# Presentation by Ronald Gilson, Professor of Law and Business, Columbia University; ECGI Fellow

I am grateful for the opportunity to participate in the first Transatlantic Corporate Governance Dialogue. Formalizing this exchange – it has been going in informally for years – under the auspices of the American Law Institute and the European Corporate Governance Institute stands witness to the fact that, despite the different histories of U.S. and European corporate governance, both systems in the end have to solve precisely the same problems to succeed in a global environment.

Competition is not only between companies, but also between national and supra-national corporate governance systems. As I will argue shortly, national governance rules function importantly to make company governance rules credible to the capital market. This, in turn, highlights a second theme of today's program – that the very different experiences of the U.S. and Europe provide compelling comparative insights – observers on each side of the Atlantic see different solutions to the same problems in the mirror of the other coast.

In the short time allotted to each speaker, I want to follow the conference theme and suggest how some of the U.S. experience with regulatory competition may prove useful to those focused on European corporate governance. Like a good lawyer, I begin with a caveat. I am a fascinated observer, but hardly an expert, on European corporate governance systems. As a result, I am freed somewhat from the curse of detailed knowledge that burdens the imagination with the weight of reality, but it also means I may get it wrong. I hope for your indulgence and will benefit from your corrections.

My analysis builds on two premises. Each is contestable and would itself warrant a talk, but given time constraints, I pause only to note then and then move on.

First, as recent work by Kahan and Kumar has demonstrated, there is not competition for corporate charters in the U.S., no competition among states for the revenue from incorporation, and this has been true for at least the length of time that the term corporate governance has been understood as something other than a peculiarly awkward oxymoron, like military music. (see note 1 below)

Second, I am persuaded by the morning's discussion and Luca Enrique's work (see note 2 below) that, save for start-ups, a market for corporate charters is unlikely to develop in Europe in the near future.

That said, and understanding that each premise is contestable, let me turn to the question I want to address this afternoon. If we take the market for corporate charters out of the analysis, does the experience of Delaware's dominance of U.S. corporate law nonetheless have implications for European corporate governance? I think the answer is yes, but the relevance, I will argue, draws not on competition theory, but on information theory.

Almost thirty years ago, my colleague and co-reporter Melvin Eisenberg wrote that corporate law was constitutional, at least in the U.S. sense of the term.(see note 3 below)

United States corporate law, like United States constitutional law, creates three decision making structures – shareholders, managers and directors like the executive, legislative and judicial branches under the U.S. constitution – and assigns more or less general spheres of authority to each. The finer jurisdictional boundaries that are implied by the general structure are left for resolution by the courts. As Mel Eisenberg both described and accurately predicted, almost everything that is interesting and important in U.S. corporate law is judge made.

From this recognition of the judiciary's critical role comes my insight. At least for the last twenty years or so, the critical advantage of Delaware has been the quality of its Chancery Court (the reference to the trial court and not the Supreme Court is intentional). It is easy to state, for example, that a controlling shareholder owes a fiduciary duty to deal fairly with the corporation. But what does that remarkably elastic term mean? The rigor with which that term is interpreted then is the critical issue – the formal terms of the statute does not provide the real constraint. It is only the presence of a serious minded judge, as Lord Black learned painfully in the Delaware Chancery Court in the Hollinger litigation, (see note 4 below) that infuses serious content into the fiduciary incantation.

So what is the point? Start with two common place observations about European corporate governance.

First, as the European commentators stressed in the morning session, European publicly held corporations (with the exception of U.K. corporations) have controlling shareholders, representing what Colin Mayer years ago labeled a system of inside finance.

Second, and perhaps a little less familiar, Europe has at least two different controlling shareholder systems (see note 5 below) – call them efficient and inefficient controlling shareholder systems. The difference is between the levels of pecuniary private benefits of control enjoyed by the controlling shareholder. The empirical literature provides an example of each. Swedish listed companies exhibit pecuniary private benefits of control on the order of one percent, in my terminology an efficient controlling shareholder system. Italy, in contrast, supports private benefits of control on the order of 35 percent, an inefficient system.

Now let us engage in a thought experiment. Imagine a company in an inefficient controlling shareholder jurisdiction (one that allows high private benefits of control) wants to demonstrate that its controlling shareholder will not extract large private benefits of control, perhaps in order to secure a lower cost of external equity capital. The problem, of course, is to avoid a lemon's market. How does the company credibly demonstrate the quality of its corporate governance?

The company could adopt restrictive governance rules in its charter. This strategy, however, has obvious limits: any rule not so specific as to restrict operations will leave room for opportunistic interpretation. Moreover, whatever limits are imposed by company level rules are not self-enforcing. What happens if the company simply ignores controlling shareholder misbehavior despite restrictive formal rules?

Suppose that the legislature decides to help by passing legislation that restricts the extraction of pecuniary private benefits of control like, for example, recent Italian corporation law reform. Will that persuade the capital market that private benefits of control will be limited, so that a higher equity value is warranted?

I think the answer is no. In the end, whether by company charter or by statute, effective corporate governance requires a credible judicial system, and now we are back to Delaware.

If the argument for harmonization is weakened because there is no race to the bottom, what might be the role of European Union level corporate law?

I suggest that one goal might be to facilitate a credible commitment by companies that wish to restrict the levels of pecuniary private benefits of control. As I have outlined above, this requires an effective and credible court system, something that may be difficult to accomplish quickly for nations that do not yet have one. This is of particular relevance in light of the expansion of the European Union to the east.

So imagine a European level corporate law court that applies the national corporate law of the litigants, whose judges are distinguished by their knowledge, reputation, and integrity (this morning's speakers seem like a good place to find such jurists), and whose jurisdiction a company elects in its charter. Putting aside for the moment complications of litigation and procedure that are plainly beyond my ken, the opportunity to elect this court's jurisdiction would operate as what economists call a forcing contract, which allows a separating equilibrium that distinguishes between good and bad companies, something of a gloss on the opt-in approach Gerard Hertig discussed this morning.

This result seems much like what happens now in the United States when a company with a controlling shareholder elects of the jurisdiction of the Court of Chancery by incorporating (or reincorporating) in Delaware. Then judges with great experience in corporate law apply fiduciary duty – put takeover law to the side for now – can be expected to apply fiduciary principles with vigor. Not surprisingly, the level of pecuniary private benefits of control in the United States for companies with controlling shareholders is roughly the same as in Sweden. Both jurisdictions support efficient controlling shareholder systems.

The idea, then, is to facilitate harmonization of the quality of European corporation governance at the company level – its capacity to support an efficient controlling shareholder regime – rather than its substance at the national level, by creating a European corporate law court, whose jurisdiction can be chosen by companies with controlling shareholders. Corporations that elect its jurisdiction then can rely either on their national corporate law if its substance is sufficient, or adopt restrictive charter provisions, in either case relying upon the European level court to provide the credibility to the corporation's governance rules necessary to support a separating equilibrium. On reflection, this strategy may be better than either continuing the effort to impose a single solution on all countries, or leaving companies in inefficient controlling shareholder systems without the ability to credibly distinguish themselves as having low private benefit of control. This approach, an implication of Delaware's role without a market for corporate charters, is consistent with Director General Schaub's preference for leveraging efforts at the state level rather than imposing mandatory top-down rules, and with the final compromise reached with respect to the European Company statute. Subsidiarity controls substance: the operative rules are determined at the state or company level, but a credible though elective European level courts supports competition among corporations, not states, based on the quality of corporate governance standards. Competition of this sort is only a race to the top.

**Notes:**

1. Marcel Kahan & Ehud Kamar, The Myth of State Competition in Corporate Law, 55 Stan. L. Rev. 679 (2002).
2. Luca Enriques, EC Company Law and the Fear of a European Delaware, 15 Eur. Bus. L. Rev. 1259 (2004).
3. Melvin Eisenberg, The Structure of the Corporation 1 (1976 ).
4. Hollinger Intn'l.Inc. v. Black, 844 A.2d 1022, 1029 (Del. Ch. 2004)(" [D]efendant Conrad M. Black, the ultimate controlling stockholder of Hollinger International … has repeatedly behaved in a manner inconsistent with the duty of loyalty he owed the company.
5. Ronald J. Gilson, Controlling Shareholders and Corporate Governance: Complicating the Taxonomy (working paper, 2004).