of the remedy by such devices as step-staging what was in essence a covered merger transaction through a series of non-covered transactions – e.g., a sale of all assets of the target company in exchange for shares of the acquiring company followed instantly by the liquidation of the former and the distribution of those shares to its shareholders as a liquidating dividend – that achieved the same goal.[375]

3. Fiduciary Duty: Loyalty

There exists one more area of subtle but important differentiation – the content of management's fiduciary duties of prudent and disinterested decision-making. Originally developed by state courts as a matter of common law

[369] The major debate is that between MANNING, *supra* note 364, and EISENBERG, *supra* note 17, at 69-84.

[370] Particularly by MANNING, *supra* note 364. But see BUXBAUM, *supra* note 347, at 1247-49; and Note, "A Reconsideration of the Stock Market Exception to the Dissenting Shareholder's Right of Appraisal," 74 *Mich. L. Rev.* 1023 (1976).

Interestingly, in its 1978 revision of the appraisal remedy, the Committee on Corporate Laws decided to introduce the remedy even in the case of publicly held corporations. See CONARD, "Amendments of Model Business Corporation Act Affecting Dissenters' Rights (Sections 73, 74, 80 and 81)," 33 *Bus. Law.* 2587 (1978). See now Model Act § 13.02; see also JENNINGS & BUXBAUM, *supra* note 194, at 1067-76.

[371] This is a term of art often used for a description of the older statute; the current law is less comprehensive but in its aggregate comes close to this catch-all phrase. N.Y. Bus. Corp. Law §§ 910(a), 806(b), 1005(a). See H. HENN, *Handbook of the Law of Corporations and Other Business Enterprises* 724 (2d ed., St. Paul 1970).

[372] Del. Code. Ann., Tit. 8, § 262 (1976).

[373] See *supra* note 370.

[374] Calif. Corp. Code § 1300 (1975); see generally BUXBAUM, *supra* note 347, at 1233-34.

[375] This "equal dignities" (of statutes) concept is to be contrasted with the "de facto merger" concept used in the majority of jurisdictions which have considered the problem. For discussion of this issue, see EISENBERG, *supra* note 17, at 218-23.

jurisprudence,[376] and derived from the law of trusts, this segment of corporation law has become more specifically corporate and autonomous in detail and, most recently, increasingly codified by positive statutory law.

The former evolution occurred in part because at least as to the conflict of interests prong of the fiduciary duty courts slowly had to back away from uncompromisingly rigid early trust law that permitted the avoidance of self-interested transactions without regard to their underlying merit.[377] Instead, but not everywhere and certainly not at the same time, courts evolved more differentiated rules which, by the 1960's, basically had come to a substantive test of the fairness of the transaction measured against some arm's-length hypothetical market test, coupled with a component that placed the burden of proof of that fairness on the proponents of the transaction. In addition, and inextricably interwoven with this simple but overriding frequency of occurrence of interested decision-making, there was the equally obvious and overriding differentiation of recurrent transaction patterns, all specific to the corporate rather than general trust setting; and all equally impinging upon the courts' ability to test all aspects of conflict by one rule of thumb.[378]

This differentiation into doctrinal subsets of conflict-of-interests law already has been mentioned; for now the point is that, again, not all courts everywhere, and certainly not all at the same time, responded similarly to this doctrinal refinement of types of interested decision-making. Some jurisdictions were late in seeing the underlying self-interest problem in sophisticated corporate transactions; others were late in giving one or the other set more lenient treatment than was afforded by that jurisdiction's basic self-dealing law. But all of these time warps and accidents of litigation that steer the development of doctrine through cases aside, there evolved, roughly between 1900 and 1975, a subtly nuanced but surprisingly large amount of state by state variation of conflict-of-interests law; catchphrases like "Delaware approach versus California approach" terribly oversimplify the interior details of these differences but they do not overstate the substantial degree of difference overall.[379] In most re-

[376] See LYNCH, "Diligence of Directors in the Management of Corporations," 2 *Cal. L. Rev.* 21 (1914) for an early criticism.

[377] To this and the following text see particularly MARSH, "Are Directors Trustees? Conflicts of Interest and Corporate Morality," 22 *Bus. Law.* 35 (1966). See also JENNINGS & BUXBAUM, *supra* note 194, at 441-543; and the full discussion in BALLANTINE, *supra* note 342, at 167-84.

[378] See JENNINGS & BUXBAUM, *supra* note 194, at 441, 466, 497, 514.

[379] The three papers most frequently cited on this issue are JENNINGS, "The Role of the States in Corporate Regulation and Investor Protection," 23 *Law & Contemp. Prob.* 193 (1958); LATTY, *supra* note 168; and CARY, "Federalism and Corporate Law: Reflections Upon Delaware," 83 *Yale L.J.* 663 (1974). For a larger and substantively more detailed review of statutory differences, see CONARD, "An Overview of the Laws of Corporations," 71 *Mich. L. Rev.* 623 (1973).

cent times, certainly less than a decade, a unifying movement has again begun, stimulated in part by the need to impose doctrinal order on this messily rich amount of jurisprudence, in part by the statutory efforts (to be discussed next) at capturing the field, in part by the semantic assistance of the new economic analysis of law movement.

The statutes in question – and we are still referring only to the conflict of interests, not to the duty of prudence – are, however, only indirectly substantive though not less substantive for that. As early as 1931 California enacted a conflict-of-interests statute,[380] and with Delaware's adoption of this model in 1967[381] the stage was set for a wave of further adoptions; today over half the jurisdictions boast this statute with only minor variations.[382] The approach is curative rather than substantive; as already indicated, the statute renders the prior common law strict avoidance doctrine inapplicable to defined conflict-of-interests transactions (usually straightforward self-dealing only) if they are effected by a disinterested component of the Board of Directors or by a (usually similarly disinterested) vote of the shareholders, or if they are proved to be at least as fair as some market analogue transaction.

The last is, of course, a substantive rule like the more modern common law rules; but the former are the more significant, since in effect they eliminate all jurisdictional variation of conflict of interests rules in favor of what is in fact a much more unitary rule of procedure. Indeed, that unifying consequence even may extend to the "proof of fairness" test if a very recent development in the technical law of derivative suits were to prevail: the rule that a suit brought to test the fairness and thus the validity of a self-dealing transaction which had not been "cured" by its adoption by a disinterested body of directors (or shareholders) could itself be blocked, settled or dismissed by the action of an even smaller group of disinterested directors.[383] In this large field, the true doctrinal distinction among jurisdictions is now less in their relatively abstract formulation of self-dealing doctrine than in their differing treatment of what at first seemed to be only a procedural adjunct to that doctrine.

4. Fiduciary Duty: Prudence

In the related fiduciary field of prudence or care a similar statutory development is just now occurring, for slightly different reasons and in slightly different form. The common law doctrine of what constituted actionable imprudence by otherwise disinterested managers or directors might have

[380] Calif. Civ. Code § 311 (1931); see Note, 29 *Cal. L. Rev.* 480 (1931).

[381] Del. Code Ann., Tit. 8, § 144 (1967).

[382] See BULBULIA & PINTO, *supra* note 260.

[383] See BUXBAUM, *supra* note 259, regarding this problem and recent judicial developments.

displayed some slight differences in doctrinal statement – the care expected of an ordinarily prudent person in the management of his own affairs as against the care expected, etc., in the management of others' assets was the favorite juxtaposition[384] – but both the sparse actual case-law and the deference paid via the "business judgment rule" to directors' actual risk-taking entrepreneurial behavior led to substantial uniformity of results in the ordinary context.[385]

What led to pressure for codification, rather, was the fear of the managerial community that standards of care imposed by federal securities law upon a specific set of directorial transactions such as preparing registration statements, reviewing proxy solicitation materials and the like, both might be influenced by and might spill over onto general state law standards of actionable imprudence.[386] As a result, the Model Act Committee in 1974 adopted a statutory standard of prudence.[387]

This statute, now law in thirty jurisdictions,[388] is less important for its abstract statement of the general standard, though it has chosen the least rigorous of the previous common law formulations, than for two other aspects. First, it unifies all care-related standards of the particular jurisdiction, changing the prior practice of maintaining a separate, higher standard for such third party-related transactions as the declaration of dividends (to which, typically, a separate substantive standard of objective legitimacy applied before and continues to apply).[389] Second, it achieves this feat among others by its more important innovation, the statement of a catalogue of subordinate officers and outside experts, and a catalogue of types of advice, upon whom and which

384 See the discussion of Selheimer v. Manganese Corp. of America, 423 Pa. 563, 224 A.2d 634 (1966) in JENNINGS & BUXBAUM, *supra* note 194, at 177-78.

385 BISHOP, "Sitting Ducks and Decoy Ducks: New Trends in Indemnification of Corporate Directors and Officers," 77 *Yale L.J.* 1078 (1968) (who also points out that there are relatively few "pure" negligence cases, *id.* at 1099).

386 JACOBS, "Role of Securities Exchange Act Rule 10b-5 in the Regulation of Corporate Management," 59 *Cornell L. Rev.* 27 (1973); see STERN, "The General Standard of Care Imposed Upon Directors Under the New California General Corporation Law," 23 *UCLA L. Rev.* 1269, 1280 (1976).

387 Model Business Corp. Act. § 35 [now § 8.30] (1974 Supp.); see ABA COMMITTEE ON CORPORATE LAWS, "Report of Committee on Corporate Laws: Changes in the Model Business Corporation Act," 30 *Bus. Law.* 501 (1975) for explanation.

388 1 *Model Business Corp. Act Annotated, supra* note 250, at § 8.30 at p. 936.

389 Thus, as to the directors' possible liability for violation of Model Business Corp. Act § 48 (concerning conditions under which dividends may be declared) the Committee on Corporate Laws, *id.* [2d ed. 1971] stated:

> The revision of the lead-in to Section 48 is intended to make clear that the types of reports, financial statements, opinions and other matters upon which directors may rely for purposes of Section 35 may also be relied upon by the directors for purposes of [Section] . . . 48. [The new explanation (*id.*, 3d ed., at 1024) is less vigorous on this point].

board members acting in good faith reasonably may rely in making their own decisions and for whose errors they will not be chargeable.[390] Whether this statutory development will have its desired effect on directors' federal liabilities is still unknown; but it is fairly certain that what few transactions might previously have been challenged under the standard of prudence will have been reduced substantially by this change.[391]

5. The Reasons for Substantive Convergence: The Threat from the Center

The foregoing review suggests that there has been some identifiable variation of substantive corporation law among the various states, but that the distinctions have been eroding. The one remaining difference, apart from a slight difference in the amount of information to be disseminated to owners mandated in some as against other statutes,[392] probably is the general sense of more rigorous scrutiny of self-interested decision-making in some as against other jurisdictions. It is interesting that the one conflict-of-laws case truly involving a judicial, rather than a statutorily mandated, choice of forum law, *Mansfield Hardwood Lumber Company v. Johnson*,[393] also involved the forum court's picture of each other's conflict-of-interests jurisprudence; that is, the one element of substantive common law that is judicial not statutory.

There are other reasons for this coalescence of substantive law. The success of the Model Act certainly is one; the magnetic pull of Delaware's jurisprudence as the touchstone of appropriate company law at times has been another. Equally important is political economy in historical context: Populism and South Dakota cement plants to the contrary notwithstanding, there simply has been no American tradition, and there is none now, of internalizing within corporation law public policy and public law elements requiring the control of corporate actors' own behavior. Just as in the *Gompers* tradition the American labor movement chose to stay outside its protagonists' decision-making structures both in government and in business and improve its lot

[390] Model Business Corp. Act § 35(a)-(c) [now § 8.30].

[391] See JENNINGS & BUXBAUM, *supra* note 194, at 190-95. This is confirmed by the very recent statutory movement to allow shareholders to eliminate all director liability for imprudence by means of charter amendment.

[392] Thus, *compare* Model Business Corp. Act § 52 [now § 16.01-.04] *with* Cal. Corp. Code § 1501; see JENNINGS & BUXBAUM, *supra* note 194, at 247-49.

[393] 268 F.2d 317 (5th Cir. 1959); see text *supra* at pp. 87-88.

through directly adversarial strategies,[394] so American public law in general has been enacted as a factor impinging on corporate actions rather than a factor insinuated into that decision-making structure. (We put aside the current and much-mooted phenomenon of the labor leader invited onto the board of a distressed company; it is still unclear whether this is better characterized as a straw in the wind or as a straw which a drowning man grasps.) The difference should not be overstated; there is always occasion for mutual cooperation, and the entire setting certainly is more fluid today than it has been since the Great Depression,[395] yet it would be equally naive to minimize this cultural and economic difference.

Finally there is the levelling influence of the parallel, and in its sphere dominant, federal corporation law embodied in the Securities Act of 1933, the Securities Exchange Act of 1934 with its 1964 and 1968 amendments, and the simply enormous body of jurisprudence that has blossomed on this base to a degree unimaginable to its progenitors. In particular the implied tort remedy under Section 10(b) of the latter statute and its equally vague and far-reaching Rule 10b-5 has captured many elements of corporation law thanks to the courts' broad definitions of the kind of management and dominant shareholder behavior that qualifies as "connected with" a securities transaction in the jurisdictional sense of the statutory phrase. This development, presently in a holding pattern if not in partial retreat thanks to the Burger Court's counter revolution, is an entire legal field to itself that would and does take books to

394 For an interesting earlier example of the degree to which this view is implicitly held by American labor law theorists, see CHAMBERLAIN, "Collective Bargaining and the Concept of Contract," 48 *Colorado L. Rev.* 829, 845-46 (1948); and, more generally, N.W. CHAMBERLAIN, *The Union Challenge to Management Control* (New York 1948). A more recent and more explicit perception of this situation is that of VAGTS, "Reforming the 'Modern' Corporation: Perspectives from the German," 80 *Harv. L. Rev.* 23, 36 (1966). See also the perceptive evaluation of this adversarial concept in SIMITIS, "Workers' Participation in the Enterprise – Transcending Company Law?," 38 *Mod. L. Rev.* 1 (1975).

This basic American view does not preclude a major and theoretically important perception of worker or union participation in corporate decision-making at the floor or even unit level. This has become a standard feature of American collective bargaining agreements, but does not (cannot?) move from the plant manager to the directorial level. See FELLER, "A General Theory of the Collective Bargaining Agreement," 61 *Cal. L. Rev.* 663, 760-71 (1973) for the most important recent articulation of this aspect.

395 See BUXBAUM, "Economic Law in the United States of America," in *Begriff und Prinzipien des Wirtschaftsrechts* 11, 15-16 (G. Rinck ed., Frankfurt 1971).

detail.[396] Here it is enough to identify the movement as one that has suffused what nominally is state level corporation law doctrine with an imposed uniformity of result, particularly in such areas as sale of control, corporate reorganization and dissolution transactions, acceptable strategies in hostile takeover situations, share transactions between insiders and other shareholders and so forth.[397]

C. The Center and the Periphery: State Blue Sky and Related Securities Regulation

This is a field not usually thought of as part of corporation law, but both because of its substantial overlap with the traditional subject and because of its European doctrinal unification with company law in the larger subject of enterprise law its American scope should at least briefly be discussed. Further, not only are recent state efforts to participate in regulation of hostile tender offers even closer to the traditional state corporation law agenda, but by drawing hostile fire from federal Supremacy Clause and Commerce Clause preemption concepts they have drawn this entire area of state securities regulation into the vortex of the division of powers in a federal system.

1. Traditional Regulation

The origin of state securities regulation lies in state efforts to counter plain promoters' fraud in the heyday of modern speculation, well before federal regulation was in the picture.[398] The generation before the Great Depression saw this movement, begun in the Populist center, capture most Western states and a large number of Eastern ones. To this day a regional difference of approach is perceptible, and the more aggressive and more substantively oriented regulations and guidelines of the semi-official Midwestern Conference of State

396 See the leading work of JENNINGS & MARSH, *supra* note 21, at 880-85, for both citation to the enormous literature on this subject and demonstration of the foregoing text. The major examples of the mentioned specialized texts are H. BLOOMENTHAL, *Securities and Federal Corporate Law* (New York 1979); A. BROMBERG & L. LOWENFELS, *Securities Fraud and Commodities Fraud* (Colorado Springs 1979); and A. JACOBS, *The Impact of Rule 10b-5* (New York 1981).

397 While its adoption is in serious doubt, the major effort at creating a new uniform federal securities law under the auspices of the American Law Institute should not be overlooked. See ALI, *Proposed Federal Securities Code* (Philadelphia 1980) (the well-known project of Prof. Louis Loss).

398 To this and the following see particularly LOSS & COWETT, *supra* note 349, at ch. 1.

Securities Commissioners are clearly distinguishable from the less cohesive and less assertive regulatory approach of most Eastern states.[399] The formal legislative patterns, however, correlate less with that organizational difference than with the line between those states more or less adhering to the *Loss* Uniform Securities Act[400] which follows federal policy in basing its regulatory philosophy on full and fair disclosure requirements, and those few but active states following the California philosophy of subjecting investor solicitation to a substantive standard of fairness of the planned use of proceeds and planned division of ownership between promoters and public investors.[401]

The administrative details of regulation of course correlate in part to this basic distinction; the latter states require a larger and more involved bureaucracy. Even among states of the first, disclosure-oriented group, however, there are substantial differences of administrative depth and scope of regulation. Some of these states provide little more than a broker or underwriter registration process with a "one bite rule" leading to decertification of those intermediaries who have committed fraud or otherwise breached disclosure requirements. Further, most of these states – and to a lesser degree some of the substantively regulating states – coordinate their registration and prospectus review requirements with those of the federal regime to such a degree that in essence they apply only to issuers which do not solicit funds in a public manner or do not solicit more than the minimum amount triggering federal involvement.[402] Since such states typically also exempt very small, so-called

[399] The best overview of these matters is still JENNINGS & MARSH, supra note 21, at 1604-74. On the Midwestern Conference, see GOODKIND, "Blue Sky Law: Is There Merit in the Merit Requirements?," [1976] *Wis. L. Rev.* 79, 86.

[400] Adopted by the National Conference of Uniform State Commissioners, it is law, in variant forms, in a majority of jurisdictions; on its analysis see LOSS & COWETT, *supra* note 349, and JENNINGS & MARSH, *supra* note 21, at 1604 ff.

[401] See H. MARSH & R. VOLK, *Practice Under the California Securities Law of 1968* (Los Angeles 1969) for general commentary on the California Act and practice thereunder.

[402] JENNINGS & MARSH, *supra* note 21, at 1604-05.

One important inroad on that natural division has been made as a result of the Congressional mandate that the costs of capital formation be eased for small and new issuers, especially in the case of the private placement of securities with institutional, wealthy or sophisticated investors. See the revised Section 19(c) of the Securities Act of 1933, 15 U.S.C. § 77s (1980). This mandate, and the SEC's 1982 Regulation D thereunder, 17 Code Fed. Regs. § 230.501-.506 (1982), combine to impose the federal version of (de)regulation on a substantial part of that lower cohort of issuers which traditionally had been regulated by the states. This is occurring not because the federal system calls for deregulation *per se*, but because it offers a relatively mild form of regulated capital formation and suggests – if it does not demand – essentially congruent state regulation of that group. See generally SUBCOMMITTEE ON ANNUAL REVIEW, "Federal Securities Regulation," 39 *Bus.Law.* 1105, 1146-49 (1984).

"close" corporations from their requirements, their own investment in a significant regulatory process is limited to that needed to supervise a very thin stratum of intermediate sized issuers.

2. Takeover Regulation: Introduction and Context

State tender offer legislation is a more recent, more diverse, more debatable and now more threatened phenomenon. An explanation thereof requires a detour into a subject in any event properly subject to explanation in this Chapter, the general structure of federal securities regulation.

The control of the capital raising process by the Securities Act of 1933, and the control of various aspects of trading in securities and of providing information about companies whose securities are traded on organized exchanges by the Securities Exchange Act of 1934, are based on a philosophy of disclosure, not of paternalistic review of the merits of investment solicitation or of the substantive contours of shareholder participation in corporate governance via their exercise of the franchise.[403] Further, for exactly one generation following their adoption, these statutes applied only to companies which voluntarily subjected themselves thereto by choosing to solicit capital from the public and to list their securities on a national exchange.

In 1964, however, the second of these two threshold limits was removed, and certain important elements of the 1934 Act were made applicable to any company of a certain, rather low size measured in asset terms and of a certain, fairly high minimum number of shareholders of any class of stock. The provisions so applied were certain reporting requirements, one rather specific sanction controlling the specific version of insider trading known as short swing trading, and most importantly the provisions controlling the conduct of shareholder meetings and in particular the solicitation of shareholder voting proxies.[404]

One aspect of shareholder voting is the annual ritual of election of directors. The realities of fragmentation of ownership have always frustrated visions of shareholder participation in that process as anything other than ratification of management slate proposals, but efforts as early as 1942[405] and as recent as 1978 to structure a more meaningful nomination and selection role have failed

[403] See the current edition of JENNINGS & MARSH, *supra* note 21, at chs. 1-3, an excellent, extensive summary both of this statutory and institutional philosophy and of the mechanism of regulation.

[404] Pub. L. No. 88-467 (20 Aug. 1964), 78 Stat. 565, *inter alia* amending § 12 (in particular § 12(g)) of the Securities Exchange Act of 1934, 15 U.S.C. § 78(l).

[405] See CAPLIN, "Proxies, Annual Meetings and Corporate Democracy: The Lawyer's Role," 37 *Va. L. Rev.* 653, 682 (1951).

of adoption.[406] They did, however, demonstrate that full disclosure, while a philosophy adequate for investment decision, was neither adequate for governance decisions nor a statutorily mandated limit for such shareholder involvement.[407] This opening for more substantive federal involvement in all aspects of investment entry, continuation and exit, while it failed to carry the director election agenda,[408] became a central element of the other, more important aspect of shareholder voting: voting, collectively or singly, on major structural reorganization and dissolution proposals.

The traditional form of this participation was on the proposal of a so-called statutory merger, or of a sale of assets in exchange for stock followed by dissolution and distribution of the stock to the target's owners (sale of assets reorganization).[409] Since both forms require a shareholder decision on a majority or higher basis, disclosure concerning either type of proposal was early recognized as vital and became a much regulated and much litigated aspect of proxy solicitation.[410] It is this type of transaction which was a major impulse for the 1964 extension of Section 14 of the 1934 Act, with its control of proxy solicitation, to a wide range of companies.[411]

That, however, heightened awareness of the one transaction similar in result to the statutory merger and sale of assets reorganization which was not similar-

406 *Compare* SEC Exchange Act Release No. 13901 (29 Aug. 1977) *with* SEC Exchange Act Release No. 34-15384 (6 Dec. 1978).

407 This is a debatable proposition from the literal perspective of the 1933 Act. *Compare* CAPLIN, *supra* note 405, at 682 *with* BLACK, "Shareholder Democracy and Corporate Governance," 5 *Sec. Reg. L.J.* 291 (1978). But at the practical level of consensus and proposals for change, it essentially has been accepted. This is well demonstrated by ABA COMMITTE ON CORPORATE LAWS, "Corporate Directors' Guidebook," 33 *Bus. Law.* 1591, 1626 (1978).

408 Interestingly, there has been some movement at the state law level, commencing in the area of membership corporations. Two important recent cases are Dozier v. Automobile Club of Michigan, 69 Mich. App. 114, 244 N.W.2d 376 (1976); and Braude v. Havenner, 78 Cal. App. 3d 178, 144 Cal. Rptr. 169 (1978). See generally JENNINGS & BUXBAUM, *supra* note 194, at 308-13.

409 For explanation and evaluation of these procedures see EISENBERG, *supra* note 17, at Part IV.

410 See 2 L. LOSS, *Securities Regulation* 916-24, 932-73 (2d ed. Boston 1961). See JENNINGS & MARSH, *supra* note 21, at 885-87 for current review, especially of the litigation aspect.

411 The recognition of the importance of proxy statements to merger and similar transactions, not surprisingly, is not apparent until about 1957; see the address of the Director of the Division of Corporate Finance reviewed in LOSS, *supra* note 410, at 866 and n.126. It is not a coincidence that the Supreme Court decision affirming the existence of a private right to complain of misleading proxy solicitations, which arose in the context of a merger vote, J.I. Case Co. v. Borak, 377 U.S. 426 (1964), arrived on the scene contemporaneously with this revision.

ly protected – the voluntary share exchange. This transaction enjoys the same vital fiscal advantage which has made all three forms of corporate combination feasible, the fact that the exchange is free of income or initial capital gains taxation to the participants.[412] Unlike the first two, however, it is not the result of a collective, majoritarian decision of the target company's shareholders but simply of their aggregate individual decisions to sell their respective shareholdings in exchange for the bidder's securities.[413] While these securities of the bidder might themselves have been registered and a prospectus prepared to accompany their distribution, this prospectus by definition was not yet available to then unknown target company shareholders at the time they were publicly solicited, by newspaper advertisements, broker announcements and the like, to tender their shares.[414]

That tender decision in recent decades has been perceived to be similar in quality to a shareholder vote for, say, a statutory merger, especially when the tender offer is for a share exchange rather than a cash transaction.[415] Not only is the first consequence of a successful solicitation in itself often sufficient to effect a change of corporate control from prior management to the new corporate shareholder. More significant is the fact that with such majority (or even substantial minority) control, a second stage full statutory merger or sale of

412 For a succinct description of the process, see D. KAHN, *Basic Corporate Taxation* 431-41 (3rd student ed., St. Paul 1981).

413 On the other hand, majoritarian approval of the target company shareholders to permit a merger or reorganization of necessity entailed the disappearance of the target company. Since this conflicted with the desire of the surviving enterprise to continue the target company in its previous legal form on occasion (typically for regulatory or tax reasons) a complicated device known as the triangular or reverse triangular merger became prevalent, which was majoritarian in substance but entity-continuing in form. Recognizing this fact of life, the Corporate Laws Committee recently proposed an amendment to the Model Business Corp. Act which would permit a direct mandatory (majoritarian) share exchange. See ABA COMMITTE ON CORPORATE LAWS, "Final Changes in the Model Business Corporation Act Revising Sections 63, 73, 74, 76, 77, 80 and Adding a New Section – 72-A," 31 *Bus. Law.* 1747 (1976). For brief discussions of both types of situations, see JENNINGS & BUXBAUM, *supra* note 194, at 1014-16, and (as to triangular mergers only) EISENBERG, *supra* note 17, at 215-18, 305-06.

414 See the brief discussion in D. RATNER, *Securities Regulation in a Nutshell* 109-10 (2d ed., St. Paul 1982). The problem, of course, was exacerbated in the case of cash tender offers. See JENNINGS & MARSH, *supra* note 21, at 658 ff, for a fuller discussion of these disclosure matters; E. ARANOW, *Tender Offers for Corporate Control* (New York 1973); and E. ARANOW, H. EINHORN & G. BERLSTEIN, *Developments in Tender Offers for Corporate Control* (New York 1977).

415 Indeed, some statutes, like Calif. Corp. Code § 1201, appropriately call for a vote of the offeror's shareholders in this situation. See to this problem generally COFFEE, "Regulating the Market for Corporate Control: A Critical Assessment of the Tender Offer's Role in Corporate Governance," 84 *Colum. L. Rev.* 1145, 1269-72 (1984).

assets reorganization could be effected;[416] with its acceptance a foregone conclusion given the new owner's voting bloc, and with its painstaking provision of full information to the remaining shareholders in that later proxy solicitation an empty charade given their inability to affect that foregone result.[417] (Voluntary deference by the controlling shareholder to the separate vote of the outside owners may be a sound tactic to defuse certain types of later claims of overreaching,[418] but has no bearing on this power based on its shareholdings.)

3. Takeover Regulation: The Arrival of Federal Controls

Recognition of this discrepancy in providing the information needed to permit rational voting decisions that indirectly are investment decisions led to the adoption of the Williams Act, which amended and added to Section 14 of the Securities Exchange Act.[419] While its passage undoubtedly was stimulated by the support of segments of the business community which feared the uncontrolled ability of hostile bidders to take over control of a target company, the ostensible purpose of the statute was to render the bidding and countering process as behaviorally neutral as possible.[420] The new law, again applicable to corporations of the size and share distribution pattern previously mentioned, provides for presentation of information about the bidder, and particularly about the securities it offers in exchange for the solicited stock, of about the same detail and in the same form as is provided in a proxy solicitation of a shareholder vote for a statutory merger or sale of assets reorganization. The information is filed with the SEC and a "prospectus" version of the information publicly disseminated, often by means of massive newspaper advertisements. In addition, and for our purposes more significant, the law requires that the solicitation of tenders remain open for a minimum period of time, that increases in the offer price also apply to already tendered stock, and that in the

416 TSC Industries, Inc. v. Northway, Inc., 426 U.S. 438 (1976).

417 Which is not to say that misleading proxy soliticitation in this situation is immune from attack; the dominant shareholder may well have other motives for seeking outside shareholders' support. See Mills v. Electric Auto-Lite Co., 396 U.S. 375 (1970); and the even more pointed discussion in Laurenzano v. Einbender, 264 F. Supp. 356 (E.D.N.Y. 1966) (a frequently cited opinion).

418 See JENNINGS & BUXBAUM, *supra* note 194, at 1094. An important recent review of this phenomenon is found in a recent pair of Delaware cases: Weinberger v. UOP, Inc., 409 A.2d 1262 (Del.Ch. 1979), *reversed on other grounds*, 457 A.2d 701 (Del. 1983) and Harman v. Masoneilan International, Inc., 442 A.2d 487 (Del. 1982).

419 Securities Exchange Act §§ 13(d), (e); 14(d)-(f), 15 U.S.C. §§ 78m(d), (e); 78n(d)-(f) (1968).

420 See JENNINGS & MARSH, *supra* note 21, at 686; ARANOW, EINHORN & BERLSTEIN, *supra* note 414, at 64-68.

case of solicitations for less than all of the target company's stock oversubscription be treated in a neutral fashion, rather than on a "first come first served" basis pressuring tendering shareholders to make their respective decisions quickly.[421] In addition, of course, full disclosure of such important secondary matters as plans for eventual full merger if control is obtained through the tender, and plans concerning disposition of target corporation assets or management resources, also is required.

The Williams Act spawned considerable litigation,[422] not only the inevitable and almost standard litigation concerning adequacy of substantive disclosure, but a good deal of formal litigation concerning the standing of various groups to claim violations of the procedure and, again important from our perspective, litigation concerning two-stage or "creeping" acquisitions – the acquisition of a block of stock privately, without a public acknowledgement of later plans and without any requirement of compliance with Williams Act requirements, followed, from that position of strength by a public tender offer.[423] All in all, while incumbent management has substantial defensive power, not only in reaction to a solicitation but also by means of early preemptive maneuvers making future takeover bids more difficult,[424] such bids continued to proliferate during the 1970's. As a result, a large number of states adopted their own takeover control regulation, much of it more explicitly protective of the status quo, usually by reference to the need to preserve local employment and continued local ownership of enterprise.[425]

421 See the full discussion in SEC Exchange Act Release No. 16385 (29 Nov. 1979).

422 See authorities cited *supra* note 420.

423 Wellman v. Dickinson, 475 F.Supp. 783 (S.D.N.Y. 1979). On this and the perhaps more important related problem of stock exchange purchases preceding tender offers, see SEC Exchange Act Release No. 8712, "Adoption of Rule 10 b-13 Under the Securities Exchange Act of 1934" (1969); and Note, "The Developing Meaning of 'Tender Offer' under the Securities Exchange Act of 1934," 86 *Harv. L. Rev.* 1250 (1973).

424 Defensive power has become the subject of a major debate, including some important theoretical pieces on the role of management and the nature of the corporation. For recent major discussions in this ongoing debate, see EASTERBROOK & FISCHEL, "The Proper Role of a Target's Management in Responding to a Tender Offer," 94 *Harv. L. Rev.* 1161 (1981); GILSON, "A Structural Approach to Corporations: The Case Against Defensive Tactics in Tender Offers," 33 *Stan. L. Rev.* 819 (1981); and BEBCHUK, "The Case for Facilitating Competing Tender Offers," 95 *Harv. L. Rev.* 1028 (1982).

425 See "State Take-Over Statutes and New Take-Over Strategies – A Panel," 32 *Bus. Law.* 1459 (1977); JENNINGS & MARSH, *supra* note 21, at 631-32. See also the discussion of just this aspect of the state-control problem in *Edgar v. MITE, supra* note 71, in the immediately following text.

4. The Issue Joined: The Constitutional Attack Under the Commerce Clause

The coexistence of two hurdles for the tender offeror caused considerable legal turmoil, a function of the mechanical as much as of the substantive differences of the two systems; indeed, of the applicability of multiple systems, since some of the state laws permitted the intrusion of that state's regulatory agencies in cases in which other states had equal and perhaps greater contact and thus equal or greater grounds for involvement. Given the nature of these hostile takeover bid disputes it was understandable that a reaction to this awkward and highly charged situation would develop, leading to constitutional attack on these statutes both under dormant Commerce Clause principles and on the basis of the preemptive effect of the Williams Act under the Supremacy Clause.

The 1982 decision of the Supreme Court in *Edgar v. MITE Corporation*[426] discusses both elements of the federal constitutional regime to strike down the Illinois Business Take-Over Act and, with it, an uncertain number of similar statutes. That Act applied if 10% of a class of equity securities (themselves a subject of the tender offer) were held by Illinois shareholders, or if the corporation had its seat in the state, or if 10% or more of its "stated capital and paid-in surplus" was (represented by assets located) in Illinois. In that case the offeror had to file its offer with the Secretary of State; it was effective 20 days thereafter unless a hearing was ordered to determine whether the offeror had made full and fair disclosure of all material facts to the officers or whether it was inequitable. The hearing could be triggered not only by the Secretary but also by a majority of the target's outside directors (not affiliated with the offeror nor executive officers of the target) or by target shareholders holding at least 10% of that class of stock. No time limit was provided within which the hearing was to be completed.

In an opinion which as to this aspect is *not* the opinion of the Supreme Court, Justice *White* found three aspects in which the Illinois Act conflicted with the Williams Act, all aspects going to the basic purpose of the latter and thus subject to its preemptive effect under the Supremacy Clause.[427] First, the

[426] 457 U.S. 624 (1982); see also the review in "The Supreme Court, 1981 Term," 96 *Harv. L. Rev.* 1, 62-71 (1982), and in the text *supra* at pp. 49-50.

[427] 457 U.S. at 630-34. *Cf.*, however, L. Loss, *Fundamentals of Securities Regulation* 603 (Boston 1983), who argues that because other Court members simply bypassed the issue (joining on other grounds), the preemptive potential of the Williams Act remains open. In Dynamics Corp. of America v. CTS Corp., 794 F.2d 250 (7th Cir. 1986), *prob. juris. noted*, 107 S. Ct. 258 (1986) (discussed *infra* at pp. 146 & 152-53), a "second generation" state takeover regulation statute was invalidated on the authority of this segment of *Edgar v. MITE*, with no discussion of whether a preemption argument in fact can rest on that decision. In April 1987 (after this Chapter went to print) the US Supreme Court decided CTS Corp. v. Dynamics Corp. of America,

20-day delay, during which the offeror could not communicate the offer to the target's shareholders though the target's directors could already do so, was held to conflict with the federal regime's failure to impose a pre-offer registration requirement. It is clear, as *White* pointed out, that this latter was an explicit choice of its proponents made after substantial debate. It is unclear, however, why pre-offer registration should collide significantly with the Williams Act and he made no effort to identify any such conflict.

White did identify these conflicts, instead, in his discussion of the second major category of collision, the delay occasioned by the administrative review and possible hearing. Because of the potentially indefinite length of that review period, the target company's management is in a position to mount substantive attacks on the offeror and the offer. The nature of these defensive maneuvers is worth looking at in some detail, because they go to the heart of the argument that differing economic philosophies explain the federal-state collision, under Commerce Clause principles, of economic regulation efforts.

Justice *White* had to accept the fact that a later Congressional enactment, the Hart-Scott-Rodino Antitrust Improvements Act of 1976,[428] contradicts the Williams Act on just this point of pre-offer notification as to all potential takeover bids having certain minimal antitrust consequences, since that Act provides for a 15-50-day delay.[429] He used the fact that this delay was so limited to contrast it with the mischief that a longer, possibly indefinite delay permitted (somewhat disingenuously, given that this time limit does not preclude later litigation by the Department of Justice to rescind a merger, not to mention even earlier preliminary injunction delays based on just that notification).[430] Quoting from the *amicus curiae* brief of the SEC, which opposed the state regulation, *White* identified the following options that extended delay offers the target company's management:

(1) repurchase its own securities;
(2) announce dividend increases or stock splits;
(3) issue additional shares of stock;

107 S. Ct. 1637 (1987), and upheld the constitutionality of the state takeover statute against both Supremacy Clause and negative Commerce Clause challenges. Unlike *MITE*, the *CTS* case accepted the legitimacy of a preemption argument under the Supremacy Clause, but held that the jurisdictionally and substantively modest statute did not impinge enough on Williams Act premises to trigger a preemption. The Commerce Clause issue was resolved in a more complex fashion: see *infra* note 458.

428 Pub. L. No. 94-435, 15 U.S.C.A. § 18a.

429 *Id.*, § 18a(e); see also the implementing rules, 16 C.F.R. § 801.30.

430 15 U.S.C.A. § 18a(f). For a more realistic view of the "flexible" administrative delay actually at work in these situations than the rather stylized view of the Supreme Court, see POGUE, "Effects on Other Merger Transactions: Does the Government Abuse Its Newly Granted Power?," 48 *Antitrust L.J.* 1471, esp. 1478-83 (1979).

(4) acquire other companies to produce an antitrust violation should the tender offer succeed;
(5) arrange a defensive merger;
(6) enter into restrictive loan agreements;
(7) institute litigation challenging the tender offer.

What is missing from his reliance on this catalogue, of course, is any normatively or factually based explanation of why this behavior contradicts the Williams Act. A substantial academic debate presently exists concerning the legitimacy of target board defensive activity of just this sort, not only from the perspective of allocative efficiency but from the political and institutional economic perspective of long-run effects on industrial policy, technological and managerial innovation, and even monetary and fiscal policy.[431] Furthermore, the extent of both reactive and preemptive defensive activity permitted by, or at least occurring despite, the Williams Act is so great that it borders on naiveté to identify the federal-state regulatory conflict as the context within which the issue of offeror and target behavior is to be fought out.[432]

That issue is even more sharply highlighted by *White*'s third category of conflict between the two laws: the debatable assertion that unlike the Williams Act's full disclosure policy, the Illinois Act permits the Secretary of State to prohibit the bid because it is "inequitable" – a paternalistic substantive standard that "offers investor protection at the expense of investor autonomy." He goes into no detail either of theory or of practice, despite the fact that at least under state blue sky regulation based on the "Western" model a substantial body of jurisprudence has helped define – and narrow – this substantive concept.[433]

And with that cross-reference the heart of the present unsatisfactory doctrinal situation is reached. As mentioned, on this part of the opinion, the question of the preemptive effect of the Williams Act under the Supremacy Clause, Justice *White*'s discussion did not carry his colleagues. One of the reasons may derive not only from the tender offer legislation area but also from the history

[431] See, e.g., the argument, from within the allocative efficiency frame of reference, that target company shareholders need a considerable amount of time to consider a tender offer, in BEBCHUK, *supra* note 424. On the play of legal arguments derived from public finance categorization of state laws as supportive of allocative, redistributive and stabilizing goals in this takeover bid field, see BUXBAUM, *supra* note 114.

[432] A reference to the recent three-way Bendix-Martin-Marietta-United Technologies takeover battle should suffice. For a brief judicial review of that battle, see Martin-Marietta Corp. v. Bendix Corp., 690 F.2d 588 (6th Cir. 1982); see also BRUDNEY, "Equal Treatment of Shareholders in Corporate Distributions and Reorganizations," 71 *Cal. L. Rev.* 1072, 1120 (1983).

[433] See DAHLQUIST, "Regulation and Civil Liability Under the California Corporate Securities Act," 34 *Cal. L. Rev.* 344, 543, 695 (1946); and MARSH & VOLK, *supra* note 401.

of state blue sky legislation. The Securities Exchange Act explicitly saves both types of state statutes to the following uncertain degree: "insofar as it does not conflict with the provisions of this chapter or the rules and regulations thereunder."[434] Since the Illinois Act clearly created only a "two-hurdle," not a "conflict-of-obeisance" problem, the conflict had to be the kind traditionally described as one in which the state law "stands as an obstacle to the accomplishment and execution of the *full* purposes and objectives of Congress."[435]

It was in applying this standard to the collision of the two statutes that *White* delivered the above discussion and failed to carry his colleagues. And it was in the first part of his subsequent discussion of the effect of the dormant Commerce Clause – that Illinois "directly" rather than only "incidentally" regulated interstate commerce (on which, again, he failed to carry the Court)[436] – that he either had or chose to distinguish the traditional federal toleration of state blue sky legislation, including, of course, legislation of the substantive and not only of the full disclosure variety, from state tender offer regulation. He did so, unfortunately, by resurrecting the all but discredited characterization of securities transactions affected by blue sky registration and permit requirements as intrastate in nature, to be contrasted with the interstate character of securities transactions affected by tender offer regulation. This distinction, based on the trio of 1917 cases upholding the first generation of state blue sky laws, not only has lost its significance with the onset of the much more expansive Depression-era definitions of interstate commerce, but is no longer even a correct factual statement of the purported reach of modern (again, post-Depression) state blue sky regulation.[437]

The overall result of Justice *White*'s approach to the preemption problem as well as to this problem of saving blue sky regulation was obviously unsatisfactory to the Court, and probably for the following reasons. First, it jeopardizes the continued legitimacy of blue sky regulation because of the unsatisfactory distinction which he drew in an effort to safeguard it. It would undoubtedly have been better to distinguish blue sky regulation on the basis of the intention of the Securities Exchange Act and to interpret its savings clause, in this instance, as permitting a ruling that the purposes of blue sky regulation are com-

[434] Securities and Exchange Act of 1934, § 28(a), 15 U.S.C. § 78bb(a).

[435] 457 U.S. at 631, *quoting* Hines v. Davidowitz, 312 U.S. 52, 67 (1941) (emphasis added by authors).

[436] This concept, a relic of the 1930's generally, is discredited today as an unrealistic and unworkable distinction. See text *supra* at p. 50; TRIBE, *supra* note 86, at 326-27.

[437] See Travelers Health Ass'n v. Virginia, 339 U.S. 643, 652 (1950) (Douglas, J., concurring); Merrill, Lynch, Pierce, Fenner & Smith, Inc. v. Ware, 414 U.S. 117, 138 (1973). For a similar criticism of the use of these cases, see WARREN, "Reflections on Dual Regulation of Securities: A Case Against Preemption," 25 *Bost. Coll. L. Rev.* 495 (1984).

patible with the purposes of federal investment regulation. To do that, however, would have converted a discussion that already was overloaded with dicta to a gratuitous and inadequately briefed advisory opinion on a relatively abstract level.

The more important reason for the discussion's unsatisfactory nature, however, lies in the sweep of the preemption argument. All state tender offer regulation presumably would be blocked thereunder, since the Illinois interest in protecting locally-owned and operated businesses from distant takeovers would be given no weight; nor would a more limited and less aggressive state law, one that applied only if most incidents of ownership, employment and asset location were local, be distinguishable and saved from the preemptive effect of the Williams Act.[438] The nature of the collisions between the state and federal regulatory approaches postulated by *White* would not depend upon or permit such jurisdictional variations; at the most, there is room to argue that a state law requiring only full disclosure, and permitting no paternalistic review of the bid, would be saved. Even that is doubtful, given the separate objection *White* raises to the pre-offer registration requirement. In short, the preemption argument based on the Williams Act logically would permit no state regulation other than that identical in procedure as well as in substance with the Williams Act and therefore useless except in the area of corporations not subject to the minimum jurisdictional threshold of the federal statute.

The majority of the Court therefore chose to place their reliance upon the dormant Commerce Clause, in that version which weighs non-discriminatory but "unintentionally" burdensome state regulation of interstate commerce

[438] Indeed, some lower courts have so understood the opinion. See *Martin-Marietta*, 690 F.2d 588 (1982), and Telvest, Inc. v. Bradshaw, 697 F.2d 576 (4th Cir. 1983); but *cf.* Agency Rent-A-Car, Inc. v. Connolly, 686 F.2d 1029 (1st Cir. 1982), heroically steering to keep both the preemptive and Commerce Clause aspects of *MITE* within bounds.

On the other hand, the suggestions in the opinion that properly defined local interests might – somehow – redefine the Commerce Clause implications, under Justice Powell's "prudential" approach, already have led to state legislative efforts to do just that. In this effort these bills can find support in the test of § 1904(c), ALI, *Proposed Federal Securities Code, supra* note 397, which would (as federal law) preserve state jurisdiction over target companies 50% or more of whose shareholders were residents thereof. On this recent development, see the discussion *infra* notes 477 & 478 and accompanying text; STEINBERG, "State Law Developments: The Pennsylvania Anti-Takeover Legislation," 12 *Sec. Reg. L. J.* 184 (1984). It remains to be seen whether the application of *Edgar v. MITE* (and, what is more surprising, of its Williams Act preemption dicta as well as of its negative Commerce Clause holding) to the more restrained state statutes of the sort at issue in *Dynamics Corp., supra* note 427, will find adherents. To that the 1987 Supreme Court decision in the latter case provides some guidance: see *supra* note 427 and *infra* note 458.

against the nature of the local interests underlying the state law.[439] Before reviewing this approach, a first not so minor doctrinal problem of constitutional law needs to be clarified: the sequence in which the Supreme Court addresses dormant Commerce Clause principles and preemption principles. As one concurrence put it, "Because it is not necessary to reach the preemption issue, I join only [the dormant Commerce Clause] opinion."[440] In fact, it would seem that one aspect of the federal statute should be reviewed first; namely, whether it intends the "exhaustion" of federal Commerce Clause power or whether there is room to argue the availability of a dormant Commerce Clause preemptive effect despite the absence of conflict between the federal regulation (itself bottomed on the Commerce Clause) and the state regulation in question. It would, of course, be possible to take any federal regulation of a subject as exhaustive in that sense, but this is neither logically necessary nor a sound policy argument. The effect of such an approach would be to force the Congress into an all-or-nothing consideration of what itself may often be an ill-defined problem area, in order to avoid the conclusion that its partial incursion into the field implies a decision that the balance of the field, or the balance of the problems already or not yet identified in that field, is free game for piecemeal and perhaps multiple non-uniform state incursions.[441]

The same objections would apply to a lesser extent in a situation such as the present one, in which an uncertain savings clause for state regulation is inserted

[439] 457 U.S. at 643-46.

[440] *Id.* at 655 (O'Connor, J., concurring in part).

[441] This problem is the obverse of that addressed by Professor Powell, in POWELL, "Business Taxes and Interstate Commerce," in *Proceedings of National Tax Association 1937,* at 337, 338, reprinted in 3 *Selected Essays on Constitutional Law* 931, 932 (St. Paul 1938) (as quoted in MONAGHAN, *supra* note 91, at 16-17 n.92 – a comment still relevant):

> Congress can regulate interstate commerce just by not doing anything about it. Of course, when congress keeps silent, it takes an expert to know what it means. But the judges are experts. They say that congress by keeping silent sometimes means that it is keeping silent and sometimes means that it is speaking. If congress keeps silent about the interstate commerce that is not national in character and that may just as well be the states', then congress is silently silent and the states may regulate. But if congress keeps silent about the kind of commerce that is national in character and ought to be regulated only by congress, then congress is silently vocal and says that the commerce must be free from state regulations.

On the continuing validity of this "observation," see Arkansas Electric Cooperative Corp. v. Arkansas Public Comm'n, 461 U.S. 375 (1983); *cf.* ANDERSON, "The Meaning of Federalism: Interpreting the Securities Exchange Act of 1934," 70 *Va. L. Rev.* 813, 818 (1984).

into the federal statute.[442] Unless that savings clause is clear enough to suggest explicit Congressional abdication in a defined field to (perhaps only preexisting) state regulation, it probably adds little to the previously discussed situation.[443] Such full abdication is rare and when it has occurred it has been on the basis that a defined area of commerce, interstate in its nature, is to be left in its entirety to the states to regulate. The best example, already mentioned,[444] is the unusual McCarran-Ferguson Act of 1945,[445] undoing the effects of the Supreme Court's *South-Eastern Underwriters* opinion[446] which (itself undermining that aspect of *Paul v. Virginia*) had held that insurance was interstate commerce. The Act, recognizing this decision, then explicitly returned to the states the duty of regulating the industry and expressed Congressional intention not to regulate the field[447] provided that state regulation of a defined adequate nature continued to exist.[448] In short, the dormant Commerce

442 The issue is briefly discussed in an inconclusive predecessor Supreme Court opinion in the state tender offer legislation area, Leroy v. Great Western United Corp., 443 U.S. 173, 182 (1979). The lower court in *MITE* did add a brief, almost off-hand separate discussion of the effect of the Commerce Clause, but only in the context of the exorbitant jurisdictional claim of the Illinois statute: MITE Corp. v. Dixon, 633 F.2d 486, 499-500 (7th Cir. 1980).

443 It is, however, worth noting that the existence of the savings clause in substantial part led the lower court to recognize that "the absence of an exclusive federal interest in the field of securities regulation is persuasively demonstrated," and, in doctrinal terms, permitted only a finding that the Williams Act, under the circumstances of the particular case, was detrimentally affected by the state law. Neither a general preemptive judgment was justified, nor – most significantly – any analysis under the dormant Commerce Clause. See *MITE v. Dixon*, 633 F.2d at 491-92, 498.

For a current statement of the Supreme Court's analytical method in preemption-Supremacy Clause cases, see Michigan Canners & Freezers Ass'n, Inc., v. Agricultural Mktg. & Bargaining Bd., 464 U.S. 548 (1984); *cf.* SUNSTEIN, "Naked Preferences and the Constitution," 84 *Colum. L. Rev.* 1689 (1984); and see now *CTS v. Dynamics, supra* note 427.

444 See *supra* at p. 48, text accompanying note 95.

445 59 Stat. 33, 15 U.S.C. §§ 1011 ff (1945). As put in DOWLING, *supra* note 95, at 556: "Taken as a whole, nothing just like this [the text of § 1011, *infra* note 447] had ever before been written on the statute books."

446 United States v. South-Eastern Underwriters Ass'n, 322 U.S. 533 (1944).

447 As stated in § 1011: "Congress declares that the continued regulation and taxation by the several States of the business of insurance is in the public interest, and that silence on the part of the Congress shall not be construed to impose any barrier to the regulation or taxation of such business by the several States."

448 The effect of this kind of delegation, in practical terms, is to force the states into uniform regulation; the whole concept of delegation would not be feasible if the several states had differing regulatory approaches to such a subject matter. For a discussion of the activity of the National Association of Insurance Commissioners following upon this decision, an activity which continues to this day, see BEACH,

Clause can best be envisaged as a kind of higher stratum of federal preemption that floats above and needs to be considered beyond the stratum of explicit Congressional enactments under the Commerce Clause, though, being itself only "constitutional common law" it can be defined, and its reach defined away, by explicit Congressional enactment.[449]

It seems, then, that the preemption issue should be faced first, but, if inconclusive, necessarily should be followed by analysis under the dormant Commerce Clause. Justice *White*'s discussion thereof is the opinion of the Court and needs further analysis. Before this, however, it is instructive to note why some Justices who apparently recognized the possibility of using the direct preemption analysis under the Williams Act, preferred to avoid that approach entirely. Most explicit is Justice *Powell*:[450] "I join [the dormant Commerce Clause discussion] because its . . . reasoning leaves some room for state regulation of tender offers." Then, and in terms of the sequence of doctrinal analysis, Justice *Powell* goes on:[451]

> [T]he Williams Act's neutrality policy does not necessarily imply a Congressional intent to prohibit state legislation designed to assure – at least in some circumstances – greater protection to interests that include but often are broader than those of incumbent management.

"The *South-Eastern Underwriters*' Decision and Its Effects," [1947] *Wis. L. Rev.* 321. The major analysis of the Act's legislative history by the Supreme Court is that in FTC v. Travelers Health Ass'n, 362 U.S. 293 (1960).

449 This is not to say that congressional effort to expose interstate commerce to potentially discriminatory state legislation or legislation otherwise assailable under due process or equal protection concepts could be legitimated by such congressional action. See, e.g., Note, "Congressional Consent to Discriminatory State Legislation," 47 *Colorado L. Rev.* 927 (1947); and, more generally, DOWLING, *supra* note 95. On the larger proposition of the text – that Supremacy Clause as well as dormant Commerce Clause rationalization is a species of judicial legislation guided more by underlying economic and social value judgments than by strict doctrine – the recent case of Southland Stores v. Keating, 465 U.S. 1 (1984) provides major and unsettling new insights. The case finds in the Federal Arbitration Act federal preemption of a state statute that prohibited arbitration in investor protection (franchise) situations on public policy grounds. This use of the Act was further extended in Dean Witter Reynolds, Inc. v. Byrd, 105 S. Ct. 1238 (1985) and may soon sweep the field, depending on the pending result in Shearson/American Express Co. v. McMahon, 788 F.2d 94 (2d Cir. 1986), *cert. granted*, 107 S. Ct. 60 (1986). See generally HIRSHMAN, "The Second Arbitration Trilogy: The Federalization of Arbitration Law," 71 *Va. L. Rev.* 1305 (1985), who suggests, at 1354-55, that even disputes about the effective formation of contracts containing arbitration clauses now may have become "federalized." That extension, however, was rebuffed in Hull v. Norcom, Inc., 750 F.2d 1547 (11th Cir. 1985).

450 457 U.S. at 646 (Powell, J., concurring in part).

451 *Id.*

The reasoning implies that the definition of the collision with state law created by the reach of the dormant Commerce Clause is a function of the explicit Congressional statute; in other words, that the Williams Act defines the existence, let alone the width, of the stratum of subject matter reserved to exclusive federal regulation under the dormant Commerce Clause.

The substance of the dormant Commerce Clause analysis, now finally reached, concerns the mentioned weighing of local interests against the already identified burden of that regulation on interstate commerce. The first local interest is that of protecting resident security holders. The Court's response to this assertion is the typical one of overinclusion and underinclusion.[452] As to the former interest, the fact that the state at the same time is affecting ("protecting") non-resident shareholders, leads the Court to assert that as to this aspect "there is nothing to be weighed in the balance to sustain the law."[453] Why the state has no legitimate interest in protecting non-resident shareholders is not explored, and the assertion is not necessarily intuitive. Even non-resident shareholders may prefer investment in a "local" company for the same reasons that lead local investors to do so. The institutional concerns that lead local investors to take an enlightened long term view of profit maximization, if legitimate, are equally legitimate when held by out of state investors in that local company; the Court's unstated assumption that out of state investors are arbitrageurs or speculators, while local investors are paragons of yeomanry, whatever else it is, is not factually demonstrated.[454]

The second, "underinclusion" aspect concerns the fact that the Illinois Act "completely exempts from coverage a corporation's acquisition of its own shares."[455] As the Court pointed out, in this very case the target company was able to make a competing tender offer for its own stock without being caught in the state regulatory machinery. Whether this fact is sufficiently explained without reviewing the legislative fact finding that led – or in sympathetic judicial interpretation might have led – to coverage of one and not the other transaction, again is doubtful. Certainly in analogous situations this kind of deference to legislative judgment is common; the Court's imposition of a substantially higher burden of persuasion on the state legislature and legislation, on the other hand, is a known feature of its understandably pro-federal protective role in its Commerce Clause jurisprudence.[456]

[452] *Id.* at 645.

[453] *Id.* See now also REGAN, *supra* note 88, at 1278-83.

[454] This point is made in a wider sense, as an element of choice-of-law theory, in ELY, "Choice of Law and the State's Interest in Protecting Its Own," 23 *Wm. & Mary L. Rev.* 173 (1981).

[455] 457 U.S. at 644.

[456] See the explicit discussion of non-deference in Foster-Fountain Packing Co. v. Haydel, 278 U.S. 1 (1928).

The second local interest Illinois claimed was its interest in regulating the internal affairs of an Illinois corporation. On this point Justice *White*'s response is interesting enough, particularly in the larger context of this chapter, to deserve full quotation:[457]

> Appellant also contends that Illinois has an interest in regulating the internal affairs of a corporation incorporated under its laws. The internal affairs doctrine is a conflict of laws principle which recognizes that only one state should have the authority to regulate a corporation's internal affairs – matters peculiar to the relationships among or between the corporation and its current officers, directors, and shareholders – because otherwise a corporation could be faced with conflicting demands. See *Restatement (Second) of Conflict of Laws*, § 302, Comment b at 307-308 (1971). That doctrine is of little use to the state in this context. Tender offers contemplate transfers of stock by stockholders to a third party and do not themselves implicate the internal affairs of the target company.

This is an interesting and potentially troublesome use of the internal affairs concept. In the first place it is too simplistic a definition of the doctrine and shortcuts a substantial debate concerning the fit of share exchange law in the larger body of corporate law dealing with reorganization and dissolution. A respectable case can be made, and the lower court discussed it fully, in favor of a definition of "corporation law" that would include this element in its agenda.[458] In any event, whether to label it as belonging to corporation law, whether to label it as subject to the choice-of-law principle expressed in shorthand fashion by the internal affairs label, seems of little use in determining the legitimacy and weight to be given to the local interest in this Commerce Clause analysis. Thus, the relation of a corporation to its putative investors, encom-

[457] 457 U.S. at 644-46.

[458] *MITE v. Dixon*, 633 F.2d. at 495 ff. *Cf.* also Diamond v. Oreamuno, 24 N.Y.2d 494, 248 N.E.2d 910, at 915 (1969):

> Although the impact of Federal securities regulation has on occasion been said to have created a 'Federal corporation law', in fact, its effect on the duties and obligations of directors and officers and their relation to the corporation and its shareholders is only occasional and peripheral.

This was said in the context of an action essentially based on investor protection, though smuggled into the doctrinal context of fiduciary duty.

In *CTS v. Dynamics*, *supra* note 427, (decided after this Chapter went to print), on the one hand, the Supreme Court rejected the notion that a collective shareholder vote on the right of a control acquiror to exercise that control somehow fell outside the "normal" range of internal affairs governed by state law. On the other hand, it came close to conditioning that result on the requirement that only one state's law – and that the law of the state of incorporation – would apply to that kind of transaction. The opinion is open-textured enough that it may allow another *significantly affected* state's law also to apply, at least to other, more traditional internal affairs matters if not also to takeover matters – see BUXBAUM, "The Threatened Constitutionalization of the Internal Affairs Doctrine in Corporation Law," 75 *Calif. L. Rev.* 29 (1987) – but the exact degree of latitude thus available cannot yet be determined.

passed within the concept of securities regulation, probably is best understood as a species of public law, not governed by an internal affairs choice-of-law rule; nevertheless, this would not lessen the significance of the local interest in the Commerce Clause analysis.

To the extent the argument was formulated in a semantically unfortunate way by the state, the problem may be trivial. What is not trivial is the implication of the argument for the question of state control of analogous reorganization transactions which are carried out through the majoritarian voting decisions of shareholders following a proxy solicitation. State blue sky control of those transactions is of somewhat more recent vintage than original state blue sky control of the issuance of securities for the raising of capital,[459] but it should

[459] See ORSCHEL, "Administrative Protection for Shareholders in California Recapitalizations," 4 *Stan. L. Rev.* 215 (1952); and more generally, LOSS, *supra* note 410, at 64-65.

A fortiori, analogous controls found in traditional corporation law regulation (such as fairness of proxy material, and judicial concepts of fairness of voting procedures or of majoritarian or – as in earlier years – supermajoritarian approval requirements) presumably would be immune from unusual scrutiny under the Commerce Clause. See *Wilson*, 138 Cal. App. 3d 216 (1982) (*supra* note 241); BUXBAUM, *supra* note 247.

See, however, the extended argument of KOZYRIS, *supra* note 220, at 35 ff, which, following HOROWITZ, *supra* note 244, comes to the conclusion that *MITE*'s casual rejection of the notion that local shareholdings justify a state's interest in the internal affairs of a foreign corporation, even if it does not directly constitutionalize the traditional conflicts rule, does limit other states' intervention to the case of pseudo-foreign corporations:

> It is clear that this extended rationale [i.e., one that reaches beyond the pseudo-foreign case] cannot withstand the *MITE* scrutiny. . . . The presence of *some* local shareholdings and *some* local corporate business is insufficient to support the interference with voting rights that occurred in *Western Air Lines*, and that, as a practical matter, extended to all shares whatever their location and whatever the situs of the other corporate contacts.

Id. at 42.

This approach, equating vertical (state-federal) with horizontal (state-state) impact on commerce (see *supra* note 244), seems to contradict the implications of *Allstate (supra* note 290) as to the proper balancing test. We emphasize, however, that this brief discussion of so comprehensive a study cannot do justice either to its underpinnings or to its nuanced qualifications. Whether the recent hints of limits on exorbitant choice-of-law rules in the context of multistate class actions, found in Phillips Petroleum Co. v. Shutts, 105 S. Ct. 1965 (1985), will bear on KOZYRIS' theses remains unclear. See MILLER & CRUMP, "Jurisdiction and Choice of Law in Multistate Class Actions After *Phillips Petroleum Co. v. Shutts*," 96 *Yale L.J.* 1 (1986). There also is a hint of further discussion to come in the following comments in Burger King Corp. v. Rudzewicz, 471 U.S. 462, 477 (1985): "[Considerations defeating personal jurisdiction] usually may be accommodated through means short of finding jurisdiction unconstitutional. For example, the potential clash of the

not for that reason suffer any more hostile scrutiny under the Commerce Clause than that earlier type of regulation.

One of us has elsewhere analyzed this effort to shape such a controversial economic efficiency argument into legal, even constitutional doctrine, and concluded that the real vice of *Edgar v. MITE* is "not that the Supreme Court claimed too much political discretion . . . but that it too abruptly and permanently foreclosed the ordinary, prudential use of that discretion in this particular [area]." It seems to us that otherwise analogous state impact on the interstate settings of similar economic activity would enjoy a more "balanced" test under *Pike v. Bruce Church, Inc.*; and would enjoy that lighter supervision whether the state regulation was explicitly redistributional in nature or simply had a different efficiency-supporting underlying rationale. It seems to be the separation of passive investment and active ownership in the stock market setting that led, perhaps inadvertently, to this overemphasis on the interstate impact and underemphasis on the countervailing state policy. If that is a valid criticism, if *Garcia*'s implications in fact will operate to restrain unduly ebullient use of dormant Commerce Clause arguments, and if the post-*MITE* straws in the wind, mentioned immediately below, indeed are harbingers of a more balanced approach toward state regulation of the specifically corporate aspects of economic activity, then the implications of *MITE* may be less critical than is suggested by the foregoing analysis.

5. Prospects for the Future

What, then, is still available as legitimate state regulation of tender offer transactions, assuming that the implications of the decisions for traditional blue sky regulation are less troublesome than a close reading of the impact of the decision might suggest?[460] The cryptic concurrences of Justices *Powell* and *Stevens*, to the effect that there is some room for state regulation of tender offers hereafter, seem to focus on "relatively small or regional target" corporations and on the local interest in having some "headquarters" activity remain in its respective prior locations.[461] *Powell*'s comment that the Williams Act does not preclude state legislation protecting local interests, even if the indirect result is to protect incumbent management, is based more upon the Supremacy Clause and its preemptive power (as this is brought into play by the Williams

forum's law with the 'fundamental substantive social policies' of another State may be accommodated through application of the forum's choice-of-law rules."

[460] But *cf. Martin-Marietta v. Bendix*, 690 F.2d at 563, 568, rather casually suggesting that aspects of blue sky regulation could fall to the wider reaches of *MITE*.

[461] 457 U.S. at 2643-44. *Cf.* the lower court discussion, *MITE v. Dixon*, 633 F.2d at 499-500.

Act) than it is upon the dormant Commerce Clause;[462] yet it is a comment particularly apposite to the latter type of analysis. At the least, it suggests that the Williams Act does not intend to "activate" the *dormant* area of potential federal preemption of state activity under the Commerce Clause, and thus still leaves room for a case by case review and balancing exercise, of course under the control of the Supreme Court.

The intriguing question, not easily answered at this stage, is what kind of legislation, both as to its jurisdictional threshold and as to the nature of its substantive standards, is still permissible. The most modest answer would suggest that only a "mini-Williams Act" state law, applicable to corporations below the threshold of applicability of the federal Williams Act, would be appropriate.[463] A more expansive prediction would suggest that there can be an overlap of regulation of the same corporate entities, but that the concerns of the state legislation can be no different than those of the Williams Act (neutrality of adversary combat and investor protection through disclosure rather than through substantive review) – which, of course, suggests that there would be no need for state law in that area.[464] A yet more expansive prediction would suggest that even as to doubly regulated entities, the state regulation can address concerns not encompassed under a simple "full disclosure" philosophy so long as the triggering jurisdictional elements (percentage of local shareholders, percentage of local assets, percentage of local employment) are at least as high as those currently used in modern statutory choice-of-law regimes for corporation law *per se*.[465]

That, of course, is both the glory and the curse of the inherently vague dormant Commerce Clause analysis from its institutional perspective. The more closely the transaction is tied to a given state the more assertive that state can be vis-à-vis federal concerns. That is not the only criterion and indeed it should be no more than a subordinate criterion; but at least in intangible "commerce" channels, channels in which "commerce" really is shorthand for a complex institutional frame of activity and corresponding frame of legal control, it is an important one. Seen from this perspective, and giving due weight to the admittedly obscure comments of at least two of the members of the majority in *MITE*, the more important defect of the Illinois statute probably was its aggressive jurisdictional claim rather than its contrary substantive philosophy.

[462] See text *supra* at note 443. See also LOSS, *supra* note 410, at 99, and JENNINGS & MARSH, *supra* note 351, at 1264-65, 1271, regarding the role of advance notification of tender offers.

[463] See the analogous approach in the area of "mini-proxy" regulation, as in Calif. Corp. Code § 1501(a).

[464] And that the unnecessary expense of complying with two (or more) sets of identical regulatory processes might weigh in the balance.

[465] See text *supra* at pp. 88-90.

If that is correct, it is an important conclusion for transfer to the general field of state corporation law, and suggests that state experimentation with restructuring the governance of corporations would be able to flourish even in a federal regime otherwise closely jealous of federal supremacy in all aspects of the definition of that federal "Common Market." This conclusion is buttressed by the Court's emphasis, and not only in *MITE*, on the distinction between the internal affairs of a corporation from the perspective of management and hierarchy of control and the separable aspect of dealing in corporate securities. American doctrine knows that distinction as applied to the protean Rule 10b-5[466] and now has seen it applied, in reverse as it were, against state intrusion into at least one aspect of securities transactions. It may well be, therefore, that this formal distinction supports a substantive and essentially political sense of state autonomy in the shaping of owner-manager relationships. The implications of that approach to such specific issues as worker codetermination, worker profit sharing, public representation on boards of directors, as well as to such revived issues as limitation of shareholder voting power and so forth are obvious.

As to some of these – actual – issues, fragmentary post-*MITE* responses already are beginning to trickle in. Too few in number to form a pattern in any event, they do suggest the beginnings of conflicting tendencies. Some well-reasoned decisions have protected the ordinary stuff of (aggressive) corporation law rules, for now, from dormant Commerce Clause or preemption arguments: The already-described California choice-of-law opinion is the relevant example.[467] Another already-mentioned contrary example off-handedly suggests the infirmity of ordinary state blue sky legislation when used in the context of domestic-foreign company mergers.[468] And even an ordinary shareholder inspection rights statute has been challenged – unsuccessfully, it seems – because it might be used in a way indirectly permitting the inspecting party to violate a federal rule of securities regulation.[469] It is our impression that, on

[466] An early limitation of Rule 10b-5 was attempted in case the deception was essentially an "internal management dispute" with a transfer of securities only peripherally or secondarily involved; see the distinctions made in O'Neill v. Maytag, 339 F.2d 764 (2d Cir. 1964) and Ruckle v. Roto American Corp., 399 F.2d 24 (2d Cir. 1964). More recently the transfer of all of a corporation's stock to an allegedly defrauded buyer began to be challenged as not creating a Rule 10b-5 complaint, on the argument that the problem is basically one of breach of contract or contractual fraud rather than fraud in the issuance or transfer of securities. Two recent decisions of the Supreme Court, however, have in substantial part repudiated this argument and have found well-pleaded Rule 10b-5 causes of action in these situations. See Landreth Timber Co. v. Landreth, 105 S. Ct. 2297 (1985) and Gould v. Ruefenacht, 105 S. Ct. 2308 (1985).

[467] See *Wilson*, 138 Cal. App. 3d 216 (1982), *supra* note 241 and accompanying text.

[468] *Martin-Marietta v. Bendix*, 690 F.2d 588 (1982), *supra* note 432 and accompanying text. See generally Note, 51 *Fordham L. Rev.* 943 (1983).

[469] See Trans World Corp. v. Odyssey Partners, 561 F.Supp. 1311 (S.D.N.Y. 1983).

balance, the courts are taking these forays with a grain of salt; as imaginative exercises of lawyers' forensic skills rather than as serious concerns with the non-enabling, non-formal corpus of state corporation and enterprise laws.[470]

Interestingly enough, it is the "second generation," post-*MITE* state takeover control statutes that have generated the more balanced considerations of the state-interest/interstate-commerce conflict. In part this is the result of more moderate state statute drafting, both as to the threshold criteria for applicability (local incorporation or greater percentage of local contacts) and as to the nature of the state's regulation (more emphasis on the substantive right of remaining, non-tendering shareholders to determine whether the acquiror should obtain the voting power inherent in the purchased shares). In part, however, it also seems to be due to a basically more judicious second glance at these statutes and their impact than was cast by the first courts that had occasion to review these issues, as the illustrative cases of *Telvest, Inc. v. Bradshaw*[471] and *Cardiff Acquisitions, Inc. v. Hatch*,[472] make clear. It is beyond the scope of this study to analyze that second generation of statutes and this second round of judicial review in any detail, but the more recent American commentary on these issues tends to confirm this impression.[473]

So far as second generation state takeover statutes are just territorially more modest versions of the invalidated Illinois statute – applying, for example, only to locally incorporated entities or requiring somewhat less lengthy delays or less discretionary review – the eventual response of the federal judiciary is at present still evolving.[474] To the extent these new statutes take the more novel and yet in division-of-powers terms more traditional tack of simply enabling a company's shareholders to adopt a variety of anti-takeover devices in their articles of incorporation,[475] it may be more difficult to dislodge these devices

[470] See, e.g., *Searle v. Cohn*, 455 U.S. 404 (1982) (*supra* note 59); *Valtz v. Penta*, 139 C.A. 3d 803 (1983) (*supra* note 219 and accompanying text).

[471] 697 F.2d 576 (4th Cir. 1983).

[472] 751 F.2d 906 (8th Cir. 1984).

[473] In lieu of extended citations to both jurisprudence and literature, see SARGENT, "Do the Second-Generation State Takeover Statutes Violate the Commerce Clause?," 8 *Corp. L. Rev.* 3 (1985); see also BUXBAUM, *supra* note 458.

[474] Thus compare *Telvest* and *Cardiff, supra* notes 471 & 472 respectively, with *Dynamics v. CTS, supra* note 427. See now *CTS v. Dynamics, supra* notes 427 & 458.

[475] State legislatures are beginning to play on this theme in a disarmingly self-serving way; see the interesting Preamble to Ohio's post-*MITE* takeover statute, Rev. Code §§ 1701.832 & 1707.42 (Nov. 1982):

> (A) . . .
>
> (4) It is in the public interest for shareholders to have a reasonable opportunity to express their views by voting on a proposed shift of control, an opportunity currently available under Ohio corporation law in transactions with similar effects. The General Assembly also believes that it is in the public interest for

under either preemption[476] or negative Commerce Clause grounds.[477] That should particularly be true if the new state statute does not itself automatically set up a "loyalist shareholder" plebiscite on the actual takeover event itself, but

> Ohio securities laws to provide evenhanded protection of offerors and shareholders from fraudulent and manipulative transactions arising in connection with control acquisitions.
>
> (5) Initial state efforts to deal with tender offer developments have been questioned by the federal courts. The General Assembly observes that responsibility for general corporate laws is the function of state legislation and that no federal law of corporations exists. The General Assembly observes that securities law protection of state residents has long been recognized as an appropriate subject of state law regulation under the federal system. The General Assembly acknowledges an in loco parentis responsibility to shareholders who invest in corporations created under the laws of Ohio and to shareholders generally who reside in Ohio.
>
> (B) . . . Nevertheless, with a view to avoiding an undue burden on interstate commerce, as expressed in recent court decisions, the amendments are designed to have the minimum impact upon such commerce consistent with Ohio responsibility in respect to the subject matter. Accordingly, the security law amendments . . . are limited to application to Ohio resident investors, and the corporate law amendments . . . are limited to corporations created under the laws of Ohio with the strong Ohio ties provided in the amendments. The corporate legislation does not include a requirement for Ohio resident investors because of the difficulty of ascertainment by potential acquirers and others of the residence of shareholders. The General Assembly finds that corporations containing the jurisdictional nexus provided by the amendments may be deemed to have a substantial and significant shareholder base in the state.

See generally Note, "Has Ohio Avoided the Wake of *MITE*? An Analysis of the Constitutionality of the Ohio Control Share Acquisition Act," 46 *Ohio St. L.J.* 203 (1985); and the extended, and typologically useful, critique of KOZYRIS, *supra* note 220, at 48 ff.

476 Thus, see Dataprobe Acquisition Corp. v. Datatab, Inc., 722 F.2d 1 (2d Cir. 1983); but *cf. Dynamics Corp., supra* note 427.

477 Both *Dataprobe, supra* note 476, and Moran v. Household Int'l, Inc., 500 A.2d 1346 (Del. 1985), argue that the negative Commerce Clause cannot apply to the behavior of private parties that is permitted but not required under the state enabling legislation:

"*Edgar v. MITE* . . . [employs] a rationale [i.e., the negative Commerce Clause argument] inapplicable to the present dispute which involves private acts." *Dataprobe*, at 4-5.

"The fact that directors of a corporation act pursuant to a state statute provides an insufficient nexus to the state for these to be state action which may violate the Commerce Clause or the Supremacy Clause." *Moran*, at 1353.

contents itself with authorizing shareholders to enact charter amendments that would trigger such plebiscites or other devices at that later point when a takeover is attempted.[478]

An institutional reason for this restraint, and for a modest reading of the implications of *MITE*, derives from a perennial and unallayable concern with the legitimacy of the large corporation and its exercise of political power through its concentrated economic power. That is an old, much-mooted question and we do not intend to reopen it now in all its breadth. One aspect of the issue, however, is relevant to the present study: the influence of formal corporation law (and of course the influence of more substantive state regulatory law) on the many private and public actors' perception of purpose and legitimacy.

At the turn of the century the role of earlier state enabling statutes in shaping and supporting entrepreneurial activity was noted by both supporters and critics; *Hurst*'s formulation that nineteenth century courts helped "promote the release of individual creative energy"[479] can be applied to such legislation as well as to the courts; and, indeed, a substantial part of his lectures, published under the revealing title, "The Legitimacy of the Business Corporation in the Law of the United States 1780-1970" explores this connection between function and legitimacy on the one hand (understood as economic and consensual public value concepts) and state corporation law on the other.[480] More recently, an explicit connection between "weak" (enabling) state law and problems

Yet *Dynamics v. CTS*, without even addressing this [itself problematic] issue, simply states, in lapidary fashion, that the statute there involved "puts the acquirer at the tender mercies of the 'disinterested' shareholders," and thus by implication puts that kind of statute in the same category as the mandatory Illinois statute. The Supreme Court's reversal of the decision (see *supra* note 427) has resolved this discrepancy.

478 Such purely contingent enabling statutes are reviewed in SARGENT, *supra* note 473. It is these to which the "contract" argument of *Dataprobe* and *Moran* would quintessentially apply. The important new New York statute, as well as the Indiana statute under attack in *Dynamics Corp., supra* note 427, by contrast only call for a shareholder vote to dismantle, not to emplace, antitakeover provisions; see PINTO, "N.Y. Law," in *Nat'l L.J.*, 24 Feb. 1986, p. 30. This approach complicates the constitutional problem for interesting technical reasons having to do with the gatekeeper function of directors in deciding whether to present or oppose dismantling resolutions before shareholder meetings. See the political and welfare analysis of these voluntary restrictions in ROMANO, "The Political Economy of State Takeover Statutes," 73 *Va. L. Rev.* 111 (1987).

479 J.W. HURST, *Law and the Conditions of Freedom in the Nineteenth-Century United States* 6 (Charlottesville 1956).

480 *Id.* For a different view of this relationship, arguing that the historical evidence suggests a more political, less economic vision at least of the early American corporation, see FRASER, "The Corporation as a Body Politic," *Telos* (No. 57) 5 (1983).

of legitimacy has been noted, in modern terms, by a proponent of federal incorporation law:[481]

> Because there is a federal power over interstate commerce, a power which is not exercised over the constituent function of the corporation, the constituent controls of any state must be respected by all the others [that is, the traditional deference to the law of the state of incorporation]. And because the constituent controls exercised by most states are largely ceremonial, the federal power over the constituent function of corporations engaged in interstate commerce is thus exercised primarily by the corporations themselves – in fact, by their management. As this situation becomes more widely understood by the general public, there may be a corresponding weakening of the perception of legitimacy of the great corporations.

Like its analogue, "the states as laboratories," this perception of social legitimacy as a legitimate basis for "strong" state law is not a model or guideline for resolving the federal-state jurisdictional tension in this area. It is, however, an important "weight" on the side of accepting the legitimacy of state experimentation with control of local emanations of corporate activity, even at some cost to the actors through the multiple burdens of multiple state controls (a cost which, given their assumed power, may or may not be a social cost).[482]

[481] J. BUXBAUM, *The Corporate Politeia – A Conceptual Approach to Business, Government and Society* 50 (Washington, D.C. 1981) (using "constituent" as a shorthand notion for the constituencies interested in and therefore influencing the corporation's behavior: owners, managers, creditors, governments). See also the interesting testimony of those who saw state enabling laws (in their heyday) as "real" pathbreakers for corporate assertiveness, blocking even federal efforts at control:

> Even in their general incorporation laws, state legislatures set basic forms and standards of corporate behavior. . . . [Critics] continually returned to the revolution in corporate law between 1837 and 1850 as the fundamental source of the unique institutional constraints on effective national railroad regulation in the 1880s and 1890s.

SKOWRONEK, "National Railroad Regulation and the Problem of State-Building: Interests and Institutions in Late Nineteenth Century America," 10 *Politics & Society* 225, 239 (1981); see also generally S. SKOWRONEK, *Building a New American State* (Cambridge 1982).

[482] See also the recent Supreme Court approval of the so-called "unitary tax" method of state taxation of foreign or alien enterprise, based on a formulaic approach to identifying the local proportion of its overall revenue-generating activity in Container Corp. of America v. Franchise Tax Bd., 463 U.S. 159 (1983). Compare the more restrictive attitude, based, interestingly, on traditional corporation law principles (formal independence of subsidiaries' business decisions from parent's) in F.W. Woolworth Co. v. Taxation & Revenue Dep't, 458 U.S. 354 (1982). *Cf.* also ASARCO, Inc. v. Idaho State Tax Comm'n, 458 U.S. 307 (1982); Bacchus Imports, Ltd. v. Dias, 468 U.S. 263 (1984); and Brown-Forman Distillers Corp. v. New York State Liquor Authority, 106 S. Ct. 2080 (1986).

VI. The Corporation Within the Polity: Protection or Apotheosis?

We have seen something of the range of substantive control that a state may attempt to impose either upon the exercise of economic activity in corporate form or upon some specific aspects of that franchise. While some of these efforts, and some of the constitutional constraints on those efforts, are equally applicable to federal as well as state legislation, many of them are constraints on state legislation only. It remains now to examine the degree to which either sovereign, but particularly the state, may control the participation of corporations in the political debate about substantive measures affecting the economic activity in corporate form. It is clear, of course, that such efforts to control political participation need not be limited to issues touching the "self interest" of the corporation, but it is equally clear that most corporate efforts to influence the polity and the legislature are caused by and designed to influence this kind of legislative activity.

A. The Impact of *Bellotti*

Modern discussion of this problem is illuminated, indeed perhaps definitively resolved, in the 1978 opinion of the Supreme Court in *First National Bank of Boston v. Bellotti.*[483] Over several decades Massachusetts had been unable to adopt a constitutional amendment authorizing the legislature to impose a state progressive income tax on individuals (and corporations), and had already before the events discussed in the case attempted to prevent expenditures by corporations designed to influence a vote on that issue. After a series of unsuccessful efforts at such constraints, a newly amended law was adopted which provided essentially that no business corporation incorporated or doing business in Massachusetts should expend money for the purpose of "influencing or affecting the vote on any question submitted to the voters, other than one materially affecting any one of the property, business or assets of the corporation." The statute then went on with the suspiciously *ad hoc* legislative finding that, "[n]o question submitted to the voters solely concerning the taxation of the income, property or transactions of individuals shall be deemed materially to affect the property, business or assets of the corporation."[484]

The appellant, apparently concerned about the effect of a graduated personal income tax on its trust business (the maintenance of individuals' assets either

[483] 435 U.S. 765 (1978).

[484] Mass. Gen. Laws, ch. 55, § 8 (West Supp. 1977).

under testamentary or *inter vivos* dispositions) wished to spend money to oppose a referendum which would have amended the state Constitution to permit this tax.

The Supreme Court began its discussion of the effect on this state legislation of the First Amendment (as applicable to the states pursuant to the Fourteenth Amendment) by characterizing the free speech concern in a fashion destined to result in the invalidation of the Massachusetts statute:[485]

> The Constitution often protects interests broader than those of the party seeking their vindication. The First Amendment, in particular, serves significant societal interests. The proper question therefore is not whether corporations 'have' First Amendment rights and, if so, whether they are coextensive with those of natural persons. Instead, the question must be whether [the Massachusetts statute] abridges expression that the First Amendment was meant to protect.
>
> . . .
>
> The question in this case, simply put, is whether the corporate identity of the speaker deprives this proposed speech of what otherwise would be its clear entitlement to protection.

The first element of the analysis, technical and yet important to the outcome, was whether the "Property" Clause or the "Liberty" Clause of the Fourteenth Amendment is the channel through which the burden of the First Amendment is applied to the states. The Massachusetts Court, upholding the legislation, had argued that because the Property Clause was the proper channel, a corporation could only claim First Amendment freedoms to the extent that it had a protectable property interest.[486] At its extreme, that approach would permit the state to deny a corporation any expressive power so long as reducing it to muteness did not deprive the corporation of property without due process of law (essentially limited to takings and totally inhibitory regulation) and did not deny it the equal protection of the laws (essentially a classification question); neither of these two Clauses would seem implicated by even such a drastic step, however.[487]

The Supreme Court rejected the Property Clause in favor of the Liberty Clause.[488] This is understandable in the context of its long standing jurisprudence that as to individuals' speech the Liberty Clause is the operative one vis-à-vis state controls. Less obvious, however, is the Court's extension of this approach to the speech of corporations. Its statement that "the Court has not identified a separate source for the right when it has been asserted by cor-

[485] *Supra* note 483, at 776.

[486] See *id.* at 778 ff, for the review of this approach and its criticism.

[487] For a succinct, provocative description and critique of recent Supreme Court deference to congressional economic regulation, see TRIBE, *supra* note 86, at 450-55.

[488] 435 U.S. at 779 ff.

porations"[489] is in turn buttressed by a footnote reference that "it has been settled for almost a century that corporations are persons within the meaning of the Fourteenth Amendment,"[490] and by further reference to cases involving ideal associations and media corporations.[491] The first reference involves a substantial overstatement. Corporations were characterized as persons for specific reasons, not in order to have all rights which natural persons may exercise transferred automatically to them as a matter of definition, irrespective of whether the permitted purpose of corporateness in turn permits, let alone requires, all Fourteenth Amendment attributes available to natural persons to be extended to corporations.

The second reference is an interesting *petitio principii*. The very question to be decided is whether commercial entities are to participate as actors in political decision-making in the same fashion as that in which individuals and ideal associations are permitted to participate. To identify both types of groups as one under the "liberty" element of the Fourteenth Amendment is, again, to foreordain the result.[492]

In putting all corporate purposes in communication under the same umbrella, that of informing and enlightening the public debate on any given issue, Justice *Powell* also was required to give the so-called "commercial speech" jurisprudence a surprisingly broad footing: "A commercial advertisement is constitutionally protected not so much because it pertains to the seller's business as because it furthers the societal interest in the 'free flow of commercial information.'"[493] In a footnote response to the state's effort to use the "commercial speech" cases as an illustration of the type of corporate communication which the Massachusetts statute would have permitted, *Powell* resorts to a debating point. He finds it "somewhat ironic that appellee . . . would invert the debate by giving constitutional significance to a corporation's 'hawking of wares' while approving criminal sanctions for a bank's expression of opinion on a tax law of general public interest."[494] That, of course, is the heart of the problem from the state's perspective. It is not surprising that

489 *Id.* at 780.

490 *Id.* at n.15. For the significance of this reference to Santa Clara County v. Southern Pacific R.R. Co., 118 U.S. 394 (1886), see particularly Note, 90 *Yale L.J.* 1833 (1981).

491 435 U.S. at 781 ff.

492 See Note, *supra* note 490, at 1856 ff, for a critique of this uniform and thus circular treatment. This is not to deny that a coherent philosophy or value framework underlying free speech may make a separate approach to "wealthy" or "enhanced" speech difficult or questionable. See particularly POWE, "Mass Speech and the Newer First Amendment," [1982] *Sup. Ct. Rev.* 243.

493 435 U.S. at 783.

494 *Id.* at n.20. This separate problem of the treatment of commercial speech continues to trouble the Court. For the most recent analysis, see Bolger v. Youngs Drug Products Corp., 463 U.S. 60, 67 ff (1983) (and Stevens, J., concurring, 80 ff).

exactly such a distinction might well be made if the state is permitted to consider the corporation as a special species of collective property, pursuing certain socially useful entrepreneurial means and goals. Long ago *Maitland* vividly highlighted the reaction of the French Revolution to intermediate associations in exactly this sense:[495]

> French lawyers can regard the nineteenth century as the century of association, and, if there is to be association, if there is to be group-formation, the problem of personality cannot be evaded, at any rate if we are a logical people. Not to mislead, I must in one sentence say, that even the revolutionary legislators spared what we call partnership, and that for a long time past French law has afforded comfortable quarters for various kinds of groups, provided (but notice this) that the group's one and only object was the making of pecuniary gain. Recent writers have noticed it as a paradox that the State saw no harm in the selfish people who wanted dividends, while it had an intense dread of the comparatively unselfish people who would combine with some religious, charitable, literary, scientific, artistic purpose in view. . . .

Having once foreshadowed the course of the debate by this preliminary characterization, it was but a short step for the Court to decide that the state statute's distinction between permissible speech that "materially affects" a corporation's business and impermissible speech that does not is no more than a distinction of subject matter impermissible under the First Amendment.[496] Again, however, the Court could come to this conclusion only by first postulating a unity of interest and purpose between business associations and ideal associations:[497]

> If a legislature may direct business corporations to 'stick to business,' it also may limit other corporations – religious, charitable, or civic – to their respective 'business' when addressing the public. Such power in government to channel the expression of views is unacceptable under the First Amendment.

One cannot escape the conclusion that the Supreme Court opinion begins with an assumption about the nature of the business enterprise which can only be characterized as corporatist: Business corporations are participants at first hand in the society and the polity.[498]

The fact that a state-imposed constraint of speech is involved does not yet invalidate the state statute. Rather, under traditional constitutional jurispru-

[495] MAITLAND, *supra* note 156, at 314.

[496] 435 U.S. at 784.

[497] *Id.* at 785.

[498] That some corporations, to paraphrase C. LINDBLOM *(Politics and Markets* 5 (New York 1977)), are "taller and richer than the rest of us" and that most "enter into politics" in the sense of interacting with state authority is inevitable and irrelevant to this point; it is the acceptance and apotheosis of this situation normatively that is at issue.

dence, the state is still permitted to impose the restrictions provided it can meet the burden of proving that a compelling government interest permits it, and that it is the least onerous alternative available to effect the compelling state interest. Massachusetts did propound two such interests: "The first is the State's interest in sustaining the active role of the individual citizen in the electoral process and thereby preventing diminution of the citizen's confidence in government."[499]

As to this countervailing argument, the answers are complex but traditional, and are not of primary significance to the narrow discussion in this Chapter. Briefly summarized, the jurisprudence distinguishes between the state's right to control contributions to and expenditures by candidates for public office from contributions to and expenditures by speakers addressing a legislative or, important in American state political processes, a referendum or initiative issue.[500] On both counts the countervailing interests of Massachusetts were minimal and inadequate to prevail against the thrust of the First Amendment, since the statute concerned expenditures not contributions, and the process involved was legislation rather than campaigning for office. Even so the Court did leave some room for a different outcome:[501]

> If appellee's arguments were supported by record or legislative findings that corporate advocacy threatened imminently to undermine democratic processes, thereby denigrating rather than serving First Amendment interests, these arguments would merit our consideration . . . [but] there has been no showing that the relative voice of corporations has been overwhelming or even significant in influencing referenda in Massachusetts, or that there has been any threat to the confidence of the citizenry in government.

The reservation of this possible ground for saving state intrusion on the corporate political process has been significantly undermined, however, by the Court's later decision in *Citizens Against Rent Control v. City of Berkeley*,[502]

In this connection, see the interesting question mooted in Brown & Williamson Tobacco Corp. v. Jacobson, 713 F.2d 262 (7th Cir. 1983), whether a large corporation can be a "private" rather than a "public" person for libel law purposes; see also the not so moot discussion there of a corporation's right to prove the generally discrediting nature of a charge that it "flouted the strong public policy against encouraging children to smoke" (*id.* at 267-68).

499 435 U.S. at 787.

500 See *id.* at 788 n.26, for its brief review of this doctrine. See also the recent analysis of the problem in California Medical Ass'n v. Federal Election Comm'n, 453 U.S. 182 (1981); and, capping this trend for now, the newest and fullest rejection by the Supreme Court of federal efforts to regulate campaign expenditures in Federal Election Comm'n v. National Conservative Political Action Comm., 470 U.S. 480 (1985) and Federal Election Comm'n v. Massachusetts Citizens for Life, Inc., 107 S. Ct. 616 (1986).

501 435 U.S. at 789-90.

502 454 U.S. 290 (1981).

which struck down a city ordinance limiting expenditures by committees formed to participate in debates over municipal legislative ballot issues to $ 250, on the newly-imposed ground that the freedom of association element of the First Amendment thereby was violated, despite the existence of a substantially better "legislative fact finding" record on the impact of group expenditures on citizen participation in the political process. The opinion is so ungenerous to this countervailing defense as to cast doubt on its continuing viability.[503]

B. Free Speech and Corporate Management

The second state argument is the more interesting and important one from our perspective of corporation law: the interest in protecting the rights of shareholders whose views differ from those expressed by management on behalf of the corporation. So far as the majority opinion is concerned, the rebuttal to the state's assertion of countervailing interests is simple, and is based upon the previously identified "traditional" approach of finding the particular statute involved "both underinclusive and overinclusive."[504] Both propositions are fairly self evident. It is obvious from the cited statute that the state legislature evinced no analogous concern for the sensitivities of dissenting shareholders in the area of other legislative lobbying, contributions to candidates, or other areas in which similar sensitivity might be expected. Rather, only the one substantive issue as to which the state as the fisc had a sensitive and direct interest was chosen as the one on which to display such solicitude for dissenting shareholders.[505]

The Court's comment on overinclusiveness, however, is rather more useful:[506]

> [a corporation could not support one of the specific referendum proposals] even if its shareholders unanimously authorized the contribution or expenditure. Ultimately shareholders may decide, through the procedures of corporate democracy, whether their corporation should engage in debate on public issues. Acting through their power to elect the board of directors or to insist upon protective provisions in the corporation's charter, shareholders normally are presumed competent to protect their own interests.

[503] See also the criticism in LOWENSTEIN, "Campaign Spending and Ballot Propositions: Recent Experience, Public Choice Theory and the First Amendment," 29 *UCLA L. Rev.* 505 (1982).

[504] 435 U.S. at 792-95.

[505] "The fact that a particular kind of ballot question has been singled out for special treatment undermines the likelihood of a genuine state interest in protecting shareholders. It suggests instead that the legislature may have been concerned with silencing corporations on a particular subject." *Id.* at 793.

[506] *Id.* at 794-95.

In addition to intracorporate remedies, minority shareholders generally have access to the judicial remedy of a derivative suit to challenge corporate disbursements alleged to have been made for improper corporate purposes. . . .

It is ironic that on this issue, so specifically corporate-organizational in character, Justice *Powell* is fully sensitive to the distinction between business and ideal associations. Rebutting the dissent's reference to "union democracy" Supreme Court opinions which essentially grant employees in unionized enterprises First Amendment rights not to have their compulsory dues used to support political activity with which they disagree, he states:[507]

[These cases] are irrelevant to the question presented in this case. . . . To the extent that these [*compulsory*] funds were used by the union in furtherance of political goals, unrelated to collective bargaining, they were held to be unconstitutional because they compelled the dissenting union member 'to furnish contributions of money for the propagation of opinions which he disbelieves. . . .'

The critical distinction here is that no shareholder has been 'compelled' to contribute anything. . . . [The] shareholder invests in a corporation of his own volition and is free to withdraw his investment at any time and for any reason. A more relevant analogy, therefore, is to the situation where an employee voluntarily joins a union, or an individual voluntarily joins an association, and later finds himself in disagreement with its stance on a political issue. [These cases] did not address the question whether, in such a situation, the union or association must refund a portion of the dissenter's dues or, more drastically, refrain from expressing the majority's views.

Whether this distinction adequately honors the extent and nature of institutional investment in large corporations is doubtful.[508]

It is, in short, fairly clear that once the corporation has been apotheosized as a political actor through the characterization provided by the majority opinion, the question of state support of dissenters' rights to prevent such corporate political (non-commercial speech) communication is difficult. There is room, it is true, for state involvement in the "crucial question . . . of the . . . power to decide *who* within the corporation, may authorize *it* to utter that speech . . .; to reify the corporation, to accept the notion that the corporation is a person and that the First Amendment protects 'its' speech, does not end the matter."[509] That approach invites an effort to carve out a place for state legislation which would focus not on a straightforward prohibition of certain corporate communication (whether by way of expenditure or contribution), but

[507] *Id.* at 794 n.34.

[508] *Cf.* also Federal Election Comm'n v. National Right to Work Comm., 459 U.S. 197 (1982) for this continuing distinction between ideal and profit-maximizing entities; though, written by Justice REHNQUIST, who dissented in *Belotti*, it uses the latter in a manner barely compatible with its holding.

[509] BRUDNEY, "Business Corporations and Stockholders' Rights Under the First Amendment," 91 *Yale L. J.* 235, 248 (1981). See also the provocative suggestion that *Belotti* indirectly requires a significant extension of shareholder proposal rights under

on the indirect control of structuring the internal decision-making process by which the corporate decision to communicate is made differently from other corporate decision-making processes.

That effort has been heroically attempted by *Brudney*,[510] who takes as his starting point for that effort the Supreme Court's quoted comment that the challenged Massachusetts statute did not exempt even unanimously approved corporate communication from its prohibition. Building on the paradigm case of corporate expenditures for a communication that is clearly *ultra vires* or a matter of waste of corporate assets under traditional corporation law, he builds a sequence of arguments which would permit the state to identify waste caused by speech as requiring more particular control than other types of waste. Any identification of corporate communication as *ultra vires*, however, is almost automatically suspect in an age which provides, and in some jurisdictions requires, all-inclusive purpose clauses in corporate charters and has long accepted an almost limitless "powers" concept for the effectuation of broad purposes. The effort, therefore, of necessity has to be one in which state structuring of the shareholder decision-making process could not depend upon the *ultra vires-intra vires* distinction but would apply to both types of acts so long as they were communication acts – i.e., speech. *Brudney*'s effort to meet this challenge is (inadequately) summarized in the following quotations:[511]

> The First Amendment does not prohibit, or indeed affect, state statutory or common law *authorizing* a contractual arrangement by the participants, voluntarily made part of the corporate charter, that provides for their special consent for political speech by the corporation. If instead the state *conditions* the banding together of the investors in a corporate venture on adoption of a special consensual [unanimity] procedure for expenditures of corporate funds on such speech, is there any better case for invoking the First Amendment to test the propriety of the condition?
>
> . . .
>
> A state could rationally conclude that freedom of speech is better preserved for individual investors if they are not obliged to give up some of that freedom to management or to a majority of their fellow investors as a condition of making an investment in a commercial enterprise. . . . A state could also rationally conclude that management is not entitled to use any discretion in such matters. . . .
>
> . . .
>
> The process of funneling individual stockholders' political or social opinions through the business corporation distorts the representation of their views in a manner at odds with the premises of the political system [one person one vote as against one share one vote]. . . .

proxy solicitation regulation, even as to political issues, in PROPP, "The SEC Shareholder Proposal Rule: Corporate Accountability at a Crossroads," 11 *Sec. Reg. L.J.* 99, 121 ff (1983).

510 BRUDNEY, *supra* note 509, at 248.

511 *Id.* at 256, 257, 258, 264-65.

. . .

Economic theory, as well as political science, suggests a legitimate government interest in requiring stockholder consent for corporate political action. Allowing capital to be raised on the condition that its contributors permit management to use it for political purposes, without providing them a meaningful choice as to the particular political or noncommercial use, may increase the cost of capital.

. . . 'Bundling' such decision-making power . . . is inefficient by conventional economic analysis. . . .

In short, *Brudney* propounds a corporation law statutory solution, that would identify the particular communicative activity to be controlled and subject it to the essentially unattainable requirement of prior unanimous shareholder approval of expenditures therefor. It is an heroic salvage effort, but at the least goes against the grain of the image of corporatist political legitimacy that underlies Justice *Powell's Bellotti* opinion.

In the modern industrialized and highly differentiated society, effective political power is organized power. It may be important, to be sure, that the scales are not illegitimately tilted in favor of one form of organized power over another – that is particularly the problem if corporations and labor unions meet in the political arena. The present Supreme Court approach also may underestimate the degree to which individual citizens' surplus resources, presumably available for the vital financial aspect of political participation, are locked up in employment-related and therefore essentially involuntary corporate savings, and thus made vulnerable to the "involuntary contribution" problem which *Powell* identified as important in the union member context.

Those two macro-political concerns aside, however, it seems clear from *Bellotti* that the state (and to a significant degree the federal government itself) are subject to a judicial vision of legitimate corporate political activity that for the near future will remain a fact of life overarching the specific substantive battles of a polity with its corporate components.[512]

Buckley v. Valeo[513] introduced a subtle but important doctrinal shift by equating money to support speech activities with pure speech. Like the introduction of 'liberty of contract,' this doctrinal shift checked the legislature in attempting to limit the extent to which wealth differentials could be translated into power differentials. *Bellotti*, like the *Santa Clara* case it reaffirmed and extended, ensured that corporations would benefit from this expansion of the constitutional prerogatives of property. Together, *Buckley* and *Bellotti* provide the basic precedents for a judicial defense of the exercise of corporate power in the realm of politics.[514]

[512] For an interesting argument that the burden of establishing a primary right to the political liberties of "personhood" should be placed on the corporation, see STONE, "Corporate Vices and Corporate Virtues: Do Public/Private Distinctions Matter?," 130 *U. Pa. L. Rev.* 1441, 1489 ff (1982).

[513] 424 U.S. 1 (1976).

[514] Note, *supra* note 490, at 1855.

VII. Conclusion

The principal purpose of the foregoing study, despite its frequent critical digressions, has been to introduce enterprise law to constitutional law in a federal setting. The American scene of present date happens to display two special characteristics in addition to the characteristics general to other highly-differentiated and industrialized societies organized federally. These are the historically explained near-legislative autonomy of the federal Supreme Court; and that Court's present only partly reflective display of a powerful and single-minded *laissez-faire* philosophy that is beginning to drift out of line from the less coherent and politically more adaptive philosophy at work in the legislature and in society at large. Analysis of and argument against the impact of these two special characteristics may have overshadowed the overall discussion. If that is a cost of this Chapter, it should be offset by the possibility that there is additional utility in comparative reflection on that debate even on the part of readers from a society that in history and in the current state of federal organization is not comparable with the society here under study. The comparability of the two societies in other, larger aspects, however, is the more important point, one which may separately justify our more narrowly comparative effort.

That comparability is reflected in the tension between legal-doctrinal explanations of federalism and value judgments about economic organization that generated much of the foregoing analysis. Both societies face similar questions about their future economic organization, and thus both face similar questions about the interplay of doctrine and values. The value of doctrine lies in its ambivalent relation to values – in the fact that it both legitimates and facilitates but also constrains and orders these typically contending social and economic values. No doctrine is useful that claims too much and adapts too little, just as none is useful that claims too little and adapts too much. For the present, when contending visions of economic organization are perhaps even more tense and uncertain than usual, the American Supreme Court's play with legal doctrine by equating federalism with *laissez-faire* is more unsettling than in the recent past and is reminiscent in paler form of some of the tensions of the 1930's. But no similarly clear opposing doctrinal vision is available at a meaningful level of detail though there is no shortage of calls for one. Some progress towards one is apparent in the legal literature though none is so developed as is the *Musgraves'* and *Oates'* "fiscal federalism" economic semantic:[515] *Clark's*[516] "fourth stage of capitalism" is a possible entrant, especially

[515] R. MUSGRAVE & P. MUSGRAVE, *Public Finance in Theory and Practice* (2d ed., New York 1976); W. OATES, *Fiscal Federalism* (New York 1972).

[516] CLARK, "The Four Stages of Capitalism: Reflections on Investment Management Treatises," 94 *Harv. L. Rev.* 561 (1981).

on the capital market side of enterprise law, though still only a drumroll without symphony;[517] *Stewart* and *Sunstein*'s[518] "production function v. distribution function" (analyzing the legitimacy of private remedies within a heavily administered field) is another. None is yet ready for transformation into a large-scale doctrine in the sense of the subject matter of this Chapter, which has been limited to description and critique of the historical and existing situation in all its messy detail.

See also the stages (a) of regulation to protect competitive results (1880's); (b) of regulation to protect from competitive results (1920's-1930's); and (c) of regulation to reassign externalities properly (1970's) suggested by STEINER, "The Legalization of American Society: Economic Regulation," 81 *Mich. L. Rev.* 1285 (1983). Each sketch suggests an evolutionary tendency which, if rendered self-conscious and guided by legal doctrine, could lead to a perception of appropriate division-of-powers schemes in economic law differing substantially from currently received doctrine. Finally, a more general but also more controversial concept, also still undeveloped empirically, is the "network of distributional coalitions" explanation of mature societies developed in M. OLSON, *The Rise and Decline of Nations: Economic Growth, Stagnation, and Social Rigidities* (New Haven 1982), especially the argument that local coalitions are more inhibiting of continued growth than broad national ones – an argument militating against allocation of generous legislative powers to states because of the possibility that this would generate the development of just such dysfunctional coalitions.

[517] Thus GAMILLSCHEG, "Gleichberechtigung der Frau und Reform des Internationalen Privatrechts", 33 *RabelsZ* 654, 701 (1969).

[518] STEWART & SUNSTEIN, "Public Programs and Private Rights," 95 *Harv. L. Rev.* 1193, 1235 ff (1982). A good discussion of the larger context in which the search for doctrinal paradigms, transcending market-defined and market-driven models, perenially goes on may be found in STEWART, "Regulation in a Liberal State: The Role of Non-Commodity Values," 92 *Yale L.J.* 1537 (1983).

Chapter Three

European Attempts to Harmonize Company and Capital Market Law

I. National Regulation of Transnational Corporations: Facts and Developments

A. The Nature of Transnational Corporate Activity

The attempt to harmonize the company and capital market laws of the Member States of the European Economic Community (EEC), begun at the end of the 1960's, is based on two premises. The first assumes that companies are the most important economic actors within the individual Member States, and that they are becoming increasingly active on a transnational basis. The second premise assumes the existence of a substantial connection between the harmonization of company and capital market laws on the one hand, and the advancement of economic integration, as defined in the Treaty of Rome, on the other. Whether the second premise is truly as obvious as the Founders of the European Community assumed will be examined later in this Chapter. The first premise, however, is a fact of economic history, most clearly demonstrated by the growth of transnational corporations in Europe.[1]

1. Roots of Transnational Corporate Activity

The roots of this phenomenon lie in the Italian Renaissance, whose bankers expanded far beyond their home markets into Europe at large, and with the South German entrepreneurial bankers (like the Fuggers)[2] who expanded across the Atlantic into the New World. As the phenomenon became more widespread with the growth of the large trading companies in the seventeenth

1 See *Multinationals: Theory and History* (P. Hertner & G. Jones eds., Aldershot 1986), and the symposium "Multinational Enterprises," 48 *Business History Rev.* 277-446 (special issue, 1974). For a short survey, see HAWRYLYSHNY, "The Internationalization of Firms," 5 *J. World Trade L.* 72 (1971).

2 *Cf.* E. LUTZ, *Die rechtliche Struktur süddeutscher Handelsgesellschaften in der Zeit der Fugger* (Tübingen 1976).

century, transnational corporations began to demonstrate the characteristics by which they are identifiable to this day.[3] These characteristics include:

(1) Transnational economic activity as a legal or actual goal of the corporation;

(2) Performance of this economic activity through the accumulation of capital from many sources including foreigners;

(3) Involvement in businesses whose large capital requirements and risks could not have been borne by individuals; and

(4) Differentiation in company organization among passive capital providers and active managers and supervisors.

By the seventeenth century, close relationships with the political structure of the home country of the enterprise can be found. The trading companies were sometimes themselves state enterprises, and were often granted privileges by the government to promote their own interests and those of the state.[4]

By the early nineteenth century the history of the transnational enterprise becomes the history of the privately-owned corporation.[5] The corporation proved the most suitable legal form for such firms and remains so to this day (a few national peculiarities aside). Between the 1860's and World War I, industrialization and internationalization of firms went hand in hand. For example, more than half the output of Siemens AG was being produced abroad before the turn of the century.[6] Similarly, banks, needed by the large and increasingly transnational firms as credit providers and business partners, were being organized on the corporate principle and thus were ready to act transnationally. It is no coincidence that about the turn of the century the corporate banks began their expansion and the system of universal banking spread throughout Europe and, for a time, America. Although the growth and economic concentration of industrial firms was not caused by the banking system or a particular banking structure, each was considerably encouraged by the other.

3 R. EHRENBERG, *Capital and Finance in the Age of the Renaissance* (London 1928; trans. by H.M. Lucas of *Das Zeitalter der Fugger*, Jena 1912); E. HECKSCHER, *Mercantilism* (2 vols., London 1935; trans. by M. Shapiro of *Merkantilismen*, 2 vols., Stockholm 1931).

4 *Cf.* K. LEHMANN, *Die geschichtliche Entwicklung des Aktienrechts bis zum Code de Commerce* §§ 2-4 (Berlin 1895); BAUMS-STAMMBERGER, "Der Versuch einer Aktiengesetzgebung in Sachsen 1836/37," at 21-27 (diss. Hagen 1980), with reference to the relevant acts set out in 2 R. SCHÜCK, *Brandenburg-Preussens Kolonialpolitik unter dem Großen Kurfürsten und seinen Nachfolgern (1647-1721)* (Leipzig 1889).

5 See *Recht und Entwicklung der Großunternehmen im 19. und frühen 20. Jahrhundert – Law and the Formation of the Big Enterprises in the 19th and Early 20th Centuries* (N. Horn & J. Kocka eds., Göttingen 1979) [hereinafter cited as HORN & KOCKA].

6 *Cf.* KOCKA & SIEGRIST, "Die hundert größten deutsche Industrieunternehmen im späten 19. und frühen 20. Jahrhundert," in HORN & KOCKA, *supra* note 5, at 55-122, esp. 76-79.

After the turn of the century, the age of groups of firms and enterprises (*Konzerne*) began.[7] In the years between the two world wars, for example, European and US automobile firms, reacting to national autarchy and protection policies, set up manufacturing plants in each other's countries. The US firms in particular expanded rapidly throughout Europe, using the experience gained in the United States when moving into other areas of the Union. This expansion was the basis for the present situation, in which the United States is by far the leading country in terms of foreign private investment. Only in the last decade have European and Japanese firms begun to approach the US level.

2. European Corporate Census

A corporate census of the kind available in the United States does not exist within the European Community. There are statistics and estimates of European business activity, but even the Brussels headquarters of the EC cannot provide integrated compilations. Since the firms concerned are more interested in specific information on turnover, branches, and competition, they do not naturally produce such material. Also, European firms avoid disclosure, in contrast to US companies. European firms see no reason to disclose strategic, quantitative information that might be the basis for legislative intrusion.

At the same time, European legislatures and other state organs are far less accustomed to using such data as the basis for decisions than are their counterparts in the United States, nor are they prepared to incur the costs necessary to prepare this information. It is quite a revelation, for example, for a student of comparative company law to set the six-volume US *Special Study of Securities Markets* of 1963-64,[8] or the seven-volume *Institutional Investor Study* of 1971,[9] against the report of the proceedings of the German Commission on Enterprise Law (prepared under the auspices of the Federal Ministry of Justice). The German Commission's seven years of work, completed in 1979, produced a comprehensive survey of the various positions of its members, but hardly any empirical documentation or analyses.[10] The few exceptions, such as the

7 B. GROSSFELD, *Aktiengesellschaft, Unternehmenskonzentration und Kleinaktionär* 149-58 (Tübingen 1968).

8 SECURITIES & EXCHANGE COMMISSION [SEC], *Report of Special Study of Securities Markets, H.R. Doc. No. 95,* 88th Cong., 1st Sess. (Washington, D.C. 1963).

9 SEC, *Institutional Investor Study Report, H.R. Doc. No. 64,* 92d Cong., 1st Sess. (Washington, D.C. 1971).

10 *Bericht über die Verhandlungen der Unternehmensrechtskommission* (Bundesministerium der Justiz ed., Cologne 1980). See the symposium on this report (with contributions by KÜBLER (at 377), WESTERMANN (at 393), SONNENSCHEIN (at 429), SCHMIDT (at 455) & SCHULZE-OSTERLOH (at 487)) in 10 *ZGR* 377-509 (1981).

outstanding surveys of the economic concentration of industrial firms and banks which are prepared regularly by the German Monopolies Commission for its main reports, are produced for the development of antitrust law and merely serve to prove the rule.

The situation is no different at the European level. If anything, the lack of such analyses is more marked. The absence of a European corporate census is not only the result of the individual Member States' inability to supply the information for such a census, but also the result of the specific difficulties that limit the integration of such national data. Thus, for instance, while the corporation is the most popular enterprise form for all economic sectors in Great Britain and the United States, the number of corporations in the Federal Republic of Germany is quite small. Instead of the corporate model, German enterprises use many company structures, such as the limited-liability company (*Gesellschaft mit beschränkter Haftung* or GmbH)[11] and the specifically German GmbH & Co., the latter composed of elements of both partnership and close corporation structure. (The reason for this disparity lies in the German law's grant of complete freedom of choice among the various forms of company structure.) With few exceptions – as, for example, in antitrust law and disclosure legislation[12] – the size of the company is not the basis for legislative regulation of its structure or conduct.

Still greater discrepancies among the Member States arise concerning the number of companies with shares quoted on the national stock exchanges. In Britain, for example, even the smallest firms seek to list their shares on the stock exchange, whereas German industrialists traditionally have tended to be skeptical toward an exchange listing. Indeed, the number of issuers whose shares are quoted on German exchanges has fallen steadily over the past few decades, in contrast to the British situation, and a reverse of the tide began only in 1983 with a whole series of smaller enterprises going public.[13]

Despite these reservations, it may be appropriate to provide a few figures on business forms in use in the Federal Republic of Germany,[14] including some

11 *Cf.* Gesetz betreffend die Gesellschaften mit beschränkter Haftung, 20 Apr. 1892, RGBl. 1892, 477.

12 *Cf.* GWB §§ 22 III, 23 I, 23a, 24 VIII, 24a I: the size criterion is especially important for regulations concerning the abuse of a market-dominating position and mergers. As to disclosure, see (since 1969) Gesetz über die Rechnungslegung von bestimmten Unternehmen und Konzernen [the so-called *Publizitätsgesetz*], 15 Aug. 1969, BGBl. I, 1189, *amended* 2 Mar. 1974, BGBl. I, 469; and now (since 1986) the new part of the Commercial Code (see especially § 267 HGB) introduced by the Bilanzrichtlichtlinien-Gesetz, 19 Dec. 1985, BGBl. I, 2355.

13 See HOPT, "Risikokapital, Nebenbörsen und Anlegerschutz," 1985 *WM* 793.

14 For the following data see K. HOPT & G. HEHL, *Gesellschaftsrecht* (3d ed., Munich 1987), Table 15 at p. 303 (with further references); see also DEUTSCHE BUNDESBANK, "Enterprises' Profitability and Financing in 1986," 39 *Monthly Report of the Deutsche*

of the same information provided on the United States in Chapter 2 of this study. As of 1985 (1986), in the Federal Republic there were reported 2,141 (2,190) corporations (*Aktiengesellschaften* or AGs), including limited-share partnerships (*Kommanditgesellschaften auf Aktien*);[15] 339,541 (346,371) limited-liability companies (GmbH);[16] and (as of 1980) 203,338 commercial partnerships (*Offene Handelsgesellschaften*) and limited partnerships (*Kommanditgesellschaften*).[17] Of the total number of businesses in 1980 in Germany, 0.1% were corporations, 5.9% were limited-liability companies and 12.2% were partnerships. The overwhelming majority of all firms, 79.5%, were individual proprietorships.

There has been a dramatic increase in the number of limited-liability companies in the last few years. For 1978 the German census reported only 98,329 as compared with nearly 300,000 in 1982, although the latter figure may be deceptive as it includes small companies that were previously excluded from the survey. The reason for this growth lies in the excessive demands on the AG type of corporations made by the law, including tax law, disclosure law, codetermination law and the general inflexibility and formalism of corporate law.[18]

The significance of these figures for the various forms of companies can be better analyzed in relation to the number of employees and gross taxable revenues of these companies. In 1970, corporations (AGs) employed 18.5% of all German workers, limited-liability companies employed 5.9%, partnerships employed 12.2% and individual proprietorships employed 79.5%. Nominal

Bundesbank, No. 11, pp. 13-27 (Nov. 1987); DEUTSCHE BUNDESBANK, *Jahresabschlüsse der Unternehmen in der Bundesrepublik Deutschland 1965 bis 1981*, Separate Publication No. 5 (1983).

15 At the end of 1982 there were only 29 enterprises in the form of a *Kommanditgesellschaft auf Aktien*. See DEUTSCHE BUNDESBANK, "The Share Market in the Federal Republic of Germany and Its Development Potential," 36 *Monthly Report of the Deutsche Bundesbank*, No.4, p. 11, at p. 12 (Apr. 1984).

16 Source: *Statistisches Jahrbuch für die Bundesrepublik Deutschland 1986*, at 116 (Stuttgart/Mainz 1986). The number of GmbH & Co. has been estimated to be 60,000 (as of 1986).

17 More recent data concerning commercial and limited partnerships are not available because unlike corporations, they are not obliged to report; but *cf.* the statistic for 1982 about the turnover tax of enterprises (grossing more than DM 20,000):
- corporations: 1,682 (turnover: DM 732,518 million)
- limited liability companies: 163,440 (turnover: DM 820,972 million)
- commercial partnerships: 128,589 (turnover: DM 241,279 million)
- limited partnerships: 90,300 (turnover: DM 841,436 million)
- individual proprietorships: 1,338,973 (turnover DM 557,721 million)

(Source: *Statistisches Jahrbuch für die Bundesrepublik Deutschland 1985*, at 452 (Stuttgart/Mainz 1985) [not included in 1986 edition]).

18 See also DEUTSCHE BUNDESBANK, *supra* note 15, at 14. As to the following data, see *Statistisches Jahrbuch für die Bundesrepublik Deutschland, supra* note 16.

share capitalization (*Grundkapital,* which, however, reveals little of the economic power of firms) was DM 110,998,000 for corporations, and DM 137,837,000 for limited-liability companies, both as of 1985. The percentage of equity capital (*Eigenkapital*) in balance sheet terms[19] was 20.9% for all firms in 1983, as compared with 30.7% for France, 48.7% for Great Britain and even 63.4% for the United States.[20]

These figures clearly show the considerable economic importance of the individual corporations. The number of shareholders in the Federal Republic has been estimated at 5 million overall as of 1980 (a small figure compared with the US estimate of 30 million), of which some 800,000 are employee shareholders.[21] The latest estimates show a shrinking of the overall shareholdership to 3.2 million (and an increase of the employee shareholders to some 900,000) which is 7% of the adult population.[22] Surprisingly, only a small number of German corporations are listed on the stock exchange: 450 as of 1982.[23] Moreover, economic concentration, caused particularly by mergers to forestall impending bankruptcies, has operated for years to reduce this figure which in former decades has been much higher.[24] Today there are only some 100 genuine publicly held companies in the Federal Republic, compared with some 10,000 in the United States.[25] This fundamental discrepancy alone

19 There is much current discussion in Germany on the problems of German enterprises having too little own capital: see REUTER, "Welche Maßnahmen empfehlen sich insbesondere im Gesellschafts- und Steuerrecht, um die Eigenkapitalausstattung der Unternehmen langfristig zu verbessern?," vol. 1, Gutachten B, *Verhandlungen des 55. Deutschen Juristentages* (Ständige Deputation des Deutschen Juristentages ed., Munich 1984); and also the 29th symposium, about credit policy, "Die Eigenkapitalknappheit in der Wirtschaft," 36 *ZKW,* 1077-98 (1983) with some updated statistical data. See also DEUTSCHE BUNDESBANK, "Business Finance in the United Kingdom and Germany," 36 *Monthly Report of the Deutsche Bundesbank,* No.11, pp. 33-42 (Nov. 1984); PERLITZ, KÜPPER & LÖBLER, "Vergleich der Eigenkapitalausstattung deutscher, US-amerikanischer und britischer Unternehmen," 14 *ZGR* 16-49 (1985). Most recently see *Risikokapital über die Börse* (W. Gerke ed., Berlin/Heidelberg/New York/Tokyo 1986).

20 Figures according to a comparative survey by the Commerzbank of 31 Oct. 1983. The German Central Bank aggregates differently: 18.5% for 1983 [now 19% for 1986]. See DEUTSCHE BUNDESBANK, "Enterprises' Profitability and Financing in 1983 [1986]," 36 *Monthly Report of the Deutsche Bundesbank,* No. 11, p. 12, at p. 18 (Nov. 1984) [39 *id.*, No. 11, p.13, at p. 18 (Nov. 1987)].

21 PORTFOLIO MANAGEMENT PM, *PM-Studie Aktionärsstruktur und Aktienbesitz in der Bundesrepublik* (Munich 1980).

22 For references see HOPT, *supra* note 13, at 794.

23 Since 1983 some 40 new corporations have gone public, some of which have already disappeared again. In the first half year of 1986, there were 11 newcomers to the stock exchange. At the end of November 1986 the total number was 462.

24 F.KÜBLER, *Gesellschaftsrecht* 167 (2d ed. Heidelberg 1985).

25 See *supra* Ch. 2, text accompanying notes 16 & 17.

should be a clear warning at the outset of this study to use caution in comparing European and US legal integration in general, and corporation and capital market law integration in particular.

Still, for purposes of this study, it may prove useful to have additional statistics on transnational investment. The German *Bundesbank* has supplied figures on the growth of capital investment by German firms abroad, and *vice versa*, most recently as of the end of 1985.[26] These figures indicate that direct German investment abroad at the end of 1985 amounted to more than DM 131.1 billion. Of this amount, DM 43.9 billion went to other EC Member States, DM 69 billion to other industrialized Western countries (including 39.3 billion to the United States and 9.6 billion to Switzerland) and DM 15.8 billion to developing countries. During the same period, direct foreign investment in the Federal Republic was DM 88.3 billion. Of this amount, DM 26.7 billion came from other EC Member States, and DM 57.1 billion from other industrialized Western countries (DM 34.1 billion from the United States and DM 12.7 billion from Switzerland).[27]

The implications of these figures for German transnational activity are clear. The German balance of direct investment abroad is positive with the EC Member States, though negative with individual countries such as Great Britain, the Netherlands and the United States.[28] Furthermore total German direct investment abroad continues to be modest in comparison with other industrialized countries; for example, Great Britain recently invested DM 150 billion abroad in just one year. Interestingly, of the some 4,900 capital investors surveyed, one in five said that it intended at least one participation, affiliate or plant in the United States. Thus, the US market has become an attractive location even for small German firms.[29]

[26] DEUTSCHE BUNDESBANK, "Trend of International Capital Links Between Enterprises from 1976 to 1985," 39 *Monthly Report of the Deutsche Bundesbank*, No. 3, pp. 20-32 (Mar. 1987); and, for an earlier period, DEUTSCHE BUNDESBANK, "International Capital Links Between Enterprises from 1976 to 1980," 34 *Monthly Report of the Deutsche Bundesbank*, No. 8, at pp. 38-43 (Aug. 1982).

[27] For more details see "Die Kapitalverflechtung der Unternehmen mit dem Ausland nach Ländern und Wirtschaftszweigen 1976-1982," in *Statistische Beihefte zu den Monatsberichten der Deutschen Bundesbank – Reihe 3: Zahlungsbilanzstatistik*, 1984.

[28] DEUTSCHE BUNDESBANK, *Monthly Report*, 3/1985, *supra* note 26, at 32 et seq. While West Germany's overall direct investment balance with abroad, which had been negative until the end of the 1970's, is now positive, its patents and licence fees balance is clearly negative, but this is true also for most other major industrialized states with notable exceptions such as the US, Great Britain and possibly Switzerland. Figures, and warnings against their misinterpretation, are given by DEUTSCHE BUNDESBANK, "Patent and Licence Transactions with Foreign Countries in 1984 and 1985," 38 *Monthly Report of the Deutsche Bundesbank*, No. 5, pp. 27-42 (May 1986).

[29] *Cf.* BUCKLEY, "The Entry Strategy of Recent European Direct Investors in the USA," 3 *J. Comp. Corp. L. & Sec. Reg.* 169 (1981) with statistical material.

B. The Development of Different National Company and Capital Market Laws

The European attempt to harmonize national company and capital market laws is confronted with considerable, sometimes fundamental, diversity of such laws, not only between Civil and Common Law states, but among the Civil Law states themselves. Some of the more important characteristics of this diversity will be considered below. It should be emphasized that despite all differences this diversity is only relative. Unlike such areas as constitutional law, administrative law, public economic law, or family and inheritance law, the basic assumptions of commercial and company law are generally similar among the Western industrialized countries.[30] The goal of company law everywhere is to find an organizational form suitable to the economic activity of the types of firms operating within an economy. All such law attempts to reconcile the differing interests of the shareholders, the creditors, and possibly the employees and the public. In general, the diversity of organizational laws is not the result of ideological conflict, apart from the questions of worker participation and representation of the public interest in the firms.

Similarly, capital market law, which has grown out of company law and in various countries become quite independent of it, is generally the subject of ideological agreement among the various states. This is particularly true to the extent that most countries agree that recourse to the capital market by firms should be linked with obligations of disclosure and conduct. Not until one considers the detailed structures of national capital markets do considerable differences appear, in such areas as access to the capital market, the constitution of the individual markets and government intervention in their function. Most of these differences may be attributed to national tradition.

1. Development of National Company Laws

The development of national company laws began in the nineteenth century. Industrialization, which had begun in the first half of the century, had transformed the economy of the Western world by the second half, leading to the development of new company structures. The trend was toward the formation of large corporations, particularly in the German *Reich* and the United

[30] For surveys of harmonization of law in the 19th century see GRIMM, "Historische Erfahrungen mit Rechtsvereinheitlichung – das frühe 19. Jahrhundert in Deutschland," 50 *RabelsZ* 61-76 (1986); BUCHHOLZ, "Zur Rechtsvereinheitlichung in Deutschland in der zweiten Hälfte des 19. Jahrhunderts," 50 *RabelsZ* 77-110, esp. at 86-92 (corporation law) (1986).

States, and to a smaller extent in Great Britain and France as well.[31] Company law played a key part in this growth, by allowing the external expansion of firms and promoting capital concentration.[32]

Developments in company law principles also spread to the banking sector, increasing capital concentration. The state played its part in promoting this process by freeing the corporate structure from historical restrictions. Originally, permits from the individual states were required to constitute a corporation as a legal person, but this concession system[33] was gradually replaced by general enabling and normative provisions.[34] Under this new system, every firm meeting the organizational conditions of the enabling statutes had a right to be constituted as a corporation. The states no longer exercised investment supervision over companies, either as protection for investors, as a restriction on company objectives, or as general control over economic power.

Today, general enabling statutes are the basis for the national company laws of all Member States of the European Community. Even the Netherlands, where a certificate of government approval from the Justice Minister is still necessary to form a corporation, is an exception only in form, since issuance of the certificate has become a mere formality.[35] Despite this structural uniformity, however, there are considerable differences in how the various nations' company laws implement their respective enabling statutes. These differences will be discussed in the following sections, particularly in the context of na-

31 See generally POHL, "Zur Entwicklung der Formen der Betriebs- und Unternehmensorganisation, insbesondere der Großorganisation im Verhältnis zum persönlich geführten Geschäft," in *Zur Verselbständigung des Vermögens gegenüber der Person im Privatrecht* 93 (1982) (vol. VI of the series *Wissenschaft und Kodifikation des Privatrechts im 19. Jahrhundert* (H. Coing & W. Wilhelm eds., Frankfurt 1974-82) [series hereinafter cited as COING & WILHELM]).

32 REICH, "Auswirkungen der deutschen Aktiensrechtsreform von 1884 auf die Konzentration der deutschen Wirtschaft," in HORN & KOCKA, *supra* note 5, at 255.

33 *Cf.* GROSSFELD, "Die rechtspolitische Beurteilung der Aktiengesellschaft im 19. Jahrhundert," in *Eigentum und industrielle Entwicklung Wettbewerbsordnung und Wettbewerbsrecht* 236, 237-40 (vol. IV, COING & WILHELM, *supra* note 31 (1979)). For the reasons for granting a concession, see M. POEHLS, *Das Recht der Aktiengesellschaften mit besonderer Rücksicht auf Eisenbahngesellschaften* 42 (Hamburg 1842). Generally *cf.* BEITZKE, "Konzessionssystem, Normativbestimmungen und freie Körperschaftsbildung," 108 *ZHR* 32 (1941).

34 England (1844), Joint Stock Companies Act 1844, 7 & 8 Vict., c. 110; France (1867), Loi No. 15.328 sur les Sociétés, du 24 juillet 1867, arts. 21 & 47, *Bull. des Lois*, No. 1513, Tome 30, p.95 (1866-1870); Germany (1870), Gesetz betr. die Kommanditgesellschaft auf Aktien u. die Aktiengesellschaften vom 11.6.1870, BGBl. Norddeutscher Bund 1870, 375.

35 Burgerlijk Wetboek, Boek 2, Art. 68. See P. SANDERS, *Dutch Company Law* 16-19 (London 1977); P. VAN SCHILFGAARDE, *Van de naamloze en de besloten Vennootschap* 42-45 (Arnheim 1976).

tional company laws governing (a) formation and financing, (b) internal organization, (c) disclosure requirements, (d) choice of the company's legal form, and (e) limitations on groups of companies and business combination.

a. Formation and Financing of the Corporation

The concession system of company law was abolished in England in 1844, in France in 1867, and in Germany in 1870. In each case, the respective legislature felt that market forces and disclosure requirements applicable to the formation of corporations would suffice for the protection of shareholders and creditors.[36] This optimism, evidenced by Gladstone's pathbreaking legislation of 1844, very soon proved unjustified.[37] After the special legislative charter controls were abandoned, corporations were frequently used fraudulently in Britain (after 1866) and in Germany after 1870, during the *"Gründerzeit."*

As a consequence of these abuses, formation and financing provisions of company law were tightened in all countries. In Germany, for example, this came about through the Companies Act of 1884.[38] However, as each country reformed its statutes, the diversity of issues requiring regulation and the variety of protection mechanisms chosen led inevitably to a divergence of national company laws. This differentiation can be seen today in such areas as: statutes on the adequacy of stated capital versus a fixed company capital requirement; provisions for raising and maintaining these amounts; provisions for contribution of property as well as, or instead of, money as capital; issuance of non-voting shares; limitations on the validity of shares with more than one vote; limitations on authorization of corporate reacquisition of shares; requirements for capital increases and reductions; requirements for minimum contents of company charters; and provisions for control and definition of the duty to observe these regulations.

b. Organs and Internal Organization of the Corporation

For the first half of the nineteenth century, creation of company organs and regulation of their tasks was largely left up to the individual articles of association.[39] The company laws of the time contained few if any of the organizational norms familiar today. This situation changed with the abandonment of

[36] *Cf.* HOPT, "Ideelle und wirtschaftliche Grundlagen der Aktien-, Bank- und Börsenrechtsentwicklung im 19. Jahrhundert," in *Geld und Banken* 128, 154-56 (vol. V, COING & WILHELM, *supra* note 31 (1980)).

[37] REICH, *supra* note 32, at 257-62.

[38] HORN, "Aktienrechtliche Unternehmensorganisation in der Hochindustrialisierung (1860-1920)," in HORN & KOCKA, *supra* note 5, at 123-89; L.C.B. GOWER, J.B. CRONIN, A.J. EASSON & LORD WEDDERBURN, *Gower's Principles of Modern Company Law* 39-52 (4th ed., London 1979) [hereinafter cited as GOWER].

[39] HORN, *supra* note 38, at 138-65.

the concession system, and by about 1870 the basic features of this area were regulated, or at least sketched out in the case law.

In Common Law countries the development of organization law was traditionally in the hands of the courts. Similarly, in France, the important initiatives also came from the courts, since the organization law enacted in 1867 was left unamended by the legislature for a long time.[40] In Germany, by contrast, the legislature made a considerable contribution to the development of internal controls through the reform statute of 1884.[41]

Even at this early date, German organization law was intended primarily to serve the capital interests of shareholders. Apart from the corporations with majority shareholders, who were usually entrepreneurs, shareholder interests and managerial functions were already largely separate. This separation of ownership and control, credited today as a fundamental insight of *Berle* and *Means*,[42] had essentially already been seen by *Rudolph von Jhering* in 1877.[43] Once this separation had been realized, the key organizational questions arose almost automatically: How should control over management be structured? Should a supervisory board be required for this purpose? Should this board be an independent organ, separate from the board of directors? What powers should be left to the shareholders' general meeting? And finally, was it possible to make management live up to its obligations through legal requirements governing its conduct or even its composition?

i. Control of Management

The problem of management control was seen as more or less fundamental everywhere it was considered, but only a few legal regimes developed a true independent supervisory body in the sense of a division of the board of directors between management and supervision.[44] This board of directors, frequently conceived of as a committee of shareholders, concerned itself with decisions of principle, while the day-to-day business was generally controlled by inside directors or special managers. The personal overlap between board and management rendered impartial control difficult from the outset. The board was in a strong legal position vis-à-vis management, but because the outside directors were not actively involved in the day-to-day business of the corpora-

40 J. PAILLUSSEAU, *La société anonyme, Technique de l'organisation de l'entreprise* 153 et seq. (Paris 1967); P. GOURLAY, *Le conseil d'administration de la société anonyme* 1 et seq. (Paris 1971).

41 *Cf.* REICH, *supra* note 32, at 265-72.

42 A. BERLE & G. MEANS, *The Corporation and Private Property* (New York 1932).

43 R. VON JHERING, 1 *Der Zweck im Recht* 244 et seq. (Leipzig 1877).

44 HOPT, "Zur Funktion des Aufsichtsrats im Verhältnis von Industrie und Bankensystem," in HORN & KOCKA, *supra* note 5, at 227-42.

tion, they could not effectively control management's activity as a practical matter.[45]

A similar situation prevailed in France,[46] where overall management was handled by an administrative board (*conseil d'administration*) whose competence was confined to decisions of principle. The daily business of the corporation was run by "managers," some of whom were members of the administrative board and some of whom were not. Legally, the administrative board could supervise management, but it was not obliged to do so because it was ultimately responsible only for business policy. The administrative board itself was supervised by "*commissaires*" who were appointed by the general assembly, but these *commissaires* were primarily responsible for supervising the accounting aspect of the corporation, without any entrepreneurial initiative.

The first compulsory provision for a functional separation between management and the supervisory organ was enacted in France, but only in the case of limited-share partnerships. The company structure known as the share partnership had, in contrast to the corporation, been available without government permission for decades and had become an instrument of serious abuses. As a result, the legal regulation of the share partnership, enacted in 1856, provided for an obligatory "*conseil de surveillance.*"[47]

This legal structure also reached Germany, via the Nuremberg Conference on the preparation of the All-German Commercial Code.[48] Accordingly, the Company Reform Act of 1870 brought about the abandonment of the concession system,[49] but at the same time as a safe-guard introduced the obligatory supervisory board for corporations. This structure was tightened even further in 1884 through additional limitations providing that the supervisory board members could not also be members or permanent representatives of the board of directors, or part of the management staff of the corporation.

The German legislature's expectations for the role of the supervisory board were not fulfilled. In part the supervisory board performed its function inadequately; in part it exceeded it by drawing part of the entrepreneurial decision-making to itself. In some cases, the extreme concentration of seats on super-

45 *Cf.* for the English law GOWER, *supra* note 38, at chs. 2 & 3.

46 See generally AMIAUD, "L'évolution du droit des sociétés par actions," in 2 *Le Droit privé français au milieu du XXe siècle: Etudes offertes à Georges Ripert* 287 (Paris 1950); P. GOURLAY, *supra* note 40.

47 *Cf.* A. VIANDIER, *La société en commandite entre son passé et son avenir* 50 et seq. (Etudes du Centre de Recherche sur les Droits des Affaires (CREDA), Paris 1983).

48 *Cf.* LANDWEHR, "Die Organisationsstrukturen der Aktienunternehmen," in *Vom Gewerbe zum Unternehmen* 251 (K.O. Scherner & A. Willoweit eds., Darmstadt 1982); LANDWEHR, "Verfassung der Aktiengesellschaften," 99 *ZRG Germ.Abt.* 1, 11-17 (1982).

49 SCHUBERT, "Die Abschaffung des Konzessionssystems durch die Aktienrechtsnovelle von 1870," 10 *ZGR* 285-317 (1981).

visory boards and the personal dependence of supervisory board members on the board of directors or major shareholders led to a failure of supervision. In other cases, where the corporation's articles of association allowed the supervisory board to participate in important decisions, the supervisory board also influenced the day-to-day management by the board of directors. Nevertheless, the obligatory separation of functions between the board of directors and the supervisory board had important effects, although different from those contemplated by the legislature.

The supervisory board proved one of the most important factors in modern economic concentration.[50] Made up of the most important business partners of the corporation and representatives of the large corporate banks,[51] these supervisory boards became instruments for the expansion of large corporations. Supervisory boards were also a key to the growth of the universal banking system. There has been little significant change in this function to date.

All the important arguments for and against the one-tier and two-tier systems had been developed by the turn of the century.[52] Little has been learned since from experience. The extent to which practice can accommodate itself to any system was shown by the result of the French legislative experiment of 1966, which allowed corporations to choose between either a single board of directors or a two-tier system incorporating a supervisory board. This opportunity was taken advantage of by only a small number of French corporations (some of them economically quite important it is true), although French scholars have been unable to fully explain this development on objective grounds.[53]

50 HOPT, *supra* note 44, at 237-39.

51 See J. RIESSER, *The German Great Banks and Their Concentration in Connection with the Economic Development of Germany* (3d ed., Washington, D.C. 1911, repr. New York 1977; trans. by M. Jacobson of *Die deutschen Großbanken und ihre Konzentration im Zusammenhang mit der Entwicklung der Gesamtwirtschaft in Deutschland* (4th ed., Jena 1912)); O. JEIDELS, *Das Verhältnis der deutschen Großbanken zur Industrie* (2d ed., Munich 1913); W. HAGEMANN, *Das Verhältnis der deutschen Großbanken zur Industrie* (Berlin 1931).

52 STIER-SOMLO, "Die Reform des Aufsichtsraths der Aktiengesellschaft," 53 *ZHR* 20-77 (1903); R. PASSOW, *Die Aktiengesellschaft* 441 (2d ed., Jena 1922). For a more recent comparative evaluation see WINDBICHLER, "Zur Trennung von Geschäftsführung und Kontrolle bei amerikanischen Großgesellschaften, Eine 'neue' Entwicklung und europäische Regelungen im Vergleich," 14 *ZGR* 50-73 (1985).

53 Y. GUYON, *Droit des affaires* 324 (3d ed. Paris 1984); P. LE CANNU, *La société anonyme à directoire* 361 et seq. (with statistical materials) (Paris 1979). See now CHARTIER, "Société à directoire ou société à conseil de surveillance?," in *Aspects actuels du droit commercial français: Etudes dédiées à René Roblot* 335-55 (Paris 1984).

A more fundamental divergence of company law has developed with the emergence in some Member States[54] of laws requiring worker participation (codetermination). The German Federal Republic became the primary example of this trend in 1976 when it adopted a model for worker participation on the supervisory board.[55] The model is based on equal representation of capital and labor, and places a final tie-breaking vote with capital through the chairman of the supervisory board. A weaker form of worker participation was introduced in the Netherlands in 1973.[56] Under the Dutch model, the managerial board of directors, the central works council and the shareholders' general assembly each makes proposals for appointments to vacant supervisory posts. The supervisory board then chooses from among those proposed. More limited attempts at codetermination have been made in other countries, with participation restricted to particular industries, or introduced on a voluntary basis.[57] Unlike other issues of company law, these decisions have not been based on technical issues of corporate organization, but involve fundamental

[54] For a survey on the state of codetermination in different Member States see EC COMMISSION, "Employee Participation and Company Structure," *Bull. EC*, Supp. 8/1975, at 51 ("Green Paper"); F. GAMILLSCHEG et al., *Mitbestimmung der Arbeitnehmer in Frankreich, Großbritannien, Schweden, Italien, den USA und der Bundesrepublik Deutschland* (Frankfurt 1978); Symposium, "Worker Participation in Management," 4 *Comp. L. Yearbook* 3-163 (1981) (USA, Austria, Belgium, Germany, Holland, Italy, Japan, Switzerland, Yugoslavia); HOPT, "Grundprobleme der Mitbestimmung in Europa: Eine rechtsvergleichende Bestandsaufnahme und Einschätzung der Vorschläge zur Rechtsangleichung der Arbeitnehmermitbestimmung in den Europäischen Gemeinschaften," 13 *ZfA* 207 (1982) (also available in French version: "Problèmes fondamentaux de la participation en Europe," 34 *Rev. trim. droit comm. et droit écon.* 401 (1981)); see also *infra* § IV.B.

[55] See Gesetz über die Mitbestimmung der Arbeitnehmer (Mitbestimmungsgesetz), 4 May 1976 (BGBl. I, 1153). For a survey in English, see MERTENS & SCHANZE, "The German Codetermination Act of 1976," 2 *J. Comp. Corp. L. & Sec. Reg.* 75-88 (1979); WIEDEMANN, "Codetermination by Workers in German Enterprises," 28 *Am. J. Comp. L.* 79 (1980).

[56] See especially Wet op de structuur van naamloze en besloten Vennootschappen, 1971, which is fully integrated into the Wetboek van Koophandel. For comments see MAEIJER, "Die Arbeitnehmermitbestimmung nach der Neuregelung für die Aufsichtsräte in großen niederländischen Kapitalgesellschaften," 3 *ZGR* 104 (1974); MAEIJER, "Der Betriebsrat in der niederländischen Unternehmung und andere Mittel zum Zweck der Mitbestimmung der Arbeitnehmer," 10 *ZfA* 69 (1979); GOTZEN, "Das niederländische Kooptionsverfahren zur Besetzung der Aufsichtsräte von Aktiengesellschaften," 20 *RIW/AWD* 676 (1974); SANDERS, "Zum Recht der Kapitalgesellschaften in den Niederlanden," 22 *AG* 173 (1977).

[57] For short surveys of different national laws see LECHER, 28 *Die Mitbestimmung* 461 (Austria) (1982) & 29 *Die Mitbestimmung* 27 (Belgium), 81 (Netherlands), 141 (France), 183 (Norway), 240 (Spain), 265 (Great Britain) (1983). For detailed information see *supra* note 54.

questions about economic systems, which are more often decided on the basis of emotion and ideology.

ii. Shareholders' General Assembly

The shareholders' general assembly, found in the company laws of all Member States, does not act as the supreme organ of the firm, although it is frequently assigned this position by the legislature. In Germany, the reform act of 1884 was intended to strengthen the shareholders' control by increasing the powers of the general assembly. In reality, however, management generally ran matters independent of this assembly. In fact, this independence went so far that the general assembly was characterized by one commentator as "not governing, but merely taking note" of decisions already made.[58] Shareholder democracy was ultimately regarded as both unworkable and undesirable,[59] and the company law reform of 1937[60] made the board of directors the most important organ of the company.

The German Companies Act of 1965,[61] in force today, was intended to improve the position of the small shareholder. The general assembly's influence on the use of profits was strengthened, and legal protections for the individual shareholder were improved. In practice, however, this reform did not change the limited influence of the general assembly, particularly in public companies without major shareholders. The general assembly continues to play a decisive role only as to basic structural decisions, which can only be made by a qualified majority of three-quarters of the share capital participating in the decision (unless the articles of association, within specific limits, provide otherwise).

Attempts to give greater power to the general assembly have failed in other jurisdictions as well. In France, for example, the legislature sought to strengthen the position of the general assembly by giving to it the right to amend the articles of association, elect the supervisory board, and approve the balance sheet. This failed to change the passivity and absenteeism of the shareholders.[62] In Britain, the ultimate decisions were intended to be reserved to the shareholders through the use of their powers of election and removal, and the case law there tended toward recognition of the separation of powers

58 PASSOW, *supra* note 52, at 479; E. STEINITZER, *Ökonomische Theorie der Aktiengesellschaft* (Leipzig 1908).

59 R. WIETHÖLTER, *Interessen und Organisation der Aktiengesellschaft im deutschen und amerikanischen Recht* 80 et seq. (Karlsruhe 1961).

60 Gesetz über Aktiengesellschaften und Kommanditgesellschaften auf Aktien, 30 Jan. 1937, RGBl. I, 107.

61 Aktiengesetz, 6 Sept. 1965, BGBl. I, 1089; for an English translation see R. MÜLLER & E.G. GALBRAITH, *The German Stock Corporation Law and the German Law on the Accounting by Major Enterprises Other than Stock Corporations* (bilingual; 2d ed., Frankfurt 1976).

62 See generally GUYON, *supra* note 53, at 277, 290-93, 302-03.

between the board and shareholders.[63] But this model also failed to increase the shareholders' control.

Today, in order to fill the vacuum created by this impotence of the general assembly in the internal organization of corporations, the Member States have adopted various reforms in national company law, particularly on the issue of proxy voting (also called nominee voting). In this area, there is a fundamental difference between the US, British and French laws and the statutes of, for example, Germany. Under the former laws, shareholders are generally free to transfer their voting rights to board members. But even though such proxy voting implies the possibility of instructing the board to make particular decisions, it became apparent long ago that it actually does little to change the dominance of the board, even where it is buttressed by comprehensive disclosure requirements. As *Gower* comments: "Although proxy voting gave an appearance of democratic freedom, this appearance was often deceptive and in reality the practice helped to enhance the dictatorship of the board."[64] Despite recent procedural improvements in proxy voting, little has changed in practice.

German law took an opposite position on proxy voting, but only in theory. While German law made proxy voting impermissible, it allowed the transfer of voting rights to parties other than managers. After the turn of the century, this practice led to the development of so-called depository voting rights, whereby shareholders who deposited their shares at a bank transferred their voting rights to the bank as part of the deposit transaction. This depository voting right, which was generally adopted, has meant that banks have frequently set the tone in the general assemblies of public companies. Serious discussion about depository voting rights began shortly after the turn of the century, and has continued despite all amendments, most recently through the Companies Act of 1965 with its many restrictive provisions and a simple power of attorney to vote.[65] Similar developments have occurred in Switzerland.[66]

iii. Board of Directors

Today, despite important differences in legal regulations, the board of directors is the dominant body in public companies without major shareholders. This

63 *Cf.* Companies Act of 1948, 11 & 12 Geo. 6, c. 38, § 184; and see GOWER, *supra* note 38, at 143 et seq. (with references to the case law).

64 GOWER, *supra* note 38, at 538; see also KARJALA, "The Board of Directors in English and American Companies Through 1920," in HORN & KOCKA, *supra* note 5, at 204, 220. For France, see GUYON, *supra* note 53, at 290-91 (legal restrictions on the "mandat blanc" since 1969).

65 WIETHÖLTER, *supra* note 59, at 322 et seq.; G. PUETTNER, *Das Depotstimmrecht der Banken* (Berlin 1963).

66 See SCHWEIZERISCHE KARTELLKOMMISSION, "Die Konzentration im schweizerischen Bankgewerbe," 14 *Veröffentlichungen der Schweizerischen Kartellkommission* 74-81, 134-36, 166-69 (Nos. 1 & 2, 1979).

dominance can be demonstrated in a variety of areas, but we shall examine only a few here. These are (1) the legal position of the board of directors vis-à-vis the other organs of the company; (2) the legal power of the board to represent the corporation; and (3) the obligations of the board with respect to the proper execution of its role.

An example of the evolution of the dominant legal position of the board of directors is provided by the German company law reform of 1937. Said to be the transfer of the "Führer principle" to corporate law,[67] this statute greatly strengthened the board's position in the company. The statute required the board of directors to pursue not only the interests of the shareholders but also the interests of the company, the interests of its workers, and the public interest in general.[68] Although this provision has since been abolished, the board remains the preeminent organ in the company. The debate continues on the board's responsibility to set the interests of the workers and the public above profitability.

The extent to which the board of directors is permitted to bind the company to third parties also provides an excellent example of an area where, despite differing regulations, the power of the board remains preeminent. Here, the older *ultra vires* doctrine of Common Law countries, even though moderated today by appropriate wording of the articles of association and by exculpatory legislation, can be compared to the widespread Continental view that business activity would be excessively restricted by such a limitation on the power of representation.[69] In the European view, the *ultra vires* doctrine would ultimately compel fidelity to the articles of association over the obligations of any individual transaction, and would be an unacceptable restriction on the power of the board. It should be noted, however, that although theoretically the Continental view is clearly more liberal than the Common Law view, there has been little practical difference between the two systems.

The differences under various national laws in the fiduciary duty of the board have rarely been dealt with before. National statutes have had little to say on these issues, so that differences have arisen chiefly through developments in case law. In the Common Law countries, the theoretical basis for regulation of the board's duties is the idea that the board of directors occupies the position of a trustee, and is subject to the wide-ranging duties of a trustee. This definition of the board's obligation results in the imposition of extensive

67 F. KLAUSING, *Aktiengesetz* 20-37 (Berlin 1937); WIETHÖLTER, *supra* note 59, at 45.

68 See generally *Corporate Governance and Directors' Liabilities – Legal, Economic and Sociological Analyses on Corporate Social Responsibility* (K.J. Hopt & G. Teubner eds., Berlin/New York 1985) [hereinafter cited as HOPT & TEUBNER]; TEUBNER, "'Corporate Responsibility' als Problem der Unternehmensverfassung," 12 *ZGR* 34 (1983).

69 *Cf.* generally R. BUXBAUM, "The Formation of Marketable Share Companies," in *Int'l Enc. Comp. L.*, Vol. XIII, *Business and Private Organizations*, ch. 3 (A. Conard ed., Tübingen n.d. [1974]).

behavioral obligations in such areas as conflict of interests, use of inside information, making of takeover offers, etc. Continental European legal systems, to which the concept of the trust is alien, are only gradually beginning to appreciate the extent of these problems, and to regulate these aspects of the board's role.[70] This is still generally true even though some countries do have some quite highly developed rules in specific fields; for example, France has developed rules on personal self-dealing of board members with their corporation and Germany has gone far in regulating competition with one's own corporation. Even less homogeneous are the views on what legal duties the board members have concerning corporate social responsibility.[71]

c. Corporate Disclosure Requirements

The area of disclosure reveals yet another aspect of the divergence of European company and capital law evolution. In most European company law systems, the transition from the concession system to the enabling system of incorporation went hand in hand with the development of compulsory minimum disclosure requirements. State control through concessions was replaced by shareholder control through disclosure. By the second half of the last century, legislatures began to recognize the special relation between disclosure and such diverse issues as the growth of free competition, the protection of shareholders, and the protection of the proper function of the stock market.[72] Despite their common goals, however, the various countries originally took quite different approaches to the use of disclosure as a means of control over the corporation.

This difference is highlighted by the contrasting approaches developed by the Common Law countries, such as Great Britain, and the Continental systems, such as Germany. While British company law has pursued far-reaching disclosure since the time of Gladstone, disclosure developed only gradually and hesitantly in German company law. Disclosure was introduced to German company law in 1870 by the All-German Commercial Code, which originally required disclosure only of the corporate balance sheet and profit-and-loss statements in public documents.[73] It was not until 1931, in the wake of the

[70] HOPT, "Self-Dealing and Use of Corporate Opportunity and Information: Regulating Directors' Conflicts of Interest," in HOPT & TEUBNER, *supra* note 68, at 285-326. See also G. ROTH, *Das Treuhandmodell des Investmentrechts* 80-109 (Frankfurt 1972) and the review by REUTER, "Das Treuhandmodell des Investmentrechts – Eine Alternative zur Aktiengesellschaft," 137 *ZHR* 405 (1973). See also A. TUNC, *Le droit américain des sociétés anonymes*, ch. 3 (organs of the corporation) (Paris 1985) (American corporate law as seen from Europe).

[71] LORD WEDDERBURN, "The Legal Development of Corporate Responsibility: For Whom Will Corporate Managers Be Trustees?," in HOPT & TEUBNER, *supra* note 68, at 3-54.

[72] HOPT, *supra* note 36, at 128, 154-56.

[73] Disclosure provisions were proposed for the first time by the Nuremberg Commis-

world economic crisis, that the law was amended to require a compulsory audit of final accounts by special auditors.[74] Broader company disclosure was not imposed until 1969, when a new law was passed requiring disclosure of the annual account based on the size of the firm, not the company's legal form (i.e., whether or not a corporation).[75] Under this statute, the disclosure obligation arises when two out of three characteristics are present: gross assets of more than DM 125 million, an annual turnover of more than DM 250 million, and more than 5,000 employees. This approach emphasizes the economic importance of the individual firm and covers even sole proprietorships.[76]

d. Choice of the Company's Legal Form

In contrast to such countries as Britain, France and Switzerland, the corporate company structure has steadily lost importance in Germany over the last two decades. The number of corporations, as well as the number quoted on the stock exchange, has fallen considerably.[77] Implementation of economic and social policies through company law has led to greater burdens placed on corporations, as compared with other company structures. These differences arise particularly in such areas as disclosure requirements, tax burdens, and labor and codetermination laws. Today one frequently hears about the "crisis of the corporation in Germany."[78]

On the other hand, the limited-liability company has steadily gained ground in Germany. Historically, this type of company structure was developed for medium and small firms that were more simply regulated than the corporation. The external stimulus to the growth of these companies was provided by the

sion, see ADHGB Art. 239 (1) (31 May 1861), amended by the Gesetz des Norddeutschen Bundes of 11 June 1870 (*supra* note 34).

74 Notverordnung, 19 Sept. 1931, RGBl. I, 493. For the historical development see H. KRONSTEIN & C. CLAUSSEN, *Publizität und Gewinnverteilung im neuen Aktienrecht* 13 et seq. (Frankfurt 1960).

75 *Publizitätsgesetz, supra* note 12. For the politico-legal discussion see *Das Frankfurter Publizitätsgespräch* (C.H. Barz *et al.* eds., Frankfurt 1962), especially the contributions by WIETHÖLTER (at 33-54) and VON CAEMMERER (at 141-82); see also RITTNER, "Die handelsrechtliche Publizität außerhalb der Aktiengesellschaft," vol. 1, Part 4, *Verhandlungen des 45. Deutschen Juristentages* (Ständige Deputation des Deutschen Juristentages ed., Munich 1964).

76 As of 1986 the Bilanzrichtlinien-Gesetz (*supra* note 12), which has transformed the Fourth and Seventh EC Directives into German law and governs all companies except the commercial partnership, has reduced the reach of the *Publizitätsgesetz (supra* note 12) considerably, but has kept a similar technique of quantitative criteria: see HGB § 267.

77 For statistical data see *supra* p. 172.

78 See the set of articles at 26 *AG* 5-24 (1981), especially KÜBLER, "Unternehmensstruktur und Kapitalmarktfunktion – Überlegungen zur Krise der Aktiengesellschaft," 26 *AG* at 5.

German company law reform act of 1884, which tightened the normative enabling provisions applicable to corporations. The 1892 Limited-Liability Companies Act was a pioneering statute,[79] which soon found imitators in neighboring European countries.[80] While the legal concept of the Act relied heavily on a small or close corporation model, which had traditionally restricted the influence of the capital provider to setting guidelines and supervising business policy, what made the 1892 Act so revolutionary was the recognition that participants in the company were free to use a more individual organization structure. The Act allowed far-reaching contractual freedom in choosing and adapting company structures, and this freedom led to extensive development of the limited-liability company. The only important limitation of the Act, which prevented large capital-intensive firms from abandoning the corporate form, was the difficulty surrounding the transfer of company shares. An unintended consequence was that a limited-liability company can obtain practically no equity capital from the general public on the capital market.[81]

The freedom of choice among company forms and the broad contractual freedom within most of these forms (other than the corporation) led German lawyers to experiment with company constructions, mixing corporate and individual structural elements. In 1922, when the court of last instance recognized the GmbH & Co. KG (limited-liability joint stock partnership),[82] there was no stopping the trend toward mixed structures. This mixed structure of the limited-liability company partnership expanded rapidly in Germany, even though in most other Member States it plays no significant role, and is explicitly forbidden in Switzerland.[83] Originally, this expansion was attributable to the tax advantages of the mixed structure, but since the corporate tax reform act of 1977, the company law advantages have been the key attraction of this structure. Today, a company so structured may enjoy the benefits of a limited-liability company, while also having flexibility in the appointment of outsiders

[79] SCHMITTHOFF, "The Future of the European Company Law Scene," in *The Harmonisation of European Company Law* 3, 11 et seq. (C.M. Schmitthoff ed., London 1973).

[80] For the text and a comparison of different national laws (in German and partly bilingually) see BEHRENS, in 1 *GmbHG Großkommentar/Hachenburg* (7th ed. Berlin 1975).

[81] Recently there has been a heated discussion on whether limited-liability companies should also have access to the stock exchange. See HOPT, *supra* note 13, at 804; VOLLMER, "Eigenkapitalbeschaffung für die GmbH durch Börsenzugang," 1984 *GmbH-Rundschau* 329.

[82] RG, Decision of 4 July 1922, RGZ 105, 101.

[83] For France see VIANDIER, *supra* note 47; see also generally the set of articles and discussions on "Financement, capital et pouvoir dans l'entreprise: une nouvelle chance pour la commandite?," *La Semaine Juridique, Cahiers de droit de l'entreprise* (JCP-édition entreprise), No. 48, 629-52 (29 Nov. 1984). For Switzerland, see Obligationenrecht, Art. 594 (2).

to the management organs (thereby facilitating the choice of management and succession) and freedom of form.[84]

Moreover, since the 1970's, practice has developed yet another type of GmbH & Co., the so-called personal public company or mass company.[85] While the circulation of shares of limited-liability companies (GmbHs) is not allowed, there is nothing in German law that prevents trading in shares of commercial partnerships, since in their case unlimited liability supposedly functions as a regulator. Thus, the GmbH & Co. made direct access to the capital market possible and removed the threat of personal liability, without requiring use of the corporate legal form. The success of the GmbH & Co. has been pervasive. In recent years more new capital has flowed into such public companies than into corporations. Moreover, despite widespread abuses, the legislature has been unable to decide on a capital market act to regulate this trend (a point dealt with below). It therefore has been up to the case law to deal with this phenomenon and to treat it as what it really is, a corporation in the disguise of a partnership. Since the federal court decision in 1972,[86] there has been a whole series of judgments on this, creating a new area of judge-made company law.[87]

e. Limitations on Groups of Companies and Business Combination

The existence of groups of companies has long been a matter of course in all Member States.[88] It has been asserted that for some countries, such as Belgium, all corporations in the industrial sector, and even those in the trade sector, belong to a combination.[89] The various states' legal reactions to such

84 See B.-H. HENNERKES & M.K. BINZ, *Die GmbH & Co.* (Munich 1984). For a survey of the case law see: BAUMBACH-DUDEN-HOPT, *Handelsgesetzbuch,* Anhang § 177a, ch. VIII (27 ed. Munich 1987).

85 KÜBLER, *supra* note 24, at § 20 III.

86 BGH, Decision of 14 Dec. 1972, 26 *NJW* 1604 (1973).

87 The whole set of decisions can be found in BAUMBACH-DUDEN-HOPT, *supra* note 84, at Anhang § 177a, ch. VIII: "Publikumsgesellschaft." See also the set of contributions to *Festschrift für Walter Stimpel* 247-350 (M. Lutter, H.-J. Mertens & P. Ulmer eds., Berlin/New York 1985).

88 See the country reports for Germany, France, Belgium, England, Switzerland and Scandinavia, in *Legal and Economic Analyses on Multinational Enterprises,* vol. 2, *Groups of Companies in European Law* (K.J. Hopt ed., Berlin/New York 1982) [hereinafter cited as 2 HOPT]. See also F. WOOLDRIDGE, *Groups of Companies, The Law and Practice in Britain, France and Germany* (Institute of Advanced Legal Studies, Univ. of London 1981); *I gruppi di società* (A. Pavone La Rosa ed., Bologna 1982); LUTTER, "The Law of Groups of Companies in Europe: A Challenge for Jurisprudence," in 1 *Forum internationale*, No. 1 (1983), and an updated version in 16 *ZGR* 324 (1987); HOPT, "Le droit des groupes de sociétés, expériences allemandes, perspectives européennes," 105 *Rev. soc.* 371 (1987).

89 See VAN OMMESLAGHE, "Les groupes de sociétés et l'expérience du droit belge," in 2 HOPT, *supra* note 88, at 59; see also, WYMEERSCH, "La Commission Bancaire belge et le droit des groupes de sociétés," 31 *Riv. soc.* 207 (1986).

groups vary widely. In most European statutory systems the issue is simply ignored. The problems of these groups (such as the liability questions) are therefore left to the courts, as for example in Britain, France and Italy,[90] or to the regulatory agencies, such as the Belgian *Commission Bancaire*.[91] As a consequence, there is little regulation of these groups. Furthermore, this regulation is uncertain in scope and inadequate to cope with cognizance of the "hollowing out" effect in the case of dependent companies. The statutes thus perpetuate the company law assumption that each company properly follows only its own interest, which ignores reality.

By contrast, since 1965 Germany has had an extensive, codified law on groups of companies that seeks to protect both shareholders and creditors of companies belonging to the group.[92] The purpose of this legislation was to induce the companies involved to enter into an affiliation contract, establishing a so-called contractually controlled group (*Vertragskonzern*). These contractually controlled groups protect the interests of creditors and members by guaranteeing the company assets and a minimum profit and compensatory and indemnification rights for shareholders. In turn the pursuit of the group's interest at the expense of the member companies is legitimated. In the case of merely *de facto* groups, the statute provides only the general company law ban on forcing the dependent company to undertake disadvantageous transactions. Even this ban does not apply if the disadvantages are compensated for.

This German law on groups of companies[93] should not be used as a model for other Member States. Not only is it extraordinarily complicated and cumbersome, and therefore out of place in countries with different legal traditions (such as Britain and Belgium), but it is even questionable whether it meets its objectives.[94] This questionable effectiveness is dramatically demonstrated by the small number of contractually controlled groups present in Germany today, despite the high concentration of the economy.

Primarily, however, the German law on groups of companies fails as a model because it regulates the group only as a completed organization, and does not intervene during the development of the group. To this extent, even countries that lack a law on groups of companies are far ahead of the Federal Republic,

90 WOOLDRIDGE, *supra* note 88, at 107-13 (Britain), and 113-25 (France); ABBADESSA, "I gruppi di società nel diritto italiano," in *I gruppi di società, supra* note 88, at 103-46.

91 See VAN OMMESLAGHE, *supra* note 89, at 72, 79-91.

92 WIEDEMANN, "The German Experience with the Law of Affiliated Enterprises," in 2 HOPT, *supra* note 88, at 21; HOPT, *supra* note 88.

93 For recent developments see, e.g., the set of articles for the Königsteiner Symposium 1984, in 13 *ZGR* 352-595 (1984); and for the Kieler Symposium 1986, in 31 *AG* 117-40 (1986), as well as FLECK, "Die Rechtsprechung des Bundesgerichtshofes zum Recht der verbundenen Unternehmen," 40 *WM* 1205-16 (1986).

94 See MOTOMURA, "Protecting Outside Shareholders in a Corporate Subsidiary: A Comparative Look at the Private and Judicial Roles in the United States and Germany," [1980] *Wis. L. Rev.* 61.

especially in such areas as the regulation of takeover bids or the sale of control blocs. This is true, for example, for Great Britain, France and Belgium. The consequence is a great diversity of concepts and regulation all over Europe[95] which will make this one of the hardest areas of company law to harmonize.

2. The Emergence of an Independent Capital Market Law

The development of European capital market law did not begin until after the world economic crisis of the 1930's. Previously, the only capital market standards that existed were provided by company law. After the crisis, a special capital market law developed out of company law in both the United States and in European countries such as Belgium and France. This genesis explains the many connections between the two areas of law, although the federalist aspects of US securities regulation, demonstrated by the conflict between federal securities statutes and state corporation laws, do not appear in Europe.

a. Capital Market Law

Belgium was the first European country to set up a capital market law of its own. The law was enacted soon after the US Securities Act of 1933, and is similar to it in that it regulates the issuance of securities, thus protecting the investor from the time of the first public sale.[96] Securities are defined to include all rights in personal and real property where a company or partnership exists *de facto* or *de jure;* the owners consequently give up personal use of the assets, and management is organized jointly. The prevailing principle of this capital market law is obligatory disclosure on issuance, which continues as current disclosure.[97] Implementation is incumbent on the highly regarded *Commission Bancaire,* which combines the roles of a banking supervisory authority and a securities exchange commission. This Commission has worked effectively, despite its very limited resources and powers.[98]

The French capital market law adopted in 1967 has parallels with the Belgian law. Similarities include: (1) the obligation to produce prospectuses on issuing

[95] See especially U. IMMENGA, "Company Systems and Affiliation," in *Int'l Enc. Comp. L.*, Vol. XIII, *Business and Private Organizations*, ch. 7 (A. Conard ed., Tübingen n.d. [1984]).

[96] Arrêté royal no. 185 du 9 juillet 1935 sur le contrôle des banques et le régime des émissions de titre et valeurs, *Moniteur belge*, 10 July 1935.

[97] For details see HOPT, "Vom Aktien- und Börsenrecht zum Kapitalmarktrecht? (Part 1)," 140 *ZHR* 201, 215-27 (1976) (with further references).

[98] BRUYNEEL, "The Belgian 'Commission Bancaire': Functions and Methods," 1 *J. Comp. Corp. L. & Sec. Reg.* 187 (1978) (with further references); see also *supra* note 89. For regularly updated information see the annual reports of the Belgian Banking Commission, e.g., COMMISSION BANCAIRE, *(50ième) Rapport Annuel 1985-86* (Brussels 1986).

securities; (2) supervision of the exchange trading of securities (which is reserved to brokers who are members of a national association); severe restrictions on public sale and recommendation of securities outside the exchanges; and implementation of the Act through the governmental stock exchange supervisory commission, with tasks similar to those of the US Securities and Exchange Commission (SEC). Nevertheless, the French and Belgian capital market laws are very different. In accordance with the French administrative tradition, the French model stresses far-reaching and clearly outlined intervention powers of the *Commission des Opérations de Bourse*.[99] The French statute makes many more aspects subject to legal norms or administrative rules and attaches much greater importance to sanctions, which go as far as penal norms.[100]

In Britain, the capital market law has always been a peculiar mix of company law and other legal norms on the one hand, and the rules and standards of the City and the federated stock exchanges on the other. Both sets of norms are complementary, and are supervised and coordinated by the Panel on Takeovers and Mergers, and ultimately by the Department of Trade. British capital market law, with its strong emphasis on self-regulation, practical experience and skepticism of legalization and bureaucratization, is fundamentally different from the many continental European systems, even though very often the same general results are achieved in practice.[101] The institutional framework and the legal norms have been changed fundamentally ("big bang") as of 27 October 1986.[102] Other European countries, such as Italy, are also moving in the direction of a capital market law.[103]

[99] GUYON, "Les missions de la Commission des Opérations de Bourse," 2 *J. Comp. Corp. L. & Sec. Reg.* 141 (1979). For regularly updated information, see the annual reports of the French Stock Exchange Commission, e.g., COMMISSION DES OPÉRATIONS DE BOURSE, *19ième rapport 1986* (Paris 1987) (summaries in English are also available).

[100] See MACQUERON, "Developments in French Law on Disclosure and Trading of Securities," 5 *J. Comp. Bus. & Cap. Mkt. L.* 71-78 (1983).

[101] SCHMITTHOFF, "Some Considerations on the Issue of Securities in English Law," in *Le régime juridique des titres de sociétés en Europe et aux Etats-Unis/The Legal Status of Securities in Europe and the United States* 205 (Institut d'Etudes Européennes, Univ. Libre de Bruxelles ed., Brussels 1970); RIDER, "Self-Regulation: The British Approach to Policing Conduct in the Securities Business, with Particular Reference to the Role of the City Panel on Take-Overs and Mergers in the Regulation of Insider Trading," 1 *J. Comp. Corp. L. & Sec. Reg.* 319 (1978).

[102] See T.P. LEE, "Current Changes in the London Securities Markets: Some Domestic and International Regulatory Issues" (Paper presented to the Third Singapore Conference on International Business Law, 1-3 Sept. 1986); RIDER et al., *Guide to the Financial Services Act 1986* Bicester/Chicago 1987).

[103] On Italy, see CORSI, "Recent Developments in Italian Corporate Law," in *Juridification of Social Spheres* 273 (G. Teubner ed., Berlin/New York 1987) (papers presented at European University Institute Colloquium, Florence, Mar. 1985). For Switzerland, see the special issue "Schweizerisches Kapitalmarktrecht, Stand und Perspek-

In contrast with other Member States, Germany's capital market law has remained at an early stage of development, because it is based on the assumption that capital market law problems can be regulated through company law and stock exchange law.[104] German company law, however, is primarily organizational law, and contains only a few rudimentary rules on conduct when issuing shares on the capital market. Nor can stock exchange law fill these gaps, since it is limited to those very few companies whose securities are quoted on the exchange. The protection of shareholders and creditors offered by the stock exchange law is almost counterproductive, because the appearance of protection created by this limited law leaves the larger capital markets outside the exchange unregulated. Furthermore, the stock exchange law itself has gaps. The prospectus responsibility of stock exchange law has traditionally played a very small role (but it had its judge-made renaissance some years ago).[105] Legal regulation of insider trading is nearly completely lacking,[106] quite in contrast to Great Britain, France and other European countries.[107]

Some development in the Federal Republic's capital market law can be found in investment company law.[108] The law on foreign investment companies,[109] for example, takes effect at the time of the first public sale of investment shares, and is not limited to the primary market. Moreover, the law relies on disclosure (both initial issue and subsequent periodic disclosure), prospectus liability, and

tiven," 38 *Wirtschaft und Recht* 81-266 (P. Nobel ed., 1986). For the Scandinavian situation, see *Stock Exchange Law and Corporation Law* (C.M. Roos ed., Lund 1984). See the comparative conclusions by E. WYMEERSCH, *Control of Securities Markets in the European Economic Community* (EC Commission, Collection Studies: Competition – Approximation of Legislation Series No. 31, Luxembourg 1977).

104 HOPT, *supra* note 97; HOPT, "Die deutsche Entwicklung im internationalen Vergleich (Part 2)," 141 *ZHR* 389 (1977); and "Institutional Problems of German Stock Exchange Law and Securities Regulation," in ROOS (ed.), *supra* note 103, at 7.

105 H.-D. ASSMANN, *Prospekthaftung* (Cologne/Berlin/Bonn/Munich 1985).

106 See *infra* § III.B.3.

107 See the comprehensive work by J. SUTER, The Regulation of Insider Dealing in Britain and France (3 Vols., PhD. Thesis, Law Department, European University Institute, Florence, Mar. 1985). See also the country reports (U.S.A., Canada, Great Britain, France, Belgium, the Netherlands, Germany, the European Communities, Japan and Brazil) in *Colloque international, L'avant-projet de la loi fédérale sur les opérations d'initiés* 175-298 (A. Hirsch, P. Forstmoser & R. Mundheim eds., Geneva 1984).

108 Gesetz über Kapitalanlagegesellschaften, 14 Jan. 1970, BGBl. I, 127. For a comprehensive survey on the law concerning investment companies in Germany, France, Ireland, Belgium, Luxembourg, the Netherlands, Denmark, Switzerland, Austria and the United States, see H. LÜTGERATH, *Die Erweiterung des Anlagekataloges von Investmentgesellschaften* 21-64 (Baden-Baden 1984).

109 Gesetz über den Vertrieb ausländischer Investmentanteile und über die Besteuerung der Erträge aus ausländischer Investmentanteilen, 28 July 1969, BGBl. I, 986; see F. BAUR, *Investmentgesetze* (Berlin 1970).

flexible intervention in cases of misleading advertising as control instruments. Implementation of the act is entrusted to the Federal Banking Supervisory Office, which thereby becomes an investment supervision office. In other areas of investment law, case law has begun to develop where the legislature has not spoken. There is now extensive judge-made law on the GmbH & Co. and the public partnership company, particularly in the areas of prospectus liability and statements to the capital market.[110]

b. Banking Systems and Other Framework Conditions

The differences between national company and capital market laws are not superficial differences in legal norms, but reach deeper. They involve complex interaction with other legal areas, such as procedural, tax, commercial, insurance and labor law, and result from genuine differences between legal systems. It is neither possible nor useful to explore these differences here: however, the problems they produce can be illustrated by a single example.

The banking system is one of the most important structural conditions affecting company and capital market law. In this area, developments in the various Member States are very different. Belgium, France and the Common Law countries start from the principle that a bank's deposit business and its securities business must be separate. By contrast, Germany, the Netherlands, Switzerland, and Austria are all strongholds of the universal banking system.[111] In these countries there is no legally prescribed separation between the commercial credit banks and investment banks; instead, the banks offer a comprehensive range of financial services. German banks, for example, act as underwriters, control security exchanges, maintain stock participation in corporations and, by exercising their depositors' proxies, place representatives on the supervisory boards of corporations, and offer their services in investment consulting and asset management.

Although theoretically the pros and cons of the dual banking system vis-à-vis the universal banking system have been worked out and the international trend is very clearly moving towards free banking, it is hard to demonstrate empirically the superiority of one or the other.[112] Nevertheless, it is obvious that

110 *Supra* notes 84, 87 & 103.

111 BUESCHGEN, "Universal Banking System in the Federal Republic of Germany," 2 *J. Comp. Corp. L. & Sec. Reg.* 1 (1979); IMMENGA, "Participatory Investments by Banks: A Structural Problem of the Universal Banking System in Germany," 2 *J. Comp. Corp. L. & Sec. Reg.* 29 (1979).

112 See in this context the detailed study of H. BUESCHGEN, *Das Universalbankensystem* (Frankfurt 1971). For a short evaluation under the aspect of investor protection, see K.J. HOPT, *Der Kapitalanlegerschutz im Recht der Banken* 190-207 (Munich 1975); see also *Bericht der Studienkommission "Grundsatzfragen der Kreditwirtschaft"* (Bundesministerium für Wirtschaft, Bonn 1979) with a careful discussion of various reform proposals. For the recent developments in the US banking law field, see Northeast Bancorp., Inc. v. Board of Governors, 105 S. Ct. 2545 (1985); NORTON,

the legal realities of corporate control mechanisms vary dramatically depending upon the particular banking system. These differences are particularly marked in areas such as the financing of corporations, the role of supervisory boards and general assemblies, and the functioning of capital markets. These differences are confirmed by a glance at the different academic approaches to company and banking law in countries under the two systems. In the United States, for example, banking law is a special field of study that has little contact with company law, while in Germany the same scholars and practitioners are often experts in both fields.[113]

II. Aims, Bases and Expectations of Harmonization of Company and Capital Market Laws in Europe

A. Aims

In light of the economic importance and volume of transnational corporate activity on the one hand, and the numerous and sometimes fundamental differences in the various national company and particularly capital market laws on the other, the endeavor to bring about European legal harmonization seems bold, if not indeed utopian. In fact, any attempt to move all six (then ten and now twelve) equal nation states toward harmonization in the central area of their legal systems would have very little prospect of success. Nevertheless, in the Treaty of Rome [114] the EC Member States declared themselves ready for

"The 1982 Banking Act and the Deregulation Scheme," 38 *Bus. Lawyer* 1627 (1983); E. CORRIGAN, *Financial Market Structure: A Longer View* (Federal Reserve Bank of New York, New York 1987); see generally PERKINS, "The Divorce of Commercial and Investment Banking: A History," 88 *Bank L.J.* 483 (1971); a good introduction to the US banking system is still HACKLEY, "Our Baffling Banking System," 52 *Va. L. Rev.* 565-632, 771-830 (1966).

113 It is no coincidence that the International Faculty for Corporate and Capital Market Law, whose main focus was originally international securities regulation, has moved on to international banking. *Cf.* KÜBLER & MUNDHEIM, "Current Problems in Transnational Banking: A Report on the Königstein Banking Symposium," 5 *J. Comp. Bus. & Capital Market L.* 233-47 (1983); ISAACSON & GOLDEN, "Summary of Proceedings: International Faculty Seminar on Corporate and Capital Market Law, Arrowwood Conference Center, October 20-22, 1983," 7 *J. Comp. Bus. & Capital Market L.* 1-36 (1985) (international lending crisis).

114 A ready source in English is E. STEIN, P. HAY & M. WAELBROECK, *Documents for European Community Law and Institutions in Perspective* (Indianapolis 1976) (*i.e.*, the document supplement to E. STEIN, P. HAY & M. WAELBROECK, *European Community Law and Institutions in Perspective* (Indianapolis 1976)).

such legal harmonization, and the drafters of the Treaty must have considered company law harmonization a key to European integration.[115]

1. The Constitutional Level: A Short Survey of the Treaty Provisions

Article 2 of the EEC Treaty states the objectives that should be legally binding on the European Economic Community. It identifies two intermediate objectives and five ultimate goals. Initially, a Common Market was to be established and the economic policies of the Member States were to be progressively approximated. This was expected to bring about the ultimate objectives of the Treaty: harmonious development of economic activities throughout the Community, the continuous and balanced economic expansion of the Community, an increase in economic stability within the Community, an accelerated raising of the standard of living, and closer relations between all the Member States.

Article 3 of the Treaty then summarizes eleven specific activities for the Community which were designed to achieve the goals discussed above. One of these, as stated in Article 3(c), is "the abolition, as between Member States, of obstacles to freedom of movement for persons, services and capital."[116]

[115] This study is concerned with the harmonization of company and capital market law. The prior question of free movement of companies and capital across European frontiers has been left to other volumes in the Florence *Integration Through Law* series. This delineation is not without problems since up to 1986 company and capital market law harmonization has made much more progress than the actual and effective opening of the frontiers for capital movements and financial market services. See generally *Bull. EC*, Supp. 7/1985; ECJ, Case 203/80, Casati, [1981] E.C.R. 2595; Joined Cases 286/82 & 26/83, Luisi and Carbone, [1984] E.C.R. 377, with comments by HAFKA, 19 *EuR* 398 (1984); OLIVER, "Free Movement of Capital Between Member States: Article 67(1) EEC and the Implementing Directives," 9 *Eur. L. Rev.* 401 (1984); TROBERG ("Vorbemerkung Arts. 67-73") and especially KIEMEL (comment to Art. 69), in H. VON DER GROEBEN, H. VON BOECKH, J. THIESING & C.-D. EHLERMANN, *Kommentar zum EWG-Vertrag* (3d ed. Baden-Baden 1983). See also *infra* note 116 and §§ IV.A.2, pp. 254-56 & IV.C.1, pp. 262-266 with further references. The study by W.-H. ROTH on the harmonization of the law of financial services in the EC, which appeared only after this book was already in print, shows the dynamics which the banking and financial services sector can expect as a consequence of the new focus on the completion of the internal market since 1985 (see *infra* note 116); ROTH, "Die Harmonisierung des Dienstleistungsrechts in der EWG," 21 *EuR* 340 (1986), 22 *EuR* 7 (1987); *cf.* also W.-H. ROTH, *Internationales Versicherungsvertragsrecht* 650 et seq. (Tübingen 1985), for the dilemma between free movement of (insurance) services and the adequate protection of the (insurance) policy holders.

[116] The present day level of liberalization of capital movements in the EC has recently been described by a member of the Board of the German Central Bank as "still lower than in the mid-1960's." GLESKE, "Die Liberalisierung des Kapitalverkehrs in der EG" (address to the Conference at the Frankfurt Institute for Capital Market Research, 3 July 1986), *reprinted in* DEUTSCHE BUNDESBANK, *Auszüge aus Pressear-*

Similarly, Article 3(h) provides for "the approximation of the laws of Member States to the extent required for the proper functioning of the common market." Both of these methods are described in more detail later in the Treaty. In 1987 Article 8A of the Treaty added a new policy objective as to the establishment of the internal market by 1992.

The company law harmonization process is described in Article 54(3)(g), and the approximation of laws is discussed in Article 100 and, as far as the realization of the internal market is concerned, in Article 100A (since 1987). The purpose of these means follows only in general terms. The Treaty states that company law harmonization is to be carried on "to the necessary extent" (Article 54), and that general approximation of laws is to be pursued only in respect of such legal and administrative provisions "as directly affect the establishment or functioning of the common market" (Article 100; without this restriction, now Article 100A). These provisions are further supported by the basic principle of the Community embodied in the general ban on discrimination contained in Article 7 of the Treaty. This states that within the scope of the application of the Treaty any discrimination on the grounds of nationality is prohibited. The ban applies to legal persons and companies as well as sovereign governments.

tikeln, No. 48, 1-5, at 4 (1986). The turning point is marked by EC COMMISSION, "Completing the Internal Market: White Paper from the Commission to the European Council," 14 June 1985, Nos 67 et seq. (minimum harmonization), 101 et seq. (free circulation of financial products), 124 et seq. (greater liberalization of capital movements) (Doc. COM(85)310 final); *cf.* the short review by SCHULTZE, 31 *RIW* 986-89 (1985). The White Paper's proposed steps until 1992 have been criticized as too half-hearted: see WISSENSCHAFTLICHER BEIRAT BEIM BUNDESMINISTERIUM FÜR WIRTSCHAFT, *Stellungnahme zum Weissbuch der EG-Kommission über den Binnenmarkt*, at ch. 5 (Bundesministerium für Wirtschaft [Federal Ministry of Economics] ed., Bonn 1986). *Cf.* now the provisions of the Single European Act, *Bull. EC*, Supp. 2/1986, particularly those meant to further the realization of an internal market such as (as of 1987) EEC Treaty Arts. 8A, 8B, 8C, 100A, 100B. The impact of the Single European Act is generally evaluated in a positive way: see, *e.g.*, STEINDORFF, "Gemeinsamer Markt als Binnenmarkt," 150 *ZHR* 687 (1986); EHLERMANN, "The Internal Market Following the Single European Act," 24 *C.M.L. Rev.* 361 (1987); but see PESCATORE, "Die 'Einheitliche Europäische Akte' – Eine ernste Gefahr für den Gemeinsamen Markt," 21 *EuR* 153 (1986). The Delors two-phase program for more liberalization of capital movements was presented in May 1986 (Doc. COM(86)292 final; *Bull. EC* 5/1986, pp. 13-16, pts 1.2.1-1.2.8; *Bull. EC* 6/1986, pp. 16-17, pts. 1.3.1-1.3.4). See also the First Commission Report on the White Paper, 26 May 1986, Doc. COM(86)300 final. The first phase has been started by a new directive in this field of 17 Nov. 1986 (see *infra* § IV.A.2.a at p. 254). A second proposal as the start of the second phase is planned for the end of 1987 (Second Commission Report on the Realization of the Aims of the White Paper, 19 May 1987, Doc. COM(87)203 final, pt. 73). A thoughtful development strategy for the EC is mapped out in the PADOA-SCHIOPPA Report to the EC Commission of April 1987, Doc. II/49/87.

2. Basic Assumptions of the EEC Treaty Relating to Company and Capital Market Law as Functions of Integration

The relationship between the ends the Treaty seeks to attain and the means used remains abstract and problematic. Therefore, an investigation of the progress that the legislative organs of the European Community expect from company law harmonization is appropriate. Unfortunately, a review of the various directives and proposals for company and capital market law harmonization[117] reveals only a few scattered statements on European integration, without theoretical connection. The preambles to the directives contain such arguments for the Community's legal integration as the following: In the Member States' economy, the activity of corporate enterprises transcends the frontiers of national sovereign territory (Second Directive); in the Community in particular, many groups of companies have a transnational structure (Proposed Ninth Directive); partners and creditors of companies ought to have equal protection in all Member States, and in particular have similar information on the companies therein (First, Fourth and Seventh Directives and the three capital market law harmonization Directives of 5 March 1979, 17 March 1980 and 15 February 1982).[118] One important argument in favor of integration which appears repeatedly in these directives is the endeavor "to bring about within the Community equal minimum legal conditions for companies competing with each other" (Fourth and Fifth Directives). Occasionally there is also the idea that "business enterprises bigger than a certain size may represent power" and that provision for the distribution and balance of that power must be made (from the *Bismark Report* of the Legal Affairs Committee concerning the Fifth Directive). The preambles frequently argue simply from consistency: Because a particular part of company law is already uniform, an immediately adjacent area ought also to be unified (e.g., the Seventh Directive on the presentation of accounts by groups, referring to the Fourth Directive on disclosure and balance sheets).

In the directives on approximation of capital market law, the appeal to market integration is closer. These directives regularly contain an appeal to "the facilitation of further reaching mutual interpenetration of the national securities markets," and ultimately for "the creation of a European capital market" (e.g., the Stock Exchange Admission Directive of 5 March 1979 and the Stock Exchange Information Directive of 15 February 1982).

[117] See the enumeration in § IV.A.2, *infra* pp. 254-55. For a convenient collection of these texts in German, see M. LUTTER, *Europäisches Gesellschaftsrecht* (2d ed., Berlin 1984) (special vol. No. 1, *ZGR*); the earlier English *European Company Law Texts* (C. Schmitthoff ed., Brit. Inst. Studies in Int'l & Comp. L., No. 7, London/New York 1974) is now somewhat dated. Useful background information on the early harmonization process is still to be found in E. STEIN, *Harmonization of European Company Laws* (Indianapolis 1971).

[118] See § IV.A.2.c *infra* pp. 254-55.

The relation between the economic ends of the Treaty and the legal means chosen to reach them is perhaps most clearly expressed by the Commission recommendation of 25 July 1977 concerning a Community standard of conduct relating to transactions in transferable securities. This recommendation states:[119]

1. The objectives set out in Article 2 of the Treaty of Rome, particularly the harmonious development of economic activities in the Community, can only be achieved if sufficient capital is available, and the sources of capital are sufficiently diversified to enable investments in the common market to be financed as rationally as possible.

The role of the securities markets is to permit a very free interplay at all times between supply and demand for capital. Consequently, the proper working and the interpenetration of these markets must be regarded as an essential aspect of the establishment of a "common market" in capital.

2. Although the existing differences between the various financial markets in the nine Member States have not so far constituted an insuperable barrier to a number of international transactions, the lack of full information on the securities themselves and ignorance or misunderstanding of the rules governing the various markets have certainly helped to confine the investments of the great majority of savers to the markets of the countries in which they live or to a few well-known major international securities.

A reduction in these disparities would therefore tend to encourage the interpenetration of the member countries' markets, particularly if this is accompanied by improving the safeguards available to savers.

Thus, both the EEC Treaty and the organs of the European Community recognize that the approximation of national company and capital market laws either is already incorporated in the Common Market or is at least a basis of Community economic policy. This understanding of the goal of legal harmonization in the Community has an important practical consequence for the work of the Commission and the Council. If it is shown that a legal harmonization measure is essential for the Common Market, or that it directly affects the Market's functioning, it is not necessary to show that the measure promotes one or more of the higher objectives of the Treaty discussed above. Since legal harmonization promotes the objectives of Article 2, and Article 2 promotes the higher goals of the Treaty, no further argument is necessary. One can do no more than speculate which of these higher goals might be promoted; primarily, perhaps, the objective of development of economic activities throughout the Community.

3. A Critique

These ideas on the objectives and end-means relations of company and capital market harmonization are not universally accepted. One may take the position

[119] Commission Recommendation of 25 July 1977 concerning a European code of conduct relating to transactions in transferable securities, O.J. L 212/37 (20 Aug. 1977) (cited in the text is "Explanatory Memorandum," paras. 1-2); textual corrections in O.J. L 294/28 (18 Nov. 1977).

that legal harmonization is a political decision by the Member States which has become the object of binding Treaty provisions and that these legal provisions in turn have a potential in the political process of law-making at the European level: this is the concept of harmonization as an instrument of European legal and economic policy.[120] Such an orientation will dominate the following sections of this study, but before proceeding to that discussion, a critique of these aims is indispensable. While the analysis will necessarily be brief, the challenges to theoretical bases of the position of those who argue for European integration through company and capital market law harmonization must be recognized.[121]

a. The Problem of Specificity Versus Discretion

The five higher objectives named in Article 2 of the EEC Treaty are of the "highest indeterminacy." Nevertheless, these definitions are binding on Com-

120 *Cf.* TIMMERMANS, "Die europäische Rechtsangleichung im Gesellschaftsrecht," 48 *RabelsZ* 1, 12-15 (1984) (with English summary); T.E. ABELTSHAUSER & J. PIPKORN, "Zur Entwicklung des Europäischen Gesellschafts- und Unternehmensrechts," at Part II: "Das Unternehmensrecht im Spannungsfeld der Gemeinschaftspolitiken" (EUI Working Paper No. 85/167, Florence 1985).

121 Consensus on an appropriate integration theory does not yet exist. Not only do the various disciplines such as political science and economics provide different approaches, but even within each of these disciplines there exist different and in part directly contradictory concepts. These are kept in very general terms, and usually focus heavily on the integration of political institutions and decision-making. Integration by means of harmonization of corporate and capital market law is not generally treated. For a partial introduction to integration theory see, e.g., *Möglichkeiten und Grenzen einer Europäischen Union*, vol. 1: *Die Europäische Union als Prozeß* (H. von der Groeben & H. Möller eds., Baden-Baden 1980), esp. at 165 et seq. (H. Möller) and 401 et seq. (H. Schneider & R. Hrbek). See also *id.* at 404 n.285, for the following quotation from E. HÄCKEL: "There is at the moment no exit from the wilderness of integration theory." [Our translation.] See also *Verfassung oder Technokratie für Europa, Ziele und Methoden der europäischen Integration* (H. von der Groeben & E.-J. Mestmäcker eds., Frankfurt 1974); C. PENTLAND, *International Theory and European Integration* (London 1973); FABER & BREYER, "Eine ökonomische Analyse konstitutioneller Aspekte der europäischen Integration," 31 *Jahrbuch für Sozialwissenschaften* 213 (1980).

More generally, and without specific reference to the EC, see, e.g., the integration theories developed by KITCH (see Ch. 1, § II.A *supra* at pp. 8-10), SCITOVSKY (see Ch. 1, § II.B *supra* at pp. 10-11) and BERNHOLZ & FABER (Ch. 1, § II.C *supra* at pp. 12-14). See also B. BALASSA, *The Theory of Economic Integration* (London 1962); J. TINBERGEN, *International Economic Integration* (Amsterdam 1965); H.J. KRAMER, *Formen und Methoden der international wirtschaftlichen Integration – Versuch einer Systematik* (Tübingen 1969). For a good recent survey of integration research in political science, economics and law, see BEHRENS, "Integrationstheorie, Internationale wirtschaftliche Integration als Gegenstand politologischer, ökonomischer und juristischer Forschung," 45 *RabelsZ* 8-50 (1981).

munity organs and constitute current law.[122] But it is also clear that the competent Community organs must have the greatest flexibility in implementing these objectives. In practice, these organs do have flexibility, not only because the objectives are abstract and complex, but also because the economic objectives of the Treaty cannot be achieved in the same manner by all the Member States. For example, the objective of Article 104 – to ensure high employment and stable prices, as well as an overall balance of payments and confidence in the currency – must be approached differently by various Member States. Moreover, the EEC Treaty is almost exclusively devoted to a discussion of economic goals, while today it is widely agreed that the Community does and should pursue some non-economic goals, such as environmental and consumer protection.[123] These can be achieved only through a more liberal interpretation of the Treaty objectives.

What is more questionable is the basic assumption underlying the EEC Treaty, that the methods it proposes will automatically achieve the goals of Article 2. Such a phase model of integration, which is based on liberal economic thinking, assumes that establishment of a common market and the gradual approximation of the Member States' economic policies will create a bigger market for business enterprises. This would create higher revenues, which would, in turn, allow enterprises to reach optimal size and become more competitive on the world market because of increased productivity. More efficient enterprises would be able to increase their output, and would be forced by increased competition to lower their prices, or at least raise them more slowly. This would mean more purchasing power for consumers. For workers, wage increases would be possible because of the enterprises' rising productivity. All this would raise the social product, leading to the ultimate goals of Article 2.

b. The Factual Assumptions and Their Legitimacy

Many conditions, embodied in the Treaty, would have to be met for this model to function properly. First, there would have to be true freedom of movement for enterprises and individuals; that is, a realization of the various freedoms of the Treaty (free movement of goods, labor, and capital, freedom of establishment, freedom to provide services). There would also have to be no distortion of markets by Member States, especially by quantitative restrictions (Article 30 *et seq.*) or subsidies (Article 92 *et seq.*). Similarly, there would have to be no distortions by the enterprises themselves, for example through cartels, monopolies or the use of trade protection rights (Article 85 *et seq.*). In addition, the

[122] For the general opinion, see, e.g., H.P. IPSEN, *Europäisches Gemeinschaftsrecht* 558 (Tübingen 1972); *The Law of the European Community – A Commentary on the EEC Treaty*, vol. 1, at 2.05 (H. Smit & P. Herzog eds., New York, looseleaf, 1976 –) [hereinafter cited as SMIT & HERZOG].

[123] A. BLECKMANN, *Europarecht* 15-16 (4th ed., Cologne 1985); ZULEEG, in VON DER GROEBEN, VON BOECKH, THIESING & EHLERMANN, *supra* note 115, at Art. 2 ann. 4-9.

Treaty's requirement concerning the approximation of laws would have to be met, to reduce national legal or administrative provisions directly affecting the Common Market or competition therein (Articles 100 and 101) and those concerning the internal market (Article 100A since 1987). Finally, the Treaty's requirement for the gradual approximation of national economic policies and social policies would have to be obeyed (Article 103 *et seq.*, 117 *et seq.*).

The unjustified optimism of this model is evidenced by the more than 10 million unemployed workers in the European Community, and the discrepancies in regional development shown by the extremes of Hamburg and Sicily. At a time when national economic and social policies face fundamental difficulties that seem almost insoluble, the exaggerated economic expectation of European integration must be brought back to a more realistic perspective. This is true despite the fact that under such economic circumstances the political possibilities of realizing European integration dwindle in the face of national fear and self-interest.

There are similar contradictions about the intermediate goals of the Common Market. There is already a lack of agreement as to what is to be understood as a common market.[124] The direction is clear: National markets should be opened up to neighboring markets and ultimately a larger European market created. And it is possible to establish some preconditions for the Common Market, e.g., the above-mentioned Treaty freedoms, the call for undistorted competition, and the ban on discrimination. But it remains to be clarified what constitutes a common market as a whole, where the economic policies of the Member States that must be approximated under the Treaty begin and end, and how far approximation must go.

c. The Critique Applied: Company Law and Capital Market Law

These uncertainties extend to the concrete level of company and capital market law harmonization. Statements by Community organs that legal harmonization promotes the transnational activity of companies and offers national shareholders[125] and creditors equal protection, and that this ultimately benefits the Common Market, provide too general a theory to be used as a working hypothesis. Instead, it must be more specifically determined what interests this approximation promotes, and how these interests advance, European integration. In making this determination, a distinction must be drawn between individual protection of shareholders and creditors, functional protection of the economy and the market, and other interests, such as those of workers or the interest of society in checking economic power.

[124] BLECKMANN, *supra* note 123, at 14-15; SMIT & HERZOG, *supra* note 122, vol. 1 at 2.04 & vol. 3, "Preliminary Observations on Articles 100-102," at 5. As to concept of internal market (Art. 84(2)), see EHLERMANN, *supra* note 116, at 364-71; STEINDORFF, *supra* note 116; PESCATORE, *supra* note 116.

[125] The term used is not to be restricted to stock corporations, but includes partners in all kinds of companies, commercial partnerships and other legal forms.

i. Protection of Shareholder/Creditor Interests

Much of European company and capital market law harmonization does in fact serve to standardize the protection of shareholders and creditors who operate under a variety of legal systems. The protection of individuals in this area is founded directly on the EEC Treaty (e.g., Article 54(3)(g) or Article 7). The harder question is what effect this protection has on European integration, beyond establishing uniform minimum protection of national market participants. One hypothesis is that shareholders and creditors are more willing to provide capital and credit when they are protected by harmonized laws, and that this willingness eases a business enterprise's investment requirements and encourages economic development. This argument is familiar from the history of US securities regulation (e.g., the 1933 and 1934 as well as later Acts). While this hypothesis is plausible, it is not verifiable in detail. Certainly, severe abuses will discourage the individual capital investor, but individual legal improvements will not induce him to invest, because he will either not know about these improvements or, as a layman, not understand them.

The effect of disclosure provisions is rather different. Here, it may be assumed that given the same information on various companies, the equity and credit markets will prefer those that make the best offer.[126] Theoretically, therefore, information requirements encourage competition among various national companies. A weakness of this hypothesis is that information is only one of the many factors that can induce a capital investor to commit to a foreign firm. Other factors, such as difficulties in securing the rights given through legal harmonization, may deter the investor no matter how much information is available. Still, disclosure law harmonization tends to promote market integration.

ii. Protection of the Economy or Market

Similar problems of evaluation arise if the question is asked whether legal harmonization promotes the functional protection of the economy and the market. Again the answer cannot be a simple yes or no, but depends on different hypotheses.

One hypothesis would argue that harmonization of laws makes it easier for business enterprises to penetrate foreign markets by subjecting them to standards similar to those of their home country. As a general rule, this will not result from the lowering of most national standards through harmonization, because harmonization will actually tend to raise national laws to the standard of the "best" national legal system or at least to raise the more backward national law to a better common minimum standard. Thus, the only real facilitation that may be brought about by harmonization is that enterprises wishing to expand abroad will find that foreign law is more familiar. However, this has limited significance for most of them. In the past, enterprises have not been

[126] See in more detail § II.C.2.b, *infra* at pp. 219-20.

deterred from foreign expansion by the different legal systems of the various Member States. It should be expected that they will still have to use experts who know the foreign law in order to continue such expansion.

The same is true of more concrete hypotheses; for example, that facilitation of mergers across frontiers, or creation of a European corporation (*Societas Europaea*), will expand the transnational activity of business enterprises. In actual fact, enterprises do not delay such economic decisions until the European legislature creates new structures. They have already developed other legal methods to reach the same end. It is therefore not only highly improbable that transnational enterprises will change their own legal form, but it also remains doubtful that they would choose the form of the *Societas Europaea* for new corporations, even for new incorporations of affiliates. The enthusiasm of German industrial corporations (such as Agfa-Gevaert, Hoesch-Hoogovens, and Fokker VFW) for multinational company structures in the early 1970's, and for a *Societas Europaea* today, has cooled substantially.[127] Many of these mergers have broken up, or at least are now problem marriages, so that there is little desire today for developing a new method for facilitating multinational structures.

On the other hand, it is safe to say that the legal harmonization measures that open up national capital markets or pave the way to a European capital market make a much clearer contribution to European integration. In particular, actions such as the removal of restrictions on the admission of foreign enterprises to national stock exchanges, and the removal of other obstacles to participation on the various national capital markets, contribute greatly to European integration. An all-European capital market (beyond the already existing Eurobond market and including an integrated market for enterprises[128]) would represent considerable progress in European market integration.

Yet the road to actual European market integration is a long one. Not only does it remain to be seen how far and how quickly the European Community will be successful in promoting fully free transnational capital transfers, but also even more difficulties lie in the fact that progress in one area of European integration may be impossible without simultaneously tackling other areas (for example setting-up an internationally attractive and competitive financial market system).[129] Furthermore, recent discussions have shown that the development of a European capital market cannot be considered without provi-

[127] BAYER, "Horizontal Groups and Joint Ventures in Europe: Concepts and Reality," in 2 HOPT, *supra* note 88, at 3.

[128] *I.e.* not only for shares, but for buying, selling and taking over the enterprise as such.

[129] Such interdependence of objectives is more extensive in the political arena and characterizes the relationship between the goals of efficiency (through free market forces), protection (of investors, depositors, consumers), stability, and social and regional policies. *Cf.* also the PADOA-SCHIOPPA Report, *supra* note 116.

sion for venture capital.[130] It is hard to say how mere harmonization of capital market law can improve this situation, since the national experiences of, for example, France or Germany[131] show that it will take very purposeful European measures to improve the capital market itself to generate any improvement.

Despite these difficulties it seems fair to say that as a general rule harmonization measures in the capital market area tend to have a more immediate effect on European integration than company law harmonization (with the exception of disclosure). This may explain in part why the EC Commission has been very active in this field.[132]

iii. Protection of Other Interests

It is worth mentioning that European company and capital market law harmonization has to date focused little on interests other than those of shareholders and creditors and possibly of the enterprises themselves.[133] Labor interests are an exception. During the discussion of the draft Fifth Directive, the institutional incorporation of worker interests into company law, as with the German parity codetermination laws, became an object of great controversy at the European level. However, it is interesting to note that both opponents and proponents of worker participation argue, *inter alia,* on the basis of the effects on European integration. The opponents fear disadvantages from participation for the efficiency of business enterprises in general, and especially that national worker representatives on the supervisory board or board of directors would block closure of factories in the country concerned and the transfer of production to other Member States. Supporters, on the other hand, expect worker participation to produce a less tense social climate, fewer strikes and, ultimately, better productivity. The latest draft has resigned to political reality and presents Member States with various models to choose from, so that national solutions can be retained.[134]

iv. Conclusion

In conclusion, it should be stressed that there has been no intention here to denigrate European harmonization in general and company and capital market

130 H. SCHMIDT, *Special Stock Market Segments for Small Company Shares: Capital Raising Mechanism and Exit Route for Investors in New Technology-Based Firms* (EC Commission, Doc. EUR 9235, Luxembourg 1984).

131 For France see REUL, "Erfahrungen mit gesellschafts- und kapitalmarktrechtlichen Maßnahmen zur Verbesserung der Eigenkapitalausstattung der Unternehmen in Frankreich," 15 *ZGR* 70-105 (1986). For Germany see *supra* note 19.

132 In this context the Commission's internal organization and repartition of tasks between two Directorates General would have to be given a closer look.

133 The validity of an own interest of the enterprise itself (*Unternehmensinteresse*) is doubtful, as the German enterprise law discussion has shown.

134 See in more detail § IV.B *infra* at pp. 259-62.

law harmonization in particular. Rather, the point of this discussion was to show the ambiguities and theoretical shortcomings of European integration, especially in its relationship with company and capital market law harmonization. If these shortcomings are overlooked, there is a danger of overestimating the consequences of this harmonization for European integration, and of neglecting the more difficult pursuit of the goal of direct integration. Legal harmonization 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 harmonization and if the dissent over the key issues is camouflaged by harmonization of details and technicalities.

B. Bases

We shall now deal with the bases of and competences for company and capital market law harmonization offered by the EEC Treaty. The point is not to go into the legal semantics of the various Articles, as to which there is an abundant literature, but instead to look at the room for maneuver that the Community institutions find for company and capital market law harmonization in the EEC Treaty.

1. Article 54(3)(g)

The first and most obvious basis for harmonization is found in Article 54(3)(g), which is mentioned in all of the directives on company law harmonization. The purpose and practicality of legal harmonization based on this provision has been the subject of exhaustive discussion in past years.[135] Two contradictory positions can be drawn from these discussions. One position reads Article 54(3)(g) narrowly, based on its placement in the chapter on the right of establishment, and restricts the Article's application to measures connected with the removal of restrictions on establishment. Another position points to the fact that in several important areas a connection between Article 54(3)(g) and the freedom of establishment is lacking. Subjects such as mutual recognition of companies, retention of their legal form when moving their headquarters, and merger of companies across Member State frontiers are all regulated by Article 220(3), not the chapter on freedom of establishment. The means of regulation provided in that Article is not the directive, but an agreement between States. The majority opinion reconciles both in a pragmatic way by treating Article 54(3)(g) as reaching beyond freedom of establishment even though having its roots therein.[136]

[135] J. BÄRMANN, *Europäische Integration im Gesellschaftsrecht* 37-46 (Cologne 1970); SCHMITTHOFF, "The Success of the Harmonization of European Company Law," 1 *Eur. L. Rev.* 100 (1976). For further references see TIMMERMANS, *supra* note 120, at 2.

[136] See TROBERG, in VON DER GROEBEN, VON BOECKH, THIESING & EHLERMANN, *supra* note 115, at Art. 54, comment 11-13; RANDELZHOFER, in *Kommentar zum EWG-Vertrag*, at Art. 54, comment 31-37 (E. Grabitz ed., Munich 1986).

The Commission, the European Parliament, and the Economic and Social Committee have gone further from the outset. In their view, Article 54(3)(g) is intended to allow the Community institutions to bring about legal harmonization which is oriented toward all the objectives of the EEC Treaty and may even go beyond the framework of traditional company law, for instance, by introducing worker participation in company organs by Community directive. The motives for this far-reaching position are of course plainly Europeanist. In strictly legal terms this is not easy to defend. The Commission seems to be aware of this and has undertaken to buttress its proposals for directives against the argument that the European Economic Community lacks competence for legal harmonization under Article 54(3)(g) by leaving the specific legal basis for its directives open. Usually it has simply stated in the preamble to the directive that: "having regard to the Treaty establishing the European Economic Community, in particular Article 54(3)(g) thereof [the following directive is promulgated]." This tactic has been called disingenuous, but is a commonly accepted one today. If one recognizes the dynamic aspects of company and capital market harmonization and treats Article 54(3)(g), as well as other Treaty provisions which will be dealt with below, as legitimate instruments of European legal and economic policy-making,[137] the practice of the Commission is well-founded in the Treaty.

2. Articles 100-102

The general provisions on the approximation of laws contained in Articles 100-102 of the EEC Treaty are also relevant for company and capital market law harmonization.[138] As seen before, the Commission and Council regularly

[137] See § II.A.3, *supra* at pp. 197-204.

[138] See generally, e.g., F. MARX, *Funktionen und Grenzen der Rechtsangleichung nach Art. 100 EWG-Vertrag* (Cologne 1976); W. SCHMEDER, *Die Rechtsangleichung als Integrationsmittel der Europäischen Gemeinschaft* (Cologne 1978); *Harmonization in the EEC* (C.C. Twitchett ed., London/Basingstoke 1981); H.C. TASCHNER, *Rechtsangleichung in der Bewährung? Kritische Überlegungen zur Tätigkeit der Europäischen Gemeinschaft auf diesem Gebiet unter besonderer Berücksichtigung des Richtlinienvorschlags "Produktenhaftung"* (Europa-Institut, Saarbrücken 1982); *Harmonization of Laws in the European Communities: Product Liability, Conflict of Laws and Corporation Law* (P.E. Herzog ed., Charlottesville, Va. 1983); C. EIDEN, *Die Rechtsangleichung gemäß Art. 100 des EWG-Vertrages* (Berlin 1984). For the latest developments since the EC Commission's White Paper (*supra* note 116) – "new strategy of harmonization," *i.e.* greater restraint and flexibility – see BRUHA, "Rechtsangleichung in der Europäischen Wirtschaftsgemeinschaft. Deregulierung durch 'Neue Strategie'?," 46 *ZaöRV* 1-33 (1986) (with English summary); SCHWARTZ, "30 Jahre EG-Rechtsangleichung," in *Festschrift für Hans von der Groeben* 337, 359-68 (E.J. Mestmäcker, H. Möller, H.-P. Schwarz, eds., Baden-Baden 1987). As to Art. 100A (since 1987) see EHLERMANN, *supra* note 116, at 381-99. The most recent survey (in view of the international market) is given by the Commission Report of 19 May 1987, *supra* note 116.

base their company law harmonization directives on Article 100 as well, either explicitly or by inference. It is not surprising that controversies similar to that surrounding Article 54(3)(g) can be found with respect to Article 100, even though the arguments here tend to be less legal than political due to the broad discretion opened up by Article 100. In order to understand national resistance it suffices to take a look at the mere quantity of Community legal harmonization measures that have been based on Article 100.[139]

Furthermore, when Community membership was expanded, the new members had to accept the legal harmonization measures enacted prior to the date of expansion *in toto,* even though their own national legal peculiarities have not been taken into account therein. This acceptance was never unquestioning, especially in the case of Great Britain with its specific parliamentary and legal tradition, the widely held strong political reservations vis-à-vis the European Community and the particular difficulties of harmonizing the European Common Law and Continental legal systems.

Among the most important national demands, as stated for example by the Select Committee on the European Communities (a committee of the House of Lords),[140] are: the limitation of legal harmonization to the necessary minimum; the greatest possible clarity on the extent of legal harmonization; the greatest possible respect for national legal structures; and a purely instrumental application of legal harmonization to attain purely economic goals.

a. The Necessary and Proper Clause

The first national demand is anticipated in Article 3(h) of the Treaty, which provides for harmonization only "to the extent required for the proper functioning of the common market." But, as pointed out above, there is little clarity about the definition of the Common Market in either the Treaty itself or in subsequent interpretations. The concept of a common market may be taken narrowly, as an instrument for realizing the basic freedoms of the Treaty. It can also be taken more broadly as a means to bring about equal competition, or indeed, as a basis for common policies among the Member States.

[139] "Community Measures on Legal Harmonization – 1958-69," *Bull. EC*, Supp. 6/1970 (later details may be found in the Annual General Reports of the EC Commission), as well as in SMIT & HERZOG, *supra* note 122, at the Appendix to Preliminary Observations on Arts. 100-102.

[140] H.L. SELECT COMMITTEE ON THE EUROPEAN COMMUNITIES, *Approximation of Laws Under Article 100 of the EEC Treaty* 131 (House of Lords, Session 1977/78, 22nd Report, 18 Apr. 1978) (London 1979). See also *Parliamentary Debates, House of Lords, Official Reports (Hansard),* Vol. 394, col. 848, 4 July 1978. *Cf.* "Editorial Comments," *C.M.L. Rev.* 4 (1978); SEIDEL, "Ziele und Ausmaß der Rechtsangleichung in der EWG – Zur britischen Auffassung," 14 *EuR* 171-85 (1979). As to the political effects on the Commission (Comblain-la-Tour, Sept. 1978) see SCHWARTZ, *supra* note 138, at 348 et seq.

Article 3(h) itself supplies no authority for action by the Community, but merely describes the Community's task "as provided [for] in this Treaty." Instead, Article 100 independently defines the preconditions for legal harmonization and provides for "the approximation of such provisions laid down by law, regulation or administrative action in Member States as directly affect the establishment or functioning of the common market." Unfortunately, the meaning of "directly affect" is not precisely defined in the Treaty, and is therefore controversial, quite apart from the fact that here again the meaning and scope of the term "common market" is also at issue.

The Community institutions and the pro-European factions in the various Member States take a broad position on the meaning of Article 100,[141] a view which is shared here even though on legal-political grounds more than on the basis of a strict economic cause-and-effect rationale.[142] It can be argued that the terms "necessity" and "directly affect" are not to be understood as meaning that only those measures absolutely necessary to defend the functioning of the Common Market are permissible. For the Community to be competent, it is sufficient that an approximation of laws be "useful and advantageous for the functioning of the Common Market."[143] This is not without limits, however, otherwise the whole of commercial law ought to be made uniform on the argument that this would be useful for the "further development" of the Community. It must therefore be recognized that unification of laws should not become an end in itself, but should be oriented toward the realization of the Treaty objectives. It follows that unification is permissible in any case having to do with uniformity of competition conditions, a primary goal of the Treaty.

This broad understanding of Article 100 implies that, since it would be extremely hard to show what effects a particular harmonization measure would have on European integration, the Community institutions may legitimately put the burden of proof on those who would defend diversity to show that a measure is not useful for European integration. Even though not impossible, this is not easy, particularly in view of the above-mentioned theoretical uncertainties. The Community institutions can therefore exercise considerable legal and political discretion in harmonizing company and capital market law.

b. The Demand for Clarity

The second national demand is for the greatest possible clarity on the extent of legal harmonization allowed under the Treaty. In its abstract form, this requirement can be readily accepted. In practice, however, there are difficulties.

[141] See, e.g., VON DER GROEBEN, "Die Politik der Europäischen Kommission auf dem Gebiet der Rechtsangleichung," 23 *NJW* 359 (1970). As to Art. 100A see EHLERMANN, *supra* note 116, at 385.

[142] See § II.A.3, *supra* at pp. 197-204.

[143] IPSEN, *supra* note 122, at 690; SMIT & HERZOG, *supra* note 122, vol. 3 at 100.07.

The Commission has never put forward a "general program on approximation of laws," despite an announcement to that effect in 1965. This is a wise decision. Politically the Commission cannot afford to tie itself to any particular norms that would create additional difficulties for the already hard, time-consuming work of legal harmonization.[144] Theoretically, the Commission's position is justified on the basis that such a programmatic fixation would be incompatible with the dynamic character of the Community. What is necessary or useful for the functioning of the Common Market must be determined by the facts of the specific situation, viewed in the context of the Community's state of development. For example, while in the early 1960's it would have been completely out of the question to contemplate achieving a uniform law on business combinations through a Community directive, today, following considerable progress in harmonizing company law, such a step can well be considered. This being the case, the Commission's policy of drafting interconnecting company and capital market approximation directives that reinforce existing directives no longer appears as pure "salami tactics," but rather corresponds to the conception of approximation as a dynamic process.

c. The Idea of Respect for National Law

The demand that the national legal systems be respected is basically sound. As seen above, unification of law cannot be a legitimate end in itself. Yet the gist of this demand, at least as presented by the Select Committee Report, is somewhat different. It aims at guaranteeing the continued existence of national legal peculiarities. This would be irreconcilable with harmonization as an instrument of European legal and economic policy. Legal harmonization can mean neither an arithmetic mean of the various national laws nor their reduction to the lowest common denominator. Instead, as in all law-making, so in legal harmonization, it is the "best" law which should be sought. Along the same lines, legal harmonization cannot be limited to simply adopting previously existing laws; it should if necessary be able to go a step further and develop legal solutions that are not yet law in any Member State.[145]

This position must not be misunderstood as freeing the European Commission and Council from all restrictions. On the contrary, by acknowledging that they are not bound in substance by existing national legal patterns the Community institutions are put in the difficult position of a modern legislator

[144] See TASCHNER, in VON DER GROEBEN, VON BOECKH, THIESING & EHLERMANN, *supra* note 115, Art. 100, comment I.2 (The Policy of Legal Harmonization).

[145] *Cf.* TIMMERMANS, *supra* note 120, at 6 et seq., and for Art. 100A, EHLERMANN, *supra* not 116, at 385. *Cf.* EEC Treaty Art. 100A (3) (as of 1987), where (on the wishes primarily of Germany and Denmark) it is expressly stated for certain areas of harmonization that a high level of protection must be taken as a base. Yet Art. 100A(4) spans a rather problematic escape route (under pressure from the United Kingdom and Ireland). But it is not available in a harmonization proceeding under Art. 100.

which is expected to discover needs, reconcile widely different interests and come up with the best solution possible. The theory and practice of legal harmonization, therefore, have recourse to the findings of the recent debate on evaluative legal harmonization.[146] Only by this process would European harmonization be in line with a modern functional concept of law in general and company and capital market law in particular.

Of course, the inherent conflict between the demand for reasonable respect for national legal systems and the process of legal harmonization remains. Yet it is somewhat mitigated by the Treaty itself. Because Article 100 calls for directives that do not themselves undertake harmonization, but are implemented by the Member States, these States are free to provide for their own method of implementation and to exploit different options through national legal provisions. Thus, they may determine, at least in part, the level of respect they feel should be accorded their own law, within the constraints of the Treaty.

d. The Pursuit of Other Than Economic Goals

Ultimately, restricting legal harmonization to an instrument for pursuing purely economic goals would be too narrow. Admittedly, the focus of legal harmonization in the European Economic Community is on the development of a system of undistorted competition (Article 3(f)). But the Founders of the Community also understood that legal harmonization together with the competition rules (Article 85 *et seq.*) would form the basis for the Community's primary policies (EEC Treaty, Part III). Moreover, it is precisely the closeness of legal harmonization to European competition law that shows that extra-economic goals are an essential implication of the harmonization policy. In modern competition theory, competition has both economic and social policy functions, such as promoting the freedom of the citizen in the market and checking economic power. It is therefore neither required nor the practice of the Community institutions to restrict legal harmonization to economic integration. This is expressly affirmed for certain goals by the Single European Act of 1986. It is important also for company and capital market law harmonization.

3. Article 220

Brief mention should be made of the fact that Article 220 also provides a basis for European integration, as it contains a special regulation for particular areas of company law. Article 220(3) concerns the mutual recognition of companies in the broadest sense, the retention of legal personality on transfer of headquarters from one country to another, and the possibility of transnational merger of companies. Unlike Article 100, however, Article 220 provides that the Member States should, when necessary, negotiate with each other to meet

[146] IPSEN, *supra* note 122, at 694 (with further references).

these requirements in favor of their nationals. These agreements, though concluded as treaties under international law, thus are true Community law agreements.

Article 220 is quite important, as was demonstrated by the 1968 Convention on Jurisdiction and Enforcement of Judgments in Civil and Commercial Matters. The importance of Article 220 in the specific area of company law is relatively slight, however, compared with other legal bases. For example, in 1968 the Member States signed an agreement on mutual recognition of companies and legal persons, but it has not entered into force because of lack of ratification by the Netherlands, and in any event would add little to the current practice.[147] Also, the 1972 draft agreement on transnational mergers[148] cannot be completed until an appropriate solution is found for the problem of worker participation rights.

The state-agreement format was probably chosen not because legal harmonization through directives would be inadequate in these areas, but because the Founding Fathers doubted whether the Treaty contained sufficient legal bases for dealing also with the areas mentioned in Article 220.[149] It follows that Article 220 does not exclude harmonization of the areas mentioned therein if such harmonization can be based, for example, on Articles 54(3)(g) or 100.[150] It can very well be argued that mutual recognition of companies, freedom to change the company seat across borders or transnational mergers can be harmonized on the basis of and under the procedure provided by Articles 54(3)(g) or 100.[151]

4. Article 235

The final basis for legal unification found in the EEC Treaty is in Article 235.[152] This Article specifies two preconditions for unification. First, action by the Community must be necessary to achieve one of the objectives of the

[147] *Bull. EC*, Supp. 2/1969, pp. 5-16; for more detail see *infra* § III.A.1, esp. note 211 and accompanying text.

[148] For a critical point of view see KOPPENSTEINER, "Grundlagenkritische Bemerkungen zum EWG-Entwurf eines Übereinkommens über die internationale Verschmelzung von Aktiengesellschaften," 39 *RabelsZ* 405 (1975).

[149] SCHWARTZ, in VON DER GROEBEN, VON BOECKH, THIESING & EHLERMANN, *supra* note 115, at Art. 220, comment 27.

[150] On the contrary, whether the existence of other legal bases excludes Article 220 is controversial. See *id.*, at Art. 220, comment 48-60.

[151] TIMMERMANS, *supra* note 120, at 37-42. See now the Draft Tenth Directive, *infra* note 317.

[152] See EVERLING (at 2-26), SCHWARTZ (at 27-44) and TOMUSCHAT (at 45-67), in "Die Rechtsetzungsbefugnisse der EWG in Generalermächtigungen, insbesondere in Art. 235 EWG-Vertrag," 11 *EuR*, Supp. 1976. See also the 1983 comments by SCHWARTZ, in VON DER GROEBEN, VON BOECKH, THEISING & EHLERMANN, *supra* note 115, at Art. 235.

Common Market. Second, the powers provided for this in the Treaty must be insufficient. The interpretation of this very broadly worded provision is in the area between legal and political definition. The provision has been called one of the most controversial of the EEC Treaty.[153] This is not surprising, because Article 235 specifically concerns the demarcation between the competences of the Community and those of the Member States, providing for a shift in favor of the Community under very ill-defined preconditions.

In the specific area of company and capital market law Article 235 has not been widely used. So far only two measures have been based on Article 235: the proposal for a *Societas Europaea*, put forward in 1970 and revised in 1975, and the regulation on the creation of a European cooperation association, the European Economic Interest Grouping, enacted in July 1985.[154] The Commission considered it necessary for the harmonious development of Community economic activities to offer an optional European companies act and an alternative European legal form for a cooperation association, but the powers provided in the Treaty seemed insufficient for such a far-reaching indigenous Community company law. Thus, it was logical to rest these statutory measures on Article 235. The question whether they are "necessary to attain . . . one of the objectives" of the Treaty, however, is just as problematic in this area as in the other cases discussed above. Similarly it is easier to argue for the cooperation association regulation which concerns facilitation of market cooperation through a newly offered legal form of company, than for the *Societas Europaea* which is pure company law.[155]

Nonetheless, it is widely recognized that broader discretion can be claimed under Article 235 for the enactment of Community harmonization measures, and reliance on the Article has become a political practice of the Community institutions, with around 30 cases each year since 1981.[156] It is true that theoretically it must be shown that such measures are in accord with the economic policy goals of the Community, and that there is no abuse of discretion by the enacting bodies.[157] But in the areas which are treated here the latter seems hardly conceivable since concepts of investor and creditor protection and of facilitating cross-border cooperation among companies are certainly not the hub of the Treaty.

153 BLECKMANN, *supra* note 123, at 160.

154 See § III.B.2, *infra* at p. 246.

155 See § II.A.3.c.ii, *supra* at p. 202, and specifically on the *Societas Europaea* see § III.B.2, *infra* at pp. 244-45.

156 For the exact numbers up to 1985 see GRABITZ, in *Kommentar zum EWG-Vertrag*, *supra* note 136, at Art. 235, comment 9.

157 As to the limits of this discussion see for the majority opinion SCHWARTZ, *supra* note 149, at Art. 235, comments 11 & 172; for a more restrictive view of Art. 235, see GRABITZ, in *Kommentar zum EWG-Vertrag*, *supra* note 136, at Art. 235, comment 2.

In sum, if not all measures of company and capital market law harmonization can be based on Article 235, at least most of them can and would be if the need should arise. Article 235 has therefore an important potential for company and capital market law harmonization. It supplements Article 54(3)(g) as a basis for integration, and enables integration to continue even where the Treaty basis itself has been largely exhausted.

C. Expectations in Community Law – Failure of National Laws

The discussion of the bases of and competence for European company and capital market law harmonization has shown that while the theoretical bases and economic correlations might present problems, the Treaty provisions give the Community institutions ample latitude for legal interpretation and broad room for political maneuver. It might seem appropriate to pass directly to a consideration of the methods and tools for legal harmonization, but this would show a rather naive optimism. As seen above, harmonization – if conceived broadly as an instrument of European legal and economic policy – gets its legitimation less from its results in integration than from the substantive content and effects of the Community law in which it results. The European Community law-makers face the same claims and expectations as their national counterparts. It may also be that the hopes placed in Community laws[158] are even higher precisely because the national law-makers either in some or all Member States have not been able to find convincing solutions for certain problems. If this is so, it is better that we first seek to lower the expectations that might be raised by Community law, for nothing is more counterproductive than exaggerated expectations.

This sobering effect can be achieved by referring to the examples of three fundamental problems with which the company and capital market laws of the Member States have only partially been able to cope. These problems challenge European legal harmonization to look for the "best law" even if such law does not yet exist in any of the individual Member States, but at the same time they present such serious legal, economic, and political difficulties that it remains doubtful whether European legal harmonization, if at all feasible, will have a chance to come up with better, let alone the best, law.

1. Implementation

The first problem involves the obvious but often forgotten fact that approximation of laws on the statute books is not enough. Such approximation may remain a mere formality, without bringing about genuine changes in structures and attitudes. If one of the central goals of company and capital market law harmonization is better and non-discriminatory protection of shareholders and

[158] The term will be used in a broad sense for genuine Community law set by Regulations or Treaties, but also for harmonized or approximated law which technically is then enacted as national law.

creditors, then implementation of that protection is essential. The key question thus becomes what subjective rights and entitlements of individual shareholders and creditors Community law should allow, and what Community law can do to reduce the procedural problems the individual will face in securing these rights. The issue of structural change by legal integration is therefore linked to the general problem of access to justice.[159]

a. Granting Subjective Legal Positions

The libertarian idea that freedom of contract is enough to guarantee observance of personal rights is correct in principle, but has many shortcomings in practice, particularly in areas in which legal relations occur on a mass basis and are often uniformly regulated. National company and capital market laws have responded to this by imposing limitations on the conduct of internal company organs and with stricter control of company activity through independent control organs, as well as through improvements in stock market disclosure and conduct requirements. Yet individual legal rights that are granted in both the individual's own interest, and that of his fellow shareholders or fellow creditors, are often lacking.

This is particularly true, for example, for German insider regulation. Despite all the progress made in other European states – Switzerland, for instance, is about to introduce a penal provision[160] – Germany has stuck to a self-regulation system of voluntary guidelines on insider trading, which do not have the character and validity of legal norms.[161] Instead these Insider Trading Guidelines are limited to contractual relations between the insiders, the corporations and the stock exchanges, without the involvement of capital investors. It has sometimes been suggested that investors should be entitled to compensation for damages through a third-party beneficiary doctrine, but both legal and practical obstacles prevent this. Nor can the investor derive any independent rights from other such legal provisions, which are read as serving general economic goals and only indirectly for the protection of specific groups such as shareholders or creditors. This will be discussed in greater detail in the context of implementing Community law by self-regulation.

The shortcomings of these traditional views have been recognized in recent times. Particularly in antitrust law, a viewpoint has emerged that no longer sees individual protection and the protection of institutions as mutually exclusive,

[159] *Access to Justice* (M. Cappelletti gen. ed., vols. 1-4, Alphen aan den Rijn/Milan 1978-79); *Access to Justice and the Welfare State* (M. Cappelletti ed., Alphen aan den Rijn 1981).

[160] 85.020, Botschaft über die Änderung des Schweizerischen Strafgesetzbuches (Insidergeschäfte), 1 May 1985, BBl. 1985 II 69.

[161] See *infra* notes 297 & 298.

[162] *Cf.* E.-J. MESTMÄCKER, *Der verwaltete Wettbewerb* 78-83 (Tübingen 1984); RAISER, "Rechtsschutz und Institutionenschutz im Privatrecht," in *Summum ius, summa iniuria* 245 (Tübingen 1963).

but combines these into a single standard.[162] This standard determines the appropriate legal position of individuals harmed by cartels and monopolies.[163] Admittedly, the question arises whether this means an undesirable overlap of administrative intervention and private action,[164] but this objection has been met by the argument that private action is a welcome instrument of institutional protection.[165] The protection of undistorted competition is thereby internalized as an individual cause of action. This strengthens the market's self-regulatory function and reduces the need for state intervention to protect competition, which is inherently dysfunctional.

Of course, these antitrust arguments cannot be directly transferred to other areas of the law, such as company and capital market law. But one must consider whether private suits should be more generally allowed as an additional instrument of control.[166] It would further the cause of European legal harmonization to expand the rights of individual capital investors and creditors by improving their subjective legal position under Community law. Community institutions would have a decisive advantage in this because they are not restricted by traditional and partially obsolete national legal structures. They can seek new paths in pursuit of the "best" law, while taking national reform debates into account.

Granting more substantive legal positions is of course no European panacea. One must admit that the use of private suits to implement public interests has its limits. The private capital investor cannot be compelled to take the public interest into account. His primary motivation is his own economic interest, which may encourage him to compromise in cases where a legal verdict in the general interest might be more desirable. Additionally, there is the danger that private actions may distort objective implementation of the law, either because

[163] L. LINDER, *Privatklage und Schadensersatz im Kartellrecht* 15 et seq. (Baden-Baden 1980) (with further references). For theoretical foundations of this concept see RAISER, *supra* note 162, at 157 et seq.; BIEDENKOPF, "Über das Verhältnis wirtschaftlicher Macht zum Privatrecht," in *Wirtschaftsordnung und Rechtsordnung, Festschrift für Franz Böhm* 113 (H. Coing, H. Kronstein & E.-J. Mestmäcker eds., Karlsruhe 1965).

[164] BENISCH, "Private Verfolgung von Wettbewerbsbeschränkungen und Allgemeininteresse," in *Wettbewerbsordnung im Spannungsfeld von Wirtschafts- und Rechtswissenschaft – Festschrift für Gunther Hartmann* 37, 41 (Forschungsinstitut für Wirtschaftsverfassung und Wettbewerb E.V. eds., Cologne 1976).

[165] LINDER, *supra* note 163, at 1; W. OEHLER, *Privater Rechtsschutz gegen Wettbewerbsbeschränkungen* (Tübingen 1983).

[166] R. BUXBAUM, *Die private Klage als Mittel zur Durchsetzung wirtschaftspolitischer Rechtsnormen* (Karlsruhe 1972); W. WITTHUHN, *Die Ausgestaltung der privaten Klage im Wirtschaftsrecht* (Hamburg 1976); STEINDORFF, "Wirtschaftsordnung und -steuerung durch Privatrecht?," in *Funktionswandel der Privatrechtsinstitutionen, Festschrift für Ludwig Raiser* 621 (F. Baur, J. Esser, F. Kübler & E. Steindorff eds., Tübingen 1974).

economically powerful plaintiffs frighten off troublesome defendants, or because powerful defendants "buy off" plaintiffs.

b. Procedural Disincentives

Granting subjective legal positions and rights of action to individual capital investors and creditors does not end the functional problems of implementing harmonization. It is just as important to remove procedural impediments that might limit the assertion of individual rights. Only three of these need be mentioned here: the cost of bringing an action, procedural limitations, and assignment of the burden of proof. In many respects, European national and federal laws in these areas lack adequate legal machinery to facilitate damage actions, particularly in comparison with US law.[167]

Cost can be a decisive factor in any individual's decision whether to bring suit. The traditional rule on costs, which divides them according to the outcome of the trial, offers little incentive to the pursuit of one's rights. Costs today are higher and outcomes less sure than ever before. Therefore, if individual factions are to be encouraged, an endeavor must be made to either increase the attraction or reduce the risk. The former effort, that is to increase the attraction of bringing an action, has been attempted in US law (and also in part in European law) through the use of treble damages in antitrust suits.[168] In such cases US law departs from its traditional principle that opponents' legal costs are not repaid, and awards legal costs to the prevailing party. The latter effort, that is the reduction of the risk associated with bringing an action, has been attempted by German law, where the plaintiff can now achieve a reduction of the sum in dispute.[169]

A procedural impediment, especially in the area of company law and securities trading, is that the individual's losses are often too small to make it economically practical to bring a damage suit individually. If private action is to be made a useful instrument of the public interest, the legal system must provide procedural facilities to compensate. Three possible cures for this problem have been considered, all based on models from US law. Among these cures, the derivative suit has received the widest attention in company and capital market law discussions, and has had various embodiments in statutory law. In a derivative suit, which is similar to the institution "*actio pro socio*" under partnership law, the individual shareholder or creditor may sue in his own name for rights that the corporation has not sought to enforce. The plaintiff bears

[167] See especially A. HOMBURGER & H. KÖTZ, *Klagen Privater im öffentlichen Interesse* (Frankfurt 1975); H. KOCH, *Prozeßführung im öffentlichen Interesse* (Frankfurt 1983).

[168] HOMBURGER & KÖTZ, *supra* note 167, at 74 et seq.; LINDER, *supra* note 163, at 67.

[169] *Cf.* AktG § 247 II (Stock Corporation Law); GebrMG § 26 (Utility Design Act); PatG § 144 (Patent Code); UWG § 23 (Law Against Unfair Competition); WZG § 31a (Trademark Act).

little risk because, as a rule, the company bears the costs of trial. If the plaintiff wins, the judgment is paid to the company alone, but this recovery indirectly benefits the plaintiff and all other members of the same group. The EC Commission has made use of this device in its draft Fifth Directive. According to the proposed Articles 16 and 17[170] a derivative suit by shareholders against board members must be embodied in the national laws. This applies also for suits against the company's auditors.[171] The 1983 revision of the draft has added a provision against strike suits. According to Article 16(2) the court can in such cases put the costs fully or in part on the plaintiff. Furthermore the new Article 17(2) leaves the national courts the option to examine the chances of success of the suit beforehand and to refuse to accept the suit if it seems obviously unfounded.

The second procedural method to reduce the obstacles to private actions is the class action, which has met with a less favorable response in the area of company and capital market law.[172] As usually structured, a class action enables an individual to bring suit to remedy the infringement of rights for all those harmed. The judgment is paid to the entire plaintiff class. The superiority of the class action, as compared to the association suit (*Verbandsklage*), lies in the fact that no organizational connection between the members of an association is required. However, for example in Germany, where the association suit has a long tradition, as does its abuses under the law of unfair competition,[173] there is little readiness to introduce the class action suit into the area of company law and securities trading. This unwillingness is only reinforced by the practical difficulties of the class action which are well known from US law. Furthermore, it must be recognized that the growth of the derivative suit and the class action in the United States have benefited greatly from the system of contingent fees. In the United States, the motive for many class actions is often less the interest of the plaintiff than that of his lawyer in the

[170] O.J. C 240/2 (9 Sept. 1983). Similarly Art. 21u for the unitary board system.

[171] See Art. 62 of the Draft. As to the liability of auditors see W.F. EBKE, *Wirtschaftsprüfung und Dritthaftung* (Bielefeld 1983); most recently HOPT, "Die Haftung des Wirtschaftsprüfers. Rechtsprobleme zu § 323 HGB (§ 168 AktG a.F.) und zur Prospekt- und Auskunftshaftung," in *Festschrift für Klemens Pleyer* 341-69 (P. Hofman, U. Meyer-Cording & H. Wiedemann eds., Cologne/Berlin/Bonn/Munich 1986).

[172] See BUXBAUM & SCHNEIDER, "Die Fortentwicklung der Aktionärsklage und der Konzernklage im amerikanischen Recht," 11 *ZGR* 199 (1982).

[173] *Cf.* BAUMBACH & HEFERMEHL, *Wettbewerbsrecht*, at comment to § 13 (14th ed., Munich 1983); PASTOR, "Die UWG-Reform und der Mißbrauch der Klagebefugnis am § 13 UWG," 24 *WRP* 245 (1978); SCHWANHÄUSER, "Bedarf der Mißbrauch der Klagebefugnis einer UWG-Novelle?," 84 *GRUR* 608 (1982).

[174] As to this danger see HOMBURGER & KÖTZ, *supra* note 167, at 87 and BUXBAUM, *supra* note 166, at 17; see also GROSSFELD, *supra* note 7, at 305 and WITTHUHN, *supra* note 166, at 145-47.

quorum litis. In most European countries, including Germany, such fees are regarded as impermissible because of the dangers of abusive suits and the corruption of the legal profession.[174] This view of contingent fees has influenced the evaluation of the class action itself.

The third procedural possibility, which lies in the area between public and private law, is for the Ministry of Justice of a state to act as representative of all those harmed, and to recover all damages caused by infringement of a particular law. In the United States this type of action currently is available, though within limits, under the *parens patriae* concept for violations of the Sherman Antitrust Act.[175] In national European systems, such experiments have not yet been undertaken.

Finally, the question of the burden of proof plays a decisive role in all forms of action. Parties in civil cases must prove their claims. It is up to them to present the necessary proof, and proof through investigative questioning of the defendant in court is not admissible. Similarly, the civil law court itself cannot order investigations.[176] Therefore, in order to encourage private actions the burden of proof on plaintiffs must be eased, perhaps by the use of prima facie evidence or even by shifting the burden of proof. Such steps have only limited possibilities, however, and even these steps are hardly capable of expanding the information-gathering machinery of civil procedure as a whole. The fundamental framework of the legal dispute is a given, because of its primary private benefit. It cannot be readily disregarded even for simultaneous assertion of public interests.

Even if a court should finally recognize a claim in a given matter, the often far more difficult problem of evaluating damages remains. Experience shows that plaintiffs and courts frequently face an almost insoluble task in assessing damages, especially in the area of business reorganization law, because of the complex economic relationships involved. This difficulty is one of the reasons why the present German law on groups of companies is commonly regarded as well-meant, but inefficient.[177] Accordingly, if the EC Commission does not take these difficulties into account in its harmonization efforts, but instead relies too much on patterns of national law (as seems the case with the planned

[175] GROSSMANN, "Die amerikanische 'Parens Patriae'-Klage: Ein Vorbild für bessere Durchsetzung des Kartellrechts in Deutschland?," 22 *AG* 177 (1977).

[176] R. STÜRNER, *Die Aufklärungspflicht der Parteien des Zivilprozesses* 12, 63 et seq., 106 et seq. (Tübingen 1976). As to "discovery" under US law see STÜRNER, "Die Gerichte und Behörden der U.S.A und die Beweisaufnahme in Deutschland," 1982 *ZVerglRW* 159 et seq., 166 et seq., 174 et seq.; A. JUNKER, *Discovery im deutsch-amerikanischen Rechtsverkehr* (Baden-Baden 1987).

[177] WIEDEMANN, *supra* note 92; V. EMMERICH & J. SONNENSCHEIN, *Konzernrecht*, at, e.g., 204 et seq., 217 et seq. and *passim* (2d ed., Munich 1977); R. TSCHANI, *Funktionswandel des Gesellschaftsrechts* 166 (Bern 1978).

harmonization of groups of companies law),[178] there is a great danger that it will not find the "best" law. In fact, it may not even find good law.

2. Problems of Economic Theory

Apart from the legal difficulties, the effort to harmonize European capital market law also involves problems of basic economic theory and practice. Each of the individual Member States has a capital market structure that is the result of long-standing national traditions.[179] The structures are extremely complex and different from each other. As a result, European legal harmonization must advance on two fronts. First, it must attempt to clarify the theoretical conditions necessary for an optimally structured capital market. Second, it must cautiously pursue the application of the laws derived from these theories to individual elements of legal harmonization. In sum, the effort should be to remove the barriers to efficient capital formation, and to reduce the problem of distorted financial intermediation.

a. Efficient Capital Markets

The theoretical economic conditions necessary for an optimally structured capital market can be described herein only through the crudest simplification. Even after the theoretical progress made in recent years, there are disputes on every detail in this area.[180] Generally, the primary function of a capital market is to transform the savings of private individuals into the investment capital required by business enterprises. This process requires mediation between the interests of the investor and those of the business enterprise seeking long term capital. There are three subfunctions that can be singled out as necessary to

[178] See § II.C.3.a, *infra* at pp. 222-24.

[179] EC COMMISSION, *Der Aufbau eines europäischen Kapitalmarktes* (*Segré Report*) (Brussels 1966); OECD, COMMITTEE FOR INVISIBLE TRANSACTIONS, *Capital Market Study* (5 vols., Paris 1967/68); VOLKSWIRTSCHAFTLICHE STUDIENGRUPPE DER AMSTERDAM-ROTTERDAM BANK N.V., DEUTSCHE BANK AG, MIDLAND BANK LTD., SOCIÉTÉ GÉNÉRALE DE BANQUE S.A., *Europäische Kapitalmärkte* (Frankfurt 1966); recently H. GIERSCH & H. SCHMIDT, *Offene Märkte für Beteiligungskapital: USA – Großbritannien – Bundesrepublik Deutschland* (Stuttgart 1986). On the importance of a unified (European) capital market for corporate expansion, see also (already) LELEUX, "Corporation Law in the United States and in the EEC: Some Comments on the Present Situation and Future Prospects," 4 *C.M.L. Rev.* 133, esp. at 169 et seq. (1967).

[180] *Cf.*, e.g., SCHMIDT, "Disclosure, Insider Information and Capital Market Functions," in HOPT & TEUBNER, *supra* note 68, at 338-51. See also H. REUTER, *Aktienmarkt und Aktieninformationsmarkt* (Göttingen 1980). A good survey of the different economic schools of thought on capital market efficiency (economics of uncertainty, economics of information, signalling theory and welfare economics) can be found in ASSMANN, *supra* note 105, at 276-88.

achieve this mediation, which may be described as the ideal preconditions for an efficient capital market (although there are different views on this point). These are institutional, operational, and allocational efficiency.[181]

Institutional efficiency of the capital market requires an effective market mechanism as a basic precondition. This mechanism must guarantee unhindered access to the market for capital providers and demanders, as well as flexibility in the various forms of capital investment. Other criteria for institutional efficiency include the ability to absorb different investments and participants (market width), flexibility of supply and demand (market depth), and market stability. Institutional efficiency is to a large extent based on market transparency. This means that disclosure, by which the various capital investments can be compared, takes on central importance.

The concept of operational efficiency primarily addresses the costs of investment mediation and capital acquisition. Based on the minimization of obstacles to transactions, this concept applies to the secondary (trading) markets for securities and other capital investments. For these, it is essential that turnover be rapid, cheap, free of fluctuations, and transparent. Removing obstacles to transactions in the trading market has repercussions on the primary market. Because capital investors prefer high liquidity, it is important for their investment decisions, and thus for the sale of new issues, that they be able to dispose of their investment readily.

The final important economic factor is allocational efficiency. This is based on the premise that scarce savings should flow to places where capital investment is attractive on a national market scale, that is, to where it is most useful and therefore (taking into account security and liquidity) gives the best yield. Again, this efficiency presupposes that the market participants are well-informed of market conditions, and thus relies on the market transparency promoted by disclosure requirements.

b. Disclosure

Once one develops this framework for the evaluation of legal policy measures, one may then ask more specific questions about possible measures for legal harmonization. The pivotal importance of disclosure is already clear. The more specific question of how far disclosure should go presents greater difficulties. Although empirical studies in the United States have not produced unam-

[181] KOHL, KÜBLER, WALZ & WÜSTRICH, "Abschreibungsgesellschaften, Kapitalmarkt und Publizitätszwang – Plädoyer für ein Vermögensanlagegesetz," 138 *ZHR* 1, 16 et seq. (1974); HOPT, "Inwieweit empfiehlt sich eine allgemeine gesetzliche Regelung des Anlegerschutzes?," vol. 1, Gutachten G, *Verhandlungen des 51. Deutschen Juristentages (Stuttgart 1976)*, at 47 et seq. (Ständige Deputation des Deutschen Juristentages ed., Munich 1967). See also GILSON & KRAAKMAN, "The Mechanisms of Market Efficiency," 70 *Va. L. Rev.* 549 (1984); ASSMANN, *supra* note 105, at 288-92.

biguous findings on the benefit of disclosure to the economy as a whole,[182] the thesis that increased disclosure tends to promote the functional efficiency of capital markets may at least rest on practical experience.[183]

The problems of disclosure are too complex to be analyzed in terms of such broad generalizations.[184] The amount of information and the range of addressees presented by any disclosure standard demonstrates this complexity. The capacity of the public investor to absorb information differs greatly according to his class and previous knowledge, constituting a decisive limit on disclosure's effectiveness. Quite simply, if an investor's capacity to absorb information is exceeded, more information does not promote clarity, but only conceals the facts.

The question of penalties for incomplete or incorrect disclosure also demonstrates the limitations of disclosure requirements.[185] An issuer's fear of possible sanctions can easily distort its understanding of the information needs of the average investor, and lead to the drafting of disclosure documents in the form of legally impeccable "insurance policies" that are comprehensible only to experts. Even the broader question of the ability of periodic reporting and of ad hoc disclosure to influence the allocative behavior of the capital market cannot be answered uniformly. This type of disclosure affects the secondary market, and, indirectly, the primary market. Yet in the "gray capital market," which is of great importance, for example, in Germany, this theory falls short from the outset, because there is no secondary market for tax-structured property-holding companies and closed-end property funds.

c. *Other Framework Conditions*

Inadequate disclosure is clearly a critical factor limiting the efficiency of the capital market. There are other important limits on the efficiency of the capital

[182] MENDELSON, "Economics and the Assessment of Disclosure Requirements," 1 *J. Comp. Corp. L. & Sec. Reg.* 49 (1978); FRIEND, "Economic and Equity Aspects of Securities Regulation," in *Management under Government Intervention: A View from Mount Scopus* 31-58 (R.F. Lanzillotti & Y.C. Peles eds., Greenwich/London 1984).

[183] KÜBLER, "Transparenz am Kapitalmarkt," 22 *AG* 85, 89 et seq. (1977) (with further references). See also ZECHER, "An Economic Perspective of SEC Corporate Disclosure," 7 *J. Comp. Bus. & Capital Market L.* 307-15 (1985).

[184] HOPT, "Die Publizität von Kapitalgesellschaften – Grundsätzliche Überlegungen zum Stand nach der 4. EG-Richtlinie und zur Reformdiskussion in den USA," 9 *ZGR* 225 (1980) (with detailed references). See generally *Transparenzprobleme des Kapitalmarktes* (G. Bruns & K. Häuser eds., Frankfurt 1977); MEIER-SCHATZ, "Objectives of Financial Disclosure Regulation," 8 *J. Comp. Bus. & Cap. Mkt. L.* 219 (1986).

[185] R. MUNDHEIM, *Selected Trends in Disclosure Requirements for Public Corporations* 9 et seq. (Center for Study of Financial Institutions, Univ. of Pennsylvania, Philadelphia 1975). See also the more fundamental critique by H. KRIPKE, *The SEC and Corporate Disclosure: Regulation in Search of a Purpose* (New York 1979).

market, although their specific effects are uncertain.[186] In particular tax factors such as double taxation of investments in shares, taxation of speculation profits on securities and taxation of stock exchange turnover are all limitations on capital market efficiency.[187]

German business and financial interests point to excessive worker participation and the Federal Cartel Office policy toward merger control as factors limiting market efficiency. It is hardly surprising that there is hefty opposition to the former claim among the proponents of worker participation, and to the latter among the partisans of antitrust law. On the other hand, it is fairly undisputed that the greater legal burden of the corporation, compared with other companies and investments, particularly in the areas of disclosure, taxes, and worker participation, has a negative effect on the stock market and is at least partially responsible for the decline in the percentage of corporations in the German economy.

Traditional habits of behavior of business enterprises and capital investors also play a part in limiting capital market efficiency. Many German entrepreneurs avoid transforming their firms into corporations or listing stock on the exchange, because they want to retain control. If that is not possible, they prefer a lucrative sale over "going public." Private investors, on the other hand, frequently distrust the structure of securities trading. This inhibition stems at least in part from the inadequate legal protection available to the capital investor, as discussed previously.

3. Economic Concentration

The historical importance of company and capital market law for economic concentration is undisputed. In the United States, company law and antitrust law have a common root in the early attempts at "trust busting." When state company laws proved ineffective, the federal legislature entered to prevent excessive concentration. In many European countries, by contrast, economic concentration was or is still generally regarded as a desirable sign of national strength. Even in Germany, with its strict post-War antitrust law, the use of company law instruments to promote concentration was accepted by both the legislature and the higher courts and merger control was not introduced until 1973. Today, however, the close factual connection between the law of groups of companies and antitrust law is widely accepted in Germany. Most other European countries have neither a statutory law on groups of companies nor

[186] KÜBLER, *supra* note 78, at 8-10; WALZ, "Empfiehlt sich eine rechtsformunabhängige Besteuerung der Unternehmen?," in Gutachten F, *Verhandlungen des 53. Deutschen Juristentages* (Ständige Deputation des Deutschen Juristentages ed., Munich 1980); IMMENGA, "Kapitalmarkt als Unternehmensmarkt," in *Die Börse und ihr Umfeld* 19, 22-28 (Niedersächsische Börse zu Hannover ed., Frankfurt 1981).

[187] See the Swiss study by VÖGELI, "Steuerliche Aspekte des Kapitalmarktes," 38 *Wirtschaft und Recht* 130-44 (1986).

any form of merger control, and the relationship between these fields has not yet been addressed.

A progressive European legal harmonization cannot ignore the connections between company and antitrust law. Instead, it should approach such a key problem as European concentration along two avenues: through the harmonization of national laws on groups of companies, and approximation of national merger control law or even creation of a European merger control authority.

a. Company Law, Particularly on Groups of Companies

(1) An examination of national company laws on groups of companies and concentration[188] shows that, in several European states, public takeover bids are regulated early in the formation of a group of companies.[189] The regulations do not have the immediate purpose of blocking concentration, but provide a standard of fair conduct that prevents distortion of competition in the market for the control of firms.[190]

On the contrary, German law, even though it provides the first comprehensive codification of the law on groups of companies,[191] scarcely considers this primary stage of the merger process. Takeover bids are not legally regulated at all, perhaps because they are relatively unimportant in actual practice. Company law merely prescribes notification when a participation limit of 25% (or 50% as the case may be) is exceeded. In comparison, at the second stage of mergers – that of the exercise of majority rule in actual de facto combinations – German corporation law does provide for detailed measures to protect minority shareholders and creditors. The main focus of German regulation, however, is on the third phase of the merger process, the exercise of management power through a company affiliation contract. It is only in this last stage that the law passes from the image of the independent firm following only its own interests to that of the group with its own articles of association. Even at this stage, associations formed by limited-liability companies and partnerships are not regulated.

188 See *supra* notes 88-95.

189 Especially in France, Great Britain, Italy and the Netherlands. In Belgium and Luxembourg they are under the supervision of the Banking Commission. See the comparative law study by IMMENGA, "Öffentliche Übernahmeangebote/Takeover Bids," 47 *Schweizerische AG* 89 (1975); IMMENGA, "Takeover Bids in Belgium," 5 *J. Comp. Bus. & Cap. Mkt. L.* 41 (1983); MEIER-SCHATZ, "Managermacht und Marktkontrolle," 149 *ZHR* 76 (1985). As to a future European directive, see BEHRENS, "Rechtspolitische Grundsatzfragen einer europäischen Regelung für Übernahmeangebote," 4 *ZGR* 433 (1975).

190 *Cf.* especially BEHRENS, *supra* note 189, at 440 et seq.

191 For an English translation of the German provisions on affiliated enterprises, see 2 HOPT, *supra* note 88, Annex II at 265 et seq.

(2) European company law harmonization efforts are paying increasing attention to the problem of corporate groups, but so far no binding regulation has been developed. An example is the draft regulation on the statute for the *Societas Europaea,* which contains many provisions governing such groups.[192] For reasons to be set out in more detail below,[193] however, no progress on this statute is to be expected in the immediate future. In any event, the proposed provisions would affect only the few European corporations formed on the basis of the statute.

Meanwhile, the Seventh Directive on groups of companies' accounts has been enacted by the Council, after twelve years of consideration. Its similarity to the Fourth Directive on corporate accounts in force since 1978 no doubt aided its passage.[194] The impact of this harmonization measure has been somewhat watered down by the many options left to the Member States and by very long transformation periods which go into the 1990's. Despite this, several Member States have taken a very long time indeed to meet their transformation duty or even have not yet transformed at all.[195] In Germany, the "Balance Sheets Directive" Act came into force only as of 1 January 1986.[196] Nevertheless the unification of accounting standards is an essential step toward a more comprehensive harmonization of the law of groups of companies.

The harmonization of the substantive law of groups of companies, however, is quite another, much more controversial, task. The EC Commission has presented several internal versions of harmonization measures which have met with extensive comment in the Member States both from practitioners and academics.[197] The latest version, which is not yet an official draft directive ap-

[192] Arts. 130-136, 191(5) & (6), 196-202, 223-240(d) (*infra* notes 328 & 329 and accompanying text). See GESSLER, "Das Konzernrecht der S.E.," in *Die Europäische Aktiengesellschaft* 275-311 (M. Lutter ed., Cologne 1976).

[193] See § III.B.2, *infra* at pp. 243-45.

[194] *Cf.* NIESSEN, "Zur Angleichung des Bilanzrechts in der Europäischen Gemeinschaft," 48 *RabelsZ* 81 (1984) (with English summary); for an extensive survey on the Seventh Directive, see BIENER, "Die Konzernrechnungslegung nach der Siebenten Richtlinie des Rates der Europäischen Gemeinschaften über den Konzernabschluß," *Der Betrieb,* Supp. 19/1983.

[195] As to the Fourth Directive see NIEHUS, "Zur Transformation der 4. EG-(Bilanz-)Richtlinie in den Mitgliedstaaten der Europäischen Gemeinschaft," 14 *ZGR* 536, 538 (1985); EC COMMISSION, *The Fourth Company Accounts Directive of 1978 and the Accounting Systems of the Federal Republic of Germany, France, Italy, the United Kingdom, the United States and Japan* (Doc., Luxembourg 1986). EG COMMISSION, *The Fourth Company Law Directive, Implementation by Member States* (Doc., Luxembourg 1987).

[196] See HGB [Commercial Code] §§ 238-339 (as of 1986). As to France, see A. VIANDIER, *Droit comptable* (Paris 1984).

[197] As to the pre-draft of 1974/75 and for further discussion see IMMENGA, "Abhängige Unternehmen und Konzerne im europäischen Gemeinschaftsrecht," 48 *RabelsZ* 48-80 (1984) (with English summary); LUTTER, *supra* note 88, with further

proved by the EC Commission, is of 1984.[198] It is rather close to German law and, therefore, suffers from similar shortcomings.[199] No authoritative draft agreed upon by the Commission, let alone a Council Directive approved by the Member State Governments, is yet in sight.

b. Antitrust Law

(1) The point of antitrust law is to guide the concentration process in agreement with the needs of effective competition. German law, for instance, provides for obligatory notification when a company exceeds a particular size. Merger control proper applies only after the integration has taken place. Preventative action is taken only in a few exceptional cases. By comparison, British merger control law has more of an economic policy nature and is less legally constricting than the German model. France is the only other Member State with merger control, although it has not been very effective.[200]

(2) The Community law in force today provides little preventive merger control and few obligations for prior notice of mergers. The Commission does attempt to guide mergers, using Articles 85 and 86 of the EEC Treaty. Since the complicated details of this policy are part of general Community antitrust law, they need not be set out here. For purposes of this discussion, we need only mention the following. Rudimentary merger control pursuant to Article 85 applies specifically to long-term exclusive purchase and requirement contracts, and to the establishment of joint ventures. Article 86 applies, on the *Continental Can* doctrine, when a merger constitutes an abusive change in the competitive structure that would restrict trade among the Member States.

This is the sum total of the Community's merger control. Although the Commission has been able to hinder some major mergers, e.g., the Saint Gobain/BSN merger, this *ex post facto* control is generally considered inadequate. Yet despite all political and theoretical endeavors, such as the German Monopoly Commission report of 1978-79,[201] no Community-wide merger control standard has been accepted. The proposal for a Community merger

references; BÖHLHOFF & BUDDE, "Company Groups – The EEC Proposal for a Ninth Directive in the Light of the Legal Situation in the Federal Republic of Germany," 6 *J. Comp. Bus. & Cap. Mkt. L.* 163-97 (1984).

198 Doc. III/1639/84, *reprinted* (without the motives) in 14 *ZGR* 446-65 (1985); IMMENGA, "L'harmonisation du droit des groupes de sociétés. La proposition d'une Directive de la Commission de la C.E.E.," 13 *Giur. Comm.* 846 (1986).

199 See *supra* § II.C.1.b, esp. text accompanying note 177. See also IMMENGA, *supra* note 197.

200 As to the situation in various European states (France, Germany, Great Britain and Switzerland) and in the EC, see the reports in *Legal and Economic Analyses on Multinational Enterprises*, vol. 1, *European Merger Control* (K.J. Hopt ed., Berlin/New York 1982) [hereinafter cited as 1 HOPT].

201 MONOPOLKOMMISSION, "Fusionskontrolle bleibt vorrangig," in *Hauptgutachten 1978/79*, at 172-177, Nos. 632-61 (Baden-Baden 1980).

regulation[202] based on the German merger control law of 1973 (and introduced in the same year) has not been adopted and despite the pressure of Commissioner Sutherland the chances that it will be are not good due to stiff resistance within the Member States.[203]

One of the main opponents aside from France seems to be Italy. Italy and other European countries as well have adopted the same merger philosophy as prevailed in Germany until the mid-1960's. While in Germany at that time economic concentration was permitted, in order to allow national firms to shorten the American multinational enterprises' lead in the world market, this seems to be the case today in some other European countries. Allowing and even promoting such concentration, it is felt, would help their industry to compete with modern German and other transnational enterprises from abroad. Other Member States, such as Germany, seem to favor the introduction of Community merger control, but are afraid that a too liberal Community merger control regulation may infringe on the restrictions of stricter national merger policies. Critics also argue that the Community proposal lacks a concept of the primary aims of its competition policy, and that it does not present a clear solution to any conflicts that may arise as a result of conflicting judgments at the Community and Member State levels.[204]

The conclusion of this part need not necessarily be pessimistic, but certainly sobered down: One of the key problems of the modern business enterprise and the transnational corporation – the problem of groups and economic concentration which according to many is *the* modern credibility problem of business enterprise law – has been spared by Community law. As to capital market law harmonization, in this field there have been some practical steps forward, but the theoretical concepts of capital market efficiency and integration are still very tentative. Even in the fields where there are quite a number of in part far-reaching directives already in force, such as in company law harmonization, there is the danger of being content with harmonization of the "law in the books" and of neglecting the question of implementation and of the "law in action." This is not to say that European harmonization must inevitably fail, but rather would suggest that it is much more difficult – and not just political-

[202] O.J. C 92/1-7 (31 Oct. 1973) (with later modifications: see O.J. C 36/3-8 (12 Feb. 1982) and O.J. C 51/8-9 (23 Feb. 1984)). The text can also be found in 1 HOPT, *supra* note 200, at Annex 4.c, pp. 253-62. For a survey of this draft regulation see "Comment," 19 *Villanova L. Rev.* 420, 456 et seq. (1974). See also D. KUTSUKIS, *Der Verordnungsvorschlag für eine europäische Fusionskontrolle im Lichte der Erfahrungen des deutschen Rechts* (Berne 1983).

[203] FAZ No. 279, 2 Dec. 1987, p. 14. *Cf.* DERINGER, "Auf dem Weg zu einer europäischen Fusionskontrolle," 9 *EuR* 99 (1974); LYON-CAEN, "Le contrôle des concentrations: étude de la loi française et de la proposition européenne," 15 *R.T.D.E.* 1 (Part I), 440 (Part II) (1979); VAN KRAAY, "Towards a Regulation on the Control of Mergers," 2 *Eur. L. Rev.* 54 (1977).

[204] For proposals hereto *cf.* MONOPOLKOMMISSION, *supra* note 201, at Nos. 659-61.

ly – than is commonly thought, so that the challenge of coming up with better Community law is greater than is generally realized.

III. Methods and Tools for Integration of Company and Capital Market Law

Integration of European company and capital market law can be advanced using a variety of methods and tools.[205] Community directives clearly play the central role, but the EC Commission also occasionally experiments with regulations and non-binding recommendations. Because the Commission is, as a rule, committed to the use of directives as the basic tool of harmonization, the pros and cons of the various methods available for integration have seldom been discussed in connection with the harmonization of company and capital market law. Such a discussion will be attempted in the next section of this chapter, with particular regard to the legal areas of interest here. While it must be kept in mind that the methods and tools under consideration are actually quite different in practical importance, as well as nature and effect, for the purposes of this discussion they will be presented distinguishing between those methods and tools that act only indirectly, and those that are intended to directly cause integration. The indirect methods of integration include conflict of laws, model laws and restatements, and the international code efforts. The more direct methods include Community directives, substantive Community law, and self-regulation in the shadow of Community law.

A. Indirect Methods and Tools

1. Conflict of Laws

The question of which law is applicable to a transnational business enterprise remains a key problem of international company law.[206] Special problems

[205] For a general survey see EASSON, "Approximation and Unification of Laws in the EEC," 2 *Revue d'intégration européenne* 375 (1978/79); GAJA, HAY & ROTUNDA, "Instruments for Legal Integration in the European Community – A Review," in I/2 *Integration Through Law* 113-60 (Berlin/New York 1986). See now, more generally GRAY, "E pluribus unum? A Bicentennial Report on Unification of Law in the United States," 50 *RabelsZ* 11-65 (1986), who enumerates as actors: (1) Commissioners on Uniform State Laws; (2) the American Law Institute; (3) the American Bar Association; (4) federal legislation; (5) state legislation; (6) state courts; (7) federal courts; (8) law schools; and (9) legal literature.

[206] B. GROSSFELD, "Internationales Gesellschaftsrecht," in *Staudinger BGB Kommentar EGBGB*, at comments 18-87 (12th ed. Berlin 1981). For the relationship between conflict of laws and substantive law rules see LOUSSOUARN, "Règles de conflit et règles matérielles dans le droit international des sociétés," in *Le Droit des relations économiques internationales – Etudes offertes à Berthold Goldman* 167 et seq. (Paris 1982).

arise when it is necessary to determine the law applicable to a company's internal relationships, rather than its relationship with creditors and other third parties. The old dispute between the headquarters theory (developed since the mid-nineteenth century in Belgium, France, and Germany), and the Anglo-American incorporation theory, has been repeatedly enlivened by various intermediate theories partially borrowed from US models.[207] In principle, the headquarters (*siège*) theory prevails in Europe, even if corrections of detail are fully accepted. This theory is generally argued to provide more effective control of internationally active companies, while the incorporation or establishment theory is widely accused of exporting the weakest law.[208] Though it would be clearly wrong to go so far as to see here a contradiction between the criteria of legal ethics and Manchester liberalism, the difference in fundamental conception is nevertheless undeniable.

Compared with the incorporation theory's unrestricted freedom of choice for the incorporators of the company, the headquarters theory seems better suited to establishing governmental control over companies for purposes of shareholder and creditor protection, and limitation of economic power. This is based on the assumption that the state in which the company has its actual headquarters (not merely where it is incorporated) is most directly affected by internal corporate activities, and therefore the body most likely to impose limitations. In protecting its own interests, this state also exercises a supervisory function that benefits other states. The headquarters theory therefore places the protection and control functions in the foreground. They would otherwise arise only at a much later stage of *ordre public*.

The prevalence of these protections under the headquarters theory commonly used throughout continental Europe is one of the major reasons why conflict of laws has contributed little to the harmonization of European company and capital market law. If protection and control functions are assigned principally to the country where corporate headquarters are located, and if this country regulates the corporation in a way acceptable to other host countries, then these other host countries will not much care that the laws used by the headquarters country differ from their own. Nor will they perceive any need to set up national protection and control laws of their own with respect to the foreign company. Considered in this light, the headquarters theory may be seen as the European predecessor of more recent attempts by American states to apply selected laws to companies which, while established in one state (such

[207] See, e.g., SANDROCK, "Die multinationalen Korporationen im Internationalen Privatrecht," in L. WILDHABER, B. GROSSFELD, O. SANDROCK & B. BIRK, *Internationalrechtliche Probleme Multinationaler Korporationen* 169, 191-204 (vol. 18 Berichte der Deutschen Gesellschaft für Völkerrecht, Heidelberg 1978); SANDROCK, "Die Konkretisierung der Überlagerungstheorie in einigen zentralen Einzelfragen," in *Festschrift für Günther Beitzke* 669 (O. Sandrock ed., Berlin 1979).

[208] A.F. CONARD, *Corporations in Perspective* 11-15 (Mineola 1976); C.-T. EBENROTH, *Konzernkollisionsrecht im Wandel aussenwirtschaftlicher Ziele* 39 (Constance 1978).

as Delaware), have their activities centered in another state (such as California).[209] The headquarters theory may also be seen, however, as creating barriers between national company law systems, precisely because the uniform statutes for a company are left up to a single legal system. Differentiations and overlaps, which play an important role in US law today, are thereby avoided; on the other hand, because of the bigger differences between European national company laws, such harmonization as may still be needed is much harder to achieve than between the generally homogeneous company laws of the American States.

The EEC Treaty might bring about some improvements in this area. It is possible, for example, that the freedom of establishment guaranteed by Article 52 (and possibly extended by Article 58 to companies and legal persons) bars application of the headquarters theory, because its legal consequence might be non-recognition of a company's legal capacity.[210] In this context, reference is made to Articles 1 and 2 of the Convention on the Mutual Recognition of Companies and Legal Persons of 29 February 1968,[211] concluded pursuant to Article 220 of the EEC Treaty. While this Convention is purportedly based on the incorporation theory, the Convention actually derogates from the theory in three ways.[212]

First, there is a controversy as to whether the law of establishment is applicable only to the legal and contractual capacity as well as to the capacity to act (Articles 6 and 7), or whether it applies generally. Besides, Article 1 makes recognition of a company established according to the law of a Member or Treaty State conditional on the company having its statutory headquarters within EEC territory. This requirement is a precautionary measure against the

[209] See hereto the fuller discussion in Ch. 2, § IVa at pp. 62 et seq.

[210] See, e.g., WIEDEMANN, "Internationales Gesellschaftsrecht," in *Internationales Privatrecht und Rechtsvergleichung im Ausgang des 20. Jahrhunderts, Festschrift für Gerhard Kegel* 187, 200 et seq. (A. Lüderitz & J. Schröder eds., Frankfurt 1977).

[211] *Bull. EC*, Supp. 2/1969, pp. 5-16; also in GROSSFELD, *supra* note 206, at comment 98 et seq., with further references more generally to the problem of recognition in international corporation law at comment 123 et seq. See *supra* note 147 and accompanying text, and *infra* note 330 and accompanying text.

[212] See especially DROBNIG, "Kritische Bemerkungen zum Vorentwurf eines EWG-Übereinkommens über die Anerkennung von Gesellschaften," 129 *ZHR* 93 (1967); DROBNIG, "Das EWG-Übereinkommen über die Anerkennung von Gesellschaften und juristischen Personen," 18 *AG* 90, 125-31 (1973); TIMMERMANS, "The Convention of 29 February 1968 on the Mutual Recognition of Companies and Firms: A Few Comments from the European Law Point of View," 27 *Netherlands Int'l L. Rev.* 357-61 (1980); 1 H. WIEDEMANN, *Gesellschaftsrecht* 62 et seq., 781, 794 et seq. (Munich 1980); C.-T. EBENROTH, *Die verdeckten Vermögenszuwendungen im transnationalen Unternehmen* 339 et seq., 374 (Bielefeld 1979). See also STEIN, "Conflict-of-Laws Rules by Treaty-Recognition of Companies in a Regional Market," 68 *Mich. L. Rev.* 1327 (1970).

company laws of third states (of incorporation) not members of the EEC, quite understandable in the context of an EEC convention.

Second, Article 3 of the Convention contains a more decisive restriction. It allows any contracting state to refuse recognition to companies with actual headquarters outside EEC territory, if the company's activity does not have a real and permanent connection with the economy of one of the Member States.

Finally, an even more significant derogation of the incorporation theory is contained in Article 4. It gives any contracting state the right to apply what it considers mandatory provisions of its own law to companies that have headquarters within its territory, even if the company is incorporated under laws of another contracting state. Germany has taken advantage of this reservation, notably in order to prevent evasion of its far-reaching codetermination rules. This example demonstrates the potential for variances from the incorporation theory through imposition of mandatory provisions by headquarter states, as is now known in the United States.

Such a development is not to be expected for the present, however, because the Convention has not come into force for lack of ratification by the Netherlands. This is no loss since the Convention has rightly been subjected to sharp criticism, particularly on the grounds that inevitable judicial interpretation of the agreement will generate many new legal problems, and that it represents a backward step in recognition practice compared with the status quo.

The status quo in Germany, for example, allows the unrestricted recognition of all commercial law associations in the EEC area and, under the prevailing headquarters theory, leaves all other company law questions to the legal system of the state in which these associations have their headquarters. On the whole, it can be seen that while the law of the EEC Treaty affects conflict of laws, the contribution of conflict of laws to the harmonization of European company law and integration within the European Community has been relatively slight. This finding coincides with the more general evaluation of conflict of laws as a technique for legal integration which has been said to have "severe shortcomings" even though being "helpful as a transient measure" in default of harmonization.[213] Quite another problem is the potential of the conflict of laws technique for the whole sector of transnational services. There the Single European Act has opened new perspectives for an internal market by 1992, especially by means of mandatory recognition of national service law under Article 100B (as of 1987).[214] But the dilemma between free movement of (financial) services and adequate (not only minimum) protection of investors and creditors remains as well.

[213] HAY, LANDO & ROTUNDA, "Conflict of Laws as a Technique for Legal Integration," in I/2 *Integration Through Law, supra* note 205, at 161-258, at 257.

[214] See *supra* notes 115 & 116.

2. Model Laws and Restatements

As is well known, model laws and restatements have had considerable influence in the United States on the approximation of state laws in general and on company and capital market law in particular.[215] Legal harmonization is achieved not through state compacts or federal legislation, but through the model's persuasive force on both state legislatures and judges. This US experience has been given consideration in Europe, where the creation of model laws was proposed many years ago as a promising method for legal harmonization.[216] The greatest advantage of this method is that, because of its pragmatic approach, it may preserve the movement toward integration even if a Member State resists making further sovereignty concessions. Currently, such resistance by even one of the Member States could bring legal harmonization to a standstill. Model laws and restatements would allow the Member States more favorably disposed to integration to proceed despite dissent by other Members without having to resort to the legally problematic integration concept of "Europe at two speeds."[217] The benefits achieved through such voluntary harmonization might then convince the resisting states to adopt the model acts.

Two major objections raised to the use of model laws and restatements in Europe are that this method can only succeed where the legal systems to be harmonized are already closely related, and that this "soft" path to harmonization would be politically impossible. In response to the first criticism it should be recognized that, despite the differences among European company and capital market laws, there is also considerable commonality. Harmonization of European company and capital market law to date has shown that this commonality is sufficient for the use of model laws. In response to the second objection, it should be recognized that the "soft" path to harmonization may be achieved through a variety of organizations. Admittedly, purely private model laws would have little chance, because Europe lacks a common organization of lawyers to perform the harmonization work, such as is available in the United States through the American Bar Association and similar organizations.

215 See the impressive Record of Passage of Uniform and Model Acts (as of 1 Sept. 1985) in GRAY, *supra* note 205, at Appendix 160-65.

216 *Cf.* ZWEIGERT, "Grundsatzfragen der europäischen Rechtsangleichung, ihrer Schöpfung und Sicherung," in 2 *Vom deutschen zum europäischen Recht, Festschrift für Hans Dölle* 401, 410 n.19 (E. von Caemmerer, A. Nikisch & K. Zweigert eds., Tübingen 1963); KRONSTEIN, "Erfahrungen aus amerikanischer Rechtsangleichung," in *Probleme des europäischen Rechts, Festschrift für Walter Hallstein* 275 (E. von Caemmerer, H.-J. Schlochauer & E. Steindorff eds., Frankfurt 1966); LELEUX, "Le rapprochement des législations dans la Communauté Economique Européenne," 4 *Cahiers du droit européen* 129, 131, 151 et seq. (1968). See generally J. KROPHOLLER, *Internationales Einheitsrecht* 67 et seq., 106 et seq. (Tübingen 1975); and most recently, GAJA, HAY & ROTUNDA, *supra* note 205, at 153-60.

217 See *infra* notes 282 & 283.

If, however, these model laws and restatements have their place in the European Community, then it is apparent that the many channels existing between the Community and the Member States may be used to bring them more closely to the attention of the national legislative authorities. The *Lando* project to develop such model laws and restatements, which has been supported by the Commission and various national institutions, has concerned a different area to date.[218] It would be entirely conceivable, however, for it to be extended to European company and capital market law.

3. The International Code Effort

EEC Treaty Article 189 gives the Community institutions the power to make recommendations. This method also provides an alternate path to legal harmonization, if binding harmonization by directives, for instance under Article 54(3)(g) or Article 100, fails. The Commission has made scarcely any use of this method for company and capital market law harmonization. The main example is its recommendation of 25 July 1977 concerning a European code of conduct relating to securities transactions.[219] Interestingly, this recommendation proceeded from the then British-led staff of the Directorate General on Financial Institutions and Taxation (Directorate General XV), rather than from the Directorate for Internal Market and Industrial Affairs (Directorate General III) which included the primarily German staffed Directorate usually responsible for legal harmonization.[220] The structure of the recommendation therefore reflects the British tradition of self-regulation, and downplays the more legalistic structure preferred in Germany.

The recommendation includes a number of principles already recognized by the Member States. The Commission's purpose in promulgating the recommendation was to create a unitary formulation of these principles, which it hopes will lead to common business ethics on these issues. This is intended to smooth the path for future directives on company and capital market law. Whether this European code of conduct can actually achieve its purpose seems doubtful. The recommendation received a lukewarm reception when it was presented, and is still relatively unknown to this day, even among experts.[221]

[218] The Commission on European Contract has privately circulated a tentative 1982 draft on "Principles of European Contract Law," for example. See also LANDO, "European Contract Law," 31 *Am. J. Comp. L.* 653[59] (1983).

[219] See *supra* note 119. See now the two banking law recommendations of 1986, § IV.A.3, *infra* at p. 258.

[220] Most recently there have been important reorganizations of the two Directorates.

[221] In Germany the text was even published by the Ministry of Finance without the two recommendations on transferring or acquiring holdings conferring control which are difficult to reconcile with German law and practice.

The OECD and UN codes of conduct have received relatively greater attention.[222]

Yet the use of international codes of conduct as a method for European legal harmonization and integration should be evaluated independently of the success or failure of this specific recommendation. Admittedly, the code method appears to present only limited opportunities. Nevertheless, it may play an important role as a precursor and complement to legally binding directives, particularly in areas of law where complexity and rapid evolution of the field prevent use of a single, comprehensive directive.

B. Legal Integration Through Community Company and Capital Market Law

1. Harmonization Through Community Directives

a. Regulation or Directive?

Both in the more specific provisions of Article 54(3)(g) and the more general ones of Article 100, the EEC Treaty provides only for the use of directives as a means of integration for company and capital market law. It is true that there is also the technique of regulations. Indeed the European Court of Justice has recognized the Commission's power to enact regulations for purposes of legal harmonization, pursuant to EEC Treaty Article 235.[223] Yet under the Treaty, directives are the predominant means of legal harmonization (so-called functional or liberal integration), whereas regulations are provided as a method of legal unification only in special areas that require stronger intervention (so-called institutional or authoritative integration).[224] As seen above recourse to Article 235 must remain an ultimate means if there are no other sufficient Treaty bases. This is the case, however, for most of the company and capital market harmonization.[225] Accordingly, to date an overwhelming proportion of the Commission's integration efforts in this field have taken the form of directives. Insofar as the establishment and functioning of the internal market is con-

222 See generally *Legal Problems of Codes of Conduct for Multinational Enterprises* (N. Horn ed., Deventer 1980); J.I. MAHARI, *Codes of Conduct für multinationale Unternehmen* (Diss., St. Gallen, Wilmington, Delaware 1985); SANDERS, "Codes of Conduct and Sources of Law," in *Etudes Goldman, supra* note 206, at 281-98.

223 Case 8/73, Hauptzollamt Bremerhaven v. Massey-Ferguson, [1973] E.C.R. 897, 907, 912.

224 SCHMEDER, *supra* note 138, at 45 et seq. He mentions the agricultural sector as an example.

225 See, e.g., ZULEEG, "Die Rechtswirkung europäischer Richtlinien," 9 *ZGR* 461, 470 (1980). See also BÄRMANN, *supra* note 135, at 143; HERBER, "Probleme der gesetzlichen Fortentwicklung des Handels- und Gesellschaftsrechts," 144 *ZHR* 47, 64 (1980).

cerned, this clear picture may become blurred in the coming years under Article 100A.[226]

The use of directives instead of regulations as the primary means for integrating company and capital market law protects the sovereignty of the various Member States. This is because directives apply to the Member States as a whole, while regulations directly establish the rights and duties of legal subjects within Member States. The directive therefore applies only "for" those Member States to which it is directed, and not "in" each Member State automatically. This implies a two-stage legislative procedure. The directive must first be enacted at the Community level, and then be transformed into national law by the legislatures within each of the Member States. As said in Article 189 of the Treaty the directive is intended to be binding only "as to the result to be achieved," while national authorities are to have "the choice of form and methods." This process implies a definite and important division of competences.

The flexible, two-stage form of the directive and its role in legal harmonization under the EEC Treaty has its clear basis in the history of the Treaty. Since the idea of supranationality was politically unfeasible at the time the Treaty was drafted, the Treaty provided for the greatest possible protection of the Member States' sovereignty, by stating that the regulatory powers of national parliaments were to be affected as little as possible. The process of nationally specific conversion of the directives by the Member States was chosen to provide a smooth and flexible method for harmonization, which it was expected would ultimately lead to a more effective integration of the various legal systems of the Member States.

Harmonization practice today is considerably removed from these concepts embodied in the Treaty. This is particularly true for the Treaty's careful division between European objectives and national choice of methods used to implement them. But other important theoretical and practical problems of integration by means of directives have also arisen or been more clearly perceived in recent times.

b. Overly Specific Directives

Many directives and draft directives contain very detailed provisions indeed that leave only a ministerial role to the Member States in transforming them into national law. This is particularly true for much of company and capital market law harmonization. The Second Directive on the harmonization of company law, for example, specifies in detail the necessary contents for corporate articles of association, as well as the provisions necessary for maintaining and changing capital. The draft Fifth and Ninth Directives are even more specific in their requirements for harmonization of corporate structure and the law of groups of companies.

[226] See § III.B.2, *infra* at pp. 243-44.

The literature has attacked this overly specific drafting practice as constituting an extension of Community law contrary to (or at least beyond the scope of) the Treaties. Most critics stress the need to draw the boundary between the ends and the means of the Treaty more exactly, and to provide at least some freedom to the Member States to structure the details of their national enactments of directives.[227] Some writers argue more forcefully that detailed directives are permissible only where essential to attain the Treaty's objectives. Yet actual practice has not been affected by these arguments. Indeed case law supports the position that the directive concept as such permits any necessary level of specificity of regulation,[228] and the theoretical possibility that, with reference to a specific directive, the Court of Justice might hold that the Council had abused its discretion is scarcely relevant in practice.

There is also another practical reason why it is hard to challenge the Council's discretion in enacting very specific directives. Research into ends-means relationships, notably in the field of economics, has shown that ends cannot be practically separated from the means by which they are achieved. There are many intermediate points between the highly abstract ends stated in the Treaty (both in the preamble and Article 1 *et seq.*) and the specific means chosen in an EEC directive. Moreover, as discussed above,[229] the ends-means relationships are often theoretically controversial (e.g., as to the usefulness of worker participation for European integration), or else may be theoretically serviceable, but ambiguous in practice or not empirically verifiable. Given these facts, it is sometimes even said that the Council's freedom to specify regulatory detail in directives has become a matter of European customary law, particularly as to directives on legal harmonization.[230] While the latter is doubtful, it is certainly true that the specificity of directives is a legal phenomenon which is commonly accepted practice today. This does not mean, however, that the problem is only of academic interest as has been said.[231] Under the present unanimity practice, the Member States can block a directive with the content and specificity of which they do not agree. At the moment in which a majority decision can be taken under Article 54(3)(g), and henceforth also under Article 100,[232] it may very well be that the present specificity practice will be challenged legally.

c. Harmonization by Options

In recent years quite the opposite problem has appeared – not that of protecting the Member States against too much intrusion by Community directives,

[227] See, e.g., OLDEKOP, "Die Richtlinien der Europäischen Wirtschaftsgemeinschaft," 21 *JöR n.f.* 58, 92-98 (1972).

[228] See ZULEEG, *supra* note 225, at 473.

[229] See § II.A.3, *supra* at pp. 197-204.

[230] BLECKMANN, *supra* note 123, at 71.

[231] TIMMERMANS, *supra* note 120, at 11.

[232] See *infra* note 238.

but rather that of securing meaningful European harmonization against the stiff defense of national legal peculiarities. At issue is the phenomenon of harmonization by options. While it is normal that harmonization is achieved through regulatory compromise, there is a growing tendency to settle on the lowest common denomination of national laws and to camouflage this by options. While in company and capital market harmonization this is an exception and, for example, the Fourth Directive has brought about considerable harmonization, it must not be forgotten that the same directive in total leaves no less than 41 options open to the Member States in addition to 35 options left to the business enterprises themselves.[233] These options do not just concern the choice of forms and methods as discussed above. Many of them rather mark the defeat of sensible Community initiatives in the face of national habits and interests successfully defended by a national lobby. It is quite obvious, for example, that the much called for uniformity of accounts and balance sheets of European business enterprises and groups is severely undermined by options which allow the enterprises to come up with alternative presentations or even worse with different figures.

It is true that options are necessary for the harmonization process. This is not only a matter of political problem-solving, in as much as options may represent the only practical method for progress. Furthermore, even a second-best solution can still be a good solution. Indeed, in certain cases options may in fact be the best solution. Their use is especially viable where the law subject to harmonization is closely connected with other areas of a national legal system, which are not yet harmonized or are not even subject to harmonization. The option method allows a certain measure of European legal harmonization without disrupting the unity of national codes through the imposition of independent Community law. This flexibility is particularly important in the area of capital market law, which has many connections with other areas of commercial and economic law that are not covered by the Treaty.

The use of options may have more drawbacks, however, if Member States retain their own legal systems and use the options to create only superficial compliance with harmonization. This may ultimately prove to be the case with the attempts of the Commission and the European Parliament to harmonize the law of worker participation by allowing a choice among four fundamentally different models.[234] The drawbacks are even greater if by only partial harmonization the misleading appearance of full harmonization is created, as for example in the accounts and balance sheet harmonization.[235] Perhaps the greatest problem in making such use of options is petrifaction. Once such

[233] NIEHUS, *supra* note 195, at 537 (with further references). See also GEBHARDT, "Tendenzen bei der Umsetzung der Vierten Richtlinie in das nationale Recht der EG-Mitgliedsländer," 10 *ZGR* 221 (1981).

[234] See § IV.B, *infra* at pp. 259-62.

[235] The remaining divergences are summarized by NIEHUS, *supra* note 195, at 565-66.

directives have been agreed upon and Member States have transformed them, it is very unlikely that they will be ready to accept a revision or tightening up on the European level.

One of the major dangers for the harmonization process is, therefore, that European solutions will get watered down by too many and too fundamental options.[236] Even worse the non-optional parts may remain half-hearted and minimalistic. This is not only because single Member States might block the more far-reaching proposals of the EC Commission, for deterioration starts at an even earlier stage: the EC Commission, painfully aware of earlier failures before the Council, anticipates the resistance of individual Member States and builds the compromise elements already into its drafts. In this way Community law can hardly become better, let alone the best, law.[237]

Most recently hope has arisen for some change since according to the resolutions of the European Council at the Luxembourg Summit of 2 and 3 December 1985 harmonization directives can be adopted also with a qualified majority, not only under Article 54(3)(g), as is the case already now, but also for company law harmonization and for more general harmonization under Article 100A.[238] However, it remains to be seen how this will work out in Council practice, since this majority rule has been hailed by some as the major European breakthrough, while others point to the national safeguards admitted by Article 100A(4) and fear that in order to avoid the threat of these the usual practice will still be unanimity decision-making. If the majority rule really will be practised, this could have a healthy deregulatory effect on the directives since all the national peculiarities and interests would no longer need to be reflected in a final overly difficult and detailed compromise text.

d. Direct Applicability as an Answer to Time-Lapses and National Balking?

Long time-lapses or even the continuing failure of Member States to enact transforming legislation is a sad fact of life in European harmonization, unfortunately also in the field of company and capital market law harmonization. The Fourth Directive is an appalling example. Despite the passage of the time-limits for national enactment – the new provisions were meant to be applicable for the business years commencing after 31 January 1982[239] – by

236 The idea of narrowing down existing options by imposing a duty on the Member States not to exercise them freely may be successful in exceptional and obvious cases, but does not resolve the general problem. But see KIRCHNER & SCHWARZE, "Umsetzung der EG-Rechnungslegungsrichtlinien in nationales Recht – Die Ausübung der Wahlrechte durch die Mitgliedstaaten," 38 *WPg* 397-404 (1985).

237 See *supra* § II.B.2.c.

238 KRIEGER, "Gesetzgeberische Perspektiven auf dem Gebiet des Gesellschaftsrechts," 150 *ZHR* 182, 186 (1986). As to Art. 100A see *supra* notes 116 & 145, and § III.B.2, *infra* at pp. 243-44.

239 Fourth Directive, Art. 55 (2).

1985 only six Member States had actually transformed the directive, and even in several of these six the national law still lacked some necessary implementation by specific ministerial ordinances and transforming decrees.[240] Germany has only transformed as of 1 January 1986.[241]

Of course, since this is a clear violation of Treaty obligations by a Member State, the EC Commission may react, and in fact has reacted by instituting proceedings against non-complying Member States. Some Member States have already been sentenced by the European Court of Justice for default in transforming the Second Directive on harmonization of company law, and the Commission has also brought such actions for non-implementation of the Fourth Directive, for example against Germany.[242] While the case against Germany should now be moot, the defense brought forward is still correct, although legally irrelevant:[243] Germany, it is argued, has transformed the Fourth, Seventh and Eighth Directives[244] in one single transformation law, this being the only means available to produce a good and homogeneous piece of legislation. Another more effective answer to delay may be the direct applicability doctrine.[245] The authors of the Treaty apparently intended that

240 NIEHUS, *supra* note 195, at 538.

241 See *supra* note 196.

242 Actions for non-implementation of the Second Directive have been successful against, for example, Italy, Belgium, Luxembourg, Ireland: see Case 136/81, [1982] E.C.R. 3547; Case 148/81, [1982] E.C.R. 3555; Case 149/81, [1982] E.C.R. 3565; Case 151/81, [1982] E.C.R. 3573. For actions concerning the Fourth Directive see Case 17/85, Commission v. Italian Republic (Judgment of 20 March 1986), 1986 *Foro italiano*, Part IV, 221; and Cases 16/85 (Ireland) & 18/85 (Germany), now removed, O.J. C 49/5 (21 Feb. 1985), O.J. C 325/9 (18 Dec. 1986) & O.J. C 43/8 (15 Feb. 1985), O.J. C 80/6 (27 Mar. 1987), respectively.

243 If more time for national harmonization is needed, this should be agreed upon already when the directive is adopted. It is important for the harmonization process that the Member States be allowed enough time for good legal transformation work.

244 KRIEGER, *supra* note 238, at 183-84.

245 M. SEIDEL, *Direktwirkung von Richtlinien* (Europa-Institut, Saarbrücken 1983); SEIDEL, "Die Direkt- oder Drittwirkung von Richtlinien des Gemeinschaftsrechts," 38 *NJW* 517-22 (1985); A. OLDENBOURG, *Die unmittelbare Wirkung von EG-Richtlinien im innerstaatlichen Bereich* (Munich 1984); TIMMERMANS, "Directives: Their Legal Effect Within the National Legal Systems," 16 *C.M.L. Rev.* 533-55 (1979); TIMMERMANS, *supra* note 120, at 33-37; LEITAO, "L'effet direct des directives: Une mythification?," 17 *R.T.D.E.* 425-41 (1981); STEINER, "Direct Applicability in EEC Law: A Chameleon Concept," 98 *L.Q.R.* 229 (1982); PESCATORE, "The Doctrine of 'Direct Effect': An Infant Disease of Community Law," 8 *Eur. L. Rev.* 155 (1983); BLECKMANN, "Zur unmittelbaren Anwendbarkeit der EG-Richtlinien," 30 *RIW* 774-77 (1984); EVERLING, "Zur direkten innerstaatlichen Wirkung von EG-Richtlinien: Ein Beispiel richterlicher Rechtsfortbildung auf der Basis gemeinsamer Rechtsgrundsätze," in 1 *Einigkeit und Recht und Freiheit – Festschrift für Karl Carstens* 95-113 (B. Börner, H. Jahrreiß & K. Stern eds., Cologne/Berlin/Bonn/Munich 1984).

directives should become applicable within a Member State only after passage of national enabling laws, but this intention has been eroded by subsequent judicial interpretation. The most important line of decisions in this process have come from the European Court of Justice. Beginning with the opinion in *van Gend & Loos,* which dealt with the problem of direct applicability of duties of forbearance, this trend continued with the so-called *Leberpfennig* judgments of 1970[246] and the *van Duyn,*[247] *Bonsignore,*[248] *Ratti*[249] and other decisions. Some national courts have taken contrary positions. The *Conseil d'Etat* held in its *Cohn-Bendit* decision of 1978, that a directive has a direct binding effect only with regard to its aims.[250] The German Federal Fiscal High Court took the same position in 1981[251] and again in 1985, this time in open conflict with the European Court of Justice.[252] The German Federal Administrative High Court on the other hand has followed the European Court.[253]

The European Court of Justice has recently clarified and consolidated its position in several decisions, for example in *Becker,*[254] *Grendel,*[255] *Felicitas*[256] and other cases.[257] In its view, those provisions of directives that can be detached from the general structure and applied independently may have a direct effect on individuals before national courts, without passage of national

246 Case 9/70, *Grad,* 20/70, *Transports Lesage,* 23/70, *Haselhorst,* [1970] E.C.R. 825, 861, 881.

247 Case 41/74, [1974] E.C.R. 1337.

248 Case 67/74, [1975] E.C.R. 297.

249 Case 148/78, [1979] E.C.R. 1629.

250 Ministère de l'Intérieur v. Cohn-Bendit, C.E. (Ass.), Decision of 22 Dec. 1978, [1978] Rec. Leb. 524, [1979] *Actualité Juridique Droit Administratif* 41, [1980] 1 C.M.L.R. 543; also in 14 *EuR* 292 (1979) with a comment by BIEBER at 294-99; see also the note by DUBOIS, in 15 *R.T.D.E.* 169-80 (1979).

251 BFH, Decree of 16 July 1981, in 27 *RIW/AWD* 690 (1981), [1982] 1 C.M.L.R. 527, and 16 *EuR* 442 (1981) with a comment by MILLARG. Similarly, see Tribunal Administratif de Paris, Decision of 2 Dec. 1980, no. 2150 de 1978-1, [1981] *Droit Fiscal* no. 52 comm. 2384.

252 BFH, Decision of 25 Apr. 1985, in 31 *RIW* 742 (1985), with a critical comment by MEIER, "Krieg der Richter – Was nun?," 31 *RIW* 748 (1985). See also the critical comments by MAGIERA, "Die Rechtswirkungen von EG-Richtlinien im Konflikt zwischen Bundesfinanzhof und Europäischem Gerichtshof," 38 *Die öffentliche Verwaltung (DÖV)* 937-44 (1985); TOMUSCHAT, "Nein, und abermals Nein! Zum Urteil des BFH vom 25. April 1985 (JR 123/84)," 20 *EuR* 346 (1985); DUHNKRACK, "Die unmittelbare Wirkung von EG-Richtlinien," 32 *RIW* 40-43 (1986).

253 BVerwG, Decree of 24 May 1984, 31 *RIW* 143 (1985) and Decision of 23 Aug. 1984, 31 *RIW* 744 (1985).

254 Case 8/81, [1982] E.C.R. 53; with comment by MEIER, 37 *BB* 480, 1711 (1982).

255 Case 255/81, [1982] E.C.R. 2301.

256 Case 270/81, [1982] E.C.R. 2771.

257 For example, Case 70/83, *Kloppenburg,* [1984] E.C.R. 1075; Case 271/82, [1983] E.C.R. 2727 (concerning veterinarians).

enabling laws. In other words, directives are directly applicable insofar as there is no scope for alteration through national enabling legislation. Unfortunately, this standard has led to considerable theoretical and practical confusion.

The theoretical distinction between regulations and directives is especially difficult in areas of legal harmonization. In many cases, directives oblige the Member States to make general enactments that apply directly to a large number of individuals in the same manner as regulations. The practical consequences of this have not been fully explored to date.[258] For instance, it is unclear whether this direct applicability refers only to a Member State's acts of omission, or to its acts of commission as well. Similarly, it was for a long time uncertain whether directives can directly prescribe not only individual rights, but also individual duties, and furthermore whether direct applicability can be raised in law-suits between private individuals or business enterprises.[259] In these latter cases the issue may also arise whether the existing national law on which one of the parties is relying has in fact transformed Community law correctly. Procedurally, it is unclear whether plaintiffs must demonstrate this direct applicability, or whether they may rely on a presumption that the directive is intended to provide standards for a particular area, as is the case with regulations.[260]

Although further examples of ambiguity could be presented, the important point – which applies also to company and capital market harmonization directives[261] – is that there is a great potential for individuals, courts and authorities within the Member States to take action to implement the directives, even where the States themselves have not enacted implementing legislation.

[258] See the authors cited *supra* note 245; see also BLECKMANN, *supra* note 123, at 261-63; ZULEEG, *supra* note 225, at 474 et seq.; TIMMERMANS, *supra* note 120, at 33-37; B. BEUTLER, R. BIEBER, J. PIPKORN & J. STREIL, *Die Europäische Gemeinschaft – Rechtsordnung und Politik* 182-85 (Baden-Baden, 3d ed., 1987).

[259] This is most often denied: see, e.g., TIMMERMANS, *supra* note 120, at 34 (with further references). But there have been also clear affirmative voices: see, e.g., BLECKMANN, *supra* note 245, at 776-77. See now ECJ, Case 152/84, *Marshall*, [1986] 1 C.M.L.R. 688 (no direct effect against private persons).

[260] On some of these controversies see RENGELING, "Europäisches Gemeinschaftsrecht und nationaler Rechtsschutz – unter besonderer Berücksichtigung der Rechtsprechung des Europäischen Gerichtshofs und deutscher Gerichte," in 1 *Das Europa der zweiten Generation, Gedächtnisschrift für C. Sasse* 197 (R. Bieber *et al.* eds., Baden-Baden 1981) [hereinafter cited as *Gedächtnisschrift Sasse*]; KOVAR, "L'intégrité de l'effet direct du droit communautaire selon la jurisprudence de la Cour de Justice de la Communauté," *id.* at 151.

[261] See, e.g., LUTTER, "Zur Europäisierung des deutschen Aktienrechts," in *Konflikt und Ordnung: Festschrift für Murad Ferid* 559, 610 (A. Heldrich, D. Henrich & H.J. Sonnenberger eds., Munich 1978). See also § III.B.1.e, *infra* at pp. 240-41, concerning the Fourth Directive.

e. Possible Conflict with National Enabling Legislation

The problem of the time-lapse between promulgation of a directive and enactment of national enabling legislation is only one adverse consequence of the two-stage nature of the directive process. An equally important problem is the different content of these national enabling laws. The European Court of Justice insists on conversion of directives through national enabling laws even for the parts of the directive that are directly applicable to individuals.[262] The reason for this insistence, theoretical considerations aside, is derived from the Court's view that individuals need to clearly know their legal position. Accordingly, in such cases of dual norms, the national implementing legislation is the primary legal standard to be applied and the directive will be treated as directly applicable only where it conflicts with the national law. To avoid these conflicts as far as possible, it is necessary to assume that national legislatures are generally obliged to incorporate the content of directives as it were verbatim into their implementing laws.[263]

So far no cases of a major difference in content between a directive and an implementing law have yet been decided by the European Court of Justice in the area of company and capital market law harmonization. But such a conflict may well appear soon, based on Germany's restrictive implementation of the Fourth Directive on corporate disclosure requirements. Specifically, it is unclear whether the Fourth Directive's disclosure requirements, prescribing the proper form for balance sheets, must not be extended to included the German GmbH & Co.[264] The first German draft statute proposed by the Schmidt Government took this position, but this was violently opposed in practice. The final "Balance Sheets Directive" Act of 19 December 1985 excludes the GmbH & Co.[265] The Fourth Directive does not explicitly mention the GmbH & Co., and the extension of the directive to the GmbH & Co. (which encompasses firms of very different types and sizes) would have far-reaching effects on German business.[266] On the other hand, because of the freedom of company structure allowed under German law and the functional similarities

262 Case 147/77, Commission v. Italian Republic, [1978] E.C.R. 1307, 1308.

263 Verbatim transformation for example of the Products Liability Directive of 25 July 1985, O.J. L 210/29 (7 Aug. 1985), is necessary according to LORENZ, "Europäische Rechtsangleichung auf dem Gebiet der Produzentenhaftung: Zur Richtlinie des Rates der Europäischen Gemeinschaften vom 29. Juli 1985," 151 *ZHR* 1, at 37 (1987).

264 As to this company form, see *supra* text accompanying note 11.

265 See HGB [Commercial Code] § 264 et seq. (as of 1986) which apply only to stock corporations, limited-share partnerships (*Kommanditgesellschaften auf Aktien)* and limited liability companies (GmbH), as compared with the Schmidt draft, BTDrucks. 9/1878, 27 July 1982.

266 STROBEL, "Publizitätspflicht und Haftungsbeschränkung," 36 *BB* 1742 (1981); see also BIENER, "Die Auswirkungen des Regierungsentwurfs eines Bilanzrichtlinien-Gesetzes auf GmbH und GmbH & Co.," 74 *GmbHRdsch.* 253 (1983).

between the limited liability company and the GmbH & Co., the exclusion of the GmbH & Co. from the scope of the German Act is difficult indeed to reconcile with the directive's purpose of providing broad coverage as to disclosure requirements.[267] In May 1986 the Commission reacted by presenting an additional draft directive which expressly extends the reach of the Fourth and Seventh Directives to the GmbH & Co.[268] This in turn has led to unusually sharp protests by Government and business in Germany.[269] As long as the present Government stays in power and the majority rule is not practised,[270] there is no political chance that the directive will be accepted.

In this deadlock there is much speculation in German legal literature whether the two Directives could be at least in part directly applicable.[271] Despite the above-mentioned ambiguities this possibility cannot be excluded since the question could come up in quite different contexts, not only horizontally between two private citizens.

f. Blocking Later National Legislation

The problem of the so-called blocking effect of directives is closely connected with the question of varying content of national implementation laws. It is not enough for a directive to be completely and expeditiously converted into national law. It is also necessary for the enactment not to be changed or even abolished later; that is, the directive must develop a "blocking effect" against later revision. The blocking effect concept is subject to differing interpretations as to its meaning and scope in relation to the supremacy of Community law.[272] The statements of the European Court of Justice imply that it interprets such statutes to have a highly preemptive effect, comparable to the Federal German legislative competence pursuant to Article 72(1) of the German Constitution. Thus, the European Court not only gives Community law preemp-

[267] See LUTTER, MERTENS & ULMER, "Die GmbH & Co. KG und das Bilanzrichtlinien-Gesetz," 38 *BB* 1737-41 (1983); most recently, see MARX & DELP, "Einbeziehung der GmbH & Co. KG in die Publizitäts- und Prüfungspflicht nach neuem Recht?," 39 *DB* 289-90 (1986).

[268] Proposal for a Directive of 5 May 1986, O.J. C 144/10 (11 June 1986).

[269] See "Bundesjustizminister Hans A. Engelhard gegen EG-Richtlinie zur Einbeziehung der GmbH & Co. KG in die Publizitäts- und Prüfungspflichten," *Recht (Informationen des Bundesministers der Justiz)*, July/Aug. 1986, No. 4, p. 64.

[270] See *supra* notes 116 & 238.

[271] See, e.g., SCHULZE-OSTERLOH, "Die Rechnungslegung der Einzelkaufleute und Personengesellschaften nach dem Bilanzrichtlinien-Gesetz," 150 *ZHR* 403, 430 (1985) (in the negative sense). See also, more generally, BLECKMANN, "Gemeinschaftsrechtliche Probleme des Entwurfs des Bilanzrichtlinien-Gesetzes," 39 *BB* 1525-26 (1984).

[272] See LANGEHEINE in *Kommentar zum EWG-Vertrag, supra* note 136, at Art. 100 comment 69; and see generally IPSEN, *supra* note 122, at 266 et seq.; LUTTER, "Europäische Gerichtsbarkeit," 88 *ZZP* 104, 147 (1973).

tive effect against conflicting national regulations, but further finds "that the effective enactment of new national legislative acts is prevented, to the extent that these would be incompatible with Community basic principles."[273] Although the Court has stated this holding explicitly only for Treaty provisions and directly applicable legal acts of Community organs, the analysis appears to have indirect importance for directives as well.

The concept of the blocking effect must therefore be understood as meaning the invalidity of any national legislative enactment not in accord with the directive under which it is created, and thus the transfer of legislative competence in the area concerned from the national sovereign to the Community. Broader application of the concept, such as has been considered in the literature, is more problematic.[274] Thus, it is inappropriate to subject any national law that conflicts with any directive immediately to this blocking effect. Such application would mean self-implementation of the directive not only with respect to those provisions which are favorable and create rights and claims for individuals, but also as regards its restrictive and duty-creating portions. As far as the latter are concerned, there is much in favor of the argument that these restrictions must first be converted into national law in order to be cognizable by the individual citizen and thus attain general force prior to direct application.

There is, however, a more fundamental criticism to be leveled at the blocking effect as understood following the Court of Justice's ruling. This criticism is based on rule of law, as well as democratic and federalist, objections.[275] In relation to the Federal Republic of Germany, for example, it is particularly problematic that the joint legislative powers of the *Bundesrat* may be overridden by such a broad rule. A method should be developed to resolve the supremacy issue without reducing the effectiveness of Community obligations. One method would be to limit application of the supremacy rule to the level of legal interpretation, and not apply the rule at the stage of legislation.[276] If this approach were adopted, a court would be given the important task of ensuring that the danger of divergent development of harmonized national laws is avoided, and the supremacy of national legislatures would continue to be respected.

g. Ratification and Possible Cures

Finally, it must be recognized that the blocking effect may do more harm than good if it is used just to maintain the status quo of harmonized European law.

[273] Case 106/77, Simmenthal II, [1978] E.C.R. 629, 644; similarly later decisions: e.g., Case 815/79, Cremonini, [1980] E.C.R. 3583, 3607.

[274] See ZULEEG, *supra* note 225, at 481-82 for further references; see also LUTTER, *supra* note 272, at 147 n.124, and LUTTER, *supra* note 261, at 615-16.

[275] SCHMEDER, *supra* note 138, at 61-62.

[276] IPSEN, "Die Rolle des Prozeßrichters in der Vorrang-Frage, Zur Bedeutung des 2. Simmenthal-Urteils (Rs. 106/77) des Europäischen Gerichtshofs," 14 *EuR* 223, 237 (1979).

Because Community directives require a long process of negotiation and compromise, there is a great danger that once a directive is enacted it will be practically impossible to amend or rescind. Any modification or repeal of a Community measure would certainly not be easier than its enactment. On the contrary, modifications of existing directives would receive little priority in relation to further harmonization proposals, and would probably even be opposed as adverse to the harmonization process in general. In the field of company and capital market law harmonization, to date there has been no major modification, let alone repeal, of a directive after its enactment by the EC Council. The above-mentioned draft directive concerning the German GmbH & Co.[277] has hardly any chance of being adopted.

It is therefore clear that the directive must be used carefully as an instrument of integration, and mechanisms must be incorporated to prevent the petrifaction of Community law.[278] Several methods are available to prevent this, but in this study a list of some of the more promising techniques must suffice. These include the (careful) use of options in directives to give Member States experience with alternate structures;[279] enactment of experimentation or review clauses in directives under which the Commission would be required to report on the success of a directive after a given amount of time and consider possible alterations;[280] granting of discretion to administrative agencies, experts, or even industries to amend certain provisions in order to adapt to a changing environment;[281] and, perhaps, adjustment of the pace of harmonization for various Member States (despite the theoretical and practical difficulties of this concept).[282]

2. Creation of a Substantive Community Law: The Societas Europaea and the European Economic Interest Grouping

Substantive Community law with comprehensive direct effect can be enacted through the instrument of the Community regulation. In the areas of company and capital market law harmonization, Community regulations can safely be based on Article 235.[283] Yet, as seen above, this route towards integration is much less frequently chosen than the directive. Up to now in company and

277 See *supra* note 268 and accompanying text.

278 See generally on legal harmonization, BEHRENS, "Voraussetzungen und Grenzen der Rechtsfortbildung durch Rechtsvereinheitlichung," 50 *RabelsZ* 18-34, 26 (1986) (with English summary).

279 See § III.B.1.c, *supra* at pp. 234-36.

280 E.g., Art. 63(c) of the Draft Fifth Directive, O.J. C 240/2 (9 Sept. 1983), especially concerning codetermination.

281 See § IV.C.2, *infra* at pp. 266-68.

282 Other names for this concept are "two-tier system," *"Europe à deux vitesses," "abgestufte Integration." Cf.* LANGEHEINE, "Abgestufte Integration," 18 *EuR* 227 (1983), esp. at 245-47 concerning harmonization of law.

283 See § II.B.4, *supra* at pp. 210-11.

capital market law there have been only two such instances: the statute of the European corporation, which has been pending for many years, and the regulation on the European Economic Interest Grouping (EEIG).

This may change since Article 100A (as of 1987) provides for the adoption of measures which have as their object the establishment and functioning of the internal market. This also includes regulations. The purpose is clearly to avoid the various shortcomings of directives which have been described above. Yet the new door is only half open. For in its declaration on Article 100A, the Commission had to give an assurance that it will prefer directives rather than regulations if harmonization under Article 100A implies a change of national law provisions in one or more Member States. If remains to be seen how this declaration of intent will be handled in future harmonization practice. It could very well be argued that such preference must be given only if in a given case the harmonization objective can be reached as effectively by use of a directive as by a regulation. If this is not the case, for excample if in the case of a mere directive harmful delays are to be expected or if a certain measure implies that stronger intervention is called for, national law provisions may also be changed by means of a regulation.[284]

a. The Societas Europaea

The foundation for the proposed *Societas Europaea*, the most comprehensive European harmonization project to date, was laid soon after enactment of the EEC Treaty. In 1965, after numerous US acquisitions of European firms, and in particular after the legal difficulties of European mergers (e.g., the Agfa-Gevaert merger), had revealed the weakness of the European position, the French Government put before the Council of Ministers an initial proposal for the creation of a European stock corporation. This proposal culminated in the amended proposal for a regulation, dated 30 April 1975.[285]

The object of the planned statute for the *Societas Europaea* is to provide a form of business organization unrestricted by a particular national legal system. It is intended to give firms planning transnational mergers the opportunity to choose a uniform company structure under Community law, and thus avoid the complexities of national corporate laws. According to Article 2 of the statute, the legal form of a European company may be used (a) for the merger of two companies with headquarters in different Member States, (b) for the formation of holding companies under Community law by companies with headquarters in different Member States, and (c) for the establishment of joint affiliates under Community law by companies with headquarters in dif-

[284] See also the examples given by EHLERMANN, *supra* note 116, at 386; *contra* SCHWARTZ, *supra* note 138, at 365.

[285] *Bull. EC*, Supp. 4/1975. The 1975 proposal is treated extensively in *Die Europäische Aktiengesellschaft* (M. Lutter ed., 2d ed., Cologne 1978); see also SMIT & HERZOG, *supra* note 122, vol. 2, App. to Art. 54 with further references.

ferent Member States. This integration measure is intended to enable the Community more effectively to meet the economic challenges facing it.

Until the mid-1970's, many firms took a positive attitude toward the creation of such a European company structure and actively supported the movement toward the *Societas Europaea.*[286] Today, however, companies are increasingly skeptical of the utility of the proposal.[287] The reasons for the skepticism are twofold. First, there is general disappointment that the proposal has thus far made so little progress, and has been at a virtual standstill since 1975. Second, because of inflation, high unemployment and the resulting social consequences, national Governments have increasingly enacted legislation that sharpens the disparities among the Member States' corporate statutes. Companies, which feel the direct effect of these measures, recognize that this can only have adverse consequences for the European integration process.

As to the substance of the draft, there are at least two major obstacles to the creation of the *Societas Europaea*: worker participation and taxation. Institutional representation of workers is also discussed in a framework determined largely by fundamental ideological positions and specific national traditions; and regulation of taxation, particularly in a period of drastically reduced tax yield, goes to the core of the issue of the extent to which the Member States are willing to abandon national sovereignty. Predictably, any approximation on these issues beyond mere formulaic compromises will be extremely difficult.

But even if a European corporate structure were to be adopted in the near future, it is doubtful whether the form would be accepted in practice, or would yield the beneficial results originally hoped for by its proponents. It has been almost twenty-five years since the first proposals for a national European company at the congress of the French Law Society. The length of the legislative process has meant that business enterprises have already created alternative transnational structures. Current practice not only manages to get by without the *Societas Europaea*, but most of the truly international multinationals have suffered economic setbacks and have realigned or even abandoned their international structures.[288]

Finally, there is the general question of the role of regulations as instruments of European integration or else of the competitive relationship between regulations and directives. In this context, the case for the directive as the primary means for integrating European company and capital market law is quite strong. This is not only so because under the Treaty the directive is the instrument primarily prescribed for company and capital market law harmonization and the Commission and Council have overwhelmingly relied on the directive in their harmonization projects to date. But, as seen above, today, the directive

[286] *Cf.* PIPKORN, "Zur Entwicklung des europäischen Gesellschafts- und Unternehmensrechts (II)," 141 *ZHR* 330, 359 (1977).

[287] BAYER, *supra* note 127, at 9 et seq.

[288] See the detailed factual description by BAYER, *id.* at 10-14.

combines its traditional advantages with some of the more beneficial features of the regulation, and it seems that only few projects are conceivable in which the regulation would have either legal or political advantages as an integrative instrument for company and capital market law.

b. The European Economic Interest Grouping

One of these projects may be the regulation on the creation of a European cooperation association, the European Economic Interest Grouping (EEIG), which was enacted on 25 July 1985.[289] This regulation, which goes back to a proposal of the Commission of 1973[290] with changes in 1978,[291] opens the possibility to business enterprises in the European Community to cooperate in the legal form of a truly European commercial partnership modeled on the successful French form of *groupement d'intérêt économique*,[292] which is the form used, for example, by *Airbus Industrie* or *Ariane Espace*. It is expected that this new company form will provide a structure especially for small- and medium-sized business enterprises which up to now may have shied away from more intensive cooperation due to the need to comply with foreign laws and company forms.[293] Whether this will prove true or whether it is not rather an underestimation of the adaptability of the medium-sized and even the small multinationals is somewhat doubtful,[294] but will be shown in practice. While the regulation widens the choice of legal form for transnational business enterprises, it must be taken into account that even as indigenous Community law the regulation could not completely escape national controversies: the EEIG may not employ a working force of more than 500; without this limit this legal form could have attracted German business enterprises weary of codetermination, an effect which Germany could not have accepted.

3. Self-Regulation in the Shadow of Community Law

The role of self-regulation remains largely unaddressed in the context of the harmonization of European company and capital market law.[295] While the relationship between legal standards and voluntary regulation, such as the

289 O.J. L 199/1 (31 July 1985); see GLEICHMANN, "Europäische Wirtschaftliche Interessenvereinigung," 149 *ZHR* 633-50 (1985); MEYER-LANDRUT, "Europäische Wirtschaftliche Interessenvereinigung (EWIV)," 32 *RIW* 107-11 (1986); GANSKE, "Die Europäische wirtschaftliche Interessenvereinigung (EWIV) – eine neue 'supranationale' Unternehmensform als Kooperationsinstrument in der Europäischen Gemeinschaft," 38 *Der Betrieb*, Supp. 20/1985.

290 Proposal of 21 Dec. 1973, O.J. C 4/30 (15 Feb. 1974), *Bull. EC*, Supp. 1/1974.

291 Modified proposal of 12 Apr. 1978, O.J. C 103/4 (28 Apr. 1978).

292 See, with statistical data (1978 more than 9,000) GUYON, *supra* note 53, at 511-40.

293 GLEICHMANN, *supra* note 289, at 633.

294 See § II.A.3.c, *supra* at pp. 197-204.

295 But *cf.* SABROWSKY, *Selbstregulierung im Wirtschafts- und Unternehmensrecht, Die niederländischen Fusionsverhaltensregeln im europäischen Vergleich* (Bonn 1978).

parallel supervisory bodies and professional organizations regulating securities trading (e.g., the Securities and Exchange Commission, the National Association of Securities Dealers and the stock exchanges), has traditionally been viewed as one of central importance in US law, there is little experience in this area under Community law. The code of conduct on securities transactions discussed above[296] is not relevant here because it is based on mere recommendation without any further backing by regulation or supervision.

The issue of self-regulation in the shadow of Community law may come up, however, in connection with the already mentioned German Insider Trading Guidelines.[297] German stock exchanges, business and banks are satisfied with these voluntary, flexible and out-of-the-public-domain self-regulation. Despite the unusually broad critique in German legal literature,[298] there is very little readiness to exchange these codes for binding Community law. This is especially true for broader coverage let alone new sanctions, given the fact that, apart from having to give away the insider profit, in Germany there are no sanctions to be feared even by those who have submitted contractually to the Guidelines. The only compromise for harmonization that seems possible at this moment is a Community arrangement that would take the form of a directive, but which would regulate only a very limited core area of actual insider trading, while leaving implementation and particularly the kind and reach of possible sanctions to national legal or voluntary arrangements. Yet such a compromise would meet with several objections.

The first and most important objection is one of effectivity. German critics of the Insider Trading Guidelines have raised considerable doubts about the reach, the sanctions and particularly the enforcement effectiveness of these guidelines. Harmonization of just the general insider trading prohibition, while leaving stiff penal sanctions in some Member States and a merely voluntary system in others, may not amount to more than lip-service to integration.

The second question is one of Community law. Traditionally, it has been taken as a basic tenet that the goal of bringing about necessary changes in European law must be achieved by modifying national legal systems. Thus, administrative regulations that bind only lower-level authorities and not judges and individuals must be avoided, in favor of laws or legal regulations. In a re-

296 See § III.A.3, *supra* at pp. 231-32.

297 For the complete text of the German Insider Trading Guidelines see BAUMBACH-DUDEN-HOPT, *supra* note 84, at Nebengesetze No. 16; E. SCHWARK, *Börsengesetz*, Annex II at 481 et seq. (Munich 1976), with further comments.

298 PFISTER, "Stand der Insiderdiskussion," 10 *ZGR* 318-47 (1981); HOPT, "Börsliche und außerbörsliche Geschäfte von Verwaltungsmitgliedern in Papieren der eigenen Gesellschaft oder konzernangehöriger Gesellschaften," in *Deutsche Landesreferate zum Privatrecht und Handelsrecht. XI Internationaler Kongress für Rechtsvergleichung, Caracas 1982,* at 171 (U. Drobnig & H. Puttfarken eds., Heidelberg 1982); HOPT, "The German Insider Trading Guidelines – Spring-Gun or Scarecrow?," 8 *J. Comp. Bus. & Capital Market L.* 381 (1986).

cent decision the European Court of Justice[299] has acknowledged that the transformation of a directive does not necessarily in every case require the national legislator to enact a law. General constitutional or administrative law principles in the Member State may already dispose of the problem in the direction prescribed by the directive. Yet there are three in fact quite far-reaching requirements: (1) These principles must guarantee the effective and complete application of the directive by the national administration. (2) If individuals may have claims under the directive, the legal situation must be sufficiently determined and clear for them. (3) Individuals must be put in a position to know their rights and to enforce them before the national courts. This latter condition has been emphasized by the European Court of Justice since individuals are normally not aware of such general principles and concrete rights and of the claims which they can make based on them. In the concrete case Germany could not meet these demands and was found guilty of not having transformed two directives in time. On the insider question, as well, these requirements would not be met by the German Insider Trading Guidelines without further legislative action. A directive cannot be transformed by the mere voluntary adherence of business.

The third problem is the theoretically most interesting. At the same time it is interlinked with the European Court's requirement that individuals must be in a position to know their rights and have the possibility to enforce them in court. This raises the question of whether voluntary regulations, such as the Insider Trading Guidelines, can be the basis of private claims for either specific performance or damages. If such claims are not allowed, then the limited significance of the self-regulatory solution as an implementation mechanism for Community directives is evident, not only as a matter of practical efficiency but already on the more basic issue of sanctions. It generally proves extremely difficult to base any form of legal action for breach or damages – be it in contract or torts – on extralegal non-binding, voluntary arrangements. This is also true for the Insider Trading Guidelines.

Contracts concluded in voluntary submission to the Insider Trading Guidelines are between the insiders, the corporations and the stock exchange. Private investors are not privy to these contracts. In the legal literature the question has arisen whether, under the traditional German doctrine concerning third-party beneficiary contracts, claimants other than the parties to the contract may seek compensation for damages caused by insider trading. At an early stage it was proposed to allow such claims under both contract and tort theories as an emergency solution. Such a protective effect for third parties, however, clearly conflicts with the will of the contracting parties, who have

[299] Case 29/84, [1985] E.C.R. 1662, 31 *RIW* 584 (1985); see also Case 300/81, [1983] E.C.R. 449 (concerning non-transformation of the First Banking Law Harmonization Directive of 1977 by Italy: steady practice of state administration which can freely be changed and is insufficiently known is no defense).

agreed to recognize the Insider Trading Guidelines only between themselves. Moreover, both the lack of privity of contract and the inability to define the group of persons entitled to be protected argue against the view that contractual recognition of the Insider Trading Guidelines between an insider and his company can have any protective effect in favor of the shareholders of that company.

Nor are there many prospects under traditional tort law for implementing the voluntary Insider Trading Guidelines for the benefit of third parties. Under German law, mere injuries to assets, unconnected with damage to tangible legal goods (such as body, health or property), are not compensable unless malicious action can be shown. While there are exceptions to this rule where there has been infringement of a federal or state law intended to protect a given group of parties, it is highly doubtful that such exceptions can be said to be applicable in the case of an infringement of voluntary codes, guidelines and directives. Courts have rightly been reluctant to assert that professional regulations have the character of protective law, because such a holding would give the professional circles involved the power to decide proper compensation for third-party claimants.

In the meantime there have been developments in German law that lie between the traditional legal categories of contract and tort. These developments, which are still very controversial, involve theories of quasi-contract or quasi-tort obligation,[300] and have particular importance in the area of professional liability.[301] Just as an investment consultant who publicly states that he will observe his professional duties toward all investors develops a relationship of trust and obligation toward them, the declaration of an insider that he recognizes the Insider Trading Guidelines might be regarded as constituting a similar relation to corporate shareholders.[302] This argument is somewhat similar to the shingle theory under US securities regulation.[303] Yet it is only

[300] See J. KÖNDGEN, *Selbstbindung ohne Vertrag* 283-417 (Tübingen 1981).

[301] For Germany, see MERTENS, "Deliktsrecht und Sonderprivatrecht – Zur Rechtsfortbildung des deliktischen Schutzes von Vermögensinteressen," 178 *AcP* 227, 248 (1978); HOPT, "Nichtvertragliche Haftung ausserhalb von Schadens- und Bereicherungsausgleich. Zur Theorie und Dogmatik des Berufsrechts und der Berufshaftung," 183 *AcP* 608 (1983); for France see G. VINEY, 4 *Traité de droit civil, Les obligations, la responsabilité: conditions*, at nos. 243-244 (p. 299 et seq.) (Paris 1982); for Great Britain, see A. DUGDALE & K. STANTON, *Professional Negligence* (London 1982); for the US, see, e.g., ZUCKERT, "Professional Responsibility," in *Annual Survey of American Law* 107 (1982).

[302] KÖNDGEN, *supra* note 300, at 37 et seq.; HOPT, "Berufshaftung und Berufsrecht der Börsendienste, Anlageberater und Vermögensverwalter," in *Festschrift für Robert Fischer* 237 (M. Lutter, W. Stimpel & H. Wiedemann eds., Berlin 1979).

[303] See in the context of duties of banks and brokers to warn their clients in certain cases of insider abuses, HOPT, *supra* note 112, at 353-59.

most recently that such an obligation has been discussed in the legal literature and it has not been recognized by the German judiciary.

It can be concluded that the status of self-regulation in the shadow of Community law is precarious. The EC Commission should recognize this weakness and take it into account before settling for an insider trading directive that not only leaves out sanctions for lack of competence, but also implicitly allows implementation by voluntary national arrangements.

Another more general conclusion is that the traditional neat division between the EC competence for enacting directly or indirectly substantive law and the Member States competence for sanctions and enforcement is a dated model. Thought should be given to the problem of how to overcome this division politically and, as far as possible, already legally. Europe too needs less law in the books and more law in action.

IV. Status, Difficulties and Prospects of Integration

A. The State of Harmonization of Company and Capital Market Law: A Preliminary Table of Contents[304]

1. Company Law

a. Company Law Harmonization

i. Directives Adopted

First Directive of 9 March 1968[305]	"*The Publicity Directive*": Deals primarily with the uniformity of minimum disclosure provisions for company information,

[304] The following is an updated version of a table taken from HOPT & HEHL, *supra* note 14, Table 18 at 307-08. See also:
- generally: Second Commission Report on the Realization of the Aims of the White Paper, *supra* note 116, annexes 1-3;
- for company law: "Stand des europäischen Gesellschaftsrechts," [1985] *Die Bank* 310-11; PIPKORN, "Der Einfluß des Europäischen Gemeinschaftsrechts auf das Unternehmens- und Betriebsverfassungsrecht," in *Integrationsrecht. Beiträge zu Recht und Politik der Europäischen Gemeinschaft* 33-60 (J. Schwarze ed., Baden-Baden 1985)(hereinafter cited as SCHWARZE];
- for capital market law: SÉCHÉ, "Perspectives européennes du droit du marché des capitaux," 38 *WuR* 193-204 (1986), with a long annex at 204-66;
- for banking law: TROBERG, "Bankrechtskoordinierung in der EG – Ein Überblick," 39 *ZGesKW* 608-16 (1986); see also *infra* note 344.

For a complete documentation of the legal literature concerning the various measures adopted or proposed up to 1984 see LUTTER, *supra* note 117.

[305] J.O. L 65/8 (14 Mar. 1968).

	both as provided in the commercial register and in the press. It also settles a few technical questions of company law (validity of commitments made by company organs, nullity of improperly established companies).
Second Directive of 13 December 1976[306]	"*The Capital Directive*": Deals exclusively with stock corporations. Its aim is to coordinate conditions of establishment, and to provide for the maintenance of the company's minimum or stated capital.
Third Directive of 9 October 1978[307]	"*The Merger Directive*": Concerns the merger of stock corporations subject to the same national laws and also lays the foundation for the planned harmonization of the law on international mergers.[308]
Fourth Directive of 25 July 1978[309]	"*The Accounts Directive*": Regulates accounting, balance sheets and the content and publication of the annual report of all kinds of limited companies.
Sixth Directive of 17 December 1982[310]	"*The Corporate Split-Up Directive*": Concerns the splitting-up of stock corporations through takeovers and reincorporations. It is therefore connected with the Third Directive (the merger directive).
Seventh Directive of 13 June 1983[311]	"*The Groups of Companies Accounts Directive*": Complements the Fourth Directive by setting up the common framework for the annual reports of groups of companies, notably transnational corporations.
Eighth Directive of 10 April 1984[312]	*"The Auditor Directive"*: Deals with the admission and qualification of auditors.

306 O.J. L 26/1 (30 Jan. 1977).
307 O.J. L 295/36 (20 Oct. 1978).
308 See *infra* notes 316 & 331.
309 O.J. L 222/11 (14 Aug. 1978). This directive is also known as the "Annual Accounts Directive" or the "Balance Sheets Directive."
310 O.J. L 378/47 (31 Dec. 1982).
311 O.J. L 193/1 (18 July 1983).
312 O.J. L 126/20 (12 May 1984).

ii. Proposed Directives

Proposal for a Fifth Directive of 9 October 1972,[313] amended on 19 August 1983[314]	*"The Structural Directive":* Deals with the structure of the corporation and the powers and obligations of its bodies. The main problem with this directive lies in the labor co-determination question.[315]
Proposal for a Tenth Directive of 14 January 1985[316]	*"The Transnational Merger Directive":* Concerns the merger of stock corporations not subject to the same national law. It complements the Third Directive (the merger directive) and tries another method after the failure of the transnational merger agreement.[317]
Proposal for an Eleventh Directive of 29 July 1986[318]	*"The Publicity of Branches Directive":* Deals with the uniformity of minimum disclosure provisions for branches of foreign companies.
Proposal for a Directive of 5 May 1986[319]	*"The GmbH & Co. Directive":* Reacts to the non-inclusion of the GmbH & Co. in the German transformation of the Fourth and Seventh Directives.[320]
Proposal for a Directive on Procedures for Informing and Consulting the Employees of Undertakings with Complex Structures, in particular Transnational Undertakings, of 24 October 1980,[321] amended on 13 July 1983[322]	*"The Vredeling Directive":* Deals with information and consulting procedures for employees of a subsidiary on the activities and prospects of the parent enterprise and all its subsidiaries.[323]

313 J.O. C 131/49 (13 Dec. 1972).
314 O.J. C 240/2 (9 Sept. 1983); also in *Bull. EC*, Supp. 6/1983. See *infra* note 360.
315 See § IV.B, *infra* at pp. 259-62. *Cf.* also EC COMMISSION, "Green Paper," *supra* note 54.
316 O.J. C 23/11 (25 Jan. 1985).
317 See *infra* note 331.
318 O.J. C 203/12 (12 Aug. 1986).
319 O.J. C 144/10 (11 June 1986).
320 See § III.B.1.e, *supra* at pp. 240-41.
321 O.J. C 297/3 (15 Nov. 1980).
322 O.J. C 217/3 (12 Aug. 1983).

iii. Prepared Directives

Ninth Directive of 1974/75,[324] amended 1985[325]	*"The Groups of Companies Law Directive":* To date, a lengthy preliminary draft for the coordination or creation of national laws governing affiliated enterprises, especially groups.

- Directive on liquidation of stock corporations[326]
- Directive on capital and merger of limited liability companies

b. European Community Company Law

i. Regulations Adopted

Regulation of 25 July 1985[327]	*"The European Economic Interest Grouping":* Provides for the creation of a flexible legal association form for transnational cooperation.[328]

ii. Proposed Regulations

(Amended) proposal for a Regulation of 30 April 1975[329]	*"The Statute on the European Stock Corporation (Societas Europaea)":* Concerns the creation of a new European form of stock corporation to supplement the national forms.

323 Even if this directive does not contain company law, strictly speaking, it should be mentioned in this context because of its various links with the "Structural Directive"; *cf.* PIPKORN, "The Draft Directive on Procedures for Informing and Consulting Employees," 20 *C.M.L. Rev.* 725 (1983); PIPKORN, "Die Mitwirkungsrechte der Arbeitnehmer aufgrund der Kommissionsvorschläge der Strukturrichtlinie und der Richtlinie über die Unterrichtung und Anhörung der Arbeitnehmer," 14 *ZGR* 567-93 (1985); WESTERMANN, "Tendenzen der gegenwärtigen Mitbestimmungsdiskussion in der Europäischen Gemeinschaft," 48 *RabelsZ* 123, 169-79 (1984) (with English summary); KOLVENBACH, "Die Europäische Gemeinschaft und die deutsche Mitbestimmung," 39 *DB* 1973, 1976-78 (1986).

324 Doc. No. XI/328/74, Doc. No. XI/593/75, Doc. No. XI/215/77.

325 Doc. No. III/1639/84; the text (without the comments) can also be found in 14 *ZGR* 446-65 (1985). See also the short introduction by LUTTER, *ibid.* at 444.

326 Doc. No. XV/43/87.

327 O.J. L 199/1 (31 July 1985).

328 See § III.B.2.b, *supra* at 246.

329 *Bull. EC*, Supp. 4/1975. See § III.B.2.a, *supra* at pp. 244-45.

c. Agreements Among Member States

i. Not in Force

Agreement of 29 February 1968[330]	*"The Recognition Agreement":* Regulates the mutual recognition of companies and legal persons, including the legal consequences of such recognition.

ii. Draft Agreements

Draft Agreement of 1972[331]	*"The Transnational Merger Agreement":* Deals with the merger of stock corporations not subject to the same national law. It has been dormant since and now seems to have been superseded by the Draft Tenth Directive.

2. Capital Market Law[332]

a. Free Movement of Capital[333]

i. Directives Adopted

First Directive of 11 May 1960[334]	Represents the first important step toward realization of the principle stated in Article 67, but this liberalization refers only to exchange regulations.
Second Directive of 18 December 1962[335]	Amends and modifies the First Directive.
Directive of 20 December 1985[335a]	Modifies the First Directive concerning the liberalization of circulation of investment shares.
Directive of 17 November 1986[336]	The first step toward implementing the Commission's program for the liberalization of capital movements announced in May 1986. Modifies the First Directive concerning further liberalization particularly for long-term commercial credit, transactions in quoted and unquoted securities and admission of securities to the capital market.

330 *Bull. EC*, Supp. 2/1969. To date this has not yet been ratified by all of the Member States.

331 *Bull. EC*, Supp. 13/1973.

332 See (as of 1986) SÉCHÉ, *supra* note 304; see also GERICKE, "Harmonisierung der Börsenbestimmungen innerhalb der Europäischen Gemeinschaft" 35-44 (Frankfurt Stock Exchange, Annual Report 1981).

333 See generally *supra* notes 115 & 116. On the free movement of trust payments and the Directive of 30 July 1963, see SÉCHÉ, *supra* note 304, at 204-05.

334 J.O. L 43/921 (12 July 1960).

335 J.O. L 9/62 (22 Jan. 1963).

335a O.J. L 372/39 (31 Dec. 1985).

336 O.J. L 332/22 (26 Nov. 1986). See *supra* note 116.

ii. Prepared Directives

– Second step toward implementing the liberalization program of May 1986, expected for the end of 1987.[336a] It will concern money and currency transactions.

b. European Community Codes

Commission Recommendation of 25 July 1977[337]	*"The Securities Transaction Code":* Sets up conduct rules for securities transactions.

c. Capital Market Law Harmonization

i. Directives Adopted

Directive of 5 March 1979[338]	*"The Stock Exchange Admission Directive":* Deals with the conditions for admission of securities to official quotation on a stock exchange.
Directive of 17 March 1980[339]	*"The Stock Exchange Prospectus Directive":* Coordinates the conditions for control and distribution of the prospectus required to be published when securities are admitted to official quotation on a stock exchange.
Directive of 15 February 1982[340]	*"The Stock Exchange Information Directive":* Ensures regular reporting by companies admitted to official quotation on a stock exchange.
Directive of 20 December 1985[341]	*"The Investment Company Directive":* Intended to unify the legal and administrative powers of the bodies responsible for collective investment in securities.
Directive of 22 June 1987[341a]	*"The Stock Exchange Prospectus Recognition Directive":* Ensures mutual recognition of national stock exchange prospectuses.

[336a] See *supra* note 116.

[337] See *supra* note 119, O.J. L 212/37 (20 Aug. 1977); textual corrections in O.J. L 294/28 (18 Nov. 1977). See § III.A.3, *supra* pp. 231-32.

[338] O.J. L 66/21 (16 Mar. 1979).

[339] O.J. L 100/1 (17 Apr. 1980).

[340] O.J. L 48/26 (20 Feb. 1982).

[341] O.J. L 375/3 (31 Dec. 1985). See LAUX, "Europäisches Investment-Recht setzt neue Maßstäbe," [1986] *Die Bank* 189-96 (Apr. 1986).

[341a] O.J. L 185/81 (4 July 1987).

ii. Proposed Directives

Proposal for a Directive of 13 January 1981,[342] amended on 19 July 1982[343]	*"The Prospectus Directive":* Intended to coordinate the conditions for distribution of the prospectus when making public securities offerings.
Proposal for a Directive of 23 December 1985[343a]	*"Block Trading Disclosure Directive":* Intended to ensure disclosure in case of acquisition or sale of an important participation in a company with officially quoted securities.
Proposal for a Directive of 22 April 1986[343b]	Intended to amend the Investment Company Directive concerning court actions.
Proposal for a Directive of 11 June 1986[343c]	Intended to amend the Investment Company Directive concerning investment limits.
Proposal for a Directive of 25 May 1987[343d]	*"Insider Trading Directive":* Intended to outlaw the core of insider trading in officially quoted securities.

iii. Prepared Directives

- Directive on take-over bids[343e]
- Directive on investment advisers[343f]
- Directive on admission conditions for stockbrokers

342 O.J. C 355/39 (31 Dec. 1980); for the Opinion of the Economic & Social Committee, see O.J. C 310/50 (30 Nov. 1981).
343 O.J. C 226/4 (31 Aug. 1982).
343a O.J. C 351/35 (31 Dec. 1985).
343b O.J. C 129/5 (28 May 1986).
343c O.J. C 155/4 (21 June 1986).
343d O.J. C 153/8 (11 June 1987).
343e Doc. No. XV/63/87 rev. 1.
343f Doc. No. XV/73/87.

3. Banking Law[344]

a. Freedom of Establishment and of Provision of Services

i. Directives Adopted

Directive of 28 June 1973[345]	Removes the restrictions on freedom of establishment and free provision of services for the independent activity of credit institutions and other financial institutions.

ii. Proposed Directives

Proposal for a Directive of 4 February 1985,[346] amended on 22 May 1987[346a]	Concerns the freedom of establishment and to provide services of mortgage banks.

b. Banking Law Harmonization

i. Directives Adopted

First Banking Law Harmonization Directive of 12 December 1977,[347] modified by a Directive of 8 July 1985[348]	*"First Bank Supervision Directive":* Coordinates provisions on the commencement and exercise of the activities of credit institutions.

[344] As to the European policy (free circulation of "financial products," minimum harmonization of surveillance and home country control), see White Paper, *supra* note 116, at Part 2, Ch. IV, Nos. 101 et seq. See, as of 1986, TROBERG, *supra* note 304; see also H.-C. HAFKE, *Bankrechtskoordinierung in der EG* (Europa-Institut, Saarbrücken 1984); *Das Bankwesen im Gemeinsamen Markt* (U. Blaurock ed., Baden-Baden 1981); CLAROTTI, "La Coordination des législations bancaires," 25 *Revue du Marché Commun* 688 (1982); CLAROTTI, "The Harmonization of Legislation Relating to Credit Institutions," 19 *C.M.L. Rev.* 245 (1982); IMMENGA & SCHÄFER, "Die Schaffung eines europäischen Bankenmarktes," 39 *WM* 2 (1985). More attention should be given to the setting up of an integrated European payment system which would entail mor liberalization, but also quite a number of rather technical harmonization steps (bank accounts, bank giro mechanisms, electronic transfers, transfer checks, Euro checks, credit cards, overdraft safety devices for individual transaction use and for systemic risks etc.).

[345] O.J. L 194/1 (16 July 1973).

[346] O.J. C 42/4 (14 Feb. 1985).

[346a] Doc. COM(87) 255 final (22 May 1987).

[347] O.J. L 322/30 (17 Dec. 1977). See also GAVALDA, "La première directive des législations bancaires de la C.E.E.," 15 *R.T.D.E.* 227-44 (1979).

[348] O.J. L 183/19 (16 July 1985).

Directive of 13 June 1983[349]	*"Consolidated Bank Supervision Directive":* Unifies the supervision of credit institutions on a consolidated basis. Concerns only cases where a credit institution is the sole or partial owner of another credit or financial institution.
Directive of 8 December 1986[350]	*"The Bank Accounts Directive":* Coordinates the provisions on annual reports of banks and other financial institutions and is therefore closely connected with the Fourth Directive on annual reports of limited companies.

ii. Proposed Directives

Proposal for a Directive of 23 December 1985[351]	*"Bank Rescue and Liquidation Directive":* Concerns harmonization of the provisions on the rescue and liquidation of banks and other financial institutions.
Proposal for a Directive of 7 August 1986[352]	*"The Publicity of Bank Branches Directive":* Deals with the publication of annual accounts of a foreign bank by its national branch(es).
Proposal for a Directive of 18 September 1986[353]	*„Liable Funds Directive":* Concerns harmonization of the concept of liable funds of banks.

iii. Prepared Directives

- Second Banking Law Harmonization Directive complementing the First Directive of 1977.

iv. Recommendations Adopted

Commission Recommendation of 22 December 1986[354]	Recommends control of granting large bank credits.
Commission Recommendation of 22 December 1986[355]	Recommends introduction of a system of bank deposit insurance.

[349] O.J. L 193/18 (18 July 1983).
[350] O.J. L 372/1 (31 Dec. 1986). See KRUMNOW, "Die Analyse von Bankbilanzen mit Blick auf die EG-Bankbilanzrichtlinie," 47 *DBW* 554 (1987).
[351] O.J. C 356/55 (31 Dec. 1985).
[352] O.J. C 230/4 (11 Sept. 1986).
[353] O.J. C 243/4 (27 Sept. 1986).
[354] O.J. L 33/10 (4 Feb. 1987).
[355] O.J. L 33/16 (4 Feb. 1987).

B. Difficulties of Integration: The Example of Worker Participation on Company Boards (Codetermination)

European company and capital market law integration has made progress, if one looks at the tables above one would even say surprising progress, in the last years. Yet this should not blind one to the considerable difficulties that remain. A particularly marked example of these difficulties and of the compromises that may be necessary to enact a directive is presented by the proposals for worker participation (codetermination) in the Fifth Directive and in the statute for the *Societas Europaea.*

1. The History

As long ago as 1972, the proposal for the Fifth Directive (which governs the harmonization of corporate structures within the Member States), provided for the compulsory introduction of a dual system of management, encompassing both a board of directors and a supervisory board. This was intended to facilitate worker participation by creating a company organ on which workers might be represented, but which would not be responsible for direct management decision-making. Participation on the supervisory board itself might be allowed either through a representation model or a co-optation model.[356]

The European Parliament expressed reservations about the worker participation question. In 1974, the Economic and Social Committee was unable to adopt a unanimous opinion on the issue.[357] But in 1979, unexpectedly and indeed as a result of internal tactical maneuvers, the Legal Affairs Committee adopted the *Schmidt* Report,[358] which was even more favorable to employee representation than the quasi-parity between owners and workers laid down in the German codetermination law of 1976. Not so unexpectedly this report was

[356] J.O. C 131/49 (13 Dec. 1972), especially Art. 4 of the proposal. *Cf.* NIESSEN, "Zum Vorschlag einer 'europäischen' Regelung der Mitbestimmung für 'nationale' Aktiengesellschaften," 2 *ZGR* 218 (1973); LUTTER, "Die Entwicklung des Gesellschaftsrechts in Europa," 10 *EuR* 44, 64 et seq. (1975); CONLON, "Industrial Democracy and EEC Company Law: A Review of the Draft Fifth Directive," 24 *I.C.L.Q.* 348 (1975); LANG, "The Fifth EEC Directive on the Harmonization of Company Law," 12 *C.M.L. Rev.* 155 (Part I), 345 (Part II) (1975); PIPKORN, "Die Diskussion über die wirtschaftliche Mitbestimmung der Arbeitnehmer in der EG," 31 *Europa Archiv* 376 (1976); SCHMITTHOFF, "Company Structure and Employee Participation in the EEC, The British Attitude," 25 *I.C.L.Q.* 611 (1976). For recent reviews see HOPT, *supra* note 54; HOPT, "New Ways in Corporate Governance – European Experiments with Labor Representation on Corporate Boards," 82 *Mich. L. Rev.* 1338 (1984); WESTERMANN, *supra* note 323; KOLVENBACH, *supra* note 323, at 1973-78, 2023-26.

[357] O.J. C 109/9-16 (19 Sept. 1974). Compare the later Opinion of the Economic & Social Committee, in O.J. C 94/2 (10 Apr. 1979).

[358] European Parliament, Session Doc. No. 136/79 (7 May 1979).

rejected by a newly constituted Legal Affairs Committee, in favor of the politically more balanced *Geurtsen* Report in 1980.[359] As provided in this later report, worker participation would be required only in companies of more than 2,000 employees, and the Member States would be permitted to choose any one of four models of participation resembling arrangements already existing within the Member States. This report is both flexible and realistic, but is open to the objection that it concerns only the form and not the substance of codetermination. The requirement that the Commission present a status report in a few years and, if necessary, make proposals for amendments does not answer this objection. Despite the continuing controversy surrounding the issue, the Commission enacted the final draft of the Fifth Directive in July 1983.[360] This draft calls for compulsory codetermination in any company with more than 1,000 employees, but allows companies to choose between a dual or unitary board structure. The remainder of the draft basically remains unchanged from the *Geurtsen* Report. It is interesting to note that the new Article 100A of the EEC Treaty for obvious reasons has been discarded as far as the position of employed persons both in company and labor law is concerned (Article 100A section 2).

The worker participation regulation contained in the amended proposal for the *Societas Europaea*[361] is no less controversial than the proposal in the harmonization directive. Based on an initiative of the European Parliament, the proposal provides for a mixed model of supervisory board, in which two-thirds of the board is made up of shareholder and worker representatives, and the final third is elected by a two-thirds majority of those representatives. The proposal also calls for the creation of a so-called European work council and group council for business combinations. This codetermination proposal within the draft, together with other factors, accounts for the total political failure of the draft so far.[362]

2. The Political Context

The tremendous difficulty in arriving at a compromise on the participation question is primarily the result of the same controversies that have preceded the enactment of the participation laws within the Member States themselves. These laws have been adopted only recently (Netherlands in 1971; Denmark in 1973 and 1980; Luxemburg in 1974; Germany in 1976; Ireland, for na-

[359] European Parliament, Session Doc. No. PE 62045 (5 May 1980).

[360] See generally KOLVENBACH, "Die Fünfte EG-Richtlinie über die Struktur der Aktiengesellschaft (Struktur-Richtlinie)," 36 *DB* 2253 (1983); VERBAND DER HOCHSCHULLEHRER FÜR BETRIEBSWIRTSCHAFT (Kommission Organisation), "Stellungnahme zum Entwurf einer 5. EG-Richtlinie (Struktur der AG)," 47 *DBW* 538 (1987).

[361] *Bull. EC*, *supra* note 285, Art. 74a, at 137-45.

[362] See § III.B.2, *supra* pp. 244-45.

tionalized firms, in 1977) and represent the outcome of long, deep-seated political conflicts.[363] Because these laws represent such hard-fought compromises, there is great resistance at the national level to enacting new changes based on European Community law.

Much of the sensitivity on the workers' side toward the participation question comes from the trade unions, which are seeking to gain greater legitimacy with their members during a recessionary period that threatens to undermine the political influence gained by the unions. This resistance was well demonstrated in Germany when the Mannesmann firm revised its group structure arrangements and as a consequence would have escaped the full-parity coal company codetermination requirements and instead would have been subject only to the general quasi-parity participation rules of the 1976 Codetermination Law. Feelings in this dispute ran so high that the then Parliament fixed the existing participation structure in Mannesmann through a special law, demonstrating that any change in workers' influence was politically unfeasible.[364]

In several other countries that have been Member States of the Community for some time or have recently joined, internal political debate on the participation question has not yet reached a conclusion. Although debate was particularly lively in Britain following the 1976 *Bullock* Report[365] and the 1978 Labour White Paper on industrial democracy, it has completely died down under the Conservative Government. For the moment, a far-reaching legalistic model of participation similar to the German pattern is out of the question there. In France,[366] the first serious discussion on worker participation took place based on the *Sudreau* Report in 1975, but without any concrete outcome. The Socialist Government revived the debate, however, and introduced a specific French model of worker participation. Other countries, such as Italy,[367] Greece and Spain, are very skeptical about the idea of worker participation. Since the lines of combat between employers and unions in these countries are still largely characterized by class-struggle stereotypes, little progress appears imminent.

363 HOPT, *supra* note 54, at 212 et seq.

364 See the references cited *id.* at 223-24. Under the present Government there seems to be no willingness to repeat this operation when a similar occasion arises.

365 For a comment on the *Bullock Report* see KLEIN, "Mitbestimmungspläne in Großbritannien," 23 *RIW/AWD* 415 (1977); DAVIES, "The Bullock Report and Employee Participation in Corporate Planning in the UK," 1 *J. Comp. Corp. L. & Sec. Reg.* 245-72 (1978).

366 *Cf.* BLANC-JOUVAN, "La participation des travailleurs à la gestion des entreprises en droit français," in *Mitbestimmung der Arbeitnehmer, supra* note 54, at 33-59; and recently, GUYON, "Die neuere Entwicklung des Französischen Gesellschaftsrechts," 14 *ZGR* 74, 92-94 (1985).

367 RUNGGALDIER, "Fragen der betrieblichen Arbeitnehmervertretung in Italien," in *Mitbestimmung der Arbeitnehmer, supra* note 54, at 123-61.

Thus far, the difficulties of legal integration discussed in this study have involved problems of getting the Member States to agree to one or more common participation models. Much greater difficulties arise when efforts toward integration go beyond mere legal harmonization of national laws and seek functional harmony among the Member States. Such functional progress is initially limited by a lack of empirical data. Even in the area of national laws, academic findings on the effects of the various types of worker participation models are limited to untested theoretical models and practical experience that is difficult to generalize.[368] It is still unclear, for instance, whether participation has more drawbacks (creation of conflicts of interest for worker representatives on company bodies, threats to business secrecy, delays in decision-making, non-market influences on the content of decisions), or more advantages (building trust between the social partners, greater company disclosure in the interest of the workers and the public, more careful decisions on basic company matters, and greater social justice). There is even greater uncertainty as to the consequences of transferring the German worker codetermination model to other Member States, which may have very different frameworks for labor law, labor conflict, worker attitudes, trade union behavior and influence, etc. The lack of socio-economic data, particularly as to consequences of such changes, presents problems at both the national level and at the European level. Not even an expert study based on national experience (such as the German Codetermination Commission undertook in the *Biedenkopf* Report of 1970[369]) can be found in Brussels, far less an investigation with the depth of a typical US Congressional hearing. Without such preparation and in-depth inquiries it is very likely that in such difficult areas of integration as worker participation it will be politically impossible to achieve harmonization; or, if harmonization can be managed by political coincidence and compromise, it is probable that such harmonization will not lead to integration, since it would be only superficial, with formal harmony but functional diversity.[370]

C. Prospects for Integration

1. Extent, Speed and Effectiveness of Integration

As can be seen from the preceding two sections, questions of potential areas for integration of European company and capital market law, as well as the content and reach of the law to be harmonized, can be given only tentative

368 See on the following HOPT, "New Ways in Corporate Governance," *supra* note 356, at 1353-63.

369 Bericht der Sachverständigenkommission, *Mitbestimmung im Unternehmen* (1970) ("Biedenkopf Report"), 1970 BT/Drucks. VI/334.

370 *Cf.* WESTERMANN, *supra* note 323, at 179-82.

answers. Specific questions remain as to the extent, speed, and effectiveness of integration, each of which will be discussed separately here.

a. Extent

The extent to which European law will be harmonized has broadened over the history of the Community. While in the early 1960's it seemed as if the Commission wished to confine itself to harmonizing only core areas of company law, it has become increasingly clear since at least the mid-1970's that the Commission is attempting a much broader harmonization of the whole of company and capital market law. The First Directive on company law harmonization was fairly limited, and dealt primarily with the protection of commerce in transnational trade. It also touched briefly on such areas as disclosure and commercial law, the validity of the actions of various corporate organs vis-à-vis third parties, and the effects of the nullity of defectively formed companies. By comparison, later efforts reached much further and were far broader, as for example was the case with the Fifth Draft Directive covering the whole structure of the corporation. Undoubtedly there is some attraction in the idea of harmonizing not by bits and pieces, but by trying to map out consistent regulation for a whole area. Yet the fate of the Fifth Directive and the even less encouraging controversies on the harmonization of the law of groups, where not even the Commission has yet reached internal agreement in itself, show that such harmonization by big jumps ahead is very difficult indeed. It may be that it is not completely impossible, as the final adoption and transformation of the Fourth and Seventh Directives shows. But it is more likely that European harmonization by directives will progress by small steps, piece by piece, and in the hands of specialists without much political appeal to a broader European polity.[371] The most recent proposals for directives seem to support this prognosis. Further proof is provided by the proposed subjects of envisaged harmonization, such as takeover bids, sales of controlling interests, treatment of brokerage shares, regulation of insider trading, integration of stock exchanges, concentration of dealings on stock exchanges, securities clearing among Member States, regulation of investment advisers, canvassing, stock brokerage activities, the treatment of non-exchange stock transactions, etc. The real difficulty lies in avoiding both too perfectionist a harmonization and complete reliance on the new formula of mutual recognition of present day national (corporate, capital market and banking) law. This is of course a dilemma well known in business and antitrust law: too much law impairs the development and the innovativeness of the markets, too little law leads to abuses and ultimately to the perversion of the free markets themselves. The answer may lie in the elaboration of market law (framework policy) and key rule harmonization (which is not the same as minimum harmonization).

[371] KRIEGER, *supra* note 238, at 185 et seq. But see also SCHWARTZ, *supra* note 138, at 361 et seq.

b. Speed

Despite the successes in legal harmonization of recent years, the ambitious program set by the Commission seems destined to take a very long time. The Member States take their time not only in agreeing on bits and pieces of the harmonization program as such, but also in transforming adopted directives into national law. In this respect, the First Directive already set a bad example. The first Commission proposal for the Directive dates back to early 1964 (not counting the preparatory phase); the Directive itself was not adopted by the Council until 1968; and the last Member State to transform it into law was Belgium, in March 1973. The Directive itself had provided for a time limit on national enabling legislation of only eighteen months from March 1968. Nine years went by before the Second Directive was adopted in 1976, even though the main reason for this may have been the intervening accession of three new Members to the Community. But transformation of the adopted directive is taking even longer, and by 1985 had still not yet been generally done. It is true that since 1976 the pace has been quicker. But delays in the conversion of directives to national law continue, contrary to the Treaty. The sad example of the Fourth Directive, for which the two-year adaptation period expired in mid-1980, but which even in 1986 has still not been implemented by every Member State, has already been described above.[372] As reported there, the Commission has in several instances brought proceedings against the defaulting Member States for infringement of the Treaty and has also won before the European Court of Justice.[373] Yet up to now this seems not to have changed the pattern. It rather seems an accepted fact that the harmonization process has been and remains a slow one.[374]

c. Effectiveness

Effectiveness presents another challenge to European integration. Even in areas where national enabling laws have been passed, there is no guarantee that harmonization will in fact be achieved to the planned extent because transformation laws, even if finally enacted, tend not only to make ample use of all options reserved, but also to vary in their content even when the directive allows no leeway. This is evident already from the experience with the First Directive: A recent study on its transformation has shown that according to the letter of the law there has been more or less satisfactory adaptation of national laws to the Directive. Yet on a number of issues this seems not to in fact be the

372 See § III.B.1.d, *supra* pp. 236-39.

373 See *supra* note 242.

374 See also SCHWARTZ, "Wege der EG-Rechtsvereinheitlichung: Verordnungen der EG oder Übereinkommen unter den Mitgliedstaaten?," in *Festschrift für Ernst von Caemmerer* 1067, 1080 et seq. (H.C. Ficker *et al.* eds., Tübingen 1978).

case.[375] For example, under the German law, required by the First Directive, there is a process for verification of both the formal and substantive legal conditions of establishment by a court of registration. By contrast, France's version of the directive provides only for formal verification of correctness; whether this procedure is compatible with the object of the directive is doubtful, and it may one day be brought before the European Court. Yet whether and when this will occur is completely fortuitous. Instead there should be a procedure which methodically checks whether transformation corresponds to what the directives prescribe. It seems that at least until very recently the EC Commission was not too eager to perform this task which is understandable in view of other priorities and of constraints on resources. It may be that the best solution would be to entrust this task to some other supervisory body, perhaps one established at the national level, provided some provision is made for organizational interchanges with parallel institutions in the other Member States[376] and for total independence from the political actors who are responsible for the transformation process.

This body should also perform an additional checking function.[377] Once transformation has been accomplished that is not the end of the story. New national laws are made, perhaps not directly on the point but with effects on the harmonized law. There is a good chance that even once harmonization has been achieved it will later be eroded. While petrifaction is a danger,[378] so is intentional and unintentional erosion, which may well occur without the Community authorities being aware of it or being in a position to evaluate its impact.

Even in cases where the conversion has been word for word in all the Member States, or where it has led to identical national regulations, the area of law may still not be genuinely harmonized. Attitudes toward written law, including national law, differ considerably among the Member States, say between Germany and Italy (this is not a critique, but simply a fact due to different historical and political traditions and experiences). For this and other

375 C. FISCHER-ZERNIN, *Der Rechtsangleichungserfolg der Ersten gesellschaftsrechtlichen Richtlinie der EWG* (Tübingen 1986), for example at 200 et seq., 226, 320, 346 et seq. & 349. See also *supra* note 195.

376 Sometimes the discrepancies between a directive and a national transformation law appear only when compared with the other Member States' transformation laws. This may be because in one's own country one too easily considers certain legal concepts, solutions and traditions to be self-evident. On the other hand, only the national observer may fully understand when there is a real discrepancy, not in the letter of the law but in its practical application and functioning.

377 Similarly, TIMMERMANS, *supra* note 120, at 32-33, but leaving the task to the national bureaucracy, without taking into consideration that they may stand behind their own national solutions which they have themselves helped to bring about. See also *infra* note 384 and accompanying text.

378 See § III.B.1.g, *supra* pp. 242-43.

reasons there is a very wide scope of opinion and practice in Europe as to the proper implementation of laws. Thus, the threat remains that despite all efforts harmonization may remain merely a formality without true behavioral change.

2. The Role of Administrative Agencies

The problems created by differences in implementation of harmonized laws are well known. As discussed above,[379] effective harmonization of substantive law therefore also requires harmonization of the implementation process. This raises the question of the role of administrative agencies in European integration. For purposes of harmonization of European company and capital market law, this question comes very much down to the pros and cons of either creating a European securities and exchange commission or else harmonizing and possibly creating national capital market supervisory bodies, which could be in part self-regulating subject to some meaningful state counterpart.

Theoretically, it would be conceivable for the Commission of the European Communities to be entrusted with the tasks of such a supervisory body. Politically, however, the prospects for such action are nil. Part of this improbability is the result of tradition, because direct administrative implementation by the EC Commission (i.e., intervention powers vis-à-vis individual firms and Common Market citizens) is the exception in the law of the EEC Treaty. Administration and implementation of Community law remains principally the task of national authorities. Furthermore, it is doubtful whether assignment of further tasks to the central staff in Brussels would be effective without a proper administrative infrastructure, even if the staff were expanded. The proposal for a regulatory agency at the European level on the model of the US Securities and Exchange Commission raises similar reservations. Again, the political chances of realization are non-existent. Moreover, it is highly questionable whether such an institution, drawn on the US model with its manifold peculiarities, could be successfully transferred to the European Community.[380]

Developments in European regulation will most likely take another route, relying on national capital market supervisory bodies. These bodies are in line with national traditions, both in structure and style, and know the nuances of their respective domestic capital markets. Thus, they will choose the style of implementation appropriate for their countries – e.g., a more authoritarian style in France, or a method of moral persuasion in Belgium. The danger in this approach lies in the discrepancies that may arise in supervision and implementation of the harmonized law.

[379] See § II.C.1 *supra* pp. 212-14.

[380] See in the context of a European insider law already K. HOPT & M. WILL, *Europäisches Insiderrecht* 170-72 (Stuttgart 1973); and specifically on the SEC problem see HOPT, *supra* note 104, at 437-40.

Current examples demonstrate this danger. There are worlds of difference between, for example, the French *Commission des Opérations de Bourse* and the Italian *CONSOB*, each of which is vastly different from the Belgian *Commission Bancaire* (which despite its name is not a mere bank supervisory body, but also exercises capital market supervisory functions). Other Member States have no such capital supervisory bodies at all, nor any plans for one. Germany has no such body because the general mistrust of central bureaucratic government offices is too strong to overcome, and because it is generally believed that self-control through the security exchanges is sufficient supervision.

Nevertheless, there are indications that the drawbacks of diverse implementation can be reduced. Thus, in the area of banking law, the EC Commission has been promoting the exchange of views and cooperation among the various national bank supervisory bodies. It believes that at least at an early stage more can be achieved through such informal coordination between national authorities than through legal harmonization of substantive banking law (while the ultimate aim remains rightly home country control on the basis of harmonized key principles of surveillance[381]). The model for this is, of course, the contact committees among the national central banks, as for example the extraordinarily successful *Cooke Committee* at the Bank for International Settlements in Basle.[382] In the area of company and capital market law there could be a similar development through the activities of the IOSCO, even though for a number of reasons matters are more difficult here than in the central bank's cooperation area.[383] The EC Commission has made provision for such contact committees in several directives or draft directives.[384] At least in the financial and capital market sector, but possibly also beyond, it would be

[381] See *supra* notes 115, 116 & 344.

[382] On the Basle Committee of Bank Supervisors (Cooke Committee) see COOKE, "Supervising Multinational Banking Organizations: Evolving Techniques for Cooperation Among Supervisory Authorities," 3 *J. Comp. Corp. L. & Sec. Reg.* 244-49 (1981); *cf. infra* note 383. On the International Organisation of Securities Commissioners (IOSCO), see on the one hand HAWES, "Internationalisation Spreads to Securities Regulators" (Paper presented to the Singapore Conference 1986, *supra* note 102); and *contra* KÜBLER, "Regelungsprobleme des grenzüberschreitenden Wertpapierhandels," 40 *WM* 2 (1985).

[383] See generally the proceedings of the Conference on the Internationalization of the Capital Markets, 19-21 Mar. 1981, New York & Amsterdam, *published in* 3 *J. Comp. Corp. L. & Sec. Reg.* 199-424 (1981). The European Stock Exchanges themselves feel the necessity of interlinkage in order to face transatlantic competition (project Interbourse Data Information System, IDIS; London's affiliation to the American NASDAQ; increased cooperation).

[384] For example, Art. 52 of the Fourth Directive or Art. 20 of the Stock Exchange Admission Directive.

helpful to go further and to entrust to these committees even certain modification and implementation tasks.[384a]

There are similar examples of informal integration in both the OECD and in GATT, where the initial institutionalization of secretariats has led to substantive rules. Integration takes place through confrontation of national experts who are familiar with each other and have similar problems to overcome. Over the course of time, they arrive at more-or-less formal routines, which may later become substantive rules.

Thus, in the most favorable case, real European integration of behavior may actually be arrived at with or without detailed harmonization through the informal efforts of such committees. The real driving forces, of course, remain international competition and innovation. They urge Europe to quickly set up an attractive and competitive integrated financial and capital market system or to play a losing game with the United States and Japan.

3. The Role of the Courts

Prospects for future European integration of company and capital market law may ultimately depend on the role played by the European Court of Justice,[385] as well as by the national courts of the Member States. So far, the European Court's role in company and capital market law has been minimal. This is partially due to the use of directives as the primary instruments of legal harmonization. Such directives, as explained above, are converted into national laws that directly govern the relationships between the state and business enterprises, and between business enterprises and their shareholders and creditors. Legal disputes are therefore decided by national courts applying national law, and the European Court of Justice is not called upon to decide national controversies.

A different result might occur in a dispute (hitherto not much more than theoretical in the field of company and capital market law)[386] concerning a question of divergence of a national law from the directive. In such a case, the national court might bring the matter before the European Court of Justice for interpretation of the directive, using the preliminary ruling procedure of

[384a] See § III.B.3 *supra* p. 249, as to competence; and as to financial services, see the Padoa-Schioppa Report, *supra* note 116, at 5.2.6.

[385] See in this context LASOK, "La Cour de Justice, Instrument de l'intégration communautaire," 2 *Revue d'intégration européenne* 391-413 (1978/79); U. EVERLING, *Das Vorabentscheidungsverfahren vor dem Gerichtshof der Europäischen Gemeinschaften. Praxis und Rechtsprechung* (Baden-Baden 1986); U. EVERLING, "Rechtsvereinheitlichung durch Richterrecht in der Europäischen Gemeinschaft," 50 *RabelsZ* 193-232 (1986) (with English summary). See generally SCHWARZE, *supra* note 304.

[386] But see § III.B.1.d, *supra* pp. 236-39 (direct applicability) and § III.B.1.e, *supra* pp. 240-41 (problem of GmbH & Co.).

EEC Treaty Article 177.[387] If the European Court were to find a discrepancy between the directive and the national implementing law, the above treated question of direct applicability of the harmonization directive would then arise. Private persons (business enterprises, shareholders, creditors), however, cannot go directly to the European Court and claim such direct applicability of the directive. If the directive leads indirectly to conflicts under national law (uniform opinion is that it cannot directly be the basis for duties) then the only recourse available to the individual is to challenge the implementing act under national law, though here, too, the preliminary ruling procedure would be available.[388]

The actual behavior of the national courts, therefore, is the decisive factor in deciding the role played by the European Court of Justice in European legal harmonization. It is in the national courts, however, that the divergent development of harmonized national laws has evolved from the very outset, despite all endeavors at integration and harmonization. The English courts, for instance, interpret harmonized statutes with greater respect to wording than the German courts, which are relatively flexible in their dealings with laws.[389] However, once a directive is transformed into national law few courts and lawyers appear to be aware that these national law provisions go back to Community directives, and that the Article 177 procedure is therefore available. Even if national courts and lawyers are aware of the statute's source, it is often neither easy nor enlightening to go back to the roots since Community law texts are tending to become more and more complex and detailed – they have been called readings for mandarins[390] – and there is no easily accessible preparatory works to help with the interpretation. Accordingly, if European integration by legal harmonization is to be promoted, national courts must rethink their interpretation of the application of Community level directives and the Community institutions should think of ways to facilitate this. If this were to develop, it would make a decisive contribution toward changing behavior as well as thought. In short, this is the crucial point: will national courts and others concerned begin to be truly "thinking federal."[391]

[387] The First Directive, for example, has been the object of a preliminary ruling pursuant to Art. 177 of the Treaty; see Case 32/74, Firma Friedrich Haaga GmbH, [1974] E.C.R. 1201. See generally M.A. DAUSES, *Das Vorabentscheidungsverfahren nach Artikel 177 EWG-Vertrag, Ein Leitfaden für die Praxis* (Office for Official Pubs. EC, Luxembourg 1985).

[388] ZULEEG, *supra* note 225, at 482.

[389] STEINDORFF, "Rechtsangleichung in der EG und Versicherungsvertrag," 144 *ZHR* 447, 482 et seq. (1980).

[390] See the critique by TIMMERMANS, *supra* note 120, at 28.

[391] *Cf.* ELAZAR & GREILSAMMER, "The Federal Democracy: The U.S.A. and Europe Compared – A Political Science Perspective," in I/1 *Integration Through Law, supra* note 205, at 71, 110-11, 116-17 & 120-21.

Chapter Four

The Legal Problems in Their Social Context

I. Harmonization of Company Law – At Which Level?

A. The Ongoing Process of Harmonization by European Community Directives

The study of the European attempts to harmonize company and capital law has shown that the harmonization process by means of Community directives and to a very small extent also of regulations will without doubt go on continuously, even though slowly and piecemeal.[1] This is the first, perhaps most obvious but certainly most important conclusion to be drawn. The potential and the dangers of this legal-political process are sometimes unevenly perceived and discussed either because of ideological Europeanist or states' rights fixations, or simply for the sake of political rhetoric. This study has tried to take a more analytical point of view and to suggest a new round of more open discussion on European integration from above.

Yet the present political reality of European integration and the expectable impact of the enlargement of the European Community together suggest that for some time to come a good part of the significant legal integration in the fields to which this study is addressed, at least on the legislative as opposed to the judicial scene, will take place "from below," and not, or at least not only, "from above." This is in accordance with recent findings as to legal harmonization in general.[2]

The slowdown of meaningful harmonization efforts is in any event a fact of life today. The political decision to expand the European Community and by doing so to encompass within its range nations of significantly different stages of economic development and industrial differentiation, not to mention cul-

1 See Ch. 3, § IV.C.1, *supra* at p. 262 et seq.

2 See the enlightening study by KÖTZ, "Rechtsvereinheitlichung – Nutzen, Kosten, Methoden, Ziele," 50 *RabelsZ* 1-18, esp. at 12 (1986) (with English summary).

tural and political diversity, has posed significant additional challenges also to the legal harmonization effort as recognized by the Single European Act (Article 8c of the EEC Treaty as of 1987). The comparison with the institutional history of American integration efforts that has been attempted in this study has the separate benefit of pointing out the relationship of different stages of economic and institutional development to the harmonization phenomenon. In this it may be of some separate utility as the European Community faces the task of maintaining the momentum of harmonization in a polity which transcends the received learning as to necessary conditions of economic integration.

B. The Judicial Role in Harmonization

The discussion of the American historical experience with legal integration, and of current political-economic controversies over various aspects of state-federal primacy in corporation law, broadly defined, provides suggestive if not conclusive comparative evidence concerning the particular subject matters which are best suited for integration from above, for integration from below or for continued differentiation of governing rules. The first task of this study, then, is to identify the candidates for this disparate treatment, given all the necessary and significant qualifications inherent in the different political and legal-cultural setting of the two societies.

Harmonization of rules has occurred in the United States and probably will occur in Europe at the level of case-law as well as at the level of codification. A good example of the former, suggested by the foregoing study, is the problem of defining the duty of care expected of directors of varying types of entities. Given the American history, it is to be expected that Member State courts, on the basis of the typically vague Member State code provisions applicable to this problem, can in time generate not only an adequate but an essentially similar body of case-law. Equally to the point, the experience suggests that the harmonization of this important aspect of corporation law might well be left to that jurisprudential process. The growing convergence of the Belgian, French, German and British case-law on this point provides some, admittedly inadequate confirmation that this process already has begun.[3]

Criteria for the selection of legal rules that are appropriate candidates for this form of harmonization are the same as those appropriate to the selection of candidates for harmonization at the Member State statutory level, discussed below, with one obvious but important addition. The issues for judicial treatment will turn out to be those with substantial and irreducible factual components to their statement: the treatment of fiduciary duties generally, in-

[3] See the comparative overview in B. GROSSFELD, "Management and Control of Marketable Share Companies," in *Int'l Enc. of Comp. Law*, Vol. XIII, *Business and Private Organizations*, ch. 4, pp. 50-62 (A. Conard ed., Tübingen n.d. [1973]).

cluding primarily the duty of loyalty and the avoidance of illegitimate transactions between directors and their own corporation;[4] the mentioned duty of care; perhaps – a political rather than a technical caveat – even rules governing insider trading.[5] All have in common the need for flexibility in the application of any general principle to a given transaction because of the rich variety of transactions that the imagination of motivated actors can generate.

C. The States' Statutory Role in Harmonization

Harmonization by member state statutory convergence is most likely to occur, as the American experience suggests, in those areas in which the affected business interests press for less cumbersome, more "enabling" rules of governance and in which countervailing public policy considerations are relatively trivial. The rich historical evidence of the trend of American legislation towards an essentially uniform "enabling act" structure amply demonstrates this point; nor should that trend be confused, though it is intertwined with, the "race to the bottom" aspect of excessively managerialist American codes. Rather, it is the convergence of such statutory rules as those that permit a corporation to purchase and own shares of another entity; that permit it to purchase and reissue its own shares; that permit it to issue new shares for special purposes (such as employee stock plans) upon the receipt of consideration other than that traditionally associated with capital formation; that mitigate the consequences of minor defects in the formation process; that modernize the procedures for the holding of directors' and shareholders' meetings; and a myriad other such examples that illustrates the point at issue. Though this development is not yet fully reflected in the existing company codes of Community Member States, these still may be better vehicles for the harmonization of the mentioned subjects than would be the embryonic legislative organs of the Community.

The reasons for the apparently odd situation that the harmonization even of rules that reflect little political controversy is more difficult for the Community than for individual nations have been well told in *Stein*'s story of the harmonization of European company laws,[6] and are reviewed below in a more appropriate context. For the moment it is sufficient to point out that the cost of delay in the achievement of this necessary harmonization at the Community level is small, because of the motivation already existing at the Member State level to do this job.

4 See *supra* Ch. 3, note 62.

5 *Cf.* Ch. 3, § III.B.3, *supra* at pp. 246-49.

6 E. STEIN, *Harmonization of European Company Laws*, esp. ch. 9 (Indianapolis 1971).

D. The Harmonization Process and the Public Choice Model

This aspect of the preceding story, and of the problem of choosing central or peripheral focal points for the harmonization process, is also useful for the evidence it brings to bear on the public choice hypothesis identified in this study with the specific version propounded by *Kitch*.[7] The *Kitch* thesis is not supported, though it also is not *per se* undermined, by the evidence concerning harmonization of themselves economically and politically uncontroversial corporation law provisions. First of all, the very fact that most of this harmonization occurred in the United States, and may occur in Europe, without any conflict renders it irrelevant to the public choice thesis. It is a necessary condition of that thesis, by definition, that a state interested in enacting protective legislation either feel constrained or in time objectively be constrained from doing so by the force of "competing" states' enactment of less protective legislation which draws away from the first state the very goods (investment, work force opportunities, etc.) which it was the purpose of the legislation to preserve. The story of American enabling legislation, however, demonstrates that no such fear nor such effect played a role in that harmonization process. It was each state's own preference for enabling legislation that brought this harmonization about. The pressure that each state in the American constellation felt to "go Delaware" was a pressure caused not by the economic realities postulated by the public choice theory, but by a legal, paradoxically perhaps even a federal-level legal doctrine – the Gresham's Law embodied in the internal affairs rule of the conflict of laws.[8] That alone renders the evidence of the American harmonization experience useless to prove, though it does not necessarily disprove, the public choice hypothesis. Minor franchise tax revenues may have tempted a West Virginia, but hardly a New York.

II. The Causes of Failure of Harmonization at the Member State or Community Level

What can be learned from various identifiable European failures to harmonize from below, or to achieve harmonization of law from above, particularly failures to achieve what the American experience suggests should have been easy to achieve?

[7] KITCH, "Regulation and the American Common Market," in *Regulation, Federalism, and Interstate Commerce* 9 (D. Tarlock ed., Cambridge 1981). See Ch. 1, § II.A *supra* at pp. 8-10.

[8] A. CONARD, *Corporations in Perspective* 11-16 (Mineola 1976).

A. The History of Accounting Law Harmonization

A first approach to this question is suggested by the struggle concerning the implementation of the Fourth Directive, the "accounts directive" with its supplemental Seventh Directive, the "groups of companies accounts directive," described in the preceding Chapter.[9] Why was there no automatic move for the harmonization of accounting principles at the Member State level, considering the substantial interest in such harmonization, an interest most substantial among the largest and, at least economically, most powerful enterprises?

In the United States that approximation had occurred over the years through the implicit acceptance, in state corporation law, of the Generally Accepted Accounting Principles (GAAP), an acceptance evidenced by the semantic and substantive conformity of various statutory rules to this underlying uniform accounting model. The phrasing and role of protective provisions guarding against dangerous distributions by way of dividends or by way of share repurchases in most state laws – references to terms of art such as "earned surplus" – can only be understood as an incorporation by reference of that accounting structure. This indirect harmonization apparently was adequate enough that only recently, and not with any great surge of adoption, have Model Act drafters supplied even a modicum of autonomous definitional detail in this area, autonomous enough to stand alone without overdependence on the accounting terminology and the accounting rules.[10] Nor has the other conceivable approach, explicit incorporation of GAAP by reference, found much favor; only California has gone that way[11] (while also going beyond the

[9] See Ch. 3, § IV. B.1.e *supra* at pp. 240-41.

[10] Thus, see the relatively simple definitions of distributions to shareholders contained in the present *1983 Revised Model Business Corporation Act (Exposure Draft)* § 6.40 (ABA Committee on Corporate Laws, 1983) – and these are about as complex as any operational rules contained in this Draft Revision. The commentary is of little help; see, e.g., "Official [*sic*] Comment [to § 6.21 – Issuance of Shares]," *id.* at 6-24 ff, 6-27.

[11] Thus, § 114 provides in part:

> All references in this division to financial statements, balance sheets, income statements and statements of changes in financial position of a corporation and all references to assets, liabilities, earnings, retained earnings and similar accounting items of a corporation, mean such financial statements or such items prepared or determined in conformity with generally accepted accounting principles then applicable, fairly presenting in conformity with generally accepted accounting principles the matters which they purport to present, subject to any specific accounting treatment required by a particular section of this division.

Model Act in particularizing many accounting terms of art within its new corporation law).[12]

Several reasons can be adduced for the absence of a similar development in Europe. First and foremost, the presumptive current need for legislative adoption of general principles, responding to the development of a Common Market, is less actual than apparent. The internal functioning of accounting rules – their role as a management or even as an audit tool – are met by appropriate internal standards insisted on by the large corporations for their own benefit and by definition paid for by them, in part through the use of large European accounting firms as well as European members of the Big Eight. The external needs of appropriate accounting – for example, corporations' own review of potential merger partners, and, more significant, financial institutions' necessary inquiries preliminary to large scale credit extension – again

[12] Thus, compare with § 6.40 of the *Revised Model Bus. Corp. Act, supra* note 10, the following partial statement of the law governing corporate distributions contained in Calif. Gen. Corp. Law § 500:

> Neither a corporation nor any of its subsidiaries shall make any distribution to the corporation's shareholders (Section 166) unless:
>
> (a) The amount of the retained earnings of the corporation immediately prior thereto equals or exceeds the amount of the proposed distribution; or
>
> (b) Immediately after giving effect thereto:
>
> (1) The sum of the assets of the corporation (exclusive of goodwill, capitalized research and development expenses and deferred charges) would be at least equal to 1¼ times its liabilities (not including deferred taxes, deferred income and other deferred credits); and
>
> (2) The current assets of the corporation would be at least equal to its current liabilities or, if the average of the earnings of the corporation before taxes on income and before interest expense for the two preceding fiscal years was less than the average of the interest expense of the corporation for such fiscal years, at least equal to 1¼ times its current liabilities; provided, however, that in determining the amount of the assets of the corporation profits derived from an exchange of assets shall not be included unless the assets received are currently realizable in cash; and provided, further, that for the purpose of this subdivision 'current assets' may include net amounts which the board has determined in good faith may reasonably be expected to be received from customers during the 12-month period used in calculating current liabilities pursuant to existing contractual relationships obligating such customers to make fixed or periodic payments during the term of the contract or, in the case of public utilities, pursuant to service connections with customers, after in each case giving effect to future costs not then included in current liabilities but reasonably expected to be incurred by the corporation in performing such contracts or providing service to utility customers. . . . [There is more.]

Cf. ACKERMAN & STERRETT, "California's New Approach to Dividends and Reacquisitions of Shares," 23 *UCLA L. Rev.* 1052, 1080 ff (1976).

are paid for by the large institutions, even if in this case substantial barriers to uniformity of accounting do exist. Inspections, external audits, and internal reconversion programs that shape submitted information to the common mold used by the entity which seeks to evaluate this outside information are typical on the European scene today. These external users of information indeed may prefer uniformity, but already have sunk a substantial investment in developing these mechanisms to harmonize received information pursuant to their own internal information requirements; and this sunk investment substantially reduces the pressure for a legal-political investment in the harmonization effort.

Small business, which as both American and European experience demonstrates can block, if not always initiate, new legislation, is even less of a supporter of harmonization of accounting rules. Accounting for management purposes is less critical the smaller the business, and to some degree less apparent as a need even when important. If required of these enterprises for shareholder or creditor protection purposes, it would represent a substantial cost of operations and would lead to opposition at the political level. (This is well demonstrated by the fate of efforts, in modern American state legislation, to adopt auditing by independent public accountants as a legal requirement for the information submitted by companies to shareholders.[13] A good example from the European scene is the stiff resistance of the Federal Republic of Germany to the inclusion of the GmbH & Co. in the Fourth Directive.[14]) To the extent small business itself needs to use external accounting information, a need clearly less important at the small business level, service operations have begun to develop that rent this expertise to customers which are too small to justify direct investment in the development of the expertise.

European legislation at the Member State level has traditionally overstructured accounting provisions and, probably for legitimate historical reasons, developed its own accounting semantics rather than incorporated professional semantics by reference or by implicit assumption.[15] This creates a stickiness problem because of the need to revamp Member State legislation to a degree that was not required at the American state code level. Even assuming that the accounting profession has reached the uniform "code" stage that exists in the United States, the dismantling of an obsolete legal superstructure itself is hard and meets some though minor entrenched resistance. An interesting analogous example is occurring in the United States at this time with the resistance to the Proposed Federal Securities Code of the American Law Institute (the *Loss* Pro-

[13] See "Official [*sic*] Comment [to § 16.20 – Financial Statements for Shareholders]," *Rev. Model Bus. Corp. Act, supra* note 10, at pp. 16-21.

[14] See *supra* Ch. 3, note 269.

[15] See generally D. VAGTS, "Law and Accounting in Business Associations," in *Int'l Enc. Comp. L.*, Vol. XIII, *supra* note 3, ch. 12A ([1972]).

ject).[16] Hailed as a clear improvement over the fragmented 1933 and 1934 legislation and its chaotic jurisprudential overlay, the Code nevertheless is failing to be adopted in substantial part because of the entrenched comfort of those who have learned to work with and profit from the current Byzantine situation.[17]

This, however, may only reflect a more important historical accident – the different starting positions of the respective accounting professions. The American profession by the luck of history borrowed from and has adapted one, primarily British, accounting tradition. The European accounting professions have had no single uniform basis but themselves developed to great extent from different national theoretical positions: the German *Schmalenbach* model, the Dutch model, the French concepts of *comptabilité*, etc.[18] This, as an autonomous factor, alone probably accounts for the largest single drag on international or at least European harmonization, quite apart from its role in creating the "entrenched position" conditions reviewed above which have in turn generated their own resistance to change.

This review of the reasons for the failure to achieve an expectable level of harmonization by an automatic move at the Member State level, despite the obvious desirability thereof, at the same time suggests the limits of any comparative study that simply seeks to identify and evaluate the legal rules of two different systems as such, without adequate attention to context.

B. Accounting Law Harmonization and Economic Models

The same example demonstrates once again that the *Kitch* version[19] of the public choice model of legislation in a federal system needs to be used with caution. Considerations of economic efficiency alone should have suggested the adoption of uniform accounting laws let alone principles well before now. That they are inevitable is no answer to the historically important second-order question – why has the time for the inevitable not yet arrived? If the public choice model were to be useful as explanation or as prescription, these timeframe questions would have to be answered more satisfactorily than so far at least has been the case.

The same case study on accounting rule harmonization may more profitably be considered in the context of the other model suggested as a guide to the im-

[16] AMERICAN LAW INSTITUTE, *Federal Securities Code* (Proposed Official Draft, Philadelphia, 15 Mar. 1978).

[17] See also LOWENFELS, "Recent Supreme Court Decisions Under the Federal Securities Laws: The Pendulum Swings," 65 *Geo. L.J.* 891, 922 (1977).

[18] See generally G. MUELLER, *International Accounting* (New York 1967).

[19] *Supra* note 7.

plementation of harmonization efforts in Europe, the *Scitovsky* hypothesis.[20] Confirmation of the utility of that hypothesis when tested against this briefly sketched history also should confirm the utility of the model to the specific choice of legal elements which the European Community's legal organs should attempt to harmonize, and on what priority.

This model, in its purely economic formulation, clearly could not pretend to predict that the particular harmonization effort embodied in the Fourth Directive and the Ninth Draft Directive, to take a random example,[21] would meet any particular level of resistance. It could, however, suggest that the harmonization there attempted does not deserve a high priority in the expenditure of the very limited and shrinking political capital the European Community institutions have available for this general legal harmonization enterprise.

In the context of the *Scitovsky* model accounting rules presumably would be characterized as useful because of their role as signals, among other signals, for the direction of investment towards or away from a particular firm or possibly a particular industry. Any such redirection of investment flows, however, itself would only be useful as an aid – among other aids – to the process of fostering appropriate competition in a given market. From that competition should come about the increase in productivity which it is a principal purpose, perhaps the principal purpose, of market integration to bring about.

This function of accounting rules, except in their bearing on investor protection rules, clearly is marginal when compared with more vital missions, missions more central to that core concept of supporting productivity-enhancing competition, which the European Community should accomplish. Indeed, even if it is merely compared with other aspects of this itself subsidiary issue of the reallocation of capital investment flows, such as the direct removal of barriers to the free movement of capital, it is a relatively unimportant sub-issue. It remains low in ranking even in comparison with secondary capital-reallocation missions that are themselves not directly linked with this primary productivity-enhancing mission; for example, when compared with the mission of removing national differentials in the level of the taxation of capital movements.

It is true, of course, that some of these somewhat more important capital-reallocation distorting rules are not susceptible of harmonization. An obvious candidate for harmonization is the current problem of nationally differentiated levels of income tax treatment of profits on invested capital. Yet, for logically insufficient but politically and institutionally unassailable reasons, this remains outside the jurisdictional reach of the European organs by constitutional definition: The Common Market may have fiscal power over commerce in

[20] T. SCITOVSKY, *Economic Theory and Western European Integration* (London 1958; repr. w. intro. 1962). See Ch. 1, § II.B *supra* at pp. 10-11.

[21] See *supra* note 9, and Ch. 3, § II.C.3a *supra* at pp. 222-24.

goods and services, but cannot extend that power, under any current politically realistic textual reading of the Rome Treaty, to the problem of full unification of direct taxation.[22] This, of course, has less significant political effects in Europe than would an analogous incomplete federalization of fiscal power in the United States, because indirect taxation, which traditionally has been a much larger component of the fiscal revenues of European nations than of the United States is, indeed, a primary target of European harmonization.[23] To leave direct taxation questions to a future agenda is in this context less significant. Nevertheless, and with all of these qualifications accepted, it still remains possible to assert that compared with this entire field of taxation, the drive to achieve harmonization of accounting standards through harmonization of national laws would not be given a very high priority under the model.

C. Securities Regulation and the Models

There is, to be sure, one area of company law or at least of enterprise law which under the productivity-enhancing model of the Common Market would deserve a high priority for implementation, and that is the general area of investor protection or securities regulation, understood both in the context of improving the transparency of securities markets through improved information flows and, perhaps even more significantly, of improving the legitimacy of the trading markets through substantive rules concerning the protection of minority shareholders or concerning insider trading.[24]

The formation of surplus savings and their direct investment in productive enterprise through equity investment stand not only at the top of any ranking of legal rules bearing on investment reallocation, but is critical to the larger issue of investment generation as a whole. Indeed, while this is not explicit in the *Scitovsky* model, it may rank as high as competition itself in the fostering of increased productivity, since it bears both on actual levels of surplus formation and on investors' acceptance of reinvestment behavior by producers. The model, wherever it places this surplus formation question, does not relegate it to the subsidiary role to which the reallocation function is relegated; if

[22] See the terms of the EC Commission's general program of 26 June 1967, Doc. R/959/67, in *Bull. EC*, Supp. 8/1967, discussed by SHOUP, in 3 *The Law of the European Community – A Commentary on the EEC Treaty* 452-54 (H. Smit & P. Herzog eds., New York 1981). For most recent information, see Commission Report of 19 May 1987, *supra* Ch. 3 note 116, at points 76-79 and annexes.

[23] See the early review of this high-priority agenda in HUISKAMP, "The Harmonisation of Legislation of EEC Member States Concerning Turnover Taxes," 5 *C.M.L. Rev.* 177 (1967).

[24] See K. HOPT & M. WILL, *Europäisches Insiderrecht* 123-76 (Stuttgart 1973); on the underlying principles, K. HOPT, *Der Kapitalanlegerschutz im Recht der Banken* 288-347 (Munich 1975).

anything, the model assumes an autonomous role for capital formation. Clearly the general effort to open channels of direct capital formation in institutional competition with indirect intermediation through universal banks, pension plans and the like requires the creation of conditions of confidence and legitimacy, conditions which in turn require the development of uniform rules of investor protection.[25]

The *Scitovsky* model then, suggests that this aspect of legal harmonization be given high priority. The *Kitch* model suggests that – in the long run – the enlightened self-interest of the member states of a federal system will see to similar harmonization at a substantive level tending towards the equilibrium of an efficient rule, in the sense of a rule (or a system of rules) maximizing appropriate investment flow by optimizing conditions that induce that flow, which include conditions of transparency and of substantive rules inspiring investor confidence.

The problem of trusting harmonization from below in this instance is the problem of the long run. The public choice model does suggest that significant differences in state law rules concerning investor protection should lead to the reallocation of capital if this rule differentiation in fact is or is perceived to be an important element in directing and determining the level of investment decisions. The history of American experience with state regulation, however, suggests that the long run may be too long to permit this optimistic deference to the Member States. The question is admittedly fairly debatable. The current trend towards improved investor protection regulation at the Member State level[26] at least will provide some further test of the respective ability of member state law in a federal system, as compared with potential federal law, to respond to these pressures for the development of legitimate investment formation mechanisms.

Investor protection aside, the rest of the agenda of "private" corporation law harmonization, perhaps even the rest of the agenda of "public" enterprise law harmonization, is sufficiently subsidiary and sufficiently indirect under the *Scitovsky* Common Market model to be relegated to a rather low ranking on the priority scale for European harmonization efforts. This suggestion accords with the actual experience of Community institutions in achieving that kind of harmonization. That observation, however, does not in turn suggest that the low ranking of a harmonization effort correlates with the existence of political or technical problems in the achievement of the agenda item. Resistance is simply a function of the controversial nature of any given proposal, exacerbated in general by the historical fact that on a national basis within Europe there is simply more stickiness to the existing differences of all such legislation

[25] See R. BUXBAUM, *Die private Klage als Mittel zur Durchsetzung wirtschaftspolitischer Rechtsnormen* 26-30 (Karlsruhe 1972).

[26] See Ch. 2, § V *supra* at p. 111 et seq.

than existed within the setting of the American federal union, with its identity of language, of legal culture and of institutions. It is not a function of the ranking; simple enabling law harmonization may in particular subsets rank low, yet be easy to attain. By the same token, however, that suggests that they should be equally easy to attain by harmonization from below – an institutional consideration which lends partial support, as to certain specific substantive rules only, to the policy prescription suggested by the *Kitch* model, though not to the economic logic underlying that public choice hypothesis.

D. The Process of Harmonization and the Models

An additional value of using an explicit economic model from which to derive operational suggestions for legal harmonization lies in the role of the model in defining and suggesting certain types of tools for that process. An economic model may suggest the desirability of specific legal research as a preliminary step to the process of identifying specific rules as candidates for the harmonization process. A useful example is the issue of impact research in the field of codetermination. Just as the *Balassa* field studies of the consequences of recent European integration[27] are important to the validation of the *Balassa*[28] and of the *Scitovsky* model of economic integration, so may similar studies be useful to a validation of the legal agenda suggested by that model.

Impact research on the institution of codetermination, research that seeks to answer both economic questions as to the role of codetermination in the achievement of greater productivity, and political questions as to whether codetermination improves or aggravates the effort at responsible participation in decision-making processes,[29] is a good example of this type of further work. Research on this issue would thus specifically include inquiry into: the formal changes needed to achieve one or the other of these postulated goals; the structural changes at the level of positive law (e.g., why the option of a two-tier board system recently introduced in French law has actually only been taken up by very few but important companies[30]); and behavioral consequences and patterns (e.g., whether there has been any effect on those few French companies that have chosen the two-tier system in the context of these postulated goals).

This agenda also suggests that among the institutional "tools" useful to achieve appropriate harmonization is the legal profession itself. A common

[27] See particularly *European Economic Integration*, esp. ch. 3 (B. Balassa ed., Amsterdam 1975).

[28] B. BALASSA, *The Theory of Economic Integration* (London 1962). See *supra* Ch. 1, note 25.

[29] See Ch. 3, § IV.B *supra* at pp. 259-62.

[30] See Ch. 3, § I.B.1.b *supra* at p. 179.

profession, with a common professional language, may well itself be a surrogate for a common substantive set of rules – a kind of black box whose legitimacy in society is a warrant for the appropriateness of the results, themselves not readily apparent to that society, which the professional interaction reaches in practice. There is, too, in this focus on the profession itself as a tool the opportunity to develop a unity which resembles but transcends a professional *esprit de corps* and which in a more intangible sense provides a similar surrogate for substantive harmonization. On the American scene this already old and strongly felt professional unity not only is expressed in such specific mechanisms as the Business Law Section of the American Bar Association, but in a much more significant way in the very existence of a federal judiciary that reaches to the level of trial courts in every significant American locality and that in its focus on federal law becomes a resource or magnetic point around which the otherwise centrifugal local profession develops a federal outlook by proxy.

The development of a European federal judiciary hierarchy of course cannot be recommended on the basis of this *desideratum* alone. But if achieved in whole or part for other reasons, it should yield this additional benefit, and that may bear marginally on the discussion of such an innovation.

Specific proposals are always anticlimactic; we make a few here without any claim as to comprehensiveness or to priorities, but only to suggest ways in which the preceding study might be made useful to the expected ongoing legal and social-science research into the European integration process.

III. Harmonization of Law on the Basis of Priorities Derived From Non-Economic Values

Some agenda items associated with the subjects of this study cannot be left for disposition to the rankings derived from either or indeed from any economic model alone. Certain agenda items are expressions of other values that, no matter how controversial their nature, rank high on some political scale; and may require achievement as a condition of the continued consensus of Member State polities to remain within the federal experiment.

A prime example of this agenda, and of course of the problems associated with its implementation, is the issue of codetermination, particularly codetermination at the level of company management rather than at the plant unit level. Ranked on the basis of its fit within the *Scitovsky* model – that is, ranked on the basis of its role in the achievement of the goal of capital formation or capital reallocation, goals which themselves are only ancillary to the achievement of the principal goal of increased productivity through increased competition – codetermination would rank at best no higher than an item such

as harmonization of accounting rules. Obviously, however, other aspects of the problem are paramount. The sharing of the essentially political power already exercised by large though in formal legal terms private power centers; the participation in particular decisions, such as issues concerning the work place and its preservation, that are central either to quality of life considerations or to the general ability of individuals to participate meaningfully in the larger polity – these are the issues implicated for better or worse in the codetermination debate.[31] They are issues of distributive justice or, in political terms, issues bearing on the avoidance of politically harmful disaffection with that democratic consensus on which rests collaboration not only between potentially antagonistic social or economic classes but between potentially antagonistic cultural and national groups.

A. Substantive Values and Value Disputes and Harmonization Efforts

On such issues there are of course disagreements based on underlying value disputes. A functioning democratic political process will filter and channel the placement of these issues on the political agenda of a particular polity. When, as may have been the case with codetermination in the early 1970's, the political process ranks them high on the agenda, they need to be faced though by definition they are profligate in dissipating any polity's political capital, let alone that of a fledgling political federation.

B. Process Consensus and Harmonization Efforts

A second set of extra-economic values which autonomously suggests certain priorities for federal harmonization of enterprise law, and which indeed is significantly related to this first briefly sketched set, might be characterized as process-oriented rather than as based upon any particular social or political content. The discussion of the American debate about the participation of corporations in the political arena, whether as actors or as spenders – indeed the whole question of the regulation of the role of money in securing effective participation in the political process of a complex industrialized society – exemplifies this set of issues.[32] It is a set particularly useful to identify because it is so close to a central professional concern of lawyers, the process of resolving contending claims of right and duty and contending claims to the distribution of goods; or, in brief, the process that legitimates the role of any specific legal rule among the members of the society who are affected by that rule. Har-

[31] See Ch. 3, § IV.B *supra* at pp. 259-62.
[32] See Ch. 2, § VI *supra* at pp. 155-63.

monizing and perhaps liberalizing the rules that divide the power of corporate governance between shareholders and management, as well as the rules that concern availability of access to courts by individual shareholders who wish to challenge dubious exercise of managerial power, would fit this aspect of an agenda.[33] Indeed, not only the evolution of appropriate direct and derivative actions, but the very question of the existence of a full hierarchy of "federal courts," are proper subjects for this kind of discussion.

The particular usefulness of courts, with their focus on individual transactions, as compared with that of parliaments, with their focus on rules, might be debated with reference to the American experience, since not only the institutional aspect of improved process but the substantive development of rules is clearly correlated with the different availability of judicial dispute resolution in the respective legal systems.[34]

C. Methods and Tools of Harmonization in Politically Fragmented Areas

The immediately preceding argument leads naturally to the question of methods and tools in politically fragmented areas. Here, as the preceding chapters of this study demonstrate, reflection on the American experience may be immediately suggestive to European harmonization efforts. This is meant less as a call for the transfer of formal legal or institutional tools to an obviously different system than as a call for imaginative adaptation of the many informal, particularly professional collaborative mechanisms that the American historical experience identifies.

Starting with agenda items of relatively low controversy, the simple strengthening of interstate professional groups working on those matters should be useful and of course has been proceeding at a reasonable pace in Europe during the past three decades. Even at the stage of harmonization of rules that have no particular public policy significance but are technically sticky and professionally controversial, more could be done, as the evaluation of company law harmonization during the decade of the 1960's amply demonstrates.[35] The principal lesson to be drawn from that study and from our own descriptions is that if harmonization, whether from above or below, is to succeed there needs to be organization from below, not only from above.

[33] See, e.g., AMERICAN LAW INSTITUTE, *Principles of Corporate Governance and Structure: Restatement and Recommendations*, Tentative Draft No. 1, part VII (Remedies) (Philadelphia, 1 Apr. 1982); *Corporate Governance and Directors' Liabilities – Legal, Economic and Sociological Analyses on Corporate Social Responsibility* (K.J. Hopt & G. Teubner eds., Berlin/New York 1985).

[34] AMERICAN LAW INSTITUTE, *supra* note 33, at 218-19.

[35] See STEIN, *supra* note 6, at 488 ff.

It is not coopted consultants or consultative committees appointed by EC agencies that are now important, but horizontally merged interstate consultative committees; "Uniform Law Commissioners" brought together by the Member States as equal sovereigns, and similar professional and even mixed professional-business-governmental bodies are the proper subject of consideration for the 1980's. Even the specific national-linguistic barrier that always will set off the European from the American experience may be more readily transcended by the *lingua franca* of each profession. One does not have to wait for the creation of a "European Law Institute" to conceive of beginning steps along that line.

It is also time to consider one more leaf from the American experience – the role of the individual states as laboratories of the law.[36] To some degree that has taken place in Europe at an unconscious level, as is demonstrated by the simple fact that Germany has experimented with codetermination and the Netherlands until recently provided a major example of a unitary company code (one applicable to all or most entities) in a setting in which dual company code systems are frequent. Even more deliberate and conscious experimentation, however, might be considered. Temporary Member State experiments with particular forms of insider trading control might be organized in coordination, so that a German focus on self-regulation through industry codes could be more fruitfully contrasted and compared with a French or English effort at mandating appropriate information flow or prohibiting specific forms of trading.[37] The preceding discussions have suggested this and other candidates for that kind of planned experimentation, and have also suggested the need (hardly a danger in Europe today) to avoid exorbitant and early inhibition of such experimental efforts through exorbitant and exclusionary federal preemption rules such as those that are beginning to choke American efforts to find a proper response to the excesses of the takeover bid phenomenon.[38]

The most important first step here would be to identify criteria for the selection of "candidates" for this kind of treatment, and not only criteria based on the economic model that underlies the general harmonization effort. Social science theorists have provided considerable assistance in recent decades to those engaged in this task, because of their concern with legal and institutional decision-making in areas of technical uncertainty and long-term but presently unknowable effects, typical aspects of decision-making in modern society. A proper model would focus on flexibility (admittedly more an administrative than a legislative phenomenon); reversibility, in the sense that a given decision or rule should not unnecessarily eliminate other potentially useful sequential options if it itself should prove in error; minimal impact in ecological or

[36] See Ch. 1 *supra* at p. 13.

[37] On this perspective see PRENTICE, "Take-Over Bids and the System of Self-Regulation," 1 *Oxf. J. Leg. Studies* 406 (1981); and Ch. 3, § III.B.3 *supra* at pp. 246-49.

[38] See Ch. 2, § V.C *supra* at pp. 130-54.

similar terms, other things being roughly equal; and so forth.[39] The readiness of respondents affected by a particular rule or of participants in the system affected by the rule to accept some change, while a more explicitly political criterion for agenda selection, is obviously also important to this effort.

The most significant and overriding generalization that seems to appear from this discussion is that the best approach for grassroots harmonization efforts, particularly for harmonization from below, is to conceive of and utilize grassroot tools.

The American history, and even the American experience with harmonization from above, also suggest new tools for the ongoing European effort, primarily tools that help achieve the educational or legitimating function of legal rules. A useful example is the SEC practice, a practice followed generally in the American administrative arena, of publishing proposed regulations with significant and genuinely informative statements of motivations and doubts; coupled with maximum opportunity for public and enterprise input to the rule finalization process on an itself open and publicized basis, with the arguments and proposals reciprocally routed through public dossiers to the responding community and to the general public; followed by the adoption of rules with full explanation of how the public input bore on the proposed rules and why these rules were or were not adapted, and to what degree, to that input.[40]

This example leads to emphasis on the access-to-justice theme. More openness in the governmental discussion of possible rule-making or law-making before it is formulated to the point of specific proposals; public discussion of tentative formulations and indeed of the process of formulation; full explanations of the governmental response to public participation, are themselves, taken together, simply one aspect of a wider range of possibilities. That wider range includes such tools as the federal Freedom of Information Act and its underlying value judgments; it also includes "Sunshine Act" requirements which abound at the state as well as at the federal level and govern such questions as public attendance at hearings conducted not only by legislative but by executive and administrative bodies, publication of transcripts of committee and administrative agency hearings, maximum circulation of governmental reports, and so forth.[41] This is not to suggest that any particular item in this

39 See TRIBE, "Technology Assessment and the Fourth Discontinuity: The Limits of Instrumental Rationality," 65 *Cal. L. Rev.* 617 (1973); but *cf.* LATIN, "The 'Significance' of Toxic Health Risks: An Essay on Legal Decisionmaking Under Uncertainty," 10 *Ecol. L.Q.* 339 (1982).

40 See the explanation of this process in H. LINDE & G. BUNN, *Legislative and Administrative Processes* 868-75 (Mineola 1976); on the related problem of private interest group participation in law formulation, see Comment, "The Federal Advisory Committee Act," 10 *Harv. J. Legis.* 217 (1973).

41 See the discussion in LINDE & BUNN, *supra* note 40, at 396-405.

catalogue is worth adopting or adapting; indeed, one of the major problems in current American administrative law discussions is the abuse of some of these freedom of information tools. Rather, it is to suggest what already has become apparent to European political institutions – that improvement in the public awareness and public participation process not only is an important legitimating function of federal government and may pay off in increased political strength of the federal government, but may also be an immediate direct and important substantive aid in the development of legal harmonization as it slowly fosters this long-term legitimating function.

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