AMMINISTRAZIONE IN CAMMINO
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a cura del Centro di ricerca sulle amministrazioni pubbliche "Vittorio Bachelet"
Direttore: Prof. Giuseppe Di Gaspare

"Managerial Cluster": a change of incentives in the market for re-incorporations.

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INTODUCTION

Europe is the process of enacting juridical changes that are likely to open the way for a regulatory competition within the different legal system's company law, right now characterizing the European juridical scenario. From an economic point of view, what seems focal is to understand if the very divers European economic scenario is ready to absorb and take the advantage of a more liberalized market of the legal rule.

In the United States corporations are free to choose between the corporation laws provided by the fifty federal states with out having to accept the entire bundle of the respective jurisdictions. This has made possible trough decades a regulatory competition in between different legal rules. This system has never been designed deliberately, but emerged in the context of the fight against trust and monopolies at the end of the nineteenth century.[1] When the Sherman Act was enacted the governor of New Jersey attempted to give monopolies and trust a new home in exchange of a tax for using the corporate law.

By studying the cross-Atlantic literature it is possible to notice that the main actors of the supply and demand dynamics, regarding regulatory competition, are on one side small states that find a very profitable business in capturing a great number of incorporations; on the other side, very big firms, most of the time publicly owned that for their particular structure and

[1] K Hein and W Kerber 'European corporate laws, regulatory competition and path dependence' European Journal of Law and Economics (2002) Vol 13 47, 71

ownership find profitable reincorporating in a state different from their own. This is due to many factors; we can try to understand it by considering the market's top product: Delaware's company law.

This particular state has established his strong hold right after New Jersey's decline in the early '20s.[2] Since then the number of firms incorporated in Delaware has constantly increased. At present the situation in the market of company law is more similar to a monopoly dominated by Delaware. Although, if we reconsider the peculiarity of this kind of market we understand that crucial variants to it are infrastructures, courts and their case law baggage, the existing law regulation and other geo-political factors that not easily change in a short period of time but that due varied.

The law of Delaware is best definable indeterminate than lax in regard to companies and their management. Combining this to the political favour that Delaware has had for companies reincorporating in his jurisdiction trough decades, we can find a very rich case law strongly protective of the management's interest.[3]

These favourable conditions have produced a proliferation of law firms that provide any possible service to firms that are or would like to incorporate in Delaware. Summing up Delaware is extremely specialized in offering a very defined and high quality service to firms that match certain requisite.

[2] R Drury 'The regulation and recognition of foreign corporation: Response to Delaware syndrome' Cambridge Law Journal (1998) 165, 165

[3] L Bebchuk and A Cohen 'Firms decisions were to incorporate' (February 2002) discussion paper no 351<http://papers.ssrn.com/abstract=296492 (28 January 2004)

As we pass on considering the demand side of the market for company law we must first remember that reincorporating in another state has a cost[4] which is composite: the expense of reincorporating in the new state and the lost of benefits deriving from abandoning the home state.

Thus the perfect candidate to reincorporate in Delaware is a large firm which is not sensible to the cost of the operation in first place, and that is not in a privileged position in her proper state.[5]

At the level of law regulation what mostly attracts a firm is the existing balance between the anti-takeover regulation and the protection accorded to shareholders in general. This is because the top management will find him self in the position of, either remaining in charge, or in case of a takeover of having a very large pay-off, and at the same time not facing a decrees of trust by the stock market and a sequential fall of the share value.[6] The firms that are more subjected to takeovers are publicly owned firms or in any case firms who's ownership is not in the and of few shareholders.

To understand if we can learn from the U.S. example first we have to consider how similarly European entrepreneurs shape their firms: the average dimension of firms, the ownership assets and the internal decisional organization. If we look at the European market we will find great differences between the average company in US and in Europe. The next step is then to

[4] For an overview of the cost of reincorporating in Delaware see M Kahan 'Price discrimination in the market for corporate governance' (working paper edited by the Centre for the Study of Law and Society March 2000). In this work the author shows the magnitude of the price for reincorporating in Delaware especially if compared with the cost of reincorporating in any other state in the United States.

[5] Bebchuk and Cohen (n 3) 2'

[6] Hostile takeovers usualy take place after the market value of the share has faced an appreciateble decrease as this implise a smaller financial exposure of the firme willing to launch a bid.

understand if the US economic model is more efficient and if is going to be "exported" in Europe.

Only in this case the US regulatory competition experience may be relevant and meaningful for European institutions, in the process of reforming the regulatory competition status in Europe.

What we will try to present now is a picture of the possible market for European company law, understanding first his macro and microeconomic variables.

1-EUROPEAN ENTERPRISES

Although in Europe firms have been acting in an increasingly integrated market we are unable to observe, neither a competition in between states in the reincorporation market, or the weakening of national differences, which still remain very strong. It might be the case that "the regulations in the area of corporate law often do not adapt gradually and smoothly, but rather in large steps".[7] On top of this we can say that the harmonization process carried on by the European institutions is sometimes unable to win States resistance due to the existence of strong path dependences.[8] In other words it is very likely that certain historical conditions will imply the emergence of a certain track that will channel the development of the legal system in a certain direction. It is therefore possible that in the European Union great differences between national governance systems can persist for a long time even if in competition with other more efficient governance systems in other countries.

[7] Kahan (n 4) 2'

1.1- *LEGAL FRAMEWORK*

Even if is commonly agreed that in the United States there is a vital competition in the market for incorporation[9] this competition has brought to a substantial harmonization of the different legal regimes. This is due to two different factors:

-States have slowly converged to a regime that reflected the interests of the companies' management.

-The Federal Government has promulgated The Revised Model Business Corporation Act to which many states have adapted their company law statutes wholesale and others have adopted partially.

On the other hand in Europe we find a minor number of company laws characterized by profound differences. Despite the harmonization efforts of European Institutions there are states that at a national level have moved in diverging directions. The differences that characterize European states have more deep origins, and is very unlikely that the national governments are willing to give them up.

At a superficial level it might seem that in continental Europe there is a wider range of business opportunity, in the sense that entrepreneurs are offered different paths to follow in structuring their firm. That initial impression might be misleading because there is often less flexibility on offer

[8] Hein and Kerber (n 1) 1'

[9] In contrast to LA Bebchuck and A Hamandi 'Vigorous race or leisurely walk: Reconsidering the competition over Corporate Charters' Yale Law Journal (2002) Vol. 112 553, 615

within these designated options than one would find in Anglo-American models.[10]

This lack of flexibility in the main corporate models, particularly in Germany and to a lesser extent in France, is now being tackled in many continental jurisdictions. A trend in favour of deregulatory measures is becoming apparent. Thus Germany enacted a number of deregulatory measures for small Stock Corporation in 1993. In the UK summery financial statements could be said to reflect a similar policy. Likewise Denmark has done much to deregulate its law on private companies as a result of 1996 legislation. French law has devised a new flexible public company structure designed to stimulate joint ventures (*S.A.S.*).

Although the balance of development favours deregulation the pattern is not uniform. In certain areas, in particular with regards to corporate governance and shareholders rights in public listed companies, the thrust of reform favours increased regulation and the creation of predetermined rights as opposed to relying on juridical protection. The reform for public listed companies in Italy enacted in 1998 attest to this.

1.2- *ECONOMIC EVIDENCE*

A possible way to explain the great differences that characterize the European countries and their companies' laws, as well as their persistence, is to consider the demand side of the market for the incorporation market. The

[10] D Milman, E Avgouleas, B Bercusson, A Griffits *Company law in Europe: Recent Developpements* a CLAB report produced for the Department of Trade and Industry (February 1999)

European population of firms is a very vast and differentiated one; a first point that we shall consider is the concept of the public company in Europe.[11]

In the UK there is the tendency to consider the public company as representing the very largest of enterprises and statistically this comprises some 1% of all registered companies (about 12,000 in total). The public company in continental Europe is a much more used vehicle and it is fairly selectively employed in jurisdictions such as Germany (where there are only some 4,000), but when we move to France (160,000) and the Latin systems (250,000in Spain) we can observe how is often used by much smaller business and sometimes more extensively than the private company. Beside this, the pattern on the continent is that often only a very small percentage of public companies are actually listed in on the appropriate stock exchange. The reason for this may be related to company law, but it often reflects cultural differences and divergences in the tax law and social welfare systems.[12]

All the US literature on regulatory competition[13] and the market for incorporation takes in to account only firms of a certain size that are publicly traded and who's ownership assets reflect a great participation of investors. At this purpose we can see how Europe distinguishes herself. In the European market there is a great prevalence of public firms that for their dimensions and structure are very unlikely to take advantage of a market for reincorporation. A small firm is very likely to be linked to the state, and even more to the region, where it holds here business at a managerial and an industrial level.

[11] As we have seen in the cross-Atlantic experience the reincorporating market regards only publicly traded firms.
[12] Milman, Avgouleas, Bercusson anf Griffits (n 10) 5'
[13] C Bernard and S Deakin 'Market access and regulatory competition' In C Barnard and J Scott *The la of the single European Market* (Oxford 2003) 197,224; Dury (n 2) 2'; Kahan (n 4) 2'

Beside, small firms can very unlikely support the cost and the effort of a reincorporation in a foreign state with a different legal system, where they speak a different language, where the cultural and the environmental gap would represent a source of extra costs that are hardly sustainable. Because the extra cost of going out of state is unlikely to raise proportionally with firm size, these costs can be expected to weight more on smaller firms, and smaller firms can be thus expected to display stronger tendencies to incorporate in-state.[14]

What we then have to notice is the issue of share ownership and diversity of participation. In the UK holdings in public companies do reflect a quite broad range of participants. On the continent it is quit common to find, with in the public company, a single shareholder with overwhelming control or a very restricted number of participants to the ownership. Thus the public company, in some sense reflects aspects of the closed corporation.[15] We have noticed before that the incentives that move the management towards a reincorporation in a different state are quite a few but the most important is the protection that the State's legislation accords to the management against hostile takeovers. Again the premises of a market for reincorporation, as it is in the US, seem to be missing. If in the United States publicly traded companies whit a very spread ownership find very convenient to reincorporate in to a State that insures to the management a good level of protection against hostile takeovers, no matter of the cost of the operation, this doesn't seem the case for the majority of European firms.

[14] Bebchuk and Kohen (n 3) 2'
[15] For the entire statistical data Milman, Avgouleas, Bercusson and Griffits (n 10) 5'

Another factor that we shall consider is the fact that in Europe very large firms are often owned by very closed family groups, that trough generations have kept the ownership of their firms firmly in their hands. This has generated a very solid link of the firm with the economic and political environment of the home state. As a consequence these firms, still very common in the old continent, have a great incentive to remain in the home state in the hope of getting a favourable treatment. Again we can observe how the potential market for reincorporation in Europe, if not widely reduced, differs broadly from the US pattern.

2-THE MARKET FOR INCORPORATION IN EUROPE

Although a number of Directives have been adopted in relation to various issues regarding company law they fall a long way short of establishing a systematic code relating the formation and governance of companies. As we have showed, diversity in the laws of the individual member state have survived attempts of harmonization. This has made possible for member states to experiment in their search for efficient and workable rules of company law. The other side of member state autonomy is the absence of an effective market for incorporation in the EU. The *Centros* case illustrates the idea of regulatory competition currently held in the European legal order. At first sight, *Centros* seems to improve the chances of a market for incorporation, by casting doubt on the *Siège réel* doctrine.

At present, EU member states are divided in the approach they take to determining the applicable law of corporate constitutions. The UK, along with Ireland, the Netherlands and Denmark, operates a 'state of incorporation' rule, according to which the applicable law is that of the state in which the company is incorporated or registered. This is in contrast with the position held in member states where operates the "real seat" doctrine". In these cases the courts will regard the applicable law as the law of the member state where the firm holds his main centre of operation, his head office or principal place of business.

2.1- *DEMAND AND SUPPLY*

Even states that follow the incorporation approach, such as the UK, would not be in a good position to replicate Delaware success. Delaware has established its position by attracting reincorporation from existing business set up in other states. Initial incorporations have formed only a small percentage of its stock of companies.[16]

On the supply side, member states would have to alter their laws with the aim of making reincorporation more feasible. This in order to allow the reincorporating firm to extract more advantages in return of a smaller cost of the operation. Incentives for states to customize their company law regimes to the needs of business owners and managers may exist, as it is the case for certain US sates, in the form of tax revenues from incorporation and registration. If we look at the Delaware case we understand how the state lacks any other important source of tax income, in part because of his small population, sizes and indigenous firms' presence. It is the high proportion of incorporation taxes in relation to the overall tax revenue that gives judges and legislators an incentive to respond to business needs and which gives managers and owners the confidence that the state will continue to be responsive to new needs.[17] Consequently it is possible to put in doubt the possibility of the emergence of a Delaware case in the Europe since only few member states would be in a position to become dependant upon company registration as a source of tax income.

[16] S Deakin 'Regulatory Competition: versus harmonization in the European Company Law' (Working paper No. 163 ESRC for Business Research University of Cambridge March 2000)
[17] R. Romano *The genius of American corporate law* (Wascington DC AEI Press 1993)

What seems more pertinent, in considering the states incentives in racing for a privileged position in the re-incorporation market, is a line of facts, which only indirectly derive from a great number of reincorporation in a member states.

As we have seen for the Delaware case the great number of re-incorporation has produced a proliferation of legal and accountancy firms that can exploit the vast concentration of firms head offices in the state. Parallel to this is the great specialization, and so the achieved efficiency, of Delaware's courts on litigations concerning corporate issues. This result is very likely to be replicated by any European state able to attract a great number of reincorporation. The importance of these "indirect consequences", due to the emergence of a Delaware case in Europe, is not to be undervalued. Even if the strictly fiscal incentive for a state to attract firms might seem absent, the gain deriving from the formation of district of financial, managerial and legal services could still be enough to stimulate a form of regulatory competition.

If we then pas on considering the demand side of the market for reincorporation we argue that even in this case, if regulatory competition will effectively take place in the European market, things are going to happen in a slightly different way. The fact that for European states the *direct fiscal incentive* is absent suggests us that legislators might be induced to attract firms not by alluring the management with favourable anti-takeover statues but by offering the firm a *juridical-economic* environment in which the firm will be able to face increased revenues from a great range of collateral services. This will be possible only by the gradual and slow convergence of firms to a financial and managerial centre that will then be able to offer to the

prospective reincorporating firm the advantages of what in industrial theories is known as cluster.[18]

The factors that make these groups of firms' clusters and that influence their ability to generate synergy, however, are more than mere counts of businesses.[19] Rather, successful clusters arise from dynamic activities and resources, such as access to specialized information and assistance, means and tendencies to associate and learn from one another, reliance on local suppliers, availability of skilled and experienced labour, tough competition, entrepreneurial energy, and shared vision.[20] Trust is a major factor in the strength of a cluster, increasing the opportunities for firms to take advantage of their collective capabilities and knowledge.

This line of thoughts is well adaptable to the market for reincorporation. Although, as we have shown above, the proportion of firms that will find profitable to move out of state is much smaller then in the US it is very likely that firms that match certain requisite will move out of state to a unique European financial managerial centre. A state offering a product that is especially good for certain type of firms will attract a significant number of out of state incorporation from firms of this type.[21]

For the remaining portion of the European firm population the future is uncertain; given that small and medium size firm have an incentive to

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[18] G Becattini *Il distretto industriale, un nuovo modo di interpretare il cambiamento economico* (Rosenberg & Sellier Torino 2000)

[19] R M Kantor *World Class* (Simon & Schuster New York 1996)

[20] R Putnam *Making Democracy Work: Civic Traditions in Modern Italy* (Princeton University Press New Jersey 1993) 163, 185

[21] Bebchuk and Cohen (n 3) 2'

incorporate in their home state it is still possible that this kind of firm will decrease in proportion in favour[22] of bigger firms' whit a spread ownership.

2.2- *THE FUTURE OF COMPANY LAW IN EUROPE*

To understand if the US example of regulatory competition is relevant in predicting the future of company law in Europe, we have to understand how the greater proportion of European firms, which still have strong incentives to incorporate in their home state, will evolve in the future. In other words, as we said at the beginning, we will try to understand if the US economic model is more efficient and if it will be more massively exported in Europe.

In the US share ownership is widely dispersed instead of being concentrated in the hands of families, banks, or other firms. Most large companies in the US have publicly traded shares and only a minority of these firms has a shareholder capable of exercising any sort of dominant influence. In this model of firm shareholders maintain their distance and give full-time executives complete decisional power. This approach prevails because investors are more concerned with the overall performance of the portfolio of shares they own than they are with developments affecting any one particular company.

Corporate governance in Europe is organized on a much different basis than it is in the US. Publicly traded companies do not play a role in the economy not even nearly as important. Also, with those firms that are publicly

[22] This transaction might happen trough an endogenous growth of the firm or as a result of concentration of firms trough mergers and acquisitions.

traded, "core" shareholders are prevalent and are usually well situated to exercise considerable influence over the management.

As we have said the market for incorporation in Europe will initially register a restricted number of participating firms. Even so the premises of a greater participation to this market are evident. In the last decade, by virtue of prosperity that has enjoyed, the American version of capitalism became widely admired.[23] In particular its rich and deep securities market where perceived as being an important source of innovation and economic dynamism. If this pattern is followed by members state in Europe it seems that the demand for a market for re-incorporation will grow and doing so will impose a great acceleration to regulatory competition. Assuming that a change towards this sort of US style economy would be beneficial to European enterprises, it follows that European policy makers, at a national and central level, would have to take in to consideration this change of direction of the economy. This would probably imply some changes within the different company law systems as so to adapt to the new economic environment.

The dispute on which would be the best approach in reforming company law in Europe is very alive and accounts very divers position, which we will not go trough. But what is our interest to state is that by considering the present and the near by future economic variables there are good possibilities for the emergence of a European Delaware; this in the sense of a financial and managerial pole, within the European states, capable of attracting a large portion of firms.

[23] B R Cheffins 'Law as Bedrock: The foundations of an economy dominated by widely heald public companies' Oxford Journal of Legal Studies (2003) Vol. 23 1, 23

For instance, the possibility that it might at some stage in the foreseeable future become UK policy to encourage re-incorporation from other member states certainly cannot be ruled out. UK company law is perceived in some quarters to be more "business friendly" than the company law regimes of most other member states,[24] not only but is already home of a great population of firm's headquarters, and the main financial centre of Europe. All this puts UK in the most favourable conditions of repeating the success of Delaware in the re-incorporation market.

3- RECONSIDERING THE DELAWARE EXPERIENCE

As we can observe in Delaware what has been named "race to the bottom" has gradually changed direction and now is aiming to the top; this is due to different factors. First of all we shall consider the fact that decisions taken by the management are constantly evaluated by vast population of consumers of financial products, which are the livelihood of publicly owned firms. At the same time the dominium of Delaware in the market for incorporation has attract the Federal State's attention; there is the possibility that the Federal State will intervene to ensure a minimum level of protection to all stakeholders with a great lost for Delaware.

What we can observe in now days is a great convergence of interests of the management, shareholders and stockholders. The shift seems orientated in

[24] Deakin (n 16) 10'

the direction of a system capable of adding the most value in terms of stability, reputability, predictability and efficiency.

The Delaware case offers a very important lesson; in a system where deregulation has been a fertile ground for firms to escape other more stringent juridical systems, the relevance to which the phenomenon has arise and the evolution of the economy have played a significant role in changing party's incentives.

In first place we shall consider the fact that what brings firms to re-incorporate in Delaware is not a pure count of the level of anti-takeover protection but a highly qualified and specialized set of services available to firms under the Delaware company law regime. Secondly, the treat of a Federal intervention to harmonize company law regimes is bringing Delaware judges to gradually adjust their position. The fact that the Delaware company law regime is based on a very rich case law baggage and not on a very detailed regulation offers courts the possibility to gradually expand the level of protection offered to creditors and other small shareholders. This leaves firms incorporated or re-incorporating in Delaware in a favourable position. The population of firms today incorporated in Delaware is a great proportion of the very big publicly owned firms in the United States. The ownership of these firms is very spread and their performance is tightly linked to the stock market. A greater level of protection from hostile take-overs will surely not cover the lost of credibility. Instead the progressive aggregation of firms under a unique juridical environment, stimulated by the Delaware government trough decades, has created a legal and economical system that stock markets recognize as more efficient and reliable.

If the European Government will promote and enact a liberalization of the market for re-incorporation it is very likely that many states will introduce new and more flexible law regimes to attract a great number of re-incorporations. Even if the direct fiscal incentive might be not as strong as it is for Delaware other are the advantages that would derive from becoming the financial centre of Europe.

Is in our opinion that firms, committed to their business and tightly linked to the stock market, will find convenient to converge towards a legal system inspired to the values cited above. The proportion of firms that will try to extract advantages for a selected portion of share holders will instead remain marginal. What we are now stating might seem optimistic but is surely coherent with efficiency.

CONCLUDING REMARKS

What we have observed is that the market for re-incorporation in the US was a singular phenomenon, very much a product of its own place and time. What other different experiences might show us is that regulatory competition is not a natural consequence of a federal system and is not a necessary consequence of the place of incorporation rule. The experience of Canada and Australia show us that a "liberalized" market for the legal rule dose not imply necessarily a regulatory competition.[25]

[25] Drury (n 2) 2'

Also history shows us that the situation in the US has changed and the system has matured; from the time when the governor of New Jersey started what as been named *race to the bottom* and competition between states and other factors, mostly market related, have eroded the major differences between the laws of the various states. Law and economics analyst have also showed that today there is not a constant rush towards the lowest common denominator of the laxest system as it was at the beginning of nineteenth century. The shift in now days seems more orientated in the direction of a system capable of adding the most value in terms of stability, reputability, predictability and efficiency.

Secondly we have considered how different the situation is in Europe. A different population of firms structured and run in a very opposite way from the US pattern and a much more fragmentised juridical environment within the member states give us the impression that the US experience for regulatory competition and the market for re-incorporation are not an accurate prevision of what might be the future in Europe.

Finally we have observed that a change towards a more centralized structure of the financial and managerial geography of European firms is very likely to take place on the bases of a spontaneous convergence of firms under a unique company law regime. Not only firms will derive great advantages from regulatory competition in terms of being incorporated under the most favourable and efficient law regime but they will also extract great advantages from being incorporated under a sole juridical system. The convenience of such a congregation of firms to a unique managerial centre can be understood

considering the theory underlying numerous economic successes of the industrial cluster.

In light of this consideration the convergence of firms towards a unique centre can only partially be explained with the firms' choice of a legal system. The extra gain of re-incorporating elsewhere will derive from other economic factors that will influence managers' decisions on where to incorporate.