CORPORATIONS AND THE MARKET FOR LAW

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The state competition for corporate law has long been studied as a distinct phenomenon. Under the traditional view, corporations are subject to a unique choice-of-law rule, the "internal affairs doctrine" (IAD). This rule is explained as a historical accident, or by the special logistics of the corporate contract. The resulting market for corporate law appears to have special characteristics, particularly including the dominance of the single state of Delaware. This article challenges the traditional view. It shows that the corporate law market is best understood as a special application of the general market for law. Parties to many types of contractual relationships are able to choose the law they wish to govern their relationship, and states compete to provide the law that the parties most desire. Any differences between the corporate and general law markets are matters of degree rather than kind and are explained by applying the general forces underlying the law market to particular sets of circumstances. Theories of corporate competition that ignore the broader law market context are incomplete, and the competition for corporate law carries lessons for the law market generally. Moreover, the connection between the corporate and other law markets has implications for the constitutional status of the IAD, the scope of the IAD, and for the relationship between state and federal law.

In 1974 William Cary popularized the notion that there was a market for corporate law. In that market, corporations could choose among states as places of incorporation, and Delaware became the dominant competitor in the provision of corporate laws.[1] Cary also asserted that

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1. *See* William L. Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 YALE L.J. 663 (1974).

because managers choose the place of incorporation, state corporate law, especially Delaware law, gives managers too much power and prerogative within their firms.[2] Cary's characterization of this market as a "race to the bottom" is controversial, and the debate it sparked has important implications for the regulation of corporate governance. Numerous scholars have joined Cary in examining the nature of the market for corporate law and the extent to which Delaware dominates this market.[3]

While examining the corporate law market, scholars have largely ignored the fact that this market for law coexists with markets for many other types of law. The corporate law market seems unique because its source is found in a special rule, the "internal affairs doctrine" (IAD), which holds that the law of the state of incorporation governs the relationship between the managers, the shareholders, and the corporation.[4] Corporations can choose their place of incorporation without having any other connection with the state of incorporation. This contrasts with the rule applicable to other contracts, as summarized in the Restatement (Second) of Conflicts, which conditions enforcement of contractual choice-of-law clauses on the parties' connection to the state whose law is chosen.[5] The contrast between the rules is apparent in Judge Posner's opinion in *Curtis 1000 Inc. v. Suess*,[6] which rejected the choice of Delaware law, the employer's state of incorporation, as applied to the non-competition clause in an employee's contract with his firm.[7] The firm was not entitled to rely on Delaware law because Delaware lacked a sufficient connection to the contract, even though, as Posner pointed out, the choice of Delaware law would have been perfectly acceptable for the corporation's internal affairs despite the shareholders' lack of connection to Delaware.[8]

Because of the IAD, states can compete to supply corporate law separate from tax law, regulatory law, or other benefits. To obtain tax and other benefits in a particular state, a corporation might need to locate a plant or other assets in that particular state. By incorporating in a different state, the corporation can choose among the particular beneficial aspects of each state's laws. Without the IAD, the corporation would be forced to choose a single state's bundle of laws, including corporate, tax, and regulatory law.

Commentators have given at least two explanations for this apparently special treatment of corporations under the IAD. First, in their

2. *Id.* at 697–99.
3. *See* discussion *infra* Part III.B.
4. *See* RESTATEMENT (SECOND) OF CONFLICT OF LAWS §§ 304, 307 (1971). Other rules recognize the application of the law of the state of incorporation concerning particular matters. *See id.* § 296 (requirements for incorporation); *id.* § 297 (states' recognition of foreign incorporations); *id.* § 303 (determination of who is shareholder); *id.* § 306 (liability of majority shareholder).
5. *See id.* § 187(2).
6. 24 F.3d 941 (7th Cir. 1994).
7. *Id.* at 948–49.
8. *Id.*

early history in the United States, corporations had to be created by special act of the state legislature, which provided for special state privileges and concessions.[9] Because corporations were "creatures" of the state that created them,[10] the IAD had strong legal traction. Indeed, the question of which law to apply to the governance of a corporation never arose as it did for other contracts.[11]

Second, there seems to be compelling practical reasons for ensuring that only one lawmaking body can determine a firm's governance and financial rights.[12] If, for example, California required one method of voting for directors while New York required another for the directors of the same company, the operations of the firm would be hampered.

Given its distinct origins and justification, it is not surprising that the corporate law market appears different from the markets for other types of law. This market seems to be dominated by a single supplier, Delaware. This market structure seems attributable not only to the IAD, but also to the sizable franchise fee Delaware is able to collect for the privilege of using its law. Numerous scholars have examined this phenomenon and its implications for the efficiency of corporate law.[13]

The apparent distinctiveness of the corporate law market and the IAD has legal implications. First, the contrast between the IAD and the general rule on enforcing contractual choice of law suggests that the corporation is something other than a mere contract. Incorporating states therefore seem to have special regulatory powers over corporations to balance the special privilege the IAD confers. Second, the special treatment of corporations suggests that the IAD has constitutional status. To the extent that the rule stems from special state involvement in corporations, a state court's application of the law of a nonincorporating state seems a serious breach of the comity that states owe each others' laws. A state's intricate involvement in "its" firms seems to demand the application of only that state's law to its firms even when transacting business in a national economy, and to privilege state rather than federal regulation of the internal affairs of the firms.

On closer examination, however, the uniqueness of the corporate law market starts to fade. A corporation is basically a set of contracts among and between many parties, including creditors, shareholders, employees, and directors.[14] These contract rules specify (1) the rights of

9. *See* Frederick Tung, *Before Competition: Origins of the Internal Affairs Doctrine*, 32 J. CORP. L. 33, 44–45 (2006).

10. *See* Larry E. Ribstein, *The Constitutional Conception of the Corporation*, 4 SUP. CT. ECON. REV. 95, 98 (1995).

11. *Id.* at 99.

12. *See, e.g.*, EUGENE F. SCOLES & PETER HAY, CONFLICT OF LAWS § 23.4 (2d ed. 1992) (expressing view that IAD is "practically a necessary rule" in order to promote uniformity of shareholders' rights and duties).

13. *See infra* Part IV.A.

14. For a discussion of the arguments for and against the contractual theory of the corporation, see Henry N. Butler & Larry E. Ribstein, *Opting Out of Fiduciary Duties: A Response to the Anti-*

some of these parties to share the contract's benefits and burdens (i.e., profits and losses), (2) the allocation of power to make decisions that bind members of the corporation, and (3) the processes by which these decisions are made. One might question, therefore, whether corporations should get a different choice-of-law rule from that applied to other contracts. After all, firms that sell insurance, franchises, or anything on the Internet somehow cope with imperfectly enforced choice-of-law clauses despite similar difficulties customizing contracts for buyers in different states.

To be sure, public corporations present unique problems. It is impossible to give thousands of shareholders different financial and voting rights according to where they reside. The market could not possibly price shares under these conditions. But these problems imply only that *one* rule needs to apply to a corporation's governance, which could be the law of the corporation's base of operations and not necessarily the law chosen by the firm.[15] A base-of-operations rule might lead to a different sort of market for corporate law, but it would not necessarily be unworkable.

The claim that the IAD derives from the special nature of the corporation must rest on the IAD's basis in the state-creation theory of the corporation.[16] In other words, once having characterized corporations as creatures of state law, the choice-of-law rule the courts applied to corporations naturally followed. From this standpoint, the IAD has little to do with the rest of the choice-of-law universe.

There are several problems with this historically based "corporate exceptionalism" approach. First, corporations long ago broke from their origins as concessions or franchises and became more like ordinary contracts.[17] Thus, in order to adhere to the IAD, courts had to ignore the widening gap between theory and reality.

Second, even if courts were reluctant to abandon this legal theory, legislatures were free to make the policy judgment that it was more important to protect their regulatory prerogatives than to adhere to an ancient concept of the corporation. Thus, once corporate operations began to expand beyond the state of incorporation, legislatures in the states in which they transacted business could have decreed that local corporate law would apply to disputes that involved their citizens.

Third, something like the IAD has been applied far beyond the corporate sphere. It applies to partnerships and other business associations

Contractarians, 65 WASH. L. REV. 1, 7–18 (1990). For an application of the contractual theory of the corporation to choice of law, see Larry E. Ribstein, *Choosing Law By Contract*, 18 J. CORP. L. 245 (1993).

15. In Europe, for example, most countries apply the law of the seat of the corporation. *See infra* Part IV.D.

16. *See supra* text accompanying notes 9–10.

17. *See infra* Part II.A.

that traditionally have *not* been regarded as state creations.[18] If the IAD can be applied to what is essentially a contract among individual members or partners of an unincorporated business association, why not to the contracts forming other long-term business relationships such as franchises? Principles similar to the IAD have been applied to many types of conventional commercial contracts.[19] Although the general rule for contractual choice of law contemplates significant limits on party choice, in practice choice-of-law clauses in conventional contracts *are* very generally enforced. Moreover, something like the IAD has been applied to trusts,[20] and, more recently, to European corporations, which have been governed by the "real seat" choice-of-law rule.[21]

In general, we show that the market for corporate law is best understood as part of a general market for laws that exists for many different types of contracts. Our main contribution is to argue that similar political forces and economic incentives underlie all of these markets. Any differences among these markets and in the rules governing them can be explained by the differing specific market forces and the relative balance of power of competing political groups affected by the market forces. Both for corporations and for other contracts, the market is driven by parties' ability to move among jurisdictions and those jurisdictions' incentives to compete for people, firms, and litigation. This broader perspective on law markets enables us to better understand both the market for corporate law and the market for other law. Moreover, this new perspective enables a richer understanding of the processes underlying jurisdictional competition and its role in disciplining states' and nations' creation of law. The focus on the market for corporate law has simply revealed one manifestation of deeper phenomena.

Placing the market for corporate law in its broader context also has significant implications for the legal treatment of corporate and contract law issues. First, the non-uniqueness of the corporate law market undermines arguments that the IAD should be subject to constitutional protection, because the new analysis shows how both the corporate and the general law market have managed to thrive without such protection. Moreover, if the IAD is, indeed, fundamentally just another contractual choice-of-law rule, any constitutional protection of the IAD would have to distinguish rules for other contracts. In other words, if the Supreme Court is prepared to hold that it is unconstitutional for California to regulate the contract governing the thousands of shareholders of a Delaware corporation, it must be prepared to explain why California law should be able to regulate the contract governing the thousands of Cali-

18. *See infra* Part IV.B–C.
19. *See infra* Part IV.F.
20. *See infra* Part IV.G.
21. *See infra* Part IV.D.

fornia employees who are working under a Delaware employment contract.

Second, this article's analysis helps to settle current controversies regarding the appropriate scope of state and federal corporate law and the states' application of the IAD. May the federal government regulate corporate governance just as it does securities trading? May California regulate insider trading in a Delaware corporation on behalf of California shareholders? If the corporate law market and the IAD are fundamentally related to the general law market and rules governing choice-of-law clauses for other contracts, then the answer to both questions is yes. If the IAD is not treated as a unique privilege conferred by the states on their corporate creations, then incorporating states no longer can claim special powers to exclusively regulate corporate contracts above and beyond their powers to regulate other contracts.

Just as contractual choice of law does not oust state and federal regulatory powers in the general law market, neither does it do so in the corporate law market. At the same time, this article's analysis provides a basis for determining how far state and federal regulation *should* go. The functioning of the law market suggests appropriate constraints on state refusal to enforce contractual choice of law. It also shows why the federal government ought generally defer to state law as long as the states are able to coordinate their regulation through the law market.

The article proceeds as follows. Part I discusses the "demand" side of both the market for law generally and the market for corporate law. The demand side of the market involves parties' desire to choose their governing law and its influence on their decisions regarding where to locate, invest, and litigate. Those choices influence the extent to which states are willing to enable parties to contract for their governing law. The same mechanisms that explain enforcement of other contractual choices also explain the origins of the IAD and the rules governing the corporate law market. Broad enforcement of the IAD resulted from corporations' mobility and interest groups' incentives both to provide corporate law and to refrain from driving commerce to other jurisdictions.

Part II discusses the "supply" side of the law market. It shows how jurisdictions (or more precisely their politicians) compete for residents, investment, and litigation. Some states are actively competing for law business, and in those states the competition is driven most importantly by lawyers. Other states, while not competing for business, nevertheless have responded to party mobility by enforcing contractual choice-of-law, choice-of-forum, and arbitration clauses in an effort to retain residents, jobs, investments, and tax revenues. These market forces have caused the law to move toward very general enforcement of contractual choice of law, at least in commercial cases. Similar forces are at work for corporations. Here, too, lawyers have played a key role in promoting active competition, particularly in Delaware.

Part III discusses the specific limitations on the general and corporate law markets that persist due to weaknesses in the forces of demand and supply. In the general law market, courts often require a connection between the parties and the contractually designated state, and even then a court can refuse to apply the law chosen by the parties if that law would interfere with the fundamental public policy of another state. Where these limitations are imposed, pro-regulatory interest groups have successfully resisted the competitive pressures of the law market. However, in order to facilitate interstate trade, the federal government can always preempt these states' refusals to enforce choice-of-law clauses. The rules for corporations seem on the surface to be quite different because they lack both the "connection" requirement and the public policy exception. On closer examination, however, law market forces have produced similar rules for corporate and for other commercial contracts. Courts in several states have relaxed the connection requirement for commercial noncorporate contracts. Conversely, corporations are subject to state public policies, though these policies tend to be located formally outside the IAD. Finally, the costly multiplicity of state corporate law has been a significant factor in the development of several federal laws.

Part IV further undercuts the notion of a distinct corporate law market by showing that there are both variations within the corporate law market and links between the market for corporate law and the market for other types of contracts. This analysis demonstrates how little the IAD in fact explains about the corporate law market and how much, rather, is explained by the operation of supply and demand forces.

Part V, then, develops the general implications of this article's analysis for constitutional law, the limits on state and federal regulation, and for future scholarship.

I. THE DEMAND SIDE OF THE LAW MARKET

This Part begins to situate the corporate law market within the forces that drive the general market for law. We discuss the demand for contractual choice of law that drives both markets. Our focus here is on how the forces of jurisdictional competition promote widespread enforcement of contractual choice of law. In other words, we focus on how contracting for law *arises*, rather than on the competition that contractual choice generates. We discuss the latter issue in our later discussion of the structure of the corporate law market.[22]

In general, we show that the law market exists because parties to most relationships that involve contracts have a strong incentive to contract for their governing law. Firms and individuals want both to clarify

22. *See infra* Part IV.

the legal rules that will apply to their contract and to select laws that enhance the likelihood that their agreement will be enforced as they intend.

The important question is why courts, with at least the tacit permission of legislators, would enforce these contracts at the expense of their own state's regulation even when that regulation is supported by strong interest groups in the state. Part of the answer is that contracting parties can be viewed as "shopping" for, or demanding, the regulation and adjudication of particular states. Contracting parties can impose two types of costs on states that attempt to impose regulation that cannot be avoided through party choice. First, the parties can decide to make investments in states that favor their preferred contracts and to avoid states that disfavor them. Second, the parties can avoid or choose to litigate in courts depending on the courts' willingness to respect their preferences for a particular state's law. Generally, the demand side of the law market focuses on parties' desire to have their choice-of-law clauses enforced. In the market for corporate law, the demand side is driven by the firm's choice of the place of incorporation.

A. The General Law Market

This subpart introduces the demand side forces in the law market generally, while subpart B considers demand side forces specific to the market for corporate law. The demand side of the law market entails two inquiries. First, why do parties contract for law? As discussed in subsection 1, the parties attempt to choose their governing law in order to enhance predictability and fit, and to attempt to eliminate multiple potentially inconsistent legal mandates. Second, subsection 2 discusses why each state as a political entity has incentives to enforce party choice of law even when enforcement of these choices enables the parties to evade that state's laws. State cooperation depends on the parties' options when confronted by a court or legislature that refuses to enforce the contract.

1. Why Do Parties Contract for Law?

Parties contract for law to ensure that their disputes will be resolved according to the law that best fits their relationship. Because the parties' contract embodies the basic terms of their relationship, the quest for fit implies that the parties want a law that enforces their contract. Without a choice-of-law clause, the parties to interstate contracts cannot confidently predict what law a court ultimately will apply to their dispute. According to the dominant rule on choice of law for contracts in the United States, courts will apply the law of the state with "the most significant relationship to the transaction and the parties."[23] When two parties contract exclusively with one another, it can be difficult for them to

23. RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 188(1) (1971).

determine at the time of contracting which state has the most significant relationship. Uncertainty creates even more difficulty when a firm contracts with many suppliers, creditors, employees, and/or customers, because a different governing law could end up applying to each contract.

Contracting for law enables the parties to know what law will apply not only at trial, but also when contracting. Obviously the parties need to know when contracting not only whether and to what extent a court will enforce their contract, but also what default rules it will apply, and whether the contract language will be interpreted rigidly or flexibly. For example, New York courts tend to adhere fairly closely to the language of the contract, while California courts are known for their greater flexibility.[24] Contracting for law is also critical when a firm enters into the same basic relationship with multiple people or firms. A contract that selects a particular state's law enables the firm to adopt a single firmwide policy for its performance that applies to all similar dealings.

Thus, by making an enforceable choice of law, parties can obtain a better fit and greater certainty and predictability, and they are better able to streamline their operating policies than is otherwise possible under default choice-of-law rules. These benefits give the parties the incentive to choose their governing law wherever possible. This is reflected in the fact that choice-of-law clauses are routinely included in most commercial contracts today.[25]

2. *Party Mobility*

While contracting for law has obvious benefits for the parties, it presents a problem for state lawmakers. Because state regulation of contracts can be negated if parties can opt out of that regulation by choosing alternative governing laws, courts and legislatures in regulating states have obvious incentives not to enforce those choices. How can parties overcome these difficulties? The answer begins with the alternatives available to contracting parties when confronted by courts or legislatures that refuse to enforce their choices (referred to here as "nonenforcing" states).

One alternative parties have to ensure enforcement of their choices is to prevent nonenforcing courts from exercising personal jurisdiction over them. Without personal jurisdiction, the nonenforcing state lacks power to compel that party to enter its courts. Personal jurisdiction is limited in the United States by the Due Process Clauses in the Fifth and Fourteenth Amendments to the U.S. Constitution.[26] Due Process pre-

24. *See* Theodore Eisenberg & Geoffrey P. Miller, *The Market for Contracts* 35 (Law & Econ. Research Paper Series, Working Paper No. 06-45, 2007), *available at* http://ssrn.com/abstract=938557.

25. *See* Theodore Eisenberg & Geoffrey P. Miller, *Ex Ante Choices of Law and Forum: An Empirical Analysis of Corporate Merger Agreements*, 59 VAND. L. REV. 1975, 1978 (2006); Larry E. Ribstein, *From Efficiency to Politics in Contractual Choice of Law*, 37 GA. L. REV. 363, 400, 403 (2003).

26. *See* U.S. CONST. amends. V & XIV.

vents states from asserting jurisdiction over parties who lack "minimum contacts" with the state.[27] Minimum contacts involve directing action toward the forum in a way that makes it fair to require the person to defend a lawsuit involving the action in that state.[28] In addition, a court may assert "general" jurisdiction over a defendant that has extensive local contacts, such as maintaining a principal place of business, even if the contacts did not arise out of or relate to the particular transaction at issue.[29] By limiting the contacts with a state to those that are nonextensive, a firm can deprive a state's courts of the ability to exercise general jurisdiction over it. By avoiding the state altogether, a firm can defeat that state's ability to exercise even more limited specific jurisdiction over the firm.

The ability of firms to manipulate contacts with states is important not just for personal jurisdiction, but also to control the outcome of a choice-of-law analysis. Prior to the 1930s, choice-of-law rules in the U.S. were based mainly on a "vested rights" approach, under which states acquired law-making jurisdiction if acts relevant to the cause of action occurred within the state.[30] Under this approach, the important event for contracts was the contract formation, although there was authority for applying the place of formation designated in the contract itself, particularly if the contract spanned several states.[31] In the 1960s, an alternative choice-of-law approach evolved under the influence of Brainerd Currie to one based on state "interests."[32] Under Currie's approach, legislatures were presumed to have an "interest" in applying local laws only to benefit local residents.[33] If multiple states had an interest in applying their laws, the forum—which could be anywhere the plaintiff could get personal jurisdiction over the defendant—applied its law.[34] About half of the states now apply a third method, the Second Restatement's most significant relationship test, to determine the governing law for contracts disputes.[35] Courts making that determination look to a variety of contacts, including the places of contracting, negotiation, subject matter of the contract, performance, and the location of the parties,[36] as well as to

27. World-Wide Volkswagen Corp. v. Woodson, 444 U.S. 286, 297 (1980); Int'l Shoe Co. v. Washington, 326 U.S. 310, 316 (1945).

28. Asahi Metal Indus. Co. v. Superior Court, 480 U.S. 102, 111–12 (1987).

29. Helicopteros Nacionales de Colombia, S.A. v. Hall, 466 U.S. 408, 414–15 (1984). For a general discussion of the constraints on personal jurisdiction in the U.S. and Europe, see RUSSELL J. WEINTRAUB, COMMENTARY ON THE CONFLICT OF LAWS § 4.9C (4th ed. 2001).

30. *See* JAMES A. MARTIN, CONFLICT OF LAWS 16–17 (2d ed. 1985).

31. *See* Erin A. O'Hara & Larry E. Ribstein, *From Politics to Efficiency in Choice of Law*, 67 U. CHI. L. REV. 1151 (2000).

32. *See generally* BRAINERD CURRIE, SELECTED ESSAYS ON THE CONFLICT OF LAWS (1963).

33. *See, e.g.*, *id.* at 201–02 (discussing California's interest in protecting community from cost of injured employee).

34. *See* Lea Brilmayer, *Rights, Fairness, and Choice of Law*, 98 YALE L.J. 1277, 1315–17 (1989) (describing Currie's approach).

35. EUGENE F. SCOLES ET AL., CONFLICT OF LAWS § 18.21, at 1002–03 n.14 (4th ed. 2004).

36. RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 188(2) (1971).

seven general principles that guide all choice-of-law questions.[37] For most modern approaches, the likelihood of a law applying to a dispute tends to rise as a party's connection with a state grows.

Firms' contacts with states also matter because most states follow the Second Restatement rules conditioning enforcement of contractual choice of law on parties' connections with the designated state. The Second Restatement drafters recognized that an indeterminate approach to choice of law threatened to undermine the predictability that parties value in forming contracts. Accordingly, they included a provision designed to maximize the extent to which parties are able to choose their own law to govern their relationships. Regarding default rules, or rules of contract interpretation, parties can pick any law they wish.[38] This reflects the parties' ability to include these rules directly in their contracts. The Second Restatement also provides for some enforcement of the parties' choice even if enforcing the choice has the effect of enabling the parties to circumvent a mandatory rule. The Second Restatement directs courts to bar enforcement as to mandatory rules where the contract designates a state that "has no substantial relationship to the parties or the transaction and there is no other reasonable basis for the parties' choice," or where the chosen state has a "substantial relationship" with the parties or contract but the chosen law is "contrary to a fundamental policy of a state which has a materially greater interest than the chosen state in the determination of the particular issue" and that state would be selected under general choice-of-law principles.[39]

The current version of the Uniform Commercial Code (UCC or the Code) also gives parties significant latitude to contract for their own governing law. In business-to-business transactions the UCC provides that the parties can effectively contract for the application of a state's law even if the law does not satisfy the reasonable relationship requirement.[40] The contractual choice is not effective if it would force courts to apply law that would be contrary to a fundamental policy of the "default" jurisdiction—i.e., the state or country whose connection with the parties or transaction would justify applying its law in the absence of agreement.[41] By contrast, in transactions involving a consumer, the Code requires that the parties have a reasonable relationship with the designated state, and it stipulates that choice-of-law clauses may not deprive the consumer of the protection of a law in which the consumer principally resides or other jurisdiction where the contract is made or the goods delivered.[42] The pre-amended version of the Code still in force in most states requires

37. *Id.* § 6.
38. *Id.* § 187(1).
39. *Id.* § 187(2).
40. U.C.C. § 1-301(c)(1) (2004).
41. *Id.*
42. *Id.* § 1-301(e)(2).

only that the parties to all UCC contracts have a reasonable relationship with the designated state.[43]

In sum, both the governing law under general choice-of-law rules and the enforcement of choice-of-law clauses typically depend on the parties' contacts with both the state whose law is chosen and the states whose laws they want to avoid. The parties' ability to use a choice-of-law clause to avoid a state's mandatory rule therefore depends not only on avoiding connections with the undesirable state, which may be difficult or impossible for a national firm, but also on establishing enough of a connection with a desirable state that that state's interest might be deemed to outweigh the interest of the undesirable state. This gives contracting parties—particularly interstate or global firms that rely extensively on choice-of-law clauses—incentives to establish close connections with, or perhaps base operations in, states that enforce the parties' contracts, including choice-of-law clauses.

Party mobility in response to regulation is becoming more important as the costs of mobility decline. With the rise of computers, the Internet, express delivery service, and other technological innovations, modern business relies less on bricks-and-mortar buildings and more on geographically independent or mobile assets such as intellectual property and human capital. Shrinking trade barriers let firms find trade and investment opportunities anywhere in the world. This means firms may be increasingly willing and able both to avoid jurisdictions that impose tough restrictions and to move to states that can offer desirable packages of legal rules, including a general policy of enforcing contracts. A state can compete to attract these firms in one of two ways. First, it can attempt to provide an appealing bundle of laws to enhance the range of firms' activities. Second, a state can attract mobile assets by providing an important subset of the laws firms desire, such as corporate law, while enabling those firms to freely contract for other states' laws when local laws prove unsuitable.

Finally, it might seem that, despite firms' increasing mobility, their location decisions would be driven primarily by factors other than enforceability of choice-of-law contracts, such as tax burdens and infrastructure. However, the impact of location on enforcement of choice of law may sometimes be a significant marginal consideration. For example, there is data indicating that franchisors have made location decisions based on the enforceability of choice-of-law and related clauses in franchise contracts.[44] Nevertheless, the extent of firm mobility, and therefore of its costs or benefits to states, depends partly on what benefits a state can offer firms to offset the costs of bad laws. The more desirable a location is because of its non-law attributes such as its labor pool, its exten-

43. *Id.* § 1-105 (1954).

44. *See* Jonathan Klick et al., The Effect of Contract Regulation: The Case of Franchises 6 (Dec. 13, 2006) (unpublished research paper), *available at* http://ssrn.com/abstract=951464.

sive consumer market, or its plentiful natural resources, the more it can get away with imposing costs on firms through harsh regulations promoted by local interest groups. We would therefore expect large, rich states like California to be less responsive to the law market than small states like Delaware.

3. Controlling the Forum

Contracting parties can increase the probability that a choice-of-law clause will be enforced by choosing to have their disputes resolved in a forum that lacks a political incentive to block exit from state mandatory rules. Parties have three ways of controlling the forum. First, the parties can choose the court or other dispute resolution forum at the time of litigation. The plaintiff obviously has some control over where to file a lawsuit. Even a potential defendant often can control the forum for litigation by filing a declaratory judgment action. Moreover, a defendant may be able to remove plaintiff's case to a federal court where there is the requisite diversity of citizenship.[45] This removal power is significant because federal courts have less incentive than state courts to block exit from mandatory rules imposed by the state legislature. Although in a diversity jurisdiction case the federal court must apply the local state choice-of-law rule,[46] these rules give judges significant discretion to enforce choice-of-law clauses.[47]

Second, the parties can include a court-selection clause in their contract. State courts obviously have a stronger incentive to apply local law than they do the law of another state. Accordingly, the parties can enhance the likelihood that the court will enforce the choice-of-law clause if they agree that the case will be tried in the state whose law the contract selects.[48] State courts do fairly routinely enforce choice-of-court clauses, at least in commercial cases.[49] One might wonder why courts would be likelier to enforce choice-of-court clauses than choice-of-law clauses if enforcing the former is tantamount to enforcing the latter. A possible explanation is that a choice-of-court clause enables the court to enforce the parties' contract while at the same time refraining from making an explicit policy choice between local law and the law designated in the contract.

Third, the parties can include an arbitration clause. Private arbitrators owe nothing to the state legislature, and must keep the parties satisfied in order to reap future arbitration business. On balance, therefore,

45. *See* 28 U.S.C. § 1332(a) (2000).

46. *See* Klaxon Co. v. Stentor Elec. Mfg. Co., 313 U.S. 487, 496 (1941).

47. *See infra* Part III.

48. O'Hara & Ribstein, *supra* note 31, at 1158.

49. *See* Leandra Lederman, *Viva Zapata!: Toward a Rational System of Forum-Selection Clause Enforcement in Diversity Cases*, 66 N.Y.U. L. REV. 422 (1991); Michael E. Solimine, *The Quiet Revolution in Personal Jurisdiction*, 73 TUL. L. REV. 1 (1998).

they can be counted on to be more committed to enforcing contracts than to preventing evasion of mandatory rules. The Federal Arbitration Act mandates that an arbitration clause in a contract that is valid under state law must be enforced not only by federal courts, but also by state courts when they decide cases that involve federal questions or interstate commerce.[50] Because arbitration clauses can be used effectively to diminish the authority of nonenforcing courts,[51] they reduce the stakes involved in choice-of-court and choice-of-law clauses. This may encourage courts to enforce these provisions as well.

B. The Corporate Law Market and the IAD

Viewed in its historical context, the IAD seems to have sprung full-blown from the corporation's origin as a creature of state law. This historical explanation appears, in turn, to explain why the states so readily recognized that the chartering state's law controls the legal rights and obligations of the parties to the corporation. However, the history of corporate law fails to explain why courts and legislatures were willing to recognize corporations formed in other states, or why once they did recognize those corporations they were willing to apply those states' governance laws. In other words, the state-creation origins of corporate law, instead of leading to broad acceptance of the IAD, could just as easily have led to rules confining state-created corporations to the states of their creation. Indeed, this alternative result would seem to have been more likely since state legislators once controlled corporate rights and privileges and derived benefits from this control. Lawmakers' benefits from the incorporation process would not be worth much if corporations could buy charters from any state and do business in any other states, since this would expose chartering states to ruinous price competition over the provision of these charters. So, we have to explain why state courts and legislators were willing to enforce a rule that broke down their profitable territorial monopolies. The explanation lies in an understanding of the general market for law. Paralleling the discussion of the general law market, subsection 1 discusses corporations' incentives to contract for the law relating to internal governance. Subsection 2 discusses how corporate mobility contributed to the demand side of the market for corporate law.[52]

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50. *See* 9 U.S.C. §§ 1–14 (2000).

51. *See* Stephen Ware, *Default Rules From Mandatory Rules: Privatizing Law Through Arbitration*, 83 MINN. L. REV. 703 (1999) (arguing that the Federal Arbitration Act's broad enforcement of arbitration in effect permits evasion of mandatory rules).

52. Since the rules governing the corporate law market were established prior to the general enforcement of choice-of-forum and arbitration clauses in the United States, there is no corporate parallel to this aspect of the general law market. However, the strength of the market forces for corporate law compared to the equivalent forces in the general law market explains why forum choice was unnecessary to facilitate the corporate law market.

1. *Why Do Parties Contract for Corporate Law?*

Firms have precisely the same reasons to choose the law governing the relations among the parties to the firm as all contracting parties have to choose governing law: to ensure that their disputes will be resolved according to the law that best fits their relationship, to enable the parties to know what law will apply at the time of contracting, and to allow the firm to deal on the same basis with multiple parties.

One apparent difference between the two contexts is that the need of corporations for the same law regarding multiple contracting parties is obviously greater than it is for parties to most other contracts. For example, divvying up a common pool of resources and applying voting rules would present a logistical nightmare for a national (not to mention international) firm facing different restrictions in each state in which its shareholders reside. Indeed, the need for a common rule is so compelling that it seems to distinguish corporate internal governance from other types of contracts. However, viewing corporations in the context of the general law market makes it obvious that corporations differ from most contracting parties in this respect in degree rather than in kind. Moreover, corporations' need for *one* rule does not mean that they need to be able to designate that rule by contract. Finally, to the extent that corporations' need for a single rule does distinguish corporate internal governance from other types of contracts, it follows that firms had a commensurately stronger incentive to avoid states that refused to enforce their choice of state of incorporation.

2. *Party Mobility*

The increasing mobility of the corporation in the latter part of the nineteenth century was an important factor in developing the IAD. Indeed, the corporate law market might be said to be a product of the industrial revolution. Technological advances like the railroad and telegraph, mass advertising, and assembly line production gave rise to firms whose production facilities and headquarters were distinct from their nationwide markets.[53] This let firms operate outside their states of incorporation and therefore choose their incorporating state based on a state's law and legal environment rather than only on its resources and markets. In addition, firms could avoid investing assets in states that were hostile to foreign corporations, withholding valuable assets and jobs from them. This would upset powerful business and labor interest groups within the state, which could be expected to lobby against such hostile legislation. At the same time, firms could continue to access state markets because

53. *See* ALFRED CHANDLER, THE VISIBLE HAND 203–06 (1977).

the Commerce Clause prevented the states from discriminating against or imposing unreasonable burdens on interstate trade.[54]

Until the 1890s, corporate mobility mainly promoted state competition for investments rather than for charters, since at that time corporations still had to incorporate in states with which they had significant contacts.[55] States could lure corporate investments by offering an attractive tax and regulatory environment, and by making it easier to get corporate charters. A "general incorporation" option, by which any firm could form a corporation without getting special permission from the state, gradually replaced special chartering.[56] At first, however, the states were content to divide up the incorporation market and limit their competition to one for corporate investments rather than for charters.[57] In other words, firms had to incorporate where they were based. In order to create today's corporate law market, states had to be willing to incorporate "tramp" firms that had no local connections.

The equilibrium shifted when changes in business practices and technologies increased the benefits of prohibited practices and gave firms incentives to avoid regulatory impediments. For example, firms needed more flexibility in pricing their shares for sale in dynamic capital markets than they had under rules developed before these markets were available.[58] Until then, firms had a choice either to engage in costly lobbying to remove local impediments or to move to states with laxer laws. Clearly they would welcome being able to choose a state's law without physically moving there. The time was ripe for a state to become a first mover to attract foreign firms to incorporate locally.

New Jersey became that first mover. It had earlier acquired a financial incentive to compete for charters when it extended its railroad taxation scheme to tax non-railroad corporations on the basis of their capital stock. The scheme was not based on the corporations' presence in the state.[59] New Jersey, therefore, was able to increase revenues despite losing railroad tax revenues by "charter-mongering," or using a flexible corporation law to attract incorporations by out-of-state firms which maintained no more than a virtual presence in New Jersey.[60]

The standard version of the New Jersey success story is that its key innovation was to expressly permit holding companies.[61] Under this story, New Jersey acquired importance and national stature through the

54. *See infra* text accompanying note 244.
55. *See* Tung, *supra* note 9, at 62–64.
56. *See* Henry N. Butler, *Nineteenth Century Jurisdictional Competition in the Granting of Corporate Privileges*, 14 J. LEG. STUD. 129 (1985).
57. *See id.*
58. *See infra* text accompanying note 71.
59. *See* Christopher Grandy, *New Jersey Corporate Charter-Mongering, 1875–1929*, 49 J. ECON. HIST. 677, 680–81 (1989).
60. *Id.*
61. *Id.*

efforts of John D. Rockefeller to bring the first of the large integrated enterprises that were emerging from the Industrial Revolution into a cohesive legal form.[62] When the Ohio Supreme Court ruled in 1892 that the trust agreement binding Standard Oil of Ohio was an illegal attempt to monopolize the petroleum business, Rockefeller and his advisors already were studying the New Jersey innovation.[63] After the Ohio decision, Standard Oil simply dissolved the trust and formed a New Jersey holding company.[64]

An alternative explanation of New Jersey's success offered by Lawrence Mitchell is that New Jersey included very favorable provisions permitting the use of stock to buy property and, more importantly, substantially empowered the directors to set the valuation.[65] Mitchell notes that New Jersey offered other advantages, including protecting officers and directors from actions brought in New Jersey under other states' laws.[66]

Even after New Jersey opened Pandora's Box and started competing for charters, there was still an important ingredient missing from the corporate law market. Other states technically could have resisted by continuing to apply their own restrictive laws to their corporations that sought to combine with New Jersey corporations. The states could, for example, adopt something like the European "real seat" rule discussed below[67] that would have applied local law to New Jersey tramp corporations headquartered in the state. Because it parallels the Second Restatement's most significant relationship test, a "real seat" rule would result in the same choice-of-law treatment as other contracts. Why did the states not take this step?[68]

The explanation for why other states became willing to respect a corporation's choice of internal governance law ultimately rests, at least in part, on demand-side factors that link corporations with other contexts for applying contractual choice of law. Corporations, like other firms, could physically exit states that otherwise refuse to apply the law of the incorporating state. More precisely, corporations could avoid contacts

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62. *See* RON CHERNOW, TITAN: THE LIFE OF JOHN D. ROCKEFELLER, SR. 332–33 (Random House 1998).

63. *Id.*

64. *See id.*

65. *See* LAWRENCE MITCHELL, THE SPECULATION ECONOMY: HOW FINANCE TRIUMPHED OVER INDUSTRY 48–54 (2007).

66. *Id.* at 54–55.

67. *See infra* Part IV.D.

68. In a draft paper, John Coates discusses some of the elements of this explanation of the IAD. *See* John C. Coates IV, The Legal Origins of the (Unimportant) U.S. "Market" for Corporate Charters (October 18, 2004) (on file with authors). Coates shows that host states legally *could have* prevented the operation of the IAD. Coates explains their failure to do so mostly by the triviality of much of corporate law, and by the fact that many of the significant issues have been separated from corporate law and dealt with under non-"corporate" state and, most importantly, federal law. This discussion is consistent with much of the story presented in this article, though unlike the present article, Coates does not analyze the IAD in light of general market for law.

with other states that would make it possible for their courts to apply their law to the corporation. In other words, firms could strategically choose where to sell their stock and where to locate their factories and other corporate assets so as to avoid states that refused to recognize the law of the incorporating state.[69]

One might be skeptical that in expanded interstate markets corporations had a realistic opportunity to avoid states that threatened to regulate their internal governance. Suppose, for example, states aggressively attempted to regulate corporate governance on the basis of having just enough contact to exercise personal jurisdiction.[70] Corporations would then be forced to go to great lengths to forgo conducting business with customers, suppliers, or shareholders in the regulating state. Is it likely corporations would incur these costs just to get the internal governance rules they wanted? If not, what incentives would states have to forgo regulating foreign firms' internal governance?

At least two factors might explain why firms' physical mobility was enough to motivate states to respect the IAD. First, expanding corporations had a strong need for flexible rules. For example, in order to access rapidly developing capital markets, firms needed relief from rules requiring newly issued securities to be sold at par.[71] Thus, differences between modern corporate rules and those based in early corporate history mattered enough to corporate development that firms might be willing to incur significant costs to avoid states with outmoded rules. Second, as discussed in subsection 1, firms had a strong practical need for assurance that a single rule would apply to all of their members. To be sure, these demand-side factors alone are not enough to explain why states responded to the threat of corporate exit by applying the law of the state of incorporation. As with the general law market, this calls for a supply-side explanation, which we provide below in Part II.

Whatever the explanation for the acceptance of a market in corporate law, the market clearly exists today. This is demonstrated by the denouement of the story of the corporate law market's early history. The corporation leader in the United States is now Delaware. What happened to New Jersey? Interest groups and reformers protested that New Jersey's law facilitated monopolies.[72] While one of these reformers, Woodrow Wilson, was governor of New Jersey, the state in 1913 amended its corporation law to restrict holding companies and add strict antitrust provisions.[73] New Jersey's next door neighbor then took over its incorporation business just as New Jersey had taken Standard Oil from

69. *See* MITCHELL, *supra* note 65, at 30–56.

70. *See supra* text accompanying notes 27–29 (discussing constitutional limits on personal jurisdiction).

71. *See* MITCHELL, *supra* note 65 (discussing the importance of stock pricing rules to New Jersey's early charter competition).

72. *See* Grandy, *supra* note 59, at 687.

73. *Id.* at 689.

Ohio. In 1917, after Wilson moved on to higher office and New Jersey saw what it had done to itself, the state tried to recapture its lost glory by reversing its moves. But by then it was too late—Delaware was already entrenched, corporations did not trust the New Jersey legislature,[74] and in any event Delaware gave them no reason to leave.

II. THE SUPPLY SIDE

This Part discusses how the supply side of both the law market generally and the market for corporate law can promote enforcement of contractual choice of law, and thereby foster the sort of jurisdictional competition that has generally been associated with the corporate law market. The mandatory rules that parties seek to avoid with choice-of-law clauses are often produced by powerful interest groups. However, exit and entry by contracting parties create costs or benefits for other interest groups in the state. These "exit-affected" interest groups can combine with the groups that are directly burdened by the regulation to promote contractual choice of law even if the antiregulatory groups could not alone either defeat the regulation or provide for enforcement of party choice. Subpart A discusses the supply side of the law market generally, while subpart B parallels this discussion with an analysis of the similar forces at work in the corporate law market.[75]

A. The General Law Market

As suppliers of law to the law market, each state typically occupies one of two positions. Some states, which we will call "competing" states, seek to have their laws selected by contracting parties. Other states, which we will call "noncompeting" states, must then decide whether to enforce these choices when their courts entertain suits involving those contracts.

1. Competing States

Some states have announced their intention to enforce choice-of-law clauses. Specifically, California, Delaware, Florida, Illinois, New York, and Texas each have statutes that provide for the automatic enforcement of choice-of-law clauses that designate the state's law in high

74. *Id.*

75. We treat state judges and legislators as a single group of lawmakers, implicitly assuming that their incentives are similar. In fact, both elected and appointed judges may have stronger incentives than legislators not to enforce choice-of-law contracts. *See* Ribstein, *supra* note 25, at 448–49. The justification for treating the two sets of lawmakers as a unit is that state judges ultimately are subject to the interest group forces discussed below in this Part through the ballot or appointment process and legislators' ability to prescribe by statute the effect of choice-of-law statutes.

value contracts.[76] There is also data indicating that the law of these states, and particularly New York and Delaware, are often designated in choice-of-law clauses.[77]

Lawyers clearly are an important factor in motivating these states to compete for choice-of-law business.[78] Lawyers have significant advantages over other interest groups (such as taxpayers or low-wage workers) in promoting the law market. Lawyers may have lower costs of political advocacy than most groups because they can produce their own lobbying activities and can coordinate their political activities through existing bar associations. Lawyers also have incentives to invest their time in law reform because this helps them acquire an aura of professionalism and enhances their reputations for expertise in particular areas of the law.

Although lawyers can work on the law of any state, they have a special incentive to devote efforts to the law of the particular state in which they are licensed[79] because licensing laws give lawyers exclusive rights to practice in the state's courts, and they also help local lawyers in their efforts to advise clients who are based in the state.[80] Because judges tend to apply forum-state law, the right to practice in a particular court carries with it an interest in that court's local law. Also, firms may establish connections with states in order to increase the chances that the state's law will apply to their contracts, and local investments often translate into demand for local lawyers. It follows that the quality of a state's legal environment, including whether the state enforces contractual choice of law, may affect a lawyer's business. Lawyers therefore have an incentive to improve the quality of their licensing state's law in order to attract clients for transactional work and as litigants in local courts. Accordingly, lawyers' participation in lawmaking can serve the interests of both lawyers and clients. Given the importance of lawyers on the supply side of the law market, it is not surprising that each of the states that have signaled their desire to compete in the law market by enacting choice-of-law statutes has a large and sophisticated commercial bar that is seeking a national clientele for both litigation and transactional work.

The incentives emphasized in this article differ from those of lawyers who want local and state laws favorable to plaintiffs suing national

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76. CAL. CIV. CODE § 1646.5 (West Supp. 2007); DEL. CODE ANN. tit. 6, § 2708 (2005); FLA. STAT. ANN. § 685.101 (West 2003); 735 ILL. COMP. STAT. ANN. 105/5-5 (West 2003); N.Y. GEN. OBLIG. LAW § 5-1401 (Consol. 2007); TEX. BUS. & COM. CODE ANN. §§ 35.51–.52 (Vernon 2002). The Texas statute also provides for enforcement of choice-of-law provisions that choose other states' laws provided that the transaction has a connection with the state whose law is chosen. For an analysis of these statutes, see Larry E. Ribstein, *Delaware, Lawyers, and Contractual Choice of Law*, 19 DEL. J. CORP. L. 999 (1994).

77. *See infra* Part IV.F.

78. *See* Ribstein, *supra* note 76 (discussing lawyers' role in promulgation of state choice-of-law statutes).

79. Because it is costly to be licensed in a particular state, lawyers tend to be licensed only in the state where they reside and maybe one or two others.

80. *See* Larry E. Ribstein, *Lawyers as Lawmakers: A Theory of Lawyer Licensing*, 69 MO. L. REV. 299, 302 (2004).

firms, often as representatives of nationwide classes of plaintiffs. In the class action cases, the plaintiff in effect unilaterally chooses the law by choosing where to sue. By contrast, the law selected in a choice-of-law clause must, in theory at least, appeal to *both* contracting parties.[81] Thus, lawyers interested in attracting choice-of-law business may tend to favor different types of laws than those interested in attracting plaintiffs.

2. *Noncompeting States*

Given that some states compete for choice-of-law business, why do *other* states, whose lawyers are not competing effectively for national litigation and transactional business, cooperate with party efforts to choose law? In other words, what motivates "noncompeting" states to enforce choice-of-law clauses that would have the effect of sending litigation and transactional work to the competing states? We have seen in subpart A that, if states do not enforce contractual choice of law, parties can avoid their borders and their courts by moving their assets to enforcing states. However, we need to understand how that mobility translates into political incentives to enforce contractual choice of law despite the state lawmakers' obvious interest in enforcing local mandatory laws. This requires an examination of the interest group dynamic in noncompeting states created by party mobility.

To begin with, any regulation that has the effect of attracting or repelling business contributes or detracts from the state's overall business environment, and thereby may affect everybody who is a part of this environment. Businesses pay taxes that may exceed the costs of the services they consume. Businesses employ workers of all types and buy goods and services from other businesses in the state. All of these beneficiaries of a favorable legal environment potentially can put pressure on lawmakers to create such an environment.

In the standard political equation, regulation results from contention between interest groups that directly gain and lose from the regulation—that is, between "proregulatory" and "antiregulatory" groups. The winner is the group that has the most political resources, which depends not only on the size of the group but also on its costs of coordinating.[82] A relatively small group therefore may be able to successfully promote legislation that imposes net costs on society because the costs are borne by individuals who have more difficulty coordinating. Most importantly for

81. This can be true whether the clause is negotiated or simply accepted as part of a standard form by a consumer or other party. To be sure, there may be a question in some circumstances whether the choice-of-law clause is priced into the contract. Our point here is only that there is a general distinction between the situation in which the law is specified ex ante in the contract and one in which it is determined ex post by a party's choice of where to sue.

82. *See generally* MANCUR OLSON JR., THE LOGIC OF COLLECTIVE ACTION (1971) (providing a comprehensive overview of group behavior).

present purposes, the costs of state legislation may fall on out-of-state firms while the benefits are incurred by powerful in-state groups.

Now add mobility to the political mix. Firms may leave the state to avoid regulation, and this can harm those locals who profited from their presence. These "exit-affected" interest groups may add their voice to "antiregulatory" interest groups. To be sure, groups affected by the reduction of in-state business may not be very effective. For example, there is evidence that low-wage service industry employees in particular types of franchise outlets lost jobs as a result of franchise regulation.[83] These employees have little ability to act as a group, and therefore have much less political clout than existing franchisees. The latter can act as a tightly coordinated group and are directly helped by franchise regulation. Nevertheless, if franchisors and existing franchisees are closely matched in political strength, the political scales might tip to franchisors if they are joined by, or can make arguments on behalf of, exit-affected groups.

Exit also influences jurisdictional competition apart from contractual choice of law. Firms often leave states that impose high taxes or regulatory costs. For example, an insurer might leave a state where liability costs are high or unpredictable.[84] Firms' physical exit or the threat of exit might cause the state to enforce a choice-of-law clause choosing the law of another state. But the state also might decide simply to refrain from regulating or to deregulate. Given this choice, why is contractual choice of law significant? If the threat of exit could deter regulation, why should it matter whether these states enforce the parties' choice of another state's law?

Contractual choice of law is a distinct and important part of the political dynamic of jurisdictional competition. First, as discussed above, firms and parties contract for law for reasons other than simply to avoid mandatory rules.[85] They seek a single governing law, a better fit, and desirable rules of contract interpretation. States recognize that these benefits are important enough to justify the enforcement of party choice in at least some circumstances.

Second, enforcing contractual choice of law is often preferable to deregulation. Political actors within a state might not know or be able to agree on what should replace the bad laws, and yet all might acknowledge the need to enable mobile firms to avoid the law with a choice-of-law clause. Enforcing choice-of-law clauses might be a workable political compromise.

Third, contractual choice of law gives states a potentially valuable mechanism for engaging in a form of political "price discrimination" between in-state and out-of-state firms. Enforcing choice-of-law clauses

83. *See* Klick et al., *supra* note 44.

84. *See, e.g.*, Michael Kunzelman, *State Farm: No New Policies in Miss.*, ASSOCIATED PRESS, Feb. 14, 2007, *available at* http://abcnews.com/us/wirestory?id=2874970.

85. *See supra* Part I.A.1.

can be especially useful for interstate firms. These firms tend to have lower costs of exit than firms whose business is concentrated in the state because interstate firms' customers and suppliers are not confined to a specific place, and because they are already informed about other states' regulations. By keeping the regulation but letting firms avoid it through contractual choice of law, legislatures can at least preserve some effect of the regulation by imposing it on firms that have relatively high exit costs. The "discrimination" is benign in the sense that it can offset the advantage that local firms have in interest group competition if out-of-state firms lack an exit option.

B. The Corporate Law Market

This subpart discusses the supply side of the corporate law market. As with the demand side, we see similar forces operating in both the general and corporate law markets. Again, it is useful to distinguish between "competing" states, the most important of which is Delaware, and "noncompeting" states. Also, we continue to focus on the dynamic that produced the IAD. *Given* the IAD, states other than Delaware can be viewed as passively competing to retain incorporation business from their firms.[86] But the question for present purposes is not only what motivates a state like Delaware to provoke a competition for corporate law, but also why other states play Delaware's game rather than blocking this competition by refusing to enforce the IAD.

1. Competing States

The standard explanation of corporate law competition asserts that states compete to obtain local incorporation fees.[87] Delaware's franchise tax, which is imposed on all firms that incorporate in Delaware, is as high as $150,000 per firm. In the aggregate, these franchise fees represent a significant percentage of the state budget of the small state.[88] The franchise fee story seems to disconnect the IAD from the rest of the law market, since franchise fees do not explain enforcement of other types of contractual choice of law.

The franchise tax helps explain the shape of the particular market for publicly held corporations, which is dominated by a single state. Because of Delaware's small size, it is unique in its reliance on the tax, and therefore in the extent to which the franchise tax can "bond" it to commit to providing high-quality corporate law.[89] In other states, the reve-

86. *See infra* Part IV.A.
87. *See generally* Cary, *supra* note 1.
88. *See* Lucian Arye Bebchuk & Assaf Hamdani, *Vigorous Race or Leisurely Walk: Reconsidering the Competition over Corporate Charters*, 112 YALE L.J. 553, 556 (2002).
89. *See infra* text accompanying note 154.

nue incentive would likely not be enough to bind legislators to refrain from serving competing interest groups.[90]

The franchise tax cannot, however, fully account for Delaware's production of high-quality corporate law, and therefore falls short as an explanation of how Delaware drives the market for corporate law. To be sure, individual taxpayers obviously would want the state to get revenues from corporate franchise fees rather than from individual income taxes and sales taxes. But firms will not pay higher fees unless they get the sort of benefits Delaware can provide. Even state legislators who care about franchise tax revenues may not want to devote the time and energy necessary to providing a state-of-the-art corporation law and corporate infrastructure.[91]

In addition to the franchise tax, and consistent with the general law market, lawyers are an explanation for the development of the corporate law market and the IAD. For example, a lawyer named James B. Dill was almost single-handedly responsible for promoting New Jersey's corporation law.[92] Delaware lawyers also have expressed their concern with protecting Delaware's law market,[93] and have played a direct role in developing Delaware corporate law.[94] The Delaware corporate bar drafts the corporate laws for the legislature, which passes the lawyers' recommendations verbatim.[95] In return, lawyers reap the significant benefits of a thriving corporate practice: Delaware lawyers' income is fifty percent higher than lawyers in comparable states.[96] Lawyers are also a significant force in developing corporate law outside of Delaware,[97] and, as we will see below in Part IV, they help jurisdictional competition for noncorporate business associations.

As with law generally,[98] lawyers have a special incentive to develop the corporate law of their home state even though any lawyer can develop an expertise in that law. For example, only lawyers licensed in Delaware may practice regularly in Delaware courts. These courts, in

90. *See* Bebchuk & Hamdani, *supra* note 88, at 580–83.

91. *See* Douglas J. Cumming & Jeffrey G. MacIntosh, *The Role of Interjurisdictional Competition in Shaping Canadian Corporate Law*, 20 INT'L REV. L. & ECON. 141, 144–46 (2000) (noting that most legislators do not gain enough from making their state's law competitive to justify engaging proactively in law reform).

92. *See* MITCHELL, *supra* note 65, at 39–42.

93. *See* Roberta Romano, *Is Regulatory Competition a Problem or Irrelevant for Corporate Governance?*, 21 OXFORD REV. OF ECON. POL'Y 212, 218–21 (2005).

94. *See* Curtis Alva, *Delaware and the Market for Corporate Charters: History and Agency*, 15 DEL. J. CORP. L. 885, 899–901 (1990); William J. Carney, *The Production of Corporate Law*, 71 S. CAL. L. REV. 715, 722–28 (1998); Jonathan R. Macey & Geoffrey P. Miller, *Toward an Interest-Group Theory of Delaware Corporate Law*, 65 TEX. L. REV. 469, 506–09 (1987); Ribstein, *supra* note 76, at 1009–12.

95. *See* Alva, *supra* note 94, at 899–900.

96. *See* Ehud Kamar, *A Regulatory Competition Theory of Indeterminacy in Corporate Law*, 98 COLUM. L. REV. 1908, 1946 (1998).

97. *See generally* Marcel Kahan & Ehud Kamar, *The Myth of State Competition in Corporate Law*, 55 STAN. L. REV. 679 (2002).

98. *See supra* Part II.A.1.

fact, are a big reason why firms choose Delaware incorporation.[99] Parties to cases in Delaware courts must hire Delaware lawyers to at least act as local counsel in litigation. Also, Delaware lawyers' inside knowledge of Delaware judges, procedures, and decisions could be expected to give them an edge in drafting agreements that Delaware judges will interpret. Delaware lawyers therefore have an incentive to write laws that will attract corporations, and their litigation, to Delaware.

2. Noncompeting States

Neither the franchise tax nor lawyers can explain one important aspect of the corporate law market: why states that are not actively competing for out-of-state corporations enforce their local firms' choice of Delaware corporate law. It is, of course, this enforcement by other states that enables the corporate law market to operate. In particular, if lawyers in states outside of Delaware want to encourage firms to incorporate locally, why do they not oppose applying Delaware corporate law to locally based firms? After all, this would make lawyers' expertise in their state's local corporate law all the more valuable.

There are at least three explanations for noncompeting states' recognition of the IAD. Although each of these factors alone probably cannot explain states' incentives, the factors arguably combine to motivate noncompeting states to enforce the IAD. First, we have seen that in the general law market exit-affected interest groups can put pressure on states to enforce contractual choice of law in order to encourage firms to maintain connections with their states.[100] The same forces contribute to the enforcement of the IAD in noncompeting states. If firms avoid nonenforcing states, lawyers, for example, may lose potential clients and litigation business.

Second, states have incentives to abide by a general rule that entitles their own corporate governance rules to respect in other states. Courts understand that their decisions denying recognition of the IAD could be used against their own state's corporations.

Third, states have reason to be concerned about the fate of their own corporate governance law if they attempt to apply it to a firm incorporated elsewhere based on slight local contacts (for example, the residence of a few shareholders). Because such a rule would impose high costs on firms,[101] this could invite a strong legal reaction. Even if the IAD itself does not have constitutional status,[102] a state's attempt to regulate the internal governance of firms that are nearly purely foreign might be unconstitutional under the Full Faith and Credit or Commerce

99. *See infra* text accompanying note 151.
100. *See supra* Part II.A.2.
101. *See supra* Part I.A.1.
102. *See infra* Part V.A (discussing constitutional protection of the IAD).

Clause.[103] Moreover, such regulation might be enough to unite management and shareholder groups to call for *federal* regulation of corporate governance. Indeed, there was pressure for federal chartering of corporations in the early twentieth century.[104]

To be sure, states might impose their laws on firms that have a strong local presence.[105] This would at least avoid the harsh consequences of applying many state laws to a single corporation. But such a rule could deter firms from making significant local investments, which might trigger a local political backlash against the regulation. That may explain why only New York and California—large, rich states that can offer firms significant non-law benefits for locating there—have attempted this move.[106] In other words, these states have a captive market that local interest groups can exploit, in part, by lobbying to apply local corporate law to foreign corporations.

Even if noncompeting states have incentives to enforce other states' laws, they could choose to impose limits on enforcement of the IAD similar to those applicable to noncorporate choice of law—that is, by requiring a connection between the parties and the designated state and imposing a public policy exception on firm choice. However, the IAD is more absolute than the general rules for enforcing contractual choice of law. The next Part explains these differences in terms of the general supply and demand forces in the market for law.

III. LIMITS ON ENFORCEMENT

This Part discusses the limits on enforcement of contractual choice of law, in both the general and corporate law markets. We show how the political dynamics created by the law market can perpetuate limitations on the enforcement of the parties' choice of governing law. Typical limitations include requirements that the law chosen have a connection to the parties or transaction, and that it not violate the fundamental public policy of interested states. Law market forces also help explain the situations in which these limitations are absent or have been eroded, particularly in the corporate law market.

Subpart A analyzes the limitations in the general law market, and subpart B analyzes the absence of limitations in the corporate law market. Subpart C explores the incentives that firms and interest groups

103. *See infra* Part V.A (discussing constitutional standards for choice of law).

104. *See supra* note 14 and accompanying text.

105. This is something like the "real seat" rule that applies in Europe. *See infra* Part IV.D.

106. Recent California cases are discussed in *infra* Part IV.D. New York has incentives similar to California's, and indeed has sought to regulate pseudo-foreign corporations. *See* P. John Kozyris, *Corporate Wars and Choice of Law*, 1985 DUKE L.J. 1, 66–67 (discussing New York statutes applying New York corporation law to foreign corporations). California has been more aggressive than New York recently, perhaps because New York wants to build a reputation as an active competitor in the market for law. *See infra* Part IV.F.

might have, both in the general and in the corporate law markets, to respond to burdensome multistate regulation by seeking protection from federal law. In particular, Congress can use its broad powers over interstate commerce to enact federal regulation that preempts inconsistent state regulation. Conversely, proregulatory interest groups might attempt to prevent defeat or erosion of their regulatory interests by seeking federal regulation. Subpart D summarizes the analysis presented in the first three Parts of the article.

A. The General Law Market

Explaining the supply side of the law market not only helps explain why states enforce party choice of law, but also accounts for the limitations on enforcing party choice. As discussed in the following sections, enforcement of party choice in the general law market can be restricted by both the connection requirement and the fundamental policy exception. In each case we will distinguish the incentives and resulting rules of states that are actively competing for law business from those of noncompeting states.

1. Connection Requirement

As a prerequisite to enforcing choice-of-law clauses, many courts require a connection between the parties or transaction and the chosen state.[107] In contrast, no such rule exists in the market for corporate law.[108] In understanding the relationship between the corporate and general law markets, it is therefore important to focus on the political and policy reasons for connection requirements.

States' motivations for imposing connection requirements can differ for competing and noncompeting states. We begin with competing states. Recall that a few states have enacted statutes mandating local court enforcement of clauses choosing their law for high-value contracts. Most of these statutes permit the parties to choose the enacting state's law without a connection with that state.[109] Though the states merely invite parties to use their own laws, the statutes are still significant in inviting use of the state's law by firms all over the country. Without a connection requirement, there is a question of what the state gains.

One possible explanation for the absence of a connection requirement in these statutes concerns the role lawyers have played in promoting them.[110] Lawyers could be expected to favor local enforcement of choice-of-law clauses even if the parties lack a connection with the state

107. *See supra* Part I.A.2.
108. *See infra* Part III.B.1.
109. *See supra* note 76. Florida has a slight connection requirement while Texas, which also permits choice of non-Texas law, requires a reasonable connection.
110. *See generally* Ribstein, *supra* note 76.

because enforcement attracts contract litigation to the forum. To be sure, transactional lawyers might instead prefer to use the statute to attract the firms to the state on the theory that in-state firms are more likely to choose in-state lawyers. But as long as noncompeting states' courts adhere to their connection requirement, this may induce some firms to physically locate in the competing states in order to ensure enforcement of the choice-of-law clauses.

Now consider noncompeting states' incentives when adjudicating a contract designating a competing state's law, whether or not pursuant to a choice-of-law statute. Lawyers in noncompeting states derive much less benefit from enforcing the parties' choice of the law of competing states because legal experts in the competing states are likely to have an edge in attracting commercial litigation and transactional business. It does not necessarily follow, however, that the noncompeting state courts will never enforce the clause. As discussed above,[111] they have an incentive not to deter firms from establishing contacts with the state. However, noncompeting states could be expected to require as a condition of enforcing choice-of-law clauses that the parties have a connection with the state whose law is chosen. Lawyers in noncompeting states would want to constrain locally based firms from sending their law business to one of the leading commercial jurisdictions. If the noncompeting state requires a connection with the designated state as a condition of enforcing the choice-of-law clause, locally based firms might be inclined to settle for local law because they value their physical connection with the forum more than they value the competing state's law. A firm whose workers are basking in Arizona sun may not find it worthwhile to relocate to Delaware just for the latter's law and courts. The noncompeting state therefore may be able to "bundle" its law with its more desirable attributes. If so, the connection requirement allows noncompeting states to preserve their laws against drastic erosion by the law market.

Although a connection requirement might serve noncompeting states' interests in many cases, the rules on contractual choice of law recognize the possibility of enforcing commercial contracts without any connection between the parties or transaction and the chosen jurisdiction. The Second Restatement says that even absent a substantive connection, another "reasonable basis" for the choice may be enough.[112] The Reporter's Note cites the famous English case of *Vita Food Products, Inc. v. Unus Shipping Co.*,[113] which enforced the contractual choice of otherwise unrelated English law in a contract for shipment of goods from Newfoundland to New York. The parties here wanted a set of familiar laws and, perhaps, to avoid potential home court bias favoring ei-

111. *See supra* Part II.A.2.
112. RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 187(2) (1971).
113. Vita Food Prod., Inc. v. Unus Shipping Co., Ltd., [1939] A.C. 277 (P.C. 1938) (appeal taken from N.S.).

ther side. Obviously, courts easily could expand this exception to acknowledge any of the reasons firms choose their governing laws.

This open-ended Restatement exception makes sense in light of the general supply-side incentives of noncompeting states discussed in this article. Recall that the connection requirement serves to protect a state's law-making prerogatives by forcing firms to balance the benefits of locating in their home state against those of using the law of a competing state. This could backfire where firms derive enough benefit from the competing state's law that they might be willing to move if the connection requirement forces them to do so. Such moves could impose costs on local lawyers and other exit-affected interest groups. Then it may make sense for the noncompeting state to let the firm use the competing state's law even if it lacks a connection with that state. This may be true not only in cases like *Vita* where the parties need *some* neutral law, but also in cases where a *particular* jurisdiction has emerged as especially expert and unbiased.

2. The "Fundamental Policy" Exception

Most states will refuse to enforce chosen law if it is contrary to an interested state's "fundamental policy." This exception carves out a category of "super-mandatory" rules that trump contractual provisions not only under local law, but also as against the law of the contractually selected jurisdiction. The Restatement provides that the trumping state must be one that (1) would be selected under the most significant relationship test, and (2) "has a materially greater interest than the chosen state in the determination of the particular issue."[114] Thus, a court determining whether the contractual choice is subject to a super-mandatory rule must consider both the nature of the policy involved (i.e., whether it is "fundamental") and the level of the state's interest in applying its policy to the relevant issue in the case.

Like the connection requirement, rules permitting regulating states to trump contractual choice are both the product of and subject to the disciplining effects of the supply and demand forces of the law market. Whether a state will impose a super-mandatory rule depends on the presence and relative political strength of proregulatory groups that favor the rule, antiregulatory groups that are directly burdened by the regulation, and the exit-affected groups that stand to lose if the super-mandatory nature of the regulation drives firms and individuals away from the state. A state's regulation has super-mandatory effect only if the interest groups favoring the rule are stronger than both the antiregulatory and the exit-affected groups.

114. RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 187(2).

Consider, for example, states' treatment of choice-of-law clauses in franchise contracts. When a state chooses to regulate the ability of franchisors to terminate their contracts with franchisees, the proregulatory group of franchisees is often stronger than the antiregulatory group of franchisors, who are usually based outside the state, plus the exit-affected group of those whose jobs or product quality are affected by franchise regulation.[115] Employees, consumers, and others affected by a potential decrease in franchises or outlets have high costs of organizing politically relative to the benefits they could derive from this particular political action. In this situation, exit-affected groups remain impotent, and the legislature (or court) remains free to treat franchise regulation as a supermandatory rule. If, however, the exit-affected interest groups are well represented in the legislature, then parties are more likely to remain free to opt out of the regulation by choosing another state's law.

It follows from these law market forces that courts must distinguish between a merely mandatory statute, which reflects one outcome of a contest between these three types of interest groups, and a supermandatory rule, which reflects a different political balance, one in which exit-affected interest groups may lack strong political influence. In fact, courts often seem to appreciate this distinction because they generally enforce choice-of-law clauses except in a limited group of cases: franchise and distributorship agreements, noncompetition provisions in employment contracts, loan interest rates, insurance contracts, and other consumer contracts involving choice-of-law provisions in standard form agreements.[116]

In deciding whether to override contractual choice of law, courts also have to determine which state's fundamental policies will be taken into account. The Second Restatement looks both to whether the trumping state would be the state whose law would be chosen under the most significant relationship test and to whether the trumping state's interest is superior to that of the chosen state.[117] A firm that wants to use a choice-of-law clause can help control whether a state's fundamental policy will override the clause through its choice of location for its headquarters or other significant investments. This rule therefore helps to ensure that the interests of exit-affected groups in both regulating and designated states will be taken into account in determining which rules have supermandatory effect.

The competing states' choice-of-law statutes[118] allow enforcement of choice-of-law clauses without regard to the public policies of other states

115. *See supra* note 44 and accompanying text.

116. *See* SCOLES ET AL., *supra* note 35, § 18.5, at 966–73; Ribstein, *supra* note 25, at 405–12; Giesela Ruehl, *Party Autonomy in the Private International Law of Contracts: Transatlantic Convergence and Economic Efficiency* 16–20 (Comparative Research L. & Pol. Econ., CLPE Research Paper No. 4/2007, 2007), *available at* http://ssrn.com/abstract=921842.

117. RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 187(2) (1971).

118. *See supra* note 76 and accompanying text.

and even if the parties lack a local connection. Since the statute merely invites the parties to use the enacting state's law, the state is not trying to override other states' policy choices. But the statute does have the significant effect of inviting parties from all over the country, regardless of lack of a local connection, to use the enacting state's law to help ensure enforcement of their contracts. This contrasts with the weighing of state interests under the traditional Restatement rule for enforcing choice-of-law clauses. As discussed above, the influence of its lawyers probably explains the competing state's willingness to be accommodating.[119] Moreover, the states have only weak interests in regulating large commercial contracts where the parties are closely enough matched in expertise and bargaining power that they rarely need any regulatory assistance, much less super-mandatory rules. In short, for competing states, the prime exit-affected group of lawyers overrides any proregulatory interests.

These choice-of-law statutes do not guarantee enforcement if plaintiff sues outside of the competing state. That forum may have no strong lawyer or other interest group that wants to attract commercial transactions and litigation, and may have strong local interest groups that want to prevent evasion of the noncompeting state's statute. Although this is unlikely for most large commercial transactions, some categories of transactions, including those listed above,[120] may trigger concerns within the noncompeting state. On the other hand, even under the traditional choice-of-law analysis, the statutes may identify an "interest" of the designated state in having its law applied. Moreover, under this article's analysis, even noncompeting states may have an incentive to limit their use of the fundamental policy exception if applying the rule causes parties to avoid the state. Thus, the interaction between exit-affected and proregulatory groups may erode limits on enforcing choice-of-law clauses in noncompeting as well as competing states.

B. The Corporate Law Market

The IAD at first glance seems strikingly different from the rules governing choice-of-law clauses generally. In contrast to these general rules, the IAD is enforced without any requirement of a connection between the corporation and the state of incorporation, and generally without a "fundamental policy" exception. However, this subpart shows that the differences between the IAD and the general rules governing choice-of-law clauses are actually not as great as they seem, and can be explained by differences in the demand and supply forces across contract types.

119. *See supra* note 110 and accompanying text.
120. *See supra* text accompanying note 116.

1. *Connection Requirement*

Delaware applies its corporate law to firms that have no connection with the state. This follows from the supply-side of the corporate competition.[121] Because of its franchise tax, Delaware's incorporation business confers benefits on the state's taxpayers regardless of whether the corporation has any contacts with the state. Even apart from the franchise fee, however, Delaware lawyers would want to attract both litigation and its associated transactional work. Requiring in-state connections for incorporation would only limit the local lawyers' market. Thus, the IAD rule operates according to incentives that are similar to those that produced the competing states' choice-of-law statutes for high-value commercial transactions which similarly lack a connection requirement.[122]

It might seem harder to explain why courts outside of Delaware also apply the IAD even to firms that lack a connection with the incorporating state. But this too makes sense given the general law market forces described in this article. First, the IAD can be analyzed as an extension of the *Vita* exception to the connection requirement[123] applied to choice of corporate law. Consistent with our analysis of that exception, firms gain so much from being able to contract for corporate governance law that noncompeting states fear firms' moving their home offices or avoiding contacts with them if they imposed a connection requirement.

Second, even if these risks of losing firms by imposing a connection requirement are only slight, noncompeting states also have little to gain from insisting on a connection requirement. As discussed in the next subpart, most important policy questions concerning corporate governance are not covered by the IAD. Restrictions on party choice of law typically require strong interest-group support. With little demand to protect the few mandatory rules that fall within the IAD, restrictions on contractual choice, including the connection requirement, are unlikely.

2. *Fundamental Policy Exception: The IAD as Optical Illusion*

Even if firm mobility and lawyers' interests encourage enforcement of the IAD, other local interest groups often would rather have the state apply local regulation than the more permissive law of another state. The presence of these competing interests explains the "fundamental policy" exception to enforcement of choice-of-law clauses for contracts generally. Yet the courts do not recognize such an exception for the IAD. This seems odd in light of the controversies perennially raging in Congress and in the press about corporate governance, some of which include the Enron-era scandals, executive compensation, shareholder

121. *See supra* Part II.B.1.
122. *See supra* Part I.D.
123. *See supra* text accompanying note 113.

voting, fraud, and protection of nonshareholder "stakeholders." These controversies, though heated, have not yet threatened the IAD. Politically powerful groups like organized labor, for example, could seek to shape corporate law to promote their interests, and it might seem that protecting labor's interests would require relaxing the IAD to protect employees outside the incorporating state. Shareholder interests are probably too diffuse to block such regulation even if it reduced shareholder wealth.[124] So why is there no fundamental policy exception to the IAD?

It is not surprising that Delaware, the leading corporate jurisdiction, has few mandatory corporate rules. Delaware is small enough that its incorporation fees really matter to its fiscal health, while it lacks the interest groups that might agitate for enforcing local public policies against foreign corporations. This was also true in New Jersey when it began competing for charters.

The puzzle concerning the lack of super-mandatory corporate rules concerns states other than Delaware that are called on to apply the IAD to Delaware corporations doing business locally. The explanation for Delaware's passivity applies to few other states. For example, by the time Wilson became governor of New Jersey, that state was developing industries and alternative sources of revenue, and through these industries was also feeling the costs of monopolization its laws were imposing elsewhere.[125] Why, then, is the IAD enforced without the usual "fundamental policy" exceptions outside of Delaware? Surely courts and legislatures could, if they wanted to, view at least ordinary investors who own shares in publicly traded corporations as equivalent to the unsophisticated individuals who are protected by super-mandatory rules in other contexts.

At least two factors can explain the absence of a fundamental policy exception to the IAD. First, there is only weak pressure for super-mandatory corporate governance rules. Consider the positions of groups that would be most interested in the sort of corporate governance issues covered by the IAD—shareholders and creditors. In the early days of the private corporation, before strong public securities markets, shareholders would have been able to protect themselves through voting provisions in corporate charters. When public securities markets developed, dispersed and passive shareholders might have needed legal protection from strong managers. But noncontrolling shareholders were a diffuse group, with no organizations that could have coordinated their lobbying. Similarly, creditors might have needed protection from owners' manipulation of corporate assets, particularly after legislatures and courts recognized limited liability of shareholders for corporate debts. But banks and other large creditors could insist on contractual protection, while small

124. *See* Coates, *supra* note 68 (discussing the potential influence of these interest groups).
125. *See* Grandy, *supra* note 59.

trade creditors were no more able than shareholders to coordinate politically. Tort creditors, such as accident victims, were weak until trial lawyers became a potent force in speaking for them, by which time corporate features were well established, accounting and disclosure technology provided significant protection for creditors,[126] and trial lawyers had plenty of corporate assets to go after. In short, possible legal protections often proved either unnecessary or unattainable.

Second, any pressure for legal protections that does exist has been channeled off into rules outside the area covered by the IAD. In other words, the IAD is a sort of optical illusion: it looks absolute because its scope has been limited to the area in which it can operate absolutely. Most public policy concerns are expressed through laws that do not fall within the IAD itself. For example, organized labor seeks employee protections in labor law. Constraints on corporate size once imposed by the capital limits of early special charters[127] were left to the antitrust laws. Creditors' direct rights against the firm are contained in the loan agreements and are therefore subject to conflict of laws principles that apply to contracts generally. In contrast to internal governance matters like shareholder voting, the benefits of being able to choose a single firmwide rule are lower for agreements with creditors. The IAD is limited to covering creditor-protection rules that concern *shareholders'* financial rights, including shareholders' personal liability for corporate harms, obligations to commit their capital to the firm, and restrictions on distributions to owners that increase the risk that the firm will not be able to pay its debts. These rules mostly affect smaller creditors who, as discussed above in this section, are less powerful as an interest group than the combination of the antiregulatory and exit-affected interest groups that support the IAD.

Consider also states' securities, or "blue sky," statutes that specify disclosure rules for securities transactions. These laws apply to transactions occurring in the state,[128] which is often the investor's home state, regardless of the location of the company's incorporation. This exception to the IAD can be explained partly by the lower costs of enforcing local law in this situation: local actions by investors do not threaten firmwide governance rules such as those dealing with shareholder voting. Moreover, in contrast to the relatively weak interest groups that might oppose the IAD, strong interest groups really cared about state securities regulation in the early twentieth century. Proregulation groups here included relatively well-organized regional securities firms and local banks that feared the big New York investment banks.[129] More recently, trial law-

126. *See generally* Henry Hansmann et al., *Law and the Rise of the Firm*, 119 HARV. L. REV. 1333 (2006).

127. *See* Tung, *supra* note 9, at 61.

128. *See* UNIF. SEC. ACT § 610, 7C U.L.A. 207 (2006).

129. *See* Macey & Miller, *supra* note 94 (discussing the influence of small banks and local industries on the enactment of blue sky laws).

yers have promoted state securities regulation as an end-run around federal restrictions on securities fraud claims.[130]

Ethics rules for professional firms also lie outside the IAD. In general, ethics rules regulate the conduct of individual professionals based on where they practice and are not really part of "corporate" law. But some professional ethics rules, such as those specifying the members' vicarious liability for the firm's debts, have at least as much impact on the firm's governance as the rules that are subject to the IAD.[131] A publicly held corporation, therefore, may not practice law in the United States and accountants and other professionals may not co-own a law firm. The persistence of these rules can be explained by the power of professional groups who want to restrict competition. For example, the rule restricting who may own the firm's shares protects professionals from having bosses who do not share their interests.[132] Because professional groups are among the most powerful and cohesive interest groups, they would be formidable opponents of enforcing contractual choice of law.[133]

These exceptions to the IAD show that corporate governance, if broadly construed to include matters that are technically outside the IAD, actually is subject to the same anti-contractual-choice pressures that affect other types of contracts. The success of opponents of contractual choice depends on the same factors that matter elsewhere in the law market, including the benefits of contractual choice, the costs and benefits of exit, and, as discussed in the next subpart, the role of federal law in mitigating the costs imposed by multiple state regulators. The only difference is that the exceptions have developed outside the IAD, thereby preserving the apparent absoluteness of the doctrine.

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130. *See* Larry E. Ribstein, Dabit*, Preemption, and Choice of Law*, 2006 CATO SUP. CT. REV. 141, 146 [hereinafter Ribstein, Dabit*, Preemption, and Choice of Law*]. There is a separate question whether firms and investors should be able to choose the applicable securities law. *See* Stephen J. Choi & Andrew T. Guzman, *Portable Reciprocity: Rethinking the International Reach of Securities Regulation*, 71 S. CAL. L. REV. 903 (1997) (arguing for allowing this choice); Roberta Romano, *Empowering Investors: A Market Approach to Securities Regulation*, 107 YALE L.J. 2359 (1998) [hereinafter Romano, *Empowering Investors*] (same). This would not necessarily lead to a race to the bottom: firms have voluntary "bonded" the accuracy and completeness of their disclosures by voluntarily subjecting themselves to higher disclosure standards than in their home countries. *See* Larry E. Ribstein, *Cross-Listing and Regulatory Competition*, 1 REV. L. & ECON. 97 (2005) [hereinafter Ribstein, *Cross-Listing and Regulatory Competition*], *available at* http://www.bepress.com/rle/vol1/iss1/art7. Also, securities prices have been shown to reflect disclosure differences across countries. *See* Roberta Romano, *The Need For Competition In International Securities Regulation*, 2 THEORETICAL INQUIRIES L. 387 (2001) [hereinafter Romano, *The Need for Competition*] (summarizing studies), *available at* http://bepress.com/til/default/vol2/iss2/art1.

131. For a discussion of the effect and politics of these rules in the law firm setting, see Larry E. Ribstein, *Ethical Rules, Law Firm Structure and Choice of Law*, 69 U. CIN. L. REV. 1161 (2001).

132. *See* Larry E. Ribstein, *Ethical Rules, Agency Costs and Law Firm Structure*, 84 VA. L. REV. 1707, 1721 (1998).

133. As with creditor and securities rules, there is a separate question whether there should be jurisdictional competition as to ethical rules as well.

C. The Federal Role

No examination of the IAD would be complete without considering the important role of federal law. We have seen that states may impose super-mandatory rules in the general law market and similarly regulate corporate governance in significant ways outside the IAD.[134] When these laws threaten to subject national firms to numerous state regulators, business groups may lobby for a single federal law to regulate the area and preempt inconsistent state laws. Conversely, proregulatory groups may lobby for federal regulation that supersedes the IAD, or other treatment of contractual choice of law, in order to facilitate super-mandatory state or federal laws. Thus, federal law is part of the optical illusion of the IAD: it provides another way to move contentious issues, such as bankruptcy, securities, antitrust, and other laws that otherwise might trigger exceptions to the IAD, outside the scope of that rule.[135]

Consider, for example, the federal government's role in protecting creditors of insolvent corporations. Although the IAD generally applies in this area,[136] federal law creates certain deviations from the IAD. A bankrupt firm is managed by the trustee in bankruptcy, which may be the corporation's managers if the corporation is being reorganized under Chapter 11 of the Bankruptcy Code.[137] Some bankruptcy courts have allowed creditors to sue shareholders or managers derivatively on behalf of the insolvent corporation if the trustee in bankruptcy refuses to bring the suit.[138] If the court allows the suit, it effectively subjects corporate management to federal bankruptcy law rather than the law of the state of incorporation. For example, some cases suggest that the corporation or its managers may have a special federal fiduciary duty to creditors that transcends the creditors' specific rights under their loan agreement or state law.[139]

The federal role in corporate governance is particularly important because of its potentially dynamic effect. Once Congress has passed a law, firms may press the courts to expand the law's preemptive effect, and thereby slowly erode state law. Although the Supreme Court gener-

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134. *See supra* Part III.B.2.

135. *See* Mark Roe, *Delaware's Competition*, 117 HARV. L. REV. 588 (2003) (discussing the increasing federalization of corporate law).

136. *See, e.g.*, Prod. Res. Group v. NCT Group, 863 A.2d 772 (Del. Ch. 2004).

137. Keith Sharfman, *Derivative Suits in Bankruptcy*, 10 STAN. J.L. & FIN. 24 (2004).

138. *See* Official Comm. of Unsecured Creditors of Cybergenics Corp. v. Chinery, 330 F.3d 548 (3d Cir. 2003) (allowing creditors committee to sue derivatively); *In re* Commodore Int'l Ltd., 262 F.3d 96 (2d Cir. 2001) (also allowing creditors committee to sue derivatively with the approval of the bankruptcy court). Others have questioned the right to bring such an action under the Bankruptcy Code. *See In re* Fox, 305 B.R. 912 (B.A.P. 10th Cir. 2004) (denying standing to bring a § 548 claim); Sharfman, *supra* note 137 (discussing cases and questioning availability of derivative remedy).

139. For a critique of these cases, see Larry E. Ribstein & Kelli Alces, *Directors' Duties in Failing Firms*, J. BUS. & TECH. L. (forthcoming), *available at* http://ssrn.com/abstract=880074.

ally has presumed against preempting state law,[140] it has departed from that presumption in areas of the law dominated by federal regulation, such as securities law.[141]

So far the federal government generally has stayed out of issues the states have chosen to keep within the IAD. Thus, a move in 1914 to consider federal chartering of corporations ended with a failed proposal for federal licensing or franchising that would have preserved state incorporation.[142] By this time, because the IAD was widely accepted, there was no need for federal law to protect firms from multiple state laws. However, the federal government's quiescence as to issues falling within the IAD may not continue. Congress responded to Enron and related scandals with the broadest federal regulation of corporate governance since the Depression—the Sarbanes-Oxley Act.[143] Federal regulation in this area might continue to expand in response either to state super-mandatory laws or to the perceived inadequacy of state regulation.

The risk of federal government action might cause proregulatory interest groups to pause before seeking state regulation that could motivate antiregulatory groups to seek federal preemption. Because the risk of federal action may depend on whether state regulations impose costs on firms outside the state, interest groups have some incentive to limit their regulatory initiatives to those that mainly affect firms that are closely connected to the state. The potential for federal action also might cause antiregulatory groups to accede to state regulation of corporate governance that, while imposing new burdens, is less costly than broadening federal regulation. When Congress preempts state law, it completely ousts the states from regulating in that area. Interest groups acting at the state level must constantly balance the benefits they derive from enacting particular regulation against the possibility of losing their jurisdiction entirely. In this sense, state law operates in the shadow of federal law.[144]

D. Summary

The market for corporate law is not as different from that for contract law generally as it might seem at first glance. In both cases parties demand the benefits of contractual choice of law, and they make that demand felt in the law market through their basic ability to move among jurisdictions. Exit-affected interest groups, particularly lawyers, respond

140. *See* Bates v. Dow AgroSciences LLC, 544 U.S. 431, 449 (2005); Medtronic, Inc. v. Lohr, 518 U.S. 470, 485 (1996).

141. *See* Merrill Lynch, Pierce, Fenner & Smith v. Dabit, 547 U.S. 71, 87–89 (2006).

142. *See* MITCHELL, *supra* note 65, ch. 5.

143. *See* Public Company Accounting Reform and Investor Protection Act, Pub. L. No. 107-204, 116 Stat. 745 (2002) (codified as amended in scattered sections of 15, 18 U.S.C.).

144. For an analogous point, see Roe, *supra* note 135 (arguing that Delaware in effect competes with federal law because of the threat of federal preemption).

by pressuring state governments to allow parties to shop for law. In both cases the market is limited by state regulation that trumps contractual choice in particular situations, and by federal law that preempts state law when multiple state regulations threaten to impede national trade. The one apparent distinction between the corporate and the general markets—the fact that the IAD requires no connection between the parties or transaction and the designated state—is readily explained by the same political considerations that underlie the general law market. Moreover, the general law market also dispenses with the connection requirement in equivalent circumstances. Thus, it is misleading to examine the corporate law market as a distinct phenomenon, and much more intellectually profitable to understand the common forces underlying markets for corporate as well as other contract law.

IV. THE STRUCTURE OF THE CORPORATE LAW MARKET

The academic writing on the corporate law market has so far focused on a relatively narrow slice of that market occupied by publicly held corporations. Scholars have argued over whether this slice involves a "race to the bottom," as William Cary suggested.[145] The literature suggests that the competition for the provision of corporate law is defective because of Delaware's overwhelming market share. Moreover, Delaware's dominance seems to be abetted by the IAD, which permits corporate law to be divorced from the place of operation.

This Part shows that the debate has drawn a misleading picture of the corporate law market. We provide a corrective by broadening the analysis to discuss the markets for many types of business associations and analogous entity-creating or -modifying contracts. Here we turn from a discussion of the development of the IAD to a discussion of the market for corporate law that has developed as a result of the IAD. We show that the processes discussed in Parts I–III above are at work throughout the many aspects of the law market. While the processes have different consequences in each setting, their important role in different contexts suggests that the corporate law market is shaped by these ongoing market and political forces rather than being the inevitable result of particular historical circumstances or legal rules. As discussed below in Part V, this analysis has important policy and theoretical implications.

Subpart A begins on conventional ground by discussing publicly held corporations. This subpart undercuts the notion that Delaware's apparent dominance sets the market for publicly held corporation law apart from the processes we have described. Subparts B, C, and D describe other business associations that are subject to versions of the IAD,

145. *See supra* text accompanying note 1.

including closely held business associations, publicly held unincorporated firms, and European corporations. Subparts E, F, and G discuss markets that are not subject to the IAD but nevertheless involve processes similar to those operating in corporate and general law markets: international securities regulation, commercial contracts, and trusts. Subpart H summarizes the implications of this Part's analysis.

A. Publicly Held Corporations

Given scholars' focus on the market for publicly held corporations, it is not surprising that the corporate law market seems unique. Delaware overwhelmingly leads all other states by incorporating more than half of public corporations.[146] Delaware's dominance is reflected in the profits it makes from its franchise fees. No other aspect of the law market operates through a franchise fee mechanism. However, we have shown that even the Delaware phenomenon can be explained by the general forces underlying the law market. Elsewhere in this Part we will show that Delaware dominates only one aspect of the corporate law market. Here we will show that Delaware's leading role in the market for publicly held corporations does not imply the absence of a viable market for law even with respect to this corner of the law market.

Several possible reasons have been given for Delaware's dominance.[147] First, Delaware may have the sort of "network" advantages that have been attributed to, for example, computer operating systems.[148] The many Delaware corporations produce cases and common practices, and those practices help to clarify contract terms over time.[149] These advantages can "lock in" Delaware law against even more efficient competitors.[150] Second, Delaware offers a legal "infrastructure" consisting of

146. *See* Lucian Arye Bebchuk et al., *Does the Evidence Favor State Competition in Corporate Law?*, 90 CAL. L. REV. 1775, 1810 (2002) (finding Delaware's share to be fifty-eight percent of publicly traded nonfinancial firms).

147. *See id.* at 1784–97 (reviewing these explanations).

148. *See* Paul A. David, *Clio and the Economics of QWERTY*, 75 AM. ECON. REV. 332, 334–36 (1985).

149. *See* Charles J. Goetz & Robert E. Scott, *The Limits of Expanded Choice: An Analysis of the Interactions Between Express and Implied Contract Terms*, 73 CAL. L. REV. 261, 286–89 (1985).

150. For discussions of the network externalities and related theories in the context of business associations, see Lucian Arye Bebchuk & Mark J. Roe, *A Theory of Path Dependence in Corporate Ownership and Governance*, 52 STAN. L. REV. 127 (1999); Marcel Kahan & Michael Klausner, *Antitakeover Provisions in Bonds: Bondholder Protection or Management Entrenchment?*, 40 UCLA L. REV. 931 (1993); Marcel Kahan & Michael Klausner, *Path Dependence in Corporate Contracting: Increasing Returns, Herd Behavior and Cognitive Biases,* 74 WASH. U. L.Q. 347 (1996); Marcel Kahan & Michael Klausner, *Standardization and Innovation in Corporate Contracting (or "The Economics of Boilerplate")*, 83 VA. L. REV. 713 (1997); Michael Klausner, *Corporations, Corporate Law, and Networks of Contracts*, 81 VA. L. REV. 757 (1995). *See also* Ehud Kamar, *Beyond Competition for Incorporations*, 94 GEO. L.J. 1725 (2006) (arguing that Delaware's legal indeterminacy enables it to increase network effects and thereby to hold onto its dominant position). For skepticism about the network externalities theory, see S. J. Liebowitz & Stephen E. Margolis, *The Fable of the Keys*, 33 J.L. & ECON. 1 (1990); S. J. Liebowitz & Stephen E. Margolis, *Network Externality: An Uncommon Tragedy*, 8 J. ECON. PERSP. 133 (1994) (showing that it may be impossible to tell whether a product, or corporate

the country's most expert corporate court and bar. A would-be competitor would have to make a large investment in developing such an infrastructure.[151] Meanwhile, Delaware could quickly respond to any other state's attempt to actively compete with it.[152] Third, a competitor state also would have to provide assurances as to its future lawmaking and adjudication. An important function of corporate law is its ability to change over time. Because amending a public corporation's charter is a costly and cumbersome process, it may be hard for corporations to change their contracts to efficiently account for changing circumstances that a firm will face over its long life. Firms, therefore, must trust the state to make necessary changes.[153] At the same time, corporations must hope that the state's politicians do not change the corporation laws in ways that reduce corporate wealth—as New Jersey did when it enacted its antitrust law at the beginning of the 20th century. Delaware's dependence on franchise taxes uniquely "bonds" its commitment to avoid similar compromises.[154]

Delaware's dominance matters because of its possible effect on the efficiency of the state competition for corporate law. This dominance is the current turn in the debate William Cary began with his "race to the bottom" paper.[155] Commentators responded that efficient securities markets discipline firms' choice of state of incorporation.[156] But an efficient securities market can only discipline the choice among available competitors. Firms' positive reaction to Delaware incorporation there-

statute, is losing the competition because users like to stick with an inferior product's "network," or just because the winning product is actually superior). For skepticism about the application of the theory to corporate law, see Romano, *supra* note 130, at 514–19. For evidence that the network externalities theory did not prevent development of a new type of closely held business association, see Larry E. Ribstein & Bruce H. Kobayashi, *Choice of Form and Network Externalities*, 43 WM. & MARY L. REV. 79 (2001).

151. Note, however, that the investment may not be large compared to a state's overall budget. Kahan & Kamar, *supra* note 97, at 725, suggest it would cost less than $2 million a year.

152. *See* Bebchuk & Hamdani, *supra* note 88, at 585–95.

153. *See* Henry Hansmann, *Corporation and Contract*, 8 AM. L. ECON. REV. 1, 7–10 (2006).

154. *See* Roberta Romano, *Law as Product: Some Pieces of the Incorporation Puzzle*, 1 J. L. ECON. & ORG. 225, 231 (1985).

155. Cary, *supra* note 1; *see also* Lucian Arye Bebchuk, *Federalism and the Corporation: The Desirable Limits on State Competition in Corporate Law*, 105 HARV. L. REV. 1435 (1992).

156. *See* FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 212–18 (1991); Daniel R. Fischel, *The "Race to the Bottom" Revisited: Reflections on Recent Developments in Delaware's Corporation Law*, 76 NW. U. L. REV. 913, 918–19 (1982); Romano, *supra* note 154, at 229–30; Ralph K. Winter, Jr., *State Law, Shareholder Protection, and the Theory of the Corporation*, 6 J. LEGAL STUD. 251, 256 (1977). There is evidence that the stock market rewards firms that reincorporate in Delaware from another jurisdiction. *See* Peter Dodd & Richard Leftwich, *The Market for Corporate Charters: "Unhealthy Competition" Versus Federal Regulation*, 53 J. BUS. 259, 274–75 (1980); Romano, *The Need for Competition*, *supra* note 130, at 495–97 (reviewing eight studies finding positive abnormal stock returns from changing incorporation state); Romano, *supra* note 154, at 232. There is also evidence that the market gives a higher value to Delaware corporations than firms incorporated in other states. *See* Robert Daines, *Does Delaware Law Improve Firm Value?*, 62 J. FIN. ECON. 525, 527 (2001) (documenting that Delaware firms had higher "Tobin's Q's" than non-Delaware firms in a study covering the period 1981–1996).

fore may be attributable not to the high quality of Delaware law, but to the fact that the market produces few competitors.[157]

Although Delaware undoubtedly has a significant market share of incorporations of public firms, this does not mean the market is not competitive. Delaware attracts about fifty percent of incorporations by new public firms,[158] and a little more than half of all publicly traded corporations,[159] with most of the rest incorporating in their home states. Given Delaware's supposed significant competitive advantages, one might ask why Delaware's dominance in these areas is not greater. Scholars have offered several explanations, most of which are skeptical of the existence of a healthy competition for corporate law.[160] For example, Robert Daines presents evidence showing that the choice of the home state correlates with the use of a local rather than national law firm.[161] But correlation is not necessarily causation. Firms may be choosing their lawyers based on their incorporation choices. There is also evidence that states use antitakeover statutes to attract incorporations,[162] and competing evidence that firms are seeking flexible rules and high-quality judicial systems rather than takeover protection.[163] Michael Klausner concludes that the evidence overall does not support a vigorous competition for corporate law.[164]

Despite these scholars' skepticism, competition with home states for incorporation business may be enough to provide realistic market discipline for corporate law.[165] This is indicated by the facts that corporate law innovations spread through the states in the same way that innovations in competitive markets have been shown to spread,[166] and that states earn franchise revenues in proportion to their willingness to respond to changes in the market with innovative legislation.[167] However, the franchise tax cannot explain why non-Delaware states would seek to keep their locally based corporations from incorporating in Delaware.

157. *See* Oren Bar-Gill, Michal Barzuza & Lucian Bebchuk, *The Market for Corporate Law,* 162 J. INSTITUTIONAL & THEORETICAL ECON. 134 *passim* (2006); Kahan & Kamar, *supra* note 97, at 685–86.

158. *See* Robert Daines, *The Incorporation Choices of IPO Firms*, 77 N.Y.U. L. REV. 1559, 1571 (2002).

159. *See* Bebchuk et al., *supra* note 146, at 1810.

160. *See* Michael Klausner, *The Contractarian Theory of Corporate Law: A Generation Later*, 31 J. CORP. L. 779, 786–89 (2006) (reviewing the literature).

161. Daines, *supra* note 158.

162. Lucian Arye Bebchuk & Alma Cohen, *Firms' Decisions Where to Incorporate*, 46 J.L. & ECON. 383, 387 (2003).

163. *See* Marcel Kahan, *The Demand for Corporate Law: Statutory Flexibility, Judicial Quality, or Takeover Protection?*, 22 J.L. ECON. & ORG. 340 (2006).

164. *See* Klausner, *supra* note 160, at 797.

165. *See* Romano, *supra* note 154, at 226.

166. *See* Carney, *supra* note 94, at 720, 734; Roberta Romano, *The States as a Laboratory: Legal Innovation and State Competition for Corporate Charters*, 23 YALE J. ON REG. 209, 231 (2006) (showing rapid diffusion of corporate law changes, but resistance to anti-takeover laws in Delaware as compared with states where labor has more influence).

167. *See* Romano, *supra* note 166, at 236–40.

Delaware is one of only a couple of states that charge a fee based on the size of the corporation (most importantly, according to the number of shares) and for which franchise taxes provide enough profit to motivate the state to compete.[168] Where franchise fees are a tiny part of the budget, taxpayers would care little about attracting incorporations. In fact, states compete, in part, because their lawyers have strong incentives to keep corporations at home, and thereby increase the value of local legal expertise, rather than sending corporations off to Delaware lawyers. In other words, the influence of lawyers explains the competition for corporate law just as it helps explain the supply side of the noncorporate competition.

A study of the corporate law market as a piece of the overall market for law can contribute to this debate over Delaware's dominance. As discussed so far in this article, the corporate law market and the rules governing it are driven by the same forces that underlie competition for other law. Exit-affected groups in corporations' home states will not readily cede the advantages of attracting public incorporations. These groups include not only lawyers, but also those who benefit from corporations' local headquarters or other connections. As we will see below in subpart F, firms' incorporation at home arguably supports this link between the corporate and general law markets insofar as they seek the advantages of local *contract* law, and not just local *corporate* law. In this sense Delaware's corporate law competes in the market for contracts.

B. Closely Held Business Associations

An important question for present purposes is whether Delaware's apparent dominance indicates that there is something special about the corporate law market. In fact, this phenomenon of dominance by a single state exists only for publicly held firms in the U.S. federal system and not in other contexts in which the IAD is applied. Indeed, the market for closely held firms looks quite different from the market for publicly held firms. Although the IAD traditionally was linked to the corporate form, and therefore did not traditionally apply to unincorporated firms,[169] this has changed significantly over the last generation. Choice-of-law clauses are now enforced so commonly in general partnerships that the rule closely resembles the IAD.[170] The same is true regarding the market for

168. *See* Bebchuk & Hamdani, *supra* note 88, at 556; Kahan & Kamar, *supra* note 97, at 724–26.

169. *See* Jennifer J. Johnson, *Risky Business: Choice-of-Law and the Unincorporated Entity*, 1 J. SMALL & EMERGING BUS. L. 249, 275 (1997); Ribstein, *supra* note 14, at 268; *see also* Thomas E. Rutledge, *To Boldly Go Where You Have Not Been Told You May Go: LLCs, LLPs, and LLLPs in Interstate Transactions*, 58 BAYLOR L. REV. 205, 213 (2006).

170. *See* ALAN R. BROMBERG & LARRY E. RIBSTEIN, BROMBERG & RIBSTEIN ON PARTNERSHIP § 1.04 (1988 & Supp.). However, in the absence of a clear statutory rule, the common law of conflict-of-laws may apply. The common law may apply the general contract choice-of-law rule rather than the IAD if the firm is a partnership, though probably not if it is an LLC. *See* RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 298 (defining "corporation" for choice-of-law purposes). It is conceivable that

limited liability partnership-type entities such as the limited liability company (LLC), to which the IAD also has been applied.[171] Thus, notwithstanding the IAD, the usual supply and demand forces that underlie the law market are at work for firms' choice of governing law. The relative influence of differing choices is due to different competitive conditions in each of these submarkets.

The market does not, however, resemble that for public corporation law. Several factors impede the development of a Delaware-type market for "tramp" closely held firms. Closely held firms' costs of operating outside the formation state, which include paying a foreign-firm fee for operating at home, are likely to be high compared to the money invested in the firm.[172] Conversely, publicly held firms must operate as foreign firms in some states whether or not they incorporate in their residence state, and so have low marginal costs of shopping for law.[173]

More importantly, publicly held firms get higher benefits than do closely held firms from the "network" of corporate law.[174] Publicly held firms face the prospect of many shareholder suits in which such law will be applied. Closely held firms, by contrast, are likely to endure such a suit only once, when the relationship falls apart. Publicly held firms also benefit from being on the same standard with other publicly held firms because this facilitates trading of their shares in public securities markets. These factors mean that public corporations are willing to pay Delaware enough to give it an incentive to maintain a substantial infrastructure, and to post a "bond" to secure the future direction of its law.[175]

Notwithstanding these differences between publicly and closely held firms, there is evidence that states have actively competed to supply the law of closely held *unincorporated* firms, particularly including LLCs, and that this competition has led to efficient legal rules.[176] Although

applying the contract rule may mean that partner's liability is governed by the law of the plaintiff's residence rather than that of the state of formation. *See id.* § 298. *See generally* Rutledge, *supra* note 169, at 238–42.

171. *See* LARRY E. RIBSTEIN & ROBERT R. KEATINGE, RIBSTEIN AND KEATINGE ON LIMITED LIABILITY COMPANIES § 13:4 (2d ed. 2004).

172. *See* Ian Ayres, *Judging Close Corporations in the Age of Statutes*, 70 WASH. U. L.Q. 365, 374–75 (1992); Bebchuk & Hamdani, *supra* note 88, at 573 (showing evidence that larger firms are more likely than smaller firms to incorporate outside home state).

173. Roberta Romano, *State Competition for Close Corporation Charters: A Commentary*, 70 WASH. U. L.Q. 409, 413 (1992) (arguing that there is relatively little competition for such firms because the transaction cost benefits of closely held firm statutes are relatively low).

174. *See supra* text accompanying note 148.

175. For a formal model of the attributes of the market for corporations which stresses the difference between firms that do and do not demand significant infrastructure, see Oren Bar-Gill et al., *supra* note 157.

176. *See* Carol R. Goforth, *The Rise of the Limited Liability Company: Evidence of a Race Between the States, But Heading Where?*, 45 SYRACUSE L. REV. 1193 (1995) (showing evidence that lawyers and others participated in competition regarding LLC laws); Bruce H. Kobayashi & Larry E. Ribstein, *Evolution and Spontaneous Uniformity: Evidence from the Evolution of the Limited Liability Company*, 34 ECON. INQUIRY 464 (1996) (showing evidence of evolution of state LLC statutes toward efficient level of uniformity); Larry E. Ribstein, *Statutory Forms for Closely Held Firms: Theories and Evidence from LLCs*, 73 WASH. U. L.Q. 369, 430–31 (1995).

there is no equivalent to Delaware in the closely held firm market, data on LLC formations in 2005 indicate that Florida has emerged as a clear leader, with Delaware next but far behind Florida, and several states bunched not far behind Delaware.[177] The leadership of Delaware and Florida in LLC formations does not reflect their standing in population relative to other states.[178]

The Florida data suggests that in the market for closely held firms a dominant state emerges by promoting both basic business activity and business formations. Florida's investment attractions include an active real estate market, fueled by retirement, tourism, and a large homestead exemption for sheltering debt from bankruptcy;[179] a thriving small service business in the real estate, tourist, and retirement industries; an estate planning industry generated by Florida's large retirement community; and an important destination for Latin American immigrants. The Florida bar has used the LLC form to exploit these advantages in a number of ways, including by making it tax friendly, reducing fees, and crafting the statute to fit estate planning and asset protection needs.[180] The payoff of these efforts and factors is that, according to data from the Florida Secretary of State, formations of Florida LLCs increased from 1892 formations in 1996 to 130,558 in 2005, an increase of 6900%. Meanwhile, formations of for-profit Florida corporations during the same period increased from 104,173 to 168,182, or 62%.[181]

It is not clear how to separate Florida's supply of law for corporate and LLC formations from its role in attracting investments. Florida's at-

177. Specifically, Florida had 123,437 formations that year, followed by Delaware at 87,360. Data on LLC formations is compiled by the International Association of Corporate Administrators. INT'L ASS'N OF COMMERCIAL ADM'RS, ANNUAL REPORT OF JURISDICTIONS 39–48 (2005), *available at* http://www.iaca.org/downloads/AnnualReports/2006_AR.pdf.

178. Other leading states include California (59,431), Texas (53,101), New Jersey (51,668), Arizona (48,663), New York (48,564), Colorado (45,302), Georgia (41,063), and Ohio (40,180). Florida is fourth in population after California, Texas, and New York. *See* U.S. CENSUS BUREAU, RESIDENT POPULATION OF THE 50 STATES, THE DISTRICT OF COLUMBIA, AND PUERTO RICO: CENSUS 2000 (2000), *available at* http://www.census.gov/population/cen2000/tab02.pdf.

179. The Florida homestead exemption, which is ensconced in a constitutional provision, protects an unlimited value of property provided that it occupies no more than a half acre within a municipality or 160 acres outside of a municipality. *See* FLA. CONST. art. X, § 4.

180. Florida revised its statute in 1999 and 2002 to increase usability, particularly for small firms and as retirement and debt-protection vehicles. These revisions, among other things, clarified provisions for single member LLCs, clarified veil-piercing standards, removed the requirement to estimate capital contributions, ensured lack of marketability and minority interest discounts for use in estate planning, and offered debtor protection by denying creditors the right to foreclose on charging orders. *See* FLA. STAT. ANN. § 608.433 (West 2007) (denying creditors the right to foreclose on charging orders); *id.* § 608.701 (applying corporate veil piercing case law to LLC context); *id.* § 608.4211 (removing requirement to estimate capital contributions); *see also id.* §§ 608.401–.705; Florida Asset Protection Blog, http://floridaassetprotection.blogs.com/alperlaw/2005/01/thoughts_about_html (Jan. 11, 2005) (noting that "the Florida legislature changed the law to specifically permit a single member LLC"). For example, until fairly recently, non-foreclosure on charging orders was an asset protection provision. *See* Larry E. Ribstein, *Reverse Limited Liability and the Design of Business Associations*, 30 DEL. J. CORP. L. 199 (2005).

181. *See* Florida Division of Corporations Annual Statistics, http://webarchive.org/web/2006/109034657/http://www.dos.state.fl.us/doc/corp_stat.html (last visited Jan. 5, 2008).

tractive business environment might have drawn investments even from firms that are organized elsewhere. On the other hand, Florida's activities in drawing investments might have motivated it also to try to attract business formations, since it could expect that firms that were already based in Florida would be inclined to invest there. Thus, Florida might be competing simultaneously in a chartering market for closely held firms and in a state market for investments. The Florida evidence therefore indicates that there may be no clear separation between the "unbundled" corporate market for law alone and the "bundled" market for law and other attributes of establishing connections with a state. While it is not clear precisely what factors are driving Florida's success, the data suggest the importance of further studying the law market in the light of the general forces driving the market for law rather than the supposedly unique characteristics of the market for corporate law.

C. The Market for Publicly Held Unincorporated Firms

The LLC formation data indicate that the Delaware phenomenon depends on the publicly held nature of the entity rather than on the type of business association. This suggests that Delaware should be dominant in the market for publicly held unincorporated firms as well. And, indeed, Delaware does dominate the market for publicly held or "master" limited partnerships.[182] Delaware does not, however, dominate the market for all types of publicly held firms. Other states have shown that they can take over submarkets for specific types of publicly held firms by tailoring their statutes to these firms' needs. Again, the underlying supply and demand forces in the market for law account for the structure of the market.

With respect to statutory business trusts, Massachusetts is a close competitor with Delaware in the number of firms (although Delaware has a significant lead in new formations of these firms).[183] Most mutual funds are either Massachusetts business trusts or Maryland corporations, although Delaware statutory trusts are rapidly catching up.[184] Maryland has nearly all of the market for real estate investment trusts (REITs) and has always led in providing a statutory vehicle for these instruments.[185] Among other things, Maryland has no franchise tax and offers takeover

182. *See generally* John Goodgame, *Master Limited Partnership Governance*, 60 BUS. LAW. 471 (2005).

183. In *The Rise of the Statutory Business Trust* (in progress), Robert H. Sitkoff shows that in 2005 Delaware had 14,164 of these firms, Massachusetts 10,535, and Connecticut 1529, though Delaware had far more formations of these firms than both other states—3200, compared to a total of 262 in the other states.

184. *Id.* (relying on data from the Investment Company Institute). Many closed end funds are Delaware limited partnerships, bringing Delaware's total entity share in that category close to the shares of Massachusetts and Maryland.

185. *See* David M. Einhorn et al., *REIT M&A Transactions—Peculiarities and Complications*, 55 BUS. LAW. 693, 698 n.26 (2000).

protection, shareholder restrictions, director powers, and other provisions that are specially tailored to REITS.[186]

These types of firms share the characteristic that their terms are heavily governed by federal law, including the Investment Company Act of 1940[187] for mutual funds formed as statutory business trusts and the REIT provisions of the Internal Revenue Code.[188] In these narrow and heavily regulated areas, Delaware's unique lawmaking advantages are less important. These firms, therefore, would be less inclined than publicly held corporations to pay Delaware's substantial franchise fee, and cheaper states can emerge as dominant.

These niche business associations are another indication of the IAD's relatively small role in determining the shape of the corporate law market. Not only is Delaware not dominant outside of the publicly held firm context, but even within this context it faces effective competition in some circumstances, especially when federal law plays a significant role.

The market for publicly held unincorporated firms suggests that policymakers should examine the general market for law. Specifically, increased federal regulation of firm governance might loosen Delaware's dominance by reducing the advantages to firms of Delaware's courts and laws. If so, the competition for state business association law will grow more robust even as it becomes less consequential. On the other hand, Delaware's apparent ability to compete even under these more constrained circumstances suggests that Delaware may have competitive advantages that remain unappreciated because of the traditional narrow focus on the market for public corporation law.

D. Europe

Recent European developments show how the IAD can emerge in a context that differs significantly from the early history of the U.S. corporation. This helps refute the historical explanation for corporate uniqueness. Although Europe has long applied the so-called "real seat" rule, pursuant to which the governing law is that of the country where the firm's administrative office is located, recent European case law has adopted a version of the IAD. European corporate law can therefore further test the effect of the IAD and its relationship to the general law market.

186. *See* National Association of Real Estate Investment Trusts, The REIT Story, http://investinreits.com/learn/reitstory.cfm (last visited Jan. 5, 2008). REITs are actually corporations formed under a special section of the Maryland Corporations and Associations Code, §§ 8-101 to 8-801. However, Maryland REITs share features with unincorporated firms. *See* Larry E. Ribstein, The Rise of the Uncorporation (unpublished manuscript, on file with author).

187. 15 U.S.C. §§ 80a-1 to -64 (2000).

188. *See* I.R.C. § 856 (2000) (providing rules for qualification of REITs for pass-through taxation).

The big break in the European market came in 1999 with the *Centros* case,[189] in which the European Court of Justice (ECJ) held that Denmark could not bar a United Kingdom (UK) corporation from opening a "branch" in Denmark merely because the corporation had never done business in the UK. The company relied on the "right of establishment" in what is now Article 48 of the Treaty of Rome, which provides that companies formed in accordance with member state law shall "be treated in the same way as natural persons who are nationals of Member States."[190] The ECJ held that this protection was available even if the company simply wanted the more favorable law of the incorporation jurisdiction, rather than having some other business purpose for expanding from its home base.[191] The same court later held that denying a Dutch corporation the right to sue in Germany because its real seat was in the Netherlands was contrary to the right of establishment.[192] This cast doubt on the survival in Europe of the real seat rule. A third case held that the right of establishment in Article 48 not only trumped a prohibition on local registration, as in *Centros*, but also barred the Netherlands from imposing local regulations on a company that was based locally but incorporated elsewhere solely in order to avoid these regulations.[193] In general, these cases clarified that the European Union (EU) constitution protects full-fledged Delaware-type charter competition for "tramp" or, in European parlance, "brass plate" corporations.[194]

Centros and other cases evidently have provoked at least some European competition in the form of "tramp" UK incorporations by companies based elsewhere in Europe, as well as responses by other European countries, particularly by revising their minimum capitalization requirements and simplifying incorporation requirements.[195] But

189. Case C-212/97, Centros Ltd. v. Erhvervs-og Selskabsstyrelsen, 1999 E.C.R. I-1459.

190. Treaty Establishing the European Community art. 8, Nov. 10, 1997, 1997 O.J. (c340) 3 [hereinafter E.C. Treaty].

191. *See Centros*, 1999 E.C.R. at I-1497–I-1498.

192. Case C-208/00, Überseering BV v. Nordic Construction Company Baumanagement GmbH (NCC), 2002 E.C.R. I-9919.

193. Case C-167/01, Kamer van Koophandel en Fabrieken voor Amsterdam v. Inspire Art Ltd., 2003 E.C.R. 1-10155.

194. European countries can still inhibit jurisdictional competition if justified "on grounds of public policy, public security or public health" under Article 46 of the Treaty of Rome. E.C. Treaty, *supra* note 190, art 46. Countries can also regulate outside of company law, such as by imposing legal capital type regulation under insolvency laws. *See* John Armour, *Who Should Make Corporate Law? EC Legislation versus Regulatory Competition* (ECGI-Law Working Paper No. 54/2005, 2005), *available at* http://ssrn.com/abstract=860444. They can also inhibit firms' ability to reincorporate in other countries, which would be a real constraint on the charter market. See Case 81/87, The Queen. H.M. Treasury and Comm'rs of Inland Revenue, *ex parte* Daily Mail and General Trust PLC, 1988 E.C.R. 5483 on the interpretation of Articles 52 and 58 of the EEC Treaty and the provisions of Council Directive 73/148 of 21 May 1973 on the abolition of restrictions on movement and residence within the Community for nationals of Member States with regard to establishment and the provision of services (holding that the right of establishment did not prevent the UK from blocking transfer of a company's headquarters to another country to keep the company from avoiding payment of capital gains tax).

195. Marco Becht et al., *Where Do Firms Incorporate? Deregulation and the Cost of Entry* 23 (Eur. Corp. Governance Inst., Working Paper No. 70, 2006), *available at* http://ssrn.com/abstract=

competition under Europe's version of the IAD so far seems to be following a different track from the United States. European firms form in the UK not because of its law or courts but simply because it is a cheaper place to incorporate.[196] The UK tramp firms are not the big Fortune 500-type companies that Delaware specializes in, but smaller companies for which incorporation costs are significant. These firms arguably do not need law as much as they need cheap recognition. Thus, Europe is arguably not yet a market for law in same sense as the U.S. corporate law market.

Europe may or may not be poised on the brink of becoming a full-scale corporate-type law market, as was the U.S. more than a century ago when New Jersey began to attract "tramp" corporations. There are at least three significant impediments in Europe to U.S.-style charter competition. First, differences in law, language, and custom among European Community (EC) countries transcend any in the United States. Firms accordingly would find it difficult to operate in one country while litigating in another country, or under another country's law.[197]

Second, as would be expected from legislation at the level of the nation rather than a small state like Delaware, interest groups are likely to interject their concerns into corporate law. In particular, labor's participation on corporate boards, or "codetermination," remains a contentious issue in some European countries.

Third, and most importantly, it is not clear whether any country has the incentive to become the European "Delaware"—the active driver of EC charter competition.[198] The EC limits a country's gains from chartering fees and taxes.[199] Even if European law allowed member countries to profit from such fees, it is unlikely any European country could earn enough fees to have the sort of incentive Delaware gets from the combination of its small size and dominant position in the competition.[200] Although the UK is emerging as the leader in tramp incorporations, so far it has made no significant changes in its law in order to attract incorpora-

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906066 found an increase in UK incorporations of firms not physically located in the UK, mostly coming from other EU countries subject to the Centros rule. Specifically, they found that the average number of European private limited companies incorporating in the U.K. increased from 4,600 firms per year before Centros to 28,000 firms per year afterward, totaling over 120,000 firms between 1997 and 2006, including 48,000 from Germany.

196. *See id.*

197. *See, e.g.*, Martin Gelter, *The Structure of Regulatory Competition in European Corporate Law*, 5 J. CORP. L. STUD. 247 (2005) (discussing use of UK corporations in Germany and the Netherlands).

198. *See id.* at 257–62; Töbias Hans Troger, *Choice of Jurisdiction in European Corporate Law—Perspectives of European Corporate Governance*, 6 EUR. BUS. ORG. L. REV. 3, 63 (2005); Marco Ventoruzzo, *'Cost-Based' and 'Rule-Based' Regulatory Competition: Markets for Corporate Charters in the U.S. and in the EU*, 3 N.Y.U. J. L. & BUS. 91, 130 (2006).

199. *See* Council Directive Concerning Indirect Taxes on the Raising of Capital 69/335, 1968–1969 O.J. Spec. Eo. (1249) 25 (EEC). For analyses of the significance of this restrictions, see Armour, *supra* note 194; Gelter, *supra* note 197; Kamar, *supra* note 150.

200. *See* Gelter, *supra* note 197 at 253–62. Note that Liechtenstein is not subject to the limitation on charter fees, but it competes mainly as a tax haven rather than for incorporations.

tions. Europe therefore may test the importance of franchise fees in developing a U.S.-style charter market.

On the other hand, some believe that U.S.-style competition might eventually break out in Europe, with England probably playing the role of Delaware.[201] Firms may come to demand not just cheaper incorporation, but also flexible laws and expert judges. In particular, the UK has delegated much of its securities law to responsive private lawmaking by the London Stock Exchange. As with the corporate and other law market competition, lawyers may heavily influence the supply side of the European corporate law market. It is as misleading in Europe as in the United States to focus on franchise taxes and incorporation fees as a main driver of the law market. The "charmed circle" of leading international UK law firms acts as an intermediary in the corporate law market, and therefore can attract European corporations to the UK. As in Delaware, the lawyers are likely to influence UK law to compete for chartering business.

Indeed, one factor favors the emergence of an even *more* active law market in Europe than in the United States: the relative inability of the EC to effectively replace member-state corporate law. Mark Roe theorizes that the ever-present threat of federal regulation constrains U.S. corporate competition.[202] This is less a problem in Europe since the EC regulatory apparatus is exceedingly slow and cumbersome. Europe's recent moves toward the IAD reflect at least partly the central government's failure to harmonize corporate governance. So even if European countries themselves have weaker incentives to compete to supply corporate law—and this is not clear given the rise of the UK—this weakness might be offset by a weaker federal constraint on competition.[203]

In general, although Europe has different competitive conditions than the United States: the same basic principles prevail in both contexts. Legislators in both systems seek to regulate corporate governance just as they do other types of contracts. However, firms are mobile, and the UK has catered to this market, at least to the extent of lowering incorporation costs for small firms. Moreover, European countries' efforts to block this competition provoked a federal response. In Europe, this response so far has been in favor of choice of law, in the form of the ECJ's decision in *Centros*, rather than federal corporate law regulations. Europe may move closer to the United States based on the same forces that have been important in the United States, particularly including the role of lawyers.

On the other hand, if European jurisdictional competition continues to develop along a different track from the United States, it is important to emphasize that this will occur *despite* the existence of a choice-of-law

201. *See* Armour, *supra* note 194, at 29–32.
202. *See supra* text accompanying note 135.
203. *See* Gelter, *supra* note 197, at 265–69.

rule for corporate governance similar to the U.S. IAD. This tends to refute the notion that the U.S. corporate law market is attributable to the IAD and the unique circumstances of its birth. Any differences between the United States and the EU will not be because different forces are at work, but because the specific environment affects the strength of each of these forces—the demand for regulation (i.e., firms' mobility because of different local conditions), the supply of regulation (i.e., the local bar), and the resistance of local proregulatory interest groups (i.e., labor).

E. International Securities Regulation

International securities regulation seems far removed from the IAD because it operates on the national level rather than within a federal system like the United States or Europe. However, recent developments in international securities regulation show that forces similar to those operating on corporate law within federal systems are also operating on international securities laws. Although federal securities laws arguably circumvent the IAD by displacing state law,[204] there is a market in international securities regulation that displays some of the same competitive processes as the market for state corporate law. Indeed, the international market for securities regulations threatens continued dominance of the U.S. federal role in securities regulation.

One example of the influence of jurisdictional competition involves issuers (in particular Lloyd's of London) selling securities to U.S. investors and inserting clauses in their stock sale agreements choosing English law and forum. Federal securities statutes specifically prohibit issuers from attempting to contract around U.S. securities laws,[205] so one might predict that U.S. courts would treat the securities laws as super-mandatory rules. Nevertheless, these clauses have generally been enforced.[206] Congress, of course, could further tighten the securities laws to provide that choice-of-law clauses in securities sales agreements are unenforceable. However, it is unlikely to do so because the demand side of the market, particularly including the ability to resort to arbitration, would likely significantly reduce the impact of any regulation that Congress feasibly could impose. Moreover, on the supply side, interest

204. *See supra* Part III.C.

205. *See* Securities Act of 1933, 15 U.S.C. § 77n (2000) ("Any condition, stipulation, or provision binding any person acquiring any security to waive compliance with any provision of this subchapter or of the rules and regulations of the Commission shall be void."); Securities Exchange Act of 1934, 15 U.S.C. § 78cc(a) (2000) ("Any condition, stipulation, or provision binding any person to waive compliance with any provision of this chapter or of any rule or regulation thereunder, or of any rule of an exchange required thereby shall be void.").

206. *See* Lipcon v. Underwriters at Lloyd's, London, 148 F.3d 1285, 1291–95 (11th Cir. 1998); Richards v. Lloyd's of London, 135 F.3d 1289, 1294 (9th Cir. 1998); Haynsworth v. The Corp., 121 F.3d 956, 969 (5th Cir. 1997); Allen v. Lloyd's of London, 94 F.3d 923, 929 (4th Cir. 1996); Bonny v. Society of Lloyd's, 3 F.3d 156, 161–62 (7th Cir. 1993); Roby v. Corp. of Lloyd's, 996 F.2d 1353, 1361–65 (2d Cir. 1993); Riley v. Kingsley Underwriting Agencies, Ltd., 969 F.2d 953, 957 (10th Cir. 1992).

groups in the United States may have an incentive to preserve access by individual U.S. investors to overseas offerings, and choice-of-law and court or arbitration clauses may be necessary to preserve that access.

Another route to jurisdictional competition in securities regulation is through the cross-listing market—that is, the listing of firms on securities exchanges outside their home country. The demand side of this market consists of firms that seek to "bond" their disclosures by willingly subjecting themselves to tight U.S. disclosure standards and fraud rules.[207] On the supply side, interest groups in cross-listing countries, including lawyers, accountants, and investment bankers, get significant benefits from cross-listing and therefore incur costs if cross-listings dry up. This law market is quite competitive, since cross-listing firms can fairly easily avoid the United States and stay home or go to other capital markets like London if the cross-listing country raises the cost or lowers the benefit of its regulation. All of this was brought home with a thud when foreign companies started avoiding the United States after the adoption of stringent new regulation in the Sarbanes-Oxley Act.[208] For example, while in 1999 and 2000, foreign IPOs on U.S. exchanges raised ten times the amount raised in London, in 2005 London exchanges raised over $4 billion more than U.S. exchanges.[209]

The cross-listing market is not strictly comparable to the IAD because cross-listing issuers are subject to *both* home country *and* U.S. law. However, competition for cross-listings might lead to a more conventional type of law market in which firms can select a single regulator rather than exposing themselves to burdens imposed by multiple regulators. The U.S. interest groups affected by the exodus of cross-listers have pressured Congress and the SEC to wholly or partially exempt foreign issuers from U.S. law.[210] Exempting foreign issuers from U.S. laws could make U.S.-based issuers wonder why they should have to compete in their own market for capital at a disadvantage to foreigners. They may have the political clout to demand the same ability to opt out of U.S. regulations. And if both U.S. and foreign firms can trade in the United States under a foreign country's law, why not under a *state's* law? After all, U.S. investors probably would be more protected under state law because it would be easier for them to litigate in Delaware than in, say, Lichtenstein. Thus, regulation and nonenforcement of contractual choice of law create an incentive to leave, and exit activates local industries that depend on the exiting firms. This, in turn, pressures politicians

207. *See* Ribstein, Dabit*, Preemption, and Choice of Law, supra* note 130, at 167.

208. *See* Ribstein, *Cross-Listing and Regulatory Competition*, *supra* note 130, at 124–29. For recent data on the effect of Sarbanes-Oxley on the cross-listing market, see the Interim Report of the Committee on Capital Markets Regulation (Dec. 5, 2006), *available at* http://www.capmktsreg.org/pdfs/11.30Committee_Interim_ReportREV2.pdf.

209. Roberta S. Karmel, *NYSE-Euronext Merger: NYSE is Losing Listings to Foreign Exchanges,* N.Y.L.J., Aug. 17, 2006, at 3.

210. *See* Ribstein, *Cross-Listing and Regulatory Competition*, *supra* note 130, at 119.

to enable jurisdictional choice, sometimes even for immobile locals. In short, the elements of the law market story apply in the international context.

F. The Market for Commercial Contracts

The notion of the uniqueness of the corporate law market is further undermined by its similarity to the market for some non-corporate-governance contracts. Eisenberg and Miller have shown that New York has a significant share of the general choice-of-law market for commercial contracts,[211] although Delaware also occupies a leading role in this market as well. Their review of several hundred merger and acquisition contracts, a context similar to the governance contracts covered by the IAD, found that while Delaware was the place of incorporation for 189 of the merged corporations, only 132 chose Delaware law for the merger agreement.[212] By contrast, there were only eight New York corporations in the set, but forty-five contracted for New York law in the merger agreement. Thus, although Delaware has managed to figure prominently in this market even in the absence of the IAD, it falls short of its dominance in the corporate market.

There is a possible connection between this market for noncorporate law and the one for public corporation law. As discussed in subpart A, there is a "home bias" in the corporate competition—publicly held firms tend to incorporate either in Delaware or in their home states.[213] Similarly, Eisenberg and Miller found that when Delaware corporations do not choose Delaware law for their merger contracts they often choose the state where the business is located.[214] These firms may be doing so partly because linking the firm's physical location with the designated law will make it more likely that the choice-of-law clause will be enforced.[215] Firms that incorporate at home rather than in Delaware may have a related objective. Incorporation might be viewed as a contact that increases the chance that the non-chosen state courts[216] will apply the chosen state's *noncorporate* law in otherwise close cases. For example, if a plaintiff consumer resides in a state with a strong pro-consumer law such as California, the decision whether to enforce the choice-of-law clause designating, say, New York, might turn on whether New York was

211. *See* Eisenberg & Miller, *supra* note 24.

212. *See* Eisenberg & Miller, *supra* note 25, at 1982.

213. *See supra* text accompanying note 158.

214. *See* Eisenberg & Miller, *supra* note 25, at 1988–2001.

215. Although these are large commercial contracts for which many commercial jurisdictions have abandoned a connection requirement, establishing a connection with the designated state may help promote enforcement in cases brought outside the designated state. *See supra* Part I.D.

216. The designated state may not require a connection with itself because it is a major commercial jurisdiction whose lawyers want to attract commercial litigation to the state. *See supra* Part I.D. However, another state may require such a connection in order to limit the ease with which firms can avoid its laws.

the defendant's state of incorporation. Also, in a large international transaction that is likely to be adjudicated in the U.S., but where the parties have a strong preference for non-U.S. law, a U.S. court may be more likely to apply foreign law if the relevant firm is also incorporated in the foreign country. For example, consider *Nedlloyd Lines B.V. v. Superior Court*[217] which involved an international multiparty shareholders' agreement to buy a Hong Kong corporation's shares and operate the firm as a joint venture. The California court enforced the contract's choice of Hong Kong law, relying substantially on the fact that the subject firm was incorporated in Hong Kong.[218] Even if the state-of-incorporation factor in enforcement is not large, firms that engage in repeated transactions in which these issues arise will want to maximize the likelihood of success over the range of cases.

This analysis provides a further indication that, rather than being insulated from noncorporate choice of law, the corporate law market is actually related to it. Although Delaware has no national competitor for choice of law, it must compete at the local level with states that attract connections for general choice-of-law purposes. The relevance of firms' connections with states may lead firms to incorporate in states other than Delaware. Delaware has to maintain its general lawmaking excellence in order to compete in this broader market. To be sure, this explanation for the home bias is speculative at this point. But the data at least suggests yet another advantage of viewing the competition for corporate law from the perspective of the broader law market rather than as a unique phenomenon.

G. Trusts

Trust law is another area of the market for unincorporated contracts that resembles the corporate law market even without the IAD. Trusts can designate the applicable law in the trust instrument, but this designation is subject to general choice-of-law rules requiring some connection between the trust and the designated state.[219] Recently, however, trust law has been subject to a competition that resembles what has happened in public corporation law.[220]

Again, the general forces of the law market explain what has happened. The trust law market was spurred by the 1986 change in tax law that allowed people to use trusts to make tax-free intergenerational wealth transfers while avoiding gift and inheritance taxes.[221] However, settlors had to contend with the Rule Against Perpetuities (RAP), which

217. 834 P.2d 1148 (Cal. 1992).

218. *See id*. at 1153, 1155–56.

219. *See* RESTATEMENT (SECOND) OF CONFLICTS OF LAWS §§ 270, 272 (1971).

220. *See* Robert H. Sitkoff & Max M. Schanzenbach, *Jurisdictional Competition for Trust Funds: An Empirical Analysis of Perpetuities and Taxes*, 115 YALE L.J. 356, 416–17 (2005).

221. *See id.* at 370–72 (discussing tax changes and their effect on trust competition).

invalidates restrictions on property, particularly including in trust instruments,[222] effective for long than the life of anyone alive at the time of the transfer (a "life in being") plus 21 years. The new tax benefit of perpetual trusts created a demand to free trusts of the RAP and, in turn, a competition for trust funds. Delaware was first to see the opportunity and abolished the RAP in 1995, explicitly acknowledging the intent to participate in a competition for trust law, and several states followed suit over the next three years.[223]

This state competition is particularly interesting for present purposes because of *why* states were willing to supply the perpetual trust market. One might think that states wanted to levy taxes on the trust assets, analogous to the standard franchise tax explanation for the corporate charter competition. But Sitkoff and Schanzenbach convincingly refute this explanation by showing that trust assets increased after the abolition of RAP *only* in the states that did *not* tax trusts they attracted from out of state.[224] This is not surprising, because as long as some states did not charge tax, settlors establishing trusts in states other than where they live would, all else equal, choose a state that did not charge the tax.

The puzzle is on the supply side: why would states participate in the competition even if they were not reaping tax revenues? The important beneficiaries of the competition for trust law turned out to be lawyers, as well as bankers who earn significant fees from organizing and managing trusts. States abolishing the RAP attracted $100 billion in additional trust assets, which based on standard fee schedules translates into about $1 billion a year in trustees' commissions.[225] Lawyers undoubtedly earned significant fees from forming and managing trusts.[226]

In short, the competition for trusts is another example of the forces at work throughout the law market: party mobility drives the demand side and exit-affected interest groups (especially including lawyers) drive the supply side. The result of this law market competition is significant changes in the underlying law.

H. Summary

This Part confirms the implications of Parts I–III: the corporate law market is not a unique phenomenon, but rather one component of the

222. *See id.* at 366 n.26 (noting that "[t]oday, because almost all life estates and future interests are created in trust rather than as legal interests, the Rule's primary modern application is to interests in trusts funded with stocks, bonds, and other liquid financial assets").

223. *See id.* at 376.

224. *Id.* at 386, 394–98.

225. *Id.* at 410–11.

226. Note that the corporate franchise tax "bonds" Delaware to continue to provide high-quality law. *See supra* text accompanying note 90. Accordingly, it might seem that the absence of a tax motivation for state trust law might lead to lower quality law. However, it is probably the case that trust law does not require the same sort of continuous updating that is important for corporate law, so bonding future performance is less necessary.

overall market for law. The market for public corporation law is actually not overwhelmingly dominated by Delaware. Rather, Delaware has only about half the market, while the other states are successfully competing for the other half, arguably because of factors relating to the general law market. Moreover, the markets for closely held firms, publicly held unincorporated firms, and European firms all exhibit different characteristics although the IAD applies to all of them. At the same time, the market for international securities regulation, commercial contracts, and trusts looks similar to that for public corporations despite the fact that the IAD does not apply to that market. In short, the idea of a unique market for corporate law does not stand up to a more general analysis of the markets for business associations and other laws. Rather, the differences are best explained by differences in the relative strengths of the same forces underlying the law market generally: demand-side mobility, supply-side competition motivated by exit-affected interest groups, and constraints imposed by proregulatory groups at the state and federal levels.

V. IMPLICATIONS

This article shows that the IAD and the market for corporate law are not attributable to unique features of corporations, but rather are specific applications of the general forces that apply to contracting for law. Firms have the same reasons for choosing the law that applies to their governance that they do for choosing the applicable law in other contexts. The IAD does not spring from the unique history of corporate law. As in other contexts, courts enforce contracts choosing corporate governance law despite their erosion of states' power to regulate because refusal to do so may cause corporations to avoid making investments in regulating states, which would harm local interest groups, or might trigger a federal reaction in order to protect the operation of multistate firms. The corporate law market therefore involves the same tension between proregulatory, antiregulatory, and exit-affected interest groups that underlies contractual choice of law in other contexts. Indeed, the congruence of the corporate and general law markets is further indicated by the facts that many different business associations are covered by the same choice-of-law rule, and that contracts covered by a different choice-of-law rule have choice-of-law features similar to those found under the IAD.

This Part explores some legal and policy implications of our insight. Subpart A argues that the law market lens undermines claims that the IAD should be given constitutional status. Subpart B discusses the implications for the debate on the contractual nature of the corporation. Subparts C and D discuss how this article's analysis helps settle conflicts between state and federal law, and among state corporate laws. Subpart

E summarizes some general implications of the analysis for future scholarship.

A. Constitutional Protection of the IAD

An implication of the historical explanation of the corporate law market is the notion that courts are constitutionally compelled to apply the IAD. After all, if corporations owe their existence and allegiance to the state that created them, presumably other states are constrained to apply that state's law. However, the IAD never has been entitled to constitutional protection, including during the period when the IAD was developed. It is even clearer that no such protection exists today to account for the continued viability of the rule.

Three constitutional provisions are relevant. The Full Faith and Credit Clause empowers Congress to decide the respect that each U.S. state must give to other states' laws.[227] The Due Process Clause[228] implicitly guarantees to the parties minimal standards of fairness in litigation, including the right to be protected from unfair surprise regarding the governing law. Finally, the Commerce Clause[229] empowers Congress to regulate interstate commerce, and in its "negative" form prevents states from usurping the federal role by enacting regulations that unreasonably interfere with interstate commerce.[230]

The Court has approached, without quite reaching the result of, giving the IAD constitutional status under the Full Faith and Credit Clause.[231] Most of the cases involved members of fraternal benefit associations who joined a local lodge and agreed to pay periodic assessments to the national organization. Because the organization agreed to make payments to the member's family when the member died, it functioned as a nonprofit insurer. When a member or beneficiary made claims against the organization, the Court consistently held that the member's rights must be determined according to the organization's formation state law. Because members paid assessments into a common fund, the Court deemed it important to the success of the organization that the

227. *See* U.S. CONST. art. IV, § 1 ("Full Faith and Credit shall be given in each State to the public Acts, Records, and judicial Proceedings of every other State. And the Congress may by general Laws prescribe the Manner in which such Acts, Records and Proceedings shall be proved, and the Effect thereof.").

228. *See* U.S. CONST. amend. XIV, § 1 ("No state shall . . . deprive any person of life, liberty, or property, without due process of law . . . .").

229. *See* U.S. CONST. art. I, § 8, cl. 3 (providing that Congress has the power "[t]o regulate commerce . . . among the several States . . . .").

230. The Equal Protection and Privileges and Immunities Clauses arguably also constrain choice-of-law approaches that discriminate in favor of state residents or against out-of-state residents. However, the Privileges and Immunities Clause applies only to persons, not entities, and the Equal Protection Clause has never been used to strike a state's choice-of-law policies. We therefore do not consider these clauses in our analysis.

231. U.S. CONST. art. IV, § 1.

members have uniform rights to the proceeds of the fund.[232] This need for a single governing law seems particularly compelling in a case like *Supreme Council of the Royal Arcanum v. Green*,[233] where the law of the state of the organization's formation was held to control an issue regarding members' assessments. Obviously it would be very hard for the organization to operate effectively when members' contributions are subject to different rules in each state. But the rule was also applied in less exigent circumstances such as *Order of United Commercial Travelers v. Wolfe*,[234] where a notice-of-claim provision in the association's constitution was enforced despite a law in the member's state of residence invalidating contractual shortening of the limitations period. Surely differing limitations periods would have interfered with the day to day operations of the Order.

The Court, however, has never applied these formation-state cases to a *business corporation*. It came closest in *Broderick v. Rosner*,[235] which held that New Jersey could not prevent a New York bank from suing its New Jersey shareholders under New York law. The Court, citing a fraternal benefit association case, said that "the act of becoming a member (of a corporation) is something more than a contract, it is entering into a complex and abiding relation, and as marriage looks to domicile, membership looks to and must be governed by the law of the State granting the incorporation."[236]

But the *Broderick* case involved whether New Jersey could thwart an assessment by a New York official, which was akin to a court order and therefore specifically covered by the Full Faith and Credit Clause. This leaves open the question whether a New Jersey court would have been required to enter a judgment consistent with New York *law* if there had been no prior court order equivalent in New York.

Whatever the constitutional support for the IAD before the mid-1930s, this support is much weaker now after *Allstate Insurance Co v. Hague*[237] has effectively merged Full Faith and Credit and Due Process for choice-of-law purposes.[238] In *Hague*, the Court let Minnesota apply its rule "stacking" uninsured motorist coverage for three vehicles owned by an insured rather than the different rule in Wisconsin. The Minnesota

232. Order of United Commercial Travelors of Am. v. Wolfe, 331 U.S. 586, 614 (1947).

233. 237 U.S. 531, 546 (1915).

234. 331 U.S. 586, 624–25 (1947). For similar cases, see Sovereign Camp of Woodmen of the World v. Bolin, 305 U.S. 66, 78 (1938) (enforcing bylaw providing that member's obligations would cease after twenty years against claim that bylaw was ultra vires); *Sovereign Camp*, 305 U.S. at 78–79 (authority of society to forgive member assessments after 20 years to be determined according to law where the society was formed); Modern Woodmen of America v. Mixer, 267 U.S. 544, 551 (1925) (enforcing bylaw concerning effect of member's prolonged absence rather than presumption-of-death law).

235. 294 U.S. 629, 643–44 (1935).

236. *Id.* (citing *Modern Woodmen*, 267 U.S. at 551).

237. 449 U.S. 302, 320 (1981).

238. *Id.* at 308 n.10.

rule applied although the policy was issued and the insured resided in Wisconsin because the decedent worked in Minnesota, his widow became a Minnesota resident after the accident, and the insurer was doing business in Minnesota. The majority thought there was "no element of unfair surprise or frustration of legitimate expectations as a result of Minnesota's choice of its law."[239] Justice Stevens, concurring, said that the parties' expectations are significant under the Full Faith and Credit Clause,[240] and suggested that the Due Process Clause would raise fairness concerns if the parties had made their expectations explicit by providing for application of a particular law.[241] In *Phillips Petroleum Co. v. Shutts*[242] the Court applied this expectations test in refusing to allow a Kansas court to apply forum state law in a nationwide class action, reasoning that because some of the leases had nothing to do with the State of Kansas, the parties did not expect the forum's law to control when they executed the leases.[243]

These cases indicate that the constitutionality of a choice-of-law rule depends on whether parties should anticipate at the time of the transaction that the law of any state with a connection to that transaction might apply. If a state attempts to apply wholly unrelated law to that transaction, as Kansas did in *Shutts*, then the Court may strike down that choice on Full Faith and Credit and Due Process grounds. Although these clauses protect the parties against arbitrary choices of law, they would not compel enforcement of choice-of-law clauses. A constitutionally mandated IAD is similarly unlikely.

The Commerce Clause provides an alternative constitutional basis for the IAD. Because the Clause most clearly prevents only overt discrimination against interstate commerce,[244] one might think it clearly would not prevent a state from applying the same law to a foreign corporation that it applies to its own firms. But the Court also has used the Clause to protect against a state's imposing costs on parties in other states by effectively regulating interstate commerce. For example, the Court struck down state regulation of the length of interstate trains,[245] and trucks,[246] and an Illinois law requiring a type of mudguard that differed from the type permitted in forty-five states and required in at least one.[247] Forcing trucks to change mudguards at the state line obviously

239. *Id.* at 318 n.24.
240. *Id.* at 324 n.11.
241. *Id.* at 328–29.
242. 472 U.S. 797 (1985).
243. *Id.* at 822.
244. *See* Donald H. Regan, *The Supreme Court and State Protectionism: Making Sense of the Dormant Commerce Clause*, 84 MICH. L. REV. 1091, 1092 (1986) (suggesting that the Court should merely prevent states from engaging in purposeful economic protectionism).
245. *See* S. Pac. Co. v. Arizona, 325 U.S. 761, 781–82 (1945).
246. *See* Kassel v. Consol. Freightways Corp., 450 U.S. 662, 678–79 (1981); Raymond Motor Trans., Inc. v. Rice, 434 U.S. 429, 447–48 (1978).
247. *See* Bibb v. Navajo Freight Lines, Inc., 359 U.S. 520, 529–30 (1959).

inhibits interstate commerce. Closer to the IAD, in *Edgar v. Mite Corp.*,[248] a plurality of the Court applied this principle to invalidate an Illinois law that regulated national tender offers to shareholders residing in Illinois.[249] By contrast, the Court held in *CTS Corp. v Dynamics Corp. of America*,[250] that the Commerce Clause supported the application of the IAD to allow Indiana to regulate a tender offer for control of an Indiana corporation.[251]

These cases seem to suggest that the Commerce Clause permits only the state of incorporation to regulate corporate governance. The supreme court of Delaware—the state that has the most to gain from the IAD—thinks that the IAD is therefore constitutionally protected.[252] California courts disagree, upholding the constitutionality of the state's "outreach" statute regulating the internal governance of firms with significant California contacts.[253] The statute provides that California law controls a number of internal governance issues if a foreign company conducts at least half of its business in California and California residents hold at least fifty percent of the company's voting securities.[254]

California has the better argument. The Court has never held that the Commerce Clause precludes a state from regulating the internal governance of a firm incorporated under another state's law. Violations of the IAD often can, but do not necessarily, involve the sort of insuperable multiple-regulation problem that demands Commerce Clause attention. As a California court noted in applying the California statute to a Utah corporation, given the significant presence in California that was necessary to trigger the statute, it is unlikely more than one such state law would apply to a given corporation.[255] So while the Commerce Clause might bar some corporate statutes that force firms to comply with multiple states' laws, this does not elevate the IAD to special constitutional status.

The strongest argument for the constitutional status of the IAD is based on the Court's use of *Trustees of Dartmouth College v. Woodward*.[256] There the Court held that the Contract Clause[257] invalidated a New Hampshire statute that altered the terms of a British crown charter

248. 457 U.S. 624 (1982).
249. *Id.* at 640–43.
250. 481 U.S. 69 (1980).
251. *Id*. at 91–94.
252. *See* Vantagepoint Venture Partners 1996 v. Examen, Inc., 871 A.2d 1108, 1116 (Del. 2005); McDermott, Inc. v. Lewis, 531 A.2d 206, 218–19 (Del. 1987); Timothy P. Glynn, *Delaware's Vantagepoint: The Empire Strikes Back in the Post-Post-Enron Era* 4–5 (Seton Hall Pub. Law & Legal Research Series, Working Paper No. 2007-001), *available at* http://ssrn.com/abstract=966449 (criticizing Delaware's assertion of the constitutional basis of the IAD).
253. *See* Wilson v. La.-Pac. Res., Inc., 187 Cal. Rptr. 852 (Ct. App. 1982).
254. CAL. CORP. CODE § 2115 (West 1990).
255. *Wilson*, 187 Cal. Rptr. at 859–60.
256. 17 U.S. 518 (1819).
257. U.S. CONST. art. I, § 10, cl. 1 (providing that "[n]o State shall . . . pass any . . . Law impairing the Obligation of Contract").

granted to Dartmouth College because the charter was a contract. *CTS* cited *Dartmouth College* in reasoning that "no principle of corporation law and practice is more firmly established than a State's authority to regulate domestic corporations, including the authority to define the voting rights of shareholders."[258] However, while this reasoning permits a state to regulate the internal affairs of its own corporations, it still does not necessarily follow that *only* the incorporating state can do so.

The IAD might have quasi-constitutional status as a limit on the reach of federal law through the Supremacy Clause. As discussed above, *CTS* emphasized the incorporating state's special province over corporate governance. Conversely, when the Court held that state securities actions were preempted by the Securities Litigation Uniform Standards Act, it reasoned that "[t]he magnitude of the federal interest in protecting the integrity and efficient operation of the market for nationally traded securities cannot be overstated."[259] But the Court seems to be distinguishing between "securities" and "internal governance" issues rather than endorsing the IAD. Many federal "securities" laws reach deep into the kind of internal governance issues covered by the IAD, including the Williams Act, which regulates takeovers, the Foreign Corrupt Practices Act, which imposes the first internal controls reporting in the wake of the corporate bribery scandals of the 1970's, and, of course, the Sarbanes-Oxley Act of 2002.[260]

Thus, while the Commerce Clause suggests that the Court might impose some order on the states, such order does not necessarily have to be achieved with the IAD. At most, the IAD helps mark out an area that is relatively safe from federal preemption. But this is only a suggestion rather than a constitutional boundary, as shown by the continuing forward march of federal corporation law.

The important question for present purposes is whether the Court should follow the implication of cases like *CTS* and use the Commerce Clause (or perhaps Full Faith and Credit/Due Process) to forbid a state from imposing its corporate law on a foreign corporation. This result cannot be based on the notion that multiple state laws would excessively burden interstate firms because although it is necessary for only one state law to apply, that state need not be the incorporating state. Even if the incorporating state has the best claim to applying its law, this claim does not necessarily deserve constitutional protection.

258. CTS Corp. v. Dynamics Corp. of Am., 481 U.S. 69, 89 (1987).

259. Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Dabit, 547 U.S. 71, 78 (2006); *see* Ribstein, Dabit*, Preemption, and Choice of Law*, *supra* note 130, at 160–65 (analyzing the case and its preemption issue).

260. For discussions of the increasing federalization of state corporate law, see Robert B. Ahdieh, *From "Federalization" to "Mixed Governance" in Corporate Law: A Defense of Sarbanes-Oxley*, 53 BUFF. L. REV. 721 (2005); Renee M. Jones, *Does Federalism Matter? Its Perplexing Role in the Corporate Governance Debate*, 41 WAKE FOREST L. REV. 879 (2006); Mark J. Loewenstein, *The Supreme Court, Rule 10b-5 and the Federalization of Corporate Law,* 39 IND. L. REV. 17 (2006).

The law market perspective contributes to this analysis. First, it shows that Commerce Clause protection may not be necessary because of the role of party mobility and exit-affected interest groups discussed in this article. Because this mobility was enough to enable the IAD to develop without any direct constitutional support, it is not clear why the constitution would be necessary to bolster it now.

Second, this article shows that the IAD has no stronger policy basis than other rules for enforcing choice-of-law clauses. Thus, if the IAD has constitutional status, so should rules enforcing choice-of-law clauses in other types of contracts. For example, if the IAD has constitutional status, why not insist on the enforcement of clauses designating the applicable law in franchise, insurance, consumer, or employment agreements—all agreements where courts are inclined to invoke the "fundamental policy" exceptions under general choice-of-law rules?[261] While there are distinctions between these contracts and those dealing with corporate governance, the question is whether these distinctions rise to a constitutional dimension. Given the close connections between the corporate and general law markets discussed in this paper, there is no obvious way the Court could carve out a distinctly "corporate" area for constitutional protection. It would then have to immerse itself in state choice-of-law jurisprudence, a move it took up but quickly abandoned at the beginning of the 20th century.

B. The Corporation as Contract

The law market has broad implications for how the government should approach regulating corporate governance. Since the inception of the modern publicly held corporation, there has been a lively debate between those who view the corporation as a political entity, consistent with its origins as a state-created franchise, and those who view it as the product of private contract.[262] An important basis for the state-creation position is that corporations are the beneficiaries of a choice-of-law rule that allows them to choose any state's law for their corporate governance. This state-created privilege seems to justify exacting the price of greater susceptibility to regulation than other contractual relationships.

We have seen, however, that the IAD does *not* give Delaware courts power over corporations' worldwide activities. Rather, this article shows that the IAD is a relatively narrow doctrine that leaves plenty of room for regulation by the states in which corporations carry on their activities. It follows that the IAD not only does not need to be justified by a political theory, but also does not itself confer a special privilege that should make the corporation, in effect, a ward of the state.

261. *See supra* text accompanying note 116.
262. *See supra* note 14.

The relationship between the corporate law market and contractual choice of law generally is also significant in deciding how the IAD should be applied. Consider, for example, *Rosenmiller v. Bordes*,[263] where the court applied Delaware law to a Delaware corporation despite a New Jersey choice-of-law clause in the firm's shareholder agreement. Because the IAD is only a rule for enforcing contractual choice of law, it arguably should be interpreted like any other choice-of-law clause—that is, consistent with the contracting parties' expectations. Incorporating in Delaware arguably indicates the parties' intent to apply Delaware law to all corporate-governance-related matters notwithstanding a contrary choice-of-law clause in the shareholder agreement. Or one might argue to the contrary that the later agreement trumps the earlier Delaware incorporation.

Even if the corporation is simply a contract, the state has the power to regulate it, just as it does other contracts. From this standpoint, the law market analysis provides a rationale for regulating corporate choice of law. Thus, the *Rosenmiller* result might be explained in terms of the law market processes discussed in this article. The Delaware court might have been attempting to avoid creating a precedent that would enable other states to undermine Delaware's investment in corporate law. Delaware needs supply side incentives in order to produce high quality law. Delaware arguably can protect its significant investment in its corporate law "infrastructure" only if it can restrict the privilege of using Delaware law in Delaware courts to Delaware corporations, which have paid the full incorporation fee. This suggests that Delaware would hesitate to let parties circumvent the fee by incorporating elsewhere and agreeing to apply Delaware law.[264] In so regulating contractual choice of law, Delaware would be protecting Delaware policy—in this case, its policy protecting Delaware's investment in its corporate infrastructure. This is not fundamentally different from any state's refusing to enforce a choice-of-law clause in order to prevent evasion of local policy.

C. State or Federal Law?

As discussed in subpart A, the Court has cited states' power over internal corporate governance as a basis for refusing to preempt state-of-incorporation takeover regulation. Under the traditional analysis, states have special rights over internal governance, while the federal government regulates the securities markets. But this is an artificial distinction. As a matter of policy it is far from clear why the federal government

263. 607 A.2d 465, 468–69 (Del. Ch. 1991).

264. *See* Ribstein, *supra* note 76, at 1022–25.

should not regulate internal corporate governance, which obviously affects the national securities markets.[265]

The law market lens provides a clearer view of this policy issue. The application of federal law to corporate or other contracts should depend at least in part on whether the IAD or other rule on contractual choice of law is a viable alternative. As long as a state regulates only firms that choose its law, state law probably does not impose the sort of burdens that require federal relief. Just as the Court need not protect the IAD under the "negative" version of the Commerce Clause, so Congress need not act under its positive Commerce Clause power. By contrast, when a nonincorporating state seeks to regulate corporate governance, there is a risk of multiple state regulations that may justify federal preemption. Note that this argument applies to any matter covered by incorporating state law, and not just those matters traditionally covered by the IAD. It follows that a state should be concerned about triggering federal preemption only when it trumps the IAD or other contractual choice of law, and not when it seeks to expand the matters covered by the IAD or other choice-of-law contracts.

Federal law theoretically could solve the problem of state nonapplication of the IAD not by displacing these laws, but alternatively by providing for federal enforcement of contractual choice. A possible mechanism for federal intervention into enforcing contractual choice of law could be through a law preempting state laws on corporate governance or securities *except* to the extent that it is subject to the IAD. Congress used a similar approach in the Securities Litigation Uniform Standards Act, which prohibited state law actions for securities fraud.[266] The Act exempted from preemption certain state disclosure actions that are currently governed by state corporate law.[267] Congress might have adopted the approach suggested here simply by extending the "carve-out" to *any* action that is governed by the IAD.[268]

The analysis so far in this section focuses on the risk of state overregulation by disregarding contractual choice. Federal intervention theoretically also may be warranted if there is evidence of underregulation, or a race-to-the-bottom, from state court enforcement of the IAD. This depends, among other things, on whether states are vigorously competing to provide corporate law, or whether, instead, Delaware dominates the market. In fact, Delaware's dominance is far from clear, given

265. *See* Ahdieh, *supra* note 260, at 741–45; Donald C. Langevoort, *Federalism in Corporate/Securities Law: Reflections on Delaware, California, and State Regulation of Insider Trading*, 40 U.S.F. L. REV. 879, 890–91 (2006).

266. 15 U.S.C. § 77p(b) (2000); *id.* § 78bb(f)(1).

267. *Id.* § 77p(d)(1); *id*. § 78bb(f)(3)(a).

268. *See* Ribstein, Dabit*, Preemption, and Choice of Law*, *supra* note 130, at 165–71 (suggesting this approach).

substantial evidence that home jurisdictions compete to keep local firms from incorporating in Delaware.[269]

Although we cannot here settle the race-to-the-bottom debate, we can at least suggest that there is a policy basis for distinguishing between federal preemption when the state courts do not respect contractual choice of law and preemption when state courts do respect contractual choice. In the former case, federal intervention often may be necessary to protect against significant interstate spillovers. In this situation state competition has broken down to the extent that single states are able to regulate national firms. That will be the case whenever national firms in interstate commerce cannot cheaply avoid state contacts that enable states to regulate.

On the other hand, when the states respect choice-of-law contracts or the IAD, a market for law theoretically can operate in which the states have incentives to meet the needs of all contracting parties. To be sure, contractual choice is not always desirable: these contracts may be impaired by bargaining defects or may impose costs on non-contracting parties. But the states have an opportunity to impose super-mandatory rules within the constraints of law market processes, including the "shadow" of potential federal preemption discussed above.[270] Given these checks, the race-to-the-bottom seems to be a lower priority risk than the risk of potential spillovers when states go outside the bounds of contractual choice. This analysis suggests that the federal government should follow a policy of presuming against preemption whenever there is a functioning law market in the sense that the states generally enforce contractual choice of law. That would certainly be the case for corporate law given the IAD.

The analysis in this subpart suggests that while states might be concerned that underregulation would trigger a federal response, they need not have this concern from regulating unless in doing so they also refuse to enforce contractual choice of law. Some recent cases in which Delaware courts have hesitated in expanding the scope of Delaware corporate law into the federal preserve of securities regulation indicate that Delaware has misperceived the nature of the federal preemption threat. The Delaware Supreme Court initially held in *Malone v. Brincat*[271] that shareholders could sue directors for breach of fiduciary duty based on false financial statements in SEC reports and shareholder communications, even if the statements are not connected with corporate transactions. Delaware Chief Justice Steele was dubious about this theory when he decided *Malone* as Vice Chancellor, noting that

> Congress has articulated a standard of disclosure to protect the national securities market. It makes little sense for Delaware courts to impose either a duplicative or stricter standard on directors of

269. *See supra* Part IV.A.
270. *See supra* Part III.C.
271. 722 A.2d 5 (Del. 1998).

> Delaware corporations. Neither the Delaware corporation code nor the common law suggests that Delaware can or should pick up the perceived regulatory slack when federal scrutiny may not include review of every actionable theory divinable by a dogged plaintiff.[272]

Vice Chancellor Leo Strine expressed a similar concern in holding against a Delaware remedy for insider trading. Referring to the Securities Litigation Uniform Standards Act,[273] he said that state regulation of insider trading "might . . . fuel further legislative developments, as what was understood by Congress to be a narrow and fixed 'Delaware carve-out' for traditional fiduciary duty claims turns out to be an expanding excavation site that unsettles the structure of federal securities law."[274] In other words, a Delaware remedy for insider trading might invite more federal preemption of state law. Professor Langevoort correctly sees Strine's restraint as an attempt to maintain separate spheres for federal and state law.[275]

The concern expressed in these cases is not warranted under this article's analysis. Congress has little reason to occupy a state law area just because Delaware has sought to provide greater protection in an area covered by federal law. The appropriate scope of federal regulation should depend for corporate law, as for the law market generally, on the costs of leaving this matter to the states. If the states can coordinate with each other by enforcing contractual choice of law, there may be little role for federal regulation. Indeed, Delaware ought to have precisely the opposite concern: that doing nothing might trigger a federal response regardless of whether such a response is appropriate.[276]

D. Which State? The Limits of the IAD

When should, and will, a state apply another state's corporation law to locally based firms? To see these issues, consider some recent California cases. One case indicated that California clearly feels bound by

272. Malone v. Brincat, No. 15510, 1997 WL 697940, at 2 (Del. Ch. Oct. 30, 1997), *rev'd*, 722 A.2d 5 (Del. 1998).

273. *See supra* text accompanying note 266.

274. *In re* Oracle Corp. Derivative Litig., No. Civ. A. 18751, 2004 WL 2756278, at *24 (Del. Ch. Dec. 2, 2004) (footnotes omitted).

275. *See* Langevoort, *supra* note 265.

276. One might argue that the federal government would be more likely to act in the face of state over-enforcement of contractual choice of law that resulted in neglecting interests that otherwise would be protected by state mandatory rules. For example, the Sarbanes-Oxley Act might be seen as a reaction to the inadequacies of state corporation law under the IAD. However, it is more accurate to view a law like SOX as a reaction to what Congress views as a mistake or inadequacy of substantive state law than as a reaction to a particular choice-of-law rule. In other words, mistaken state policy rather than excessive state coordination is the basis for federal action. Thus, if the IAD were less universally recognized—if, for example, California defected and imposed its own version of SOX—Congress would more likely see this as a justification for acting than as undercutting the need to act. To the extent that a *choice-of-law* rule is a basis for Congressional action, the rejection of the IAD is more likely to call for federal action than its acceptance.

the IAD. In *State Farm Mutual Automobile Insurance Co. v. Superior Court*,[277] the court applied Illinois corporate law to determine the duty of directors of an Illinois mutual insurance company to pay dividends, relying on the IAD rather than the usual contract analysis under Second Restatement § 187.

The California courts are, however, less sure about the scope of the rule. Thus, a California appellate court held in *Friese v. Superior Court*[278] that a shareholders' derivative action brought on the corporation's behalf under the California securities law for insider trading was not barred by the fact that the incorporating state (Delaware) did not allow such a claim. Meanwhile, a federal court held in In re *Sagent Technology, Inc. Derivative Litigation*[279] that the IAD did apply to this type of claim. And yet another California appellate court held in *Grosset v. Wenaas*[280] that the incorporating state's law trumped California's requirement that derivative plaintiffs hold their shares throughout the litigation, although recognizing the California requirement that plaintiff own shares at the time of the transaction would have applied. *Grosset* is now being reviewed by the California Supreme Court.

The issue in these cases arguably does not concern the appropriate sphere of state internal governance regulation, but only what issues the incorporating state has actually sought to regulate. Because the IAD is simply a contractual choice-of-law rule, a court need not decide whether the suit involves "securities trading" or "internal governance" in some fundamental sense. Thus, if Delaware decides that shareholders should be able to sue their firms derivatively to recover an insider's trading profits, this constitutes a contract among the shareholders to apply Delaware law to these suits wherever they are brought and wherever the shareholders and insiders reside. This would also be the case if Delaware clearly has determined to provide a breach of fiduciary action for insider trading.

California could, of course, decide to regulate Delaware corporations, including aspects that relate to internal governance, and thereby protect California residents. As discussed in subpart A, the constitution would not preclude this regulation. States arguably should be able to invalidate choice-of-law contracts pursuant to a statute that clearly expresses their intent to do so.[281] Because the IAD is a contractual choice-of-law rule, the same approach should apply to the IAD.

277. 8 Cal. Rptr. 3d 56 (Ct. App. 2003).

278. 36 Cal. Rptr. 3d 558 (Ct. App. 2005), *cert. denied*, Moores v. Friese, 127 S. Ct. 138 (Oct 02, 2006).

279. 278 F. Supp. 2d 1079 (N.D. Cal. 2003).

280. 35 Cal. Rptr. 3d 58 (Ct. App. 2005), *review granted and opinion superseded by* Grosset v. Wennas, 127 P.3d 27 (Cal. 2006).

281. *See* O'Hara & Ribstein, *supra* note 31, at 1199–1200 (proposing this rule for choice-of-law clauses).

The question, then, is when it would be appropriate for California to regulate a Delaware corporation.[282] California might reasonably decide that whether it trumps Delaware law depends on whether the matter relates to a central aspect of Delaware policy and expertise—that is, internal corporate governance rather than securities regulation. On the other hand, California could decide that it wishes to impose its law whenever the potential harm to California residents is enough to justify California regulation. The focus on internal governance impedes analysis by forcing courts into awkward modes to rationalize their result. Rather than making an artificial distinction between internal governance and other issues, the California legislature should face the tough question of whether it wants to impose the regulation and act accordingly.

If several states regulating Delaware corporate insiders impose undue burdens on multistate firms, Congress may have to step in, just as it did when California's nonderivative securities law liability provoked passage of the Securities Litigation Uniform Standards Act.[283] Indeed, the securities laws generally could be viewed as a reaction to burdensome state securities regulation. Although Congress did not preempt state law in 1933 or 1934, it did so in 1997 when California threatened to undercut Congress's attempt to limit securities class actions.[284] But whether Congress should act depends on whether the states can coordinate without federal help by construing the scope of the IAD. This article's analysis suggests that the law market can constrain aggressive state action in many cases without aggressive federal intervention.

E. Implications for Future Scholarship

This article has important implications for studying jurisdictional competition. Instead of focusing on a specific subset of contracts relating to the governance of publicly held corporations, the appropriate perspective is the general market for law. Indeed, there are different submarkets for a continuum of different types of contracts, including business-

282. There is a separate question as to whether and under what circumstances a state other than Delaware may adjudicate governance issues under *Delaware* law. Delaware judges have refused to stay or dismiss actions in Delaware in the face of related suits involving the same firm filed in other jurisdictions. *See In re* Topps Co. S'holders Litig., 2007 No. Civ. A. 2786-UCS, WL 1412990 (Del. Ch. May 9, 2007); Ryan v. Gifford, 918 A.2d 341 (Del. Ch. 2007). Both courts rely heavily on Delaware courts' interest and expertise in maintaining the quality of Delaware law, particularly in cases involving novel questions of law. Clearly this would be a strong consideration supporting enforcement in Delaware or New York of a provision designating a Delaware forum either in the corporate charter or as a statutory default rule. But it is not clear what the Delaware courts should do in the unlikely event that the parties entered into a choice-of-forum clause explicitly choosing a *New York* court. Perhaps Delaware should be able to protect its investment in its law by refusing to enforce the clause. On the other hand, enforcement of this contract would enable the law market to exert discipline on Delaware courts.

283. *See supra* text accompanying note 259.

284. *See* Joshua D. Ratner, *Stockholders' Holding Claim Class Actions Under State Law After the Uniform Standards Act of 1998*, 68 U. CHI. L. REV. 1035, 1042–51 (2001).

association-type contracts. Future work should continue exploring these differences and similarities. This article has suggested some issues that are ripe for analysis. For example, why is there a single dominant player in the market for public corporations, but an oligopoly in the market for noncorporate commercial contracts? What explains Florida's evident success in the market for closely held firms? Why have non-Delaware states, particularly Maryland, succeeded in dominating the market for some publicly held unincorporated firms? What explains when a particular state will compete in the law market, and the nature of the competition it engages in? What types of laws are susceptible to being "traded" in the market for law?

These issues are important to understanding the role of state law in an increasingly globalizing world. When even the smallest e-commerce firms have broad international networks of suppliers and customers, state law seems to be increasingly an anachronism. Yet giving law-making functions to a single lawmaker eliminates exit as a constraint on suboptimal laws, and reduces experimentation and diversity at a time when these features are increasingly necessary. The corporate law market, in which party choice is generally enforced subject to reserving the power to states and countries to enact explicitly super-mandatory rules, points the way toward accommodating local law with a global economy.

F. Summary

This Part has examined some implications of the law market perspective. First, the scope of constitutional protection for the IAD depends directly on the relationship between the IAD and the general law market: the closer this relationship, the weaker the argument for giving special protection to corporate choice of law. Moreover, the competitive forces underlying the law market, which among other things were responsible for the birth of the IAD even in the absence of constitutional protection, indicate that constitutional protection may not be necessary.

Second, the close relationship between the corporate law market and the general market for law supports the characterization of the corporation as a contract. The IAD is not a special privilege accorded corporations because of their origin as state-conferred concessions. It is rather an application of the same forces that underlie other aspects of the law market.

Third, the law market analysis bears on the dividing line between state and federal law. Clearly there is no sharp distinction between "corporate" and "securities" law. But this does not tell us where the divide should be, and even less that federal law should encroach even further on the state domain. The law market analysis instructs that federal law is necessary, and indeed has been used, mainly as a fallback when the states have failed to enforce contractual choice of law. Thus, the division between state and federal law does not depend on whether Delaware seeks

to regulate securities, but on whether California is willing to respect that regulation.

This analysis obviously carries over to the question of the extent to which states should be able to regulate firms whose governance is subject to the law of another state. Again, the answer does not depend on a sharp divide between "corporate" and other law, for the simple reason that there is no unique market for corporate law. As in other aspects of the law market, Delaware makes its own decision about the extent to which it seeks to regulate corporations, while California makes its decision about the extent to which it will respect Delaware law. The IAD as currently configured is important only because it has been generally successful as a coordinating mechanism. In other words, the states have been willing to respect other states' laws as long as they stay within the relatively innocuous confines of the IAD rather than intruding on policy concerns the states care more about. But this does not mean that there is a hard and fast policy distinction between the issues that are within, and those that are outside, the IAD.

Finally, the law market analysis has important implications for future scholarship. This article has indicated several issues on which more research is appropriate concerning the nature of the law market. There are many other potential illustrations of the advantages of escaping the intellectual rut of the supposedly unique market for corporate law.

VI. CONCLUDING REMARKS

The IAD and the market for corporate law have been studied as unique phenomena. In fact, these topics need to be understood within the context of the general market for law. There are important connections between choice of law for corporations and contractual choice of law in other settings. These include not only the commercial contracts examined for comparison in this article, but also domestic relations,[285] property,[286] securities regulation,[287] bankruptcy,[288] and electronic commerce.[289] As with the IAD, understanding the general policies and politics underlying the law market can produce useful insights into jurisdictional competition, with important implications for such topics as constitutional law and the nature of the corporation.

285. *See* F.H. Buckley & Larry E. Ribstein, *Calling a Truce in the Marriage Wars*, 2001 U. ILL. L. REV. 561.

286. *See* Abraham Bell & Gideon Parchmovsky, *Of Property and Federalism*, 115 YALE L.J. 72 (2005).

287. *See* Romano, *Empowering Investors*, *supra* note 130.

288. *See* Robert R. Rasmussen, *Resolving Transnational Insolvencies Through Private Ordering*, 98 MICH. L. REV. 2252 (2000).

289. *See* Larry E. Ribstein & Bruce H. Kobayashi, *State Regulation of Electronic Commerce*, 51 EMORY L.J. 1 (2002).