Centros, California's 'Women on Boards' Statute and the Scope of Regulatory Competition

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Abstract

In its 1999 Centros decision, the European Court of Justice affirmed that the EU right of establishment protects a corporation's right to select a state of incorporation. Specifically, Centros rejected the argument that, under the real seat doctrine, the country in which the corporation's head office is located may deny recognition or apply domestic corporate law to a corporation that is validly formed in another EU state. At the time, commentators broadly viewed Centros as opening the door to greater regulatory competition in Europe.

Twenty years later we examine Centros through the lens of SB 826 – the California statute mandating a minimum number of women on boards. SB 826, like Centros, raises questions about the extent to which a forum state, as opposed to the state of incorporation, can impose its laws on corporations that operate within its borders. In the U.S., these questions that are typically addressed by application of the internal affairs doctrine which provides that the law of the state of incorporation applies to the corporation's internal affairs. Both SB 826 and Centros thus highlight the critical importance of understanding the scope of the internal affairs doctrine. In this chapter, we stress the importance of understanding the scope of US corporate law in light of the shareholder primacy norm, which results in corporate law focusing primarily on matters of shareholder economic interest. We argue that the internal affairs doctrine should be understood within the context of the shareholder primacy norm and therefore directed to rules oriented to enhancing firm economic value. Considered in this context, SB 826 is distinctive in that it focuses on broader societal interests than traditional corporate law. In the same vein, EU corporate law has traditionally had a broader stakeholder orientation. We posit that the limited impact of the Centros decision, an impact which differed significantly from its predicted revolutionary effect, can be attributed to the greater focus of EU corporate law on social ordering and a more limited adherence to the shareholder primacy norm. Ironically, California's adoption of SB 826 may portend a movement of the United States towards Centros-style governance.

Keywords: corporations, corporate law, comparative law, European company law, EU & US regulatory competition, Centros, corporate charters, internal affairs doctrine, shareholder primacy norm, social ordering, SB 826, California 'Women on Boards' Statute

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Twenty years later we examine Centros *through the lens of SB 826 – the California statute mandating a minimum number of women on boards. SB 826, like* Centros*, raises questions about the extent to which a forum state, as opposed to the state of incorporation, can impose its laws on corporations that operate within its borders. In the U.S., these questions that are typically addressed by application of the internal affairs doctrine which provides that the law of the state of incorporation applies to the corporation's internal affairs. Both SB 826 and* Centros *thus highlight the critical importance of understanding the scope of the internal affairs doctrine.*

In this chapter, we stress the importance of understanding the scope of US corporate law in light of the shareholder primacy norm, which results in corporate law focusing primarily on matters of shareholder economic interest. We argue that the internal affairs doctrine should be understood within the context of the shareholder primacy norm and therefore directed to rules oriented to enhancing firm economic value. Considered in this context, SB 826 is distinctive in that it focuses on broader societal interests than traditional corporate law. In the same vein, EU corporate law has traditionally had a broader stakeholder orientation. We posit that the limited impact of the Centros *decision, an impact which differed significantly from its predicted revolutionary effect, can be attributed to the greater focus of EU corporate law on social ordering and a more limited adherence to the shareholder primacy norm. Ironically,*

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Introduction

It has been twenty years since the European Court of Justice issued its decision in *Centros*.[1] Since that time, *Centros* has been widely understood as shifting the European Union (EU) from the real seat doctrine, in which a corporation is governed by the corporate law of the country in which it is headquartered, to an era of increased corporate mobility.[2] Specifically *Centros*, together with subsequent decisions, allowed EU corporations, by incorporating in another jurisdiction, to choose their governing corporate law deliberately.[3]

We consider the *Centros* decision in the context of the current debate, in the United States, over the legitimacy of SB 826, the California statute mandating that public companies whose principal executive offices are located in California have a minimum number of female directors.[4] California has previously attempted to resist the limitations of the internal affairs doctrine by imposing its corporate law on so-called foreign corporations, corporations that are incorporated outside the state but conduct the majority of their business in California. The legitimacy of these attempts has been hotly contested and, indeed rejected by the Delaware courts.[5] SB 826 is different from other aspects of California's foreign corporation law, however, in that it applies exclusively to public companies and to all such companies that have their principal executive offices located within the state. The extent to which California has the power to extend the reach of its corporate law this far is disputed, and at least one prominent commentator has already argued that SB 826 is invalid to the extent it applies to corporations that are not both chartered and headquartered in California.[6]

SB 826 is somewhat distinctive from most US corporate law, however, in that it addresses a timely and controversial public policy issue – gender quotas for corporate boards. From the US perspective, corporate law is focused primarily on limiting managerial agency costs and maximizing shareholder value. The connection between gender quotas and shareholder value remains unclear. As such, SB 826 highlights the question of the degree to which the internal affairs doctrine is intertwined with the objective of shareholder value maximization and with, more generally, the principle of shareholder primacy. Shareholder primacy has emerged as

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[1] Case C-212/97, Centros Ltd. v. Erhvervs- og Selskabsstyrelsen, 1999 E.C.R. I-1459.
[2] *See, e.g.,* Carney 2001, p. 718 n.5 ("For European Community members, the real seat rule appears to have been repealed in favor of the internal affairs rule by the recent decision of the Court of Justice of the European Communities, Centros Ltd. v. Erhvervsog Selskabsstyrelsen, 1999 ECJ CELEX LEXIS 708 (Mar. 9 1999)"); Doré 2014, p. 331 (observing that, although commentators initially debated the scope of the Centros decision, "there is now general agreement that the EU Treaty requires Member States to apply the internal affairs rule to companies organized in other European countries.").
[3] Doré 2014, p. 221.
[4] Senate Bill 826.
[5] *See, e.g.,* VantagePoint Venture Partners 1996 v. Examen, Inc., 871 A.2d 1108, 1110 n.1 (Del. 2005).
[6] See Grundfest 2018, p. 1 (arguing that, except with respect to 72 such corporations, SB 826 is unconstitutional "because of the internal affairs doctrine").

a dominant organizing principle of U.S. corporate law. [7] This enables the internal affairs doctrine to serve as a tool for economic ordering.

Shareholder primacy reflects, to a large extent, a peculiarly US perspective.[8] Most of the EU does not subscribe to shareholder primacy. The interests of other stakeholders – creditors, employees and communities – play a more compelling role in EU company law. One example is the protection of employee interests, in several EU countries, through codetermination. Another is the proliferation of jurisdictions that have adopted legislation imposing gender quotas on corporate boards.[9] We argue that the commitment by EU member states to these interests raises serious questions about the viable scope of US-style regulatory competition in Europe.

SB 826 highlights the difference in orientation. SB 826, which reflects a concern with broader societal goals such as discrimination and sexual harassment, can be understood as an effort to extend corporate law to issues beyond shareholder value maximization and to consider the type of stakeholder interests that play a greater role in the EU. As such, the application of the internal affairs doctrine to SB 826 is, we argue, uncharted territory. California was the first US state to adopt a mandatory gender quota, although several other states subsequently indicated a willingness to follow California's lead.[10] This development raises critical questions about the extent to which the US internal affairs doctrine constrains state regulatory power.

In the case of SB 826, we argue that the shareholder primacy norm informs the validity of California's actions. We argue that because US corporate law focuses on principles of shareholder primacy, these principles offer a basis for limiting the scope of regulatory competition.[11] Specifically, we claim that the internal affairs doctrine can be understood as limited to matters that are subject to internal ordering and relationships among the firm's officers, directors and shareholders. Under this rubric, pure matters of corporate governance are subject to the internal affairs doctrine while laws governing external interests are not. We argue that SB 826 falls within the latter category. [12]

These principles explain the effect of *Centros* and perhaps its future course. *Centros* generated widespread concern that it would introduce US-style regulatory competition into the EU. Although a significant number of corporations responded to the enhanced mobility provided by *Centros,* the decision primarily had the effect of narrowing the differences in capitalization requirements across Europe. Corporations largely failed to use the freedom of incorporation to avoid other elements of their home county's corporate law. We argue that this result can be

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[77] See American Law Institute, Principles of Corporate Governance §2.01 (1994).

[8] The UK also adheres the principal of shareholder primacy. For a call to reconsider shareholder primacy and a claim that a corporation's purpose should extend beyond profit maximization see The British Academy 2018.

[9] See von Meyerinck, et al. 2019 (observing that Norway, "Belgium, France, Germany, Iceland, India, Israel, Italy, and Spain have all established" mandatory gender quotas for corporate boards).

[10] On March 29, 2018, the Illinois House advanced a bill that would mandate both gender and racial diversity on corporate boards. See Bainbridge 2019. A pending bill in the New Jersey legislature would require public companies to have a minimum of three female directors on their boards. Vittorio 2018.

[11] See Fisch 2006.

[12] The statute may also be vulnerable under the Equal Protection Clause of the U.S. Constitution and the Civil Rights Act. See, e.g., Amar and Mazzone 2018 (discussing analysis under the Equal Protection Clause). This article does not address those issues.

explained by the fact that regulatory competition, and the internal affairs doctrine which makes such competition possible, are focused on principles of economic ordering relating to shareholder value. The broader range of objectives addressed by EU company law results in a deeper commitment to country-specific differences both at the political level and in the context of specific firm decisions, a commitment that is not readily undercut by freedom of establishment. In this regard, the EU is unlikely to see substantial additional convergence in corporate law. Indeed, as SB 826 portends, this reality may be coming to the United States and its own peculiar form of regulatory competition. In other words, and ironically, while the past history of the internal affairs doctrine in the US partially explains *Centros'* effects, the limitations of the *Centros* decision in the EU may explain the future of the internal affairs doctrine in the United States.

1. ***Centros* and its progeny**

1.1 The *Centros* Trilogy

Until 1999, many countries in Europe adhered to the real seat doctrine, in which a corporation is governed by the law of the country in which its head office is located.[13] In a trio of decisions starting with the 1999 *Centros* decision, the European Court of Justice held that the real seat doctrine cannot be used to deny recognition or apply domestic corporate law to a corporation that is validly formed in another EU member state. [14] This had the effect of recognizing the principle of free choice of incorporation.[15]

Centros involved Danish citizens who formed a U.K. corporation to avoid Denmark's minimum capital requirements. When they sought to register a branch office of the corporation to do business in Denmark, Denmark refused to register it. The Court held that "the fact that a national of a Member State who wishes to set up a company chooses to form it in the Member State whose rules of company law seem to him the least restrictive and to set up branches in other Member States cannot, in itself, constitute an abuse of the right of establishment."[16] Consequently, the Court concluded that Denmark was required to register Centros to do business.

Commentators initially questioned the scope of the *Centros* decision.[17] As a result, the "death knell" of the real seat doctrine did not come until 2002, when the ECJ decided *Überseering*.[18] Germans bought the stock of Überseering, a Dutch company, and moved its operations to Germany. Subsequently, Überseering filed suit in Germany against Nordic, a

[13] Other countries adhered to the incorporation doctrine, which applied the law of the country in which the business was incorporated. Gelter 2017.
[14] Case C-208/00, Überseering BV v. Nordic Construction Company Baumanagement GmbH, 2002 E.C.R. I-9919. See Gelter 2017.
[15] Gelter 2017.
[16] *Centros*, ¶ 27.
[17] *See, e.g.,* Gelter 2017.
[18] Id.

German company. The German court held that Überseering did not have the legal capacity to bring suit because Germany, a real seat country, required Überseering to reincorporate in Germany when it moved its operations there, and Überseering had not done so. The ECJ disagreed, holding that articles 43 and 48 of the EU Treaty required both that Germany recognize Überseering as a valid Dutch corporation and uphold its right to bring suit in Germany.

The final decision of the trio repudiating the real seat doctrine was *Inspire Art*.[19] Inspire Art was what amounts to a pseudo-foreign corporation, essentially a Dutch company that had been organized under U.K. law, ostensibly to avoid capital requirements imposed by Dutch corporate law. Although the Netherlands did not adhere to the real seat doctrine and recognized foreign corporations, its company law took a similar approach to §2115 of the California statute and applied various components of its corporate law to pseudo-foreign corporations such as Inspire Art.[20]

The Netherlands defended its statute by arguing that it was nondiscriminatory and that it provided only minimal obligations necessary to protect those in the Netherlands who deal with corporations, whether foreign or domestic. The ECJ was not persuaded. It held first "that the fact that the company was formed in a particular Member State for the sole purpose of enjoying the benefit of more favourable legislation does not constitute abuse even if that company conducts its activities entirely or mainly in that second State."[21] Second, the ECJ concluded "that Articles 43 EC and 48 EC preclude national legislation such as the WFBV which imposes on the exercise of freedom of secondary establishment in that State by a company formed in accordance with the law of another Member State certain conditions provided for in domestic law in respect of company formation relating to minimum capital and directors' liability."[22]

1.2 The Impact of the *Centros* Trilogy

The result of the three decisions – *Centros, Überseering* and *Inspire Art* -- was to provide greater scope for corporations in the EU to select their state of incorporation and, through that selection, the applicable company law regime. As one commentator explains, "It is no abuse of the freedom of establishment if the company founders select the law which best suits their needs

[19] Case C-167/01, Kamer van Koophandel en Fabrieken voor Amsterdam v. Inspire Art Ltd., 2003 E.C.R. I-10155.
[20] The applicable Dutch law was the Wetop de Formeel Buitenlandse Vennootschappen (Law on Formally Foreign Companies) (WFBV). The "WFBV defines a formally foreign company as a capital company formed under laws other than those of the Netherlands and having legal personality, which carries on its activities entirely or almost entirely in the Netherlands and also does not have any real connection with the State within which the law under which the company was formed applies." Inspire Art ¶22. The WFBV imposed various obligations on formally foreign companies including "obligations concerning the company's registration in the commercial register, an indication of that status in all the documents produced by it, the minimum share capital and the drawing-up, production and publication of the annual documents." Id. ¶23.
[21] Id. at ¶96.
[22] Id. at ¶105.

even if, as a result, the company is established under a more permissible company law regime than the one prevailing at its real seat." [23]

Following the decisions, a number of commentators predicted that the decisions would lead to regulatory competition among EU nations akin to that in the United States.[24] They further expressed the concern that this competition would lead to a race-to-the bottom as opposed to no race or a race to the top.[25] Other commentators argued that concerns about a race to the bottom were overstated, and that regulatory competition would likely be limited by a number of a factors such as the absence of any Member state with the characteristics to make it likely to emerge as a winner in the competition for corporate charters as well as the relatively greater importance of non-shareholder interests such as those of employees and banks.[26] As Ron Gilson has observed: "the effect of *Centros* may be attenuated by responsive efforts by EC member states to impose restrictions in ways that cannot be avoided by instrumental choice of where to incorporate."[27]

Over the twenty years since the *Centros* decision the greatest fears of commentators concerning *Centros'* effect of creating a European "Delaware" failed to appear.[28] Instead, *Centros* has mostly have leveling effects in corporate law. In the immediate wake of *Centros*, Marco Becht, Colin Mayer, and Hannes Wagner found a substantial increase in the number of private limited companies from other EU Member States incorporating in England and Wales from 1997 to 2005, an increase that the authors attribute to the ECJ rulings.[29] Most of the corporations that elected to incorporate outside of their real seat did so in an effort to avoid minimum capital requirements.[30]

In order to stem this flight risk, the major EU countries reformed their corporate law to reduce minimum capitalization requirements and to more generally conform basic corporate governance features with English law. [31] This corporate law reform was paired with a shift of creditor protection from corporate law to insolvency law, which allowed the forum state to reassert its interest in protecting local creditors.[32] Luca Enriques and Martin Gelter term this

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[23] Kieninger 2009, p. 609.

[24] *See, e.g.,* Dammann 2004 p. 530 ("European corporations faced with the prospect of free choice are likely to reincorporate in one or a few Member States, and it is highly probable that one or more of the smaller Member States will emerge as the leading jurisdiction(s).").

[25] *See, e.g.,* Jankolovits 2004, p. 1004 ("[T]he holding in *Centros* may create a race for the bottom in Europe."). See generally Fisch 2000 (describing academic debate over whether regulatory competition results in a race to the bottom, a race to the top, or no race at all).

[26] *See, e.g.,* Tröger 2005.

[27] Gilson, 2001.

[28] *See, e.g.,* Gelter and Reif 2017, p. 1426 (observing that "the jurisdiction within the United Kingdom called 'England and Wales' did not establish itself as the European Delaware").

[29] Becht et al. 2008, p. 242.

[30] Incorporation choices were also the result of company-specific incorporation costs. See Becht et al. 2008.

[31] See Ferran 2019 (observing that "the *Centros* decision . . . was a powerful catalyst for the dynamic dismantling of minimum capital requirements in national company laws").

[32] Choice of law rules in insolvency law "more closely resemble the real seat doctrine." Bruner 2018. *See* Kornhaas v. Dithmar, CJEU Case No. C-5941/14 [2016] (holding that the application of German national law regarding the reimbursement of dividend payments made by a director after insolvency is properly characterized as insolvency law

"insolvencification."[33] The end result of these reforms was to stem reincorporation from the continent to the United Kingdom. A subsequent study reports a significant decrease in migration of German firms to incorporate in the UK after 2006 and concludes that the migration observed by Becht et al. may merely have been a "flash in the pan."[34]

The limited effect of *Centros* is even more startling in that other, more defining (and arguably more burdensome) features of country-specific corporate law have failed to spur more corporate flight.[35] Martin Gelter, for example, argued that corporations could use *Centros* to avoid Germany's codetermination requirement.[36] This fear initially appeared justified when, in 2006, Air Berlin went public as a UK company in a move that was widely explained as an effort to avoid codetermination.[37] Some commentators predicted that other corporations would follow Air Berlin's lead, but this prediction failed to materialize. Rather, Air Berlin was exceptional, and only a handful of other German companies incorporated outside of Germany to avoid codetermination.[38] At the time, commentators also debated the legal question of whether issuers could even use regulatory competition to avoid codetermination.[39] In the 25 years since the *Centros* decision, the ECJ has never addressed this question.[40]

Why did *Centros* not result in greater regulatory competition in Europe?[41] We argue that this question can be addressed, in part, by a better understanding of the true scope of regulatory competition in the United States, as effectuated through the internal affairs doctrine.

2. **Regulatory Competition in the United States**

2.1 The Origins of the U.S. Internal Affairs Doctrine

rather than company law and, as a result, does not infringe freedom of establishment as applied to an English corporation operating in Germany).

33 Enriques and Gelter 2007, pp. 600-602.

34 Ringe 2013, p. 262.

35 Dammann 2003, p. 613 (describing whether Germany would be able to keep codetermiation as "the single most relevant question in the wake of Centros").

36 Gelter 2018 (reasoning that "'regulatory competition' on the US model could permit a German firm to shuck co-determination and its two-tiered board via a simple merger with a UK shell set up for purpose of the merger").

37 See Wiesmann 2006.

38 See Roth 2010 (stating that the Centros trio "has not produced any visible effect on German co-determination practice" and observing that, as of 2010, only 37 German companies incorporated or reincorporated outside of Germany to avoid codetermination and "The only major company incorporated as a public limited company (plc) is Germany′s second biggest airline, Air Berlin.").

39 *See, e.g.,* Tröger 2005 ("The explicitly ′political′ character of codetermination as a specific distributional settlement between corporate constituents makes it questionable whether a simple opt-out can be legitimised. Although freedom of choice in corporate law is generally granted, an opt-out from codetermination might be barred").

40 See Hodge 2010, p. 142 (observing that "the ECJ has never specifically addressed a case where freedom of establishment has been used to avoid codetermination").

41 Moreover, any such result is far less likely after Brexit. See, e.g., Eidenmuller 2018 (arguing that Brexit will lessen regulatory competition by making it more difficult to choose UK law in the future).

The real seat doctrine has never been a feature of US law and thus there is no *Centros*-like decision governing corporate mobility in the United States. Rather, corporations in the US historically have been free to incorporate in the state of their choice and to have that state's corporate law govern their affairs rather than the law of the state in which they conduct their operations. The principle that allows this is known as the internal affairs doctrine which effectively allows corporations to choose their corporate law by determining in which state to incorporate.[42]

Although the internal affairs doctrine is widely-cited as a major tenet of U.S. corporate law,[43] it did not arise out of a deliberate policy decision to promote regulatory competition. Rather, it began as a tool that enabled each state's legislature to exercise control over the regulation of local corporations.[44] Courts perpetuated the internal affairs doctrine in the face of developing charter competition, largely as a response to interest group pressure and competition among states to retain local business operations, competition that would have been threatened by restrictive corporate law rules.[45] The resulting so-called market for corporate law has led to what some commentators describe as regulatory competition.[46] It has also spurred a debate about whether the U.S. is racing to the top or bottom in corporate law in terms of corporate law quality.[47]

Both the scope of the internal affairs doctrine and its legal basis remain somewhat unclear. Some commentators have taken the position that the doctrine is constitutionally compelled, finding constitutional foundations for the internal affairs doctrine in the Commerce Clause and the Full Faith and Credit Clause.[48] Notably, the Delaware courts have asserted this claim powerfully. For example, the Delaware Supreme Court in *VantagePoint*[49] stated that "The 'internal affairs doctrine is a major tenet of Delaware corporation law having important federal

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42 Ventoruzzo 2007.
43 VantagePoint. at 1116 (quoting McDermott, Inc. v. Lewis, 531 A.2d 206, 209 (Del. 1987)).
44 Tung 2006, pp. 45-46.
45 Id. As Richard Buxbaum lucidly explains, the internal affairs doctrine began as a concept that addressed the power of courts to exercise jurisdiction over foreign corporations. Buxbaum 1987. See H.N.P., Jr. 1949, p. 666 ("Since the middle of the last century, American courts have uniformly expressed their reluctance to entertain controversies arising from the 'internal affairs' of corporations incorporated in other states."). Even at this time, the scope of the doctrine was unclear. As one court noted, to undertake an enumeration of when jurisdiction would and would not be entertained "would be a difficult and hazardous venture." Travis v. Knox Terpezone Co., 215 N.Y. 259, 264, 109 N.E. 250, 251 (1915).
46 *See, e.g.,* Ribstein and O'Hara 2008 (describing debate over regulatory competition).
47 *See, e.g.*, Cary 1974 (claiming that issuer freedom to choose corporate law through selection of a state of incorporation produces a "race to the bottom"); Winter 1977 (challenging Cary's claim and arguing that regulatory competition results in a "race to the top").
48 *See, e.g.,* Suggs 1995, p. 1103 ("the requirements of a federal system of coequal sovereign states necessitates the promotion of [the internal affairs] doctrine to constitutional status").
49 VantagePoint Venture Partners 1996 v. Examen, Inc., 871 A.2d 1108 (Del. 2005).

constitutional underpinnings.'"[50] Other commentators, however, challenge the constitutional claim and argue that the internal affairs doctrine is simply a choice of law doctrine.[51]

Even within the United States, the principle that a corporation's internal affairs will be regulated by the law of the state of incorporation is not absolute. A few states, most notably New York and California, have adopted legislation that explicitly attempts to limit the scope of the internal affairs doctrine as applied to local corporations that are incorporated in other states.[52] These statutes are commonly described as "foreign" or "pseudo-foreign" corporation statutes. Both the California and New York provisions have traditionally applied only to corporations that conduct a designated amount of business within the state. They also exclude listed or publicly-traded companies from their scope.[53]

The justification for these statutory incursions upon the internal affairs doctrine is that they are consistent with conflict of law principles that authorize states to regulate firms that have substantial ties with the state. For example, under standard "interest analysis" a forum state may apply its local law when it has a strong policy interest in doing so, despite the claim that another state's law should apply. Thus, in *Havlicek*,[54] a California court used a conflict of laws analysis to determine the scope of the inspection rights of the director of a corporation incorporated in Delaware. The court reasoned that "California's interest would be more impaired by the application of Delaware law than Delaware's interest would be impaired by the opposite result. California law applies to the inspection issue."[55]

The Delaware courts have challenged this analysis, reasoning that the internal affairs doctrine is of Constitutional magnitude and, as a result, other states do not have the power to apply these statutes to Delaware-incorporated firms[56] This dispute between California and Delaware remains unresolved, and may presumably be exacerbated by SB 826, which is not limited to corporations that conduct the majority of their operations in California.[57]

2.2 The Scope of the U.S. Internal Affairs Doctrine

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[50] Id. See also McDermott, Inc. v. Lewis, 531 A.2d 206, 216-17 (concluding that the internal affairs doctrine is "compelled' by the Due Process Clause, the Commerce Clause and the Full Faith and Credit Clause).

[51] See Rubenfeld 1988 (analyzing and rejecting arguments that the internal affairs doctrine is compelled by the Commerce Clause); Stevelman 2009 ("Under modern law the [internal affairs doctrine] is best understood merely as a choice of law regime"); O'Hara and Ribstein 2009 (asserting that the doctrine does not have "special constitutional status").

[52] See N.Y. Bus. Corp. Law §§1317-1320; Cal. Corp. Code § 2115.

[53] The extent to which foreign corporation statutes are invalid under the internal affairs doctrine is unclear and is, in fact, the subject of an ongoing disagreement between the Delaware and California courts. Edwards 2010.

[54] Havlicek v. Coast-to-Coast Analytical Services, Inc., 39 Cal. App. 4th 1844 (Cal. App. 1995).

[55] Id. at 1853.

[56] Thus, for example in *VantagePoint Venture Partners 1996 v. Examen, Inc*., 871 A.2d 1108 (Del. 2005). the Delaware Supreme Court held that the U.S. Constitution prohibited California from imposing its corporate governance rules on companies with substantial business ties to California that were incorporated elsewhere.

[57] *See, e.g.,* Stevens 2007 (comparing the perspectives of the courts in both states). Absent a determination by the U.S. Supreme Court that the internal affairs doctrine is constitutionally compelled, it is unclear how this difference could be resolved.

In terms of scope, the internal affairs doctrine in the US has the role of policing the boundary between corporate law, which is dictated by the state of incorporation and other laws such as environmental law, labor law, consumer protection law, etc. which are determined by the forum state. In addressing this objective, the key question is whether the statute or legal rule is directed to internal corporate constituencies or affects the interests of third parties external to the corporation. As Vice-Chancellor Laster observed in *Sciabacucci v. Salzberg*, "the state of incorporation cannot use corporate law to regulate the corporation's external relationships."[58]

How does one distinguish between internal and external relationships? A starting point is differentiating between internal corporate constituencies and third parties external to the corporation.[59] Former Delaware Supreme Court Justice Jack Jacobs explains that those internal corporate constituencies are typically a corporation's officers, directors and shareholders.[60] Consistent with the principle of shareholder primacy,[61] US law provides shareholders with distinctive treatment relative to other corporate stakeholders.[62] As the court explained in *Salzberg*, whether a forum selection bylaw dealt with an internal corporate affair was determined by analyzing whether the bylaw addressed the rights and powers of a stockholder "as a stockholder."[63] Similarly the Restatement (2d) of Conflicts of Laws defines internal affairs as "[m]atters . . . which involve primarily a corporation's relationship to its shareholders."[64]

The fact that the statute addresses internal corporate constituencies is not enough; the statute must also focus on internal issues rather than external activities.[65] In. *Salzberg*, Laster explained that Delaware corporate law, by virtue of the internal affairs doctrine, could regulate matters such as "the rights, powers, and privileges of a share of stock, determine who holds a corporate office, and adjudicate the fiduciary relationships that exist within the corporate form."[66] Jack Jacobs observed that "Illustrative examples of internal affairs include: the mechanics of incorporating, the election or appointment of officers and directors, the adoption of by-laws, the issuance of shares and bonds, the holding of directors' and shareholders' meetings, voting, the right to examine corporate records, corporate charter and by-law amendments, mergers, reorganizations, the reclassification of shares, the declaration and payment of dividends, and stock repurchases and redemptions."[67]

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[58] Sciabacucchi v. Salzberg, 2018 Del. Ch. LEXIS 578 (2018).
[59] See Rubenfeld 1988, p. 379-80 ("There can be no bright line-indeed no line at all-drawn to separate internal and external affairs; a corporation's internal affairs are external affairs when they implicate third-party rights").
[60] Jacobs 2009, p. 1161 ("The internal affairs doctrine is a judge-made choice-of-law rule which mandates that disputes regarding 'internal affairs'—'those matters which are peculiar to the relationships among or between the corporation and its … directors, officers and shareholders' - are governed by the laws of the state of incorporation.").
[61] See generally Smith 1998 (describing the shareholder primacy norm in U.S. corporate law).
[62] For example, directors and officers are accountable to shareholders alone by the constraints of fiduciary duties. Similarly, shareholders have the authority to elect directors and exercise voting power with respect to designated corporate transactions such as mergers and dissolutions.
[63] 2018 Del. Ch. LEXIS 578 (2018).
[64] Rest.2d Conf. of Laws, § 302, com. a, p. 307.
[65] Sciabacucchi v. Salzberg, 2018 Del. Ch. LEXIS 578 (2018).
[66] Id.
[67] Jacobs 2009, p. 1161.

2.3. The Proper Scope of the Internal Affairs Doctrine

We argue that, although neither courts nor commentators have developed a satisfactory definition of the internal affairs doctrine, the explanations and examples cited here reflect a common core principle: the internal affairs doctrine applies to rules governing the *economic* relationships among shareholders, officers and directors. As such, the internal affairs doctrine is critically intertwined with the norm of shareholder primacy. Similarly, we argue that rules addressed to issues of general social welfare and the rights of third-party stakeholders fall outside the parameters of the internal affairs doctrine. [68]

We note that the considerations of predictability and fairness that are frequently cited in support of the internal affairs doctrine focus on the role of corporate law in protecting shareholder interests, and primarily shareholder economic interests, through regulation of issues such as shareholder voting, director duties and the process for effecting a merger. For example, the fact that a corporation may have shareholders throughout the world, allowing each shareholder's home country to seek to protect that shareholders interests through the application of local law would be highly problematic. As the court observed in *Citigroup Inc. v. AHW Inv. P'ship*:[69] "When a public corporation such as Citigroup has shares in the market, it will have investors from all around the world, and certainly in virtually every state in our nation. For investors to be able to sue not only under federal law, but purport to sue under their own state's bespoke laws, subjects corporations to potential inconsistencies, inefficiencies, and unfairness."[70]

Understanding the internal affairs doctrine in terms of economic relationships provides critical support for the doctrine and for the regulatory competition that it facilitates. In particular, in a system with efficient capital markets, share prices will respond both to the adoption of new legal rules and to firm-specific governance choices, but only as long as those rules concern investor-oriented firm value. Regulatory competition enables corporations to select those states that provide efficient rules because those rules will enhance share prices.[71] The role of the capital markets is essential in preventing regulatory competition, through the internal affairs doctrine, from generating a race to the bottom.[72]

Notably, however, the capital markets are ineffective in responding to legal rules that do not affect share price such as rules that affect the interests of third-party stakeholders or general

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[68] As the Supreme Court has noted, "As a general matter, the law of the state of incorporation normally determines issues relating to the internal affairs of a corporation. … Different conflicts principles apply, however, where the rights of third parties external to the corporation are at issue." First Nat'l City Bank v. Banco Para El Comercio Exterior De Cuba, 462 U.S. 611, 621 (1983).
[69] 140 A.3d 1125, 1136.
[70] Id. at 1136. The court nonetheless concluded that these concerns did not warrant extending the internal affairs doctrine to the plaintiffs' Holders Claims (claims alleging damages based on the plaintiffs' continuing to hold stock in reliance on the defendant's misstatements).
[71] *See, e.g.,* Easterbrook and Fischel 1991.
[72] See Winter 1977, pp. 251-52.

social welfare.[73] In addition, the U.S. system does not provide states with complete freedom to compete. In areas in which regulatory competition is viewed as problematic, Congress, the SEC and the stock exchanges have the ability to intervene and to eliminate such competition by imposing a uniform rule.[74] Similarly, regulations that focus on the protection of non-shareholder interests are found outside the scope of corporate law where they are similarly insulated from state competition.

2.4 The Import of the U.S. Internal Affairs Doctrine for *Centros* and the EU

We argue that the above historical account shows that the internal affairs doctrine as applied in the United States is one of economic ordering. More specifically, the effect of the U.S. internal affairs doctrine has had a leveling effect akin to *Centros'* effect (but in greater measure). Corporate law rules in the U.S. do vary from state to state but in large measure are identical in both scope and principle. The lack of significant litigation over the internal affairs doctrine is testament to this harmony.

This account and understanding of the internal affairs doctrine has import for the future of more substantive principles which involve issues which affect constituencies other than stockholders. In order to address this issue and its impact on *Centros* better, we consider in the next section the question of whether SB 826 is directed to internal corporate affairs. In the following section we consider the application of these principles to regulatory competition in Europe.

3. The California "Women on Boards" Statute

3.1 The Scope and Structure of SB 826

SB 826, California's "Women on Boards" statute illustrates the uncertain scope of the internal affairs doctrine. On Sept. 30, 2018, California Governor Jerry Brown signed SB 826 into law, making California the first U.S. state to require women on corporate boards of directors. The statute applies to "publicly held domestic or foreign corporation[s] whose principal executive offices, according to the corporation's SEC 10-K form, are located in California."[75]

SB 826 initially requires that corporations subject to its requirements have at least one female director on their boards by the end of 2019. By the end of 2021, the requirement increases to a minimum of two female directors for corporations with a total board size of four or five

[73] More problematically, the capital markets will not value the benefits legal rules provide to non-shareholder stakeholders.
[74] For example, the New York Stock Exchange requires listed corporations to have a minimum number of independent directors on their boards. NYSE, Inc., Listed Company Manual § 303A.
[75] Notably, neither SB 826 nor the federal securities laws provides a definition of principal executive offices. See Bainbridge 2019a.

directors and three female directors for corporations with a board consisting of six or more directors. Notably, the law does not require that women replace men who are currently serving as directors, but authorizes a corporation simply to add additional women directors to the board. Although the statute does not follow the European approach of designating that women comprise a designated percentage of female directors on boards,[76] the structure of the statute appears to respond to a literature observing that the benefits of gender diversity on corporate boards require a critical mass and that it is particularly beneficial to have at least three women directors.[77]

SB 826 was not California's first effort to increase board diversity. In 2013, the California legislature enacted a non-binding resolution, Senate Concurrent Resolution 62, which called for all publicly-traded corporations in California to have a minimum of 1-3 women on their boards of directors within a timeline of three years.[78] The resolution made California the first state in the U.S. to "take a stand on gender diversity in the boardroom" and was described as a "'California leads the nation' moment."[79] Several other states adopted similar resolutions, but, because the resolutions were non-binding, they did not generate substantial changes in board diversity. One commentator observed that, as of the end of the three-year timeframe of SCR 62, "approximately 20% of the firms included in the Russell 3000 Index and headquartered in California complied with the resolution's targeted number of female directors."[80]

SB 826 was enacted as part of the California foreign corporation statute.[81] It differs from the rest of the California foreign corporation statute, however, in two critical ways. First, as noted above, its application is based exclusively on the location of the corporation's principal executive offices. In contrast, the other provisions of §2115 only apply if both the corporation does more than half its business in the state and has more than half of its voting securities held by California residents.[82] Second, rather than providing an exemption for publicly-traded corporations, SB 826 applies exclusively to such corporations.

The statute grants the California Secretary of State the authority to enforce the statute by imposing fines of $100,000 for the first violation and $300,000 for subsequent violations.[83] The author of the legislation, California state senator Hannah-Beth Jackson, said that "she believes having more women in power could help reduce sexual assault and harassment in the

[76] France, Norway, Italy, Spain, Belgium, India and Germany have all adopted gender quotas, Zillman 2017. The European Commission has proposed but not adopted legislation that would impose a 40% gender quota. Boffey 2017.
[77] See, e.g., Kramer, et al. 2006.
[78] CA Urges its Public Companies to Put More Women on Their Boards - SCR 62, 2020 Womenonboards.com, https://www.2020wob.com/blog/ca-urges-its-public-companies-put-more-women-their-boards-scr-62.
[79] Id.
[80] Von Meyerinck et al. 2019.
[81] See SB 826 §3 (adding §2115.5 to the California Corporation code).
[82] See §2115 (a).
[83] The statute also directs the Secretary of State to publish statistics on corporate compliance with the requirements as well as information on the number of corporations who move their headquarters into or out of California or that go private.

workplace."[84] Governor Brown signed the Bill despite significant commentary that it could be unconstitutional.[85]

3.2 SB 826 and the Internal Affairs Doctrine

Although commentators quickly characterized SB 826's application to corporations incorporated outside of California as impermissible based on the internal affairs doctrine,[86] we question that conclusion here. Specifically, we ask whether SB 826 truly addresses corporate internal affairs. [87] At first blush, it seems like the answer to that question is obviously yes in that SB 826 is addressed to the composition of the board of directors, and the board of directors is vested with the legal authority to act for the corporation.[88] Upon further reflection, however, this analysis appears overly simplistic. It is not clear that any regulation that touches upon the board of directors is necessary a matter of corporate internal affairs. SB does not seem to deal directly with the board's role or responsibilities. It does not address the identity of directors, the size or structure of the board, the manner by which directors are selected, or their power and duties. Unlike Dodd-Frank, it does not impose skill or knowledge requirements.[89] Nor does it interfere with existing corporate operations or shareholder choice by disqualifying any existing members of the board.[90]

Instead, to determine whether SB 826 regulates internal corporate affairs, it is necessary to interrogate whether SB 826 is directed to the corporate law objective of shareholder value maximization. Toward this end, identifying California's objectives in adopting SB 826 presents some challenges. In its preamble, SB826 initially cites research that female board representation

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[84] Gov. Brown Signs Law Requiring Women on Corporate Boards, Sept. 30, 2018, CBS SF Bayarea, https://sanfrancisco.cbslocal.com/2018/09/30/gov-brown-signs-law-requiring-women-on-corporate-boards/

[85] See Letter from Governor Edmund G. Brown, Jr. to the Members of the California State Senate dated Sept. 30, 2018, https://www.gov.ca.gov/wp-content/uploads/2018/09/SB-826-signing-message.pdf. (observing that "[there] have been numerous objections to this bill and serious legal concerns have been raised."). Commentators have identified two principal bases on which the legislation may be vulnerable. First, because the statute purports to regulate firms incorporated outside of Delaware, it may violate the internal affairs doctrine. See Grundfest 2018. Second, the imposed gender quota may violate the equal protection rights conferred by both the U.S. and California Constitutions. See, e.g., Amar and Mazzone 2018. California's own legislative analysis concluded that "the use of a quota-like system, as proposed by this bill … may be difficult to defend." Clark and Nakagawa 2018, p. 6. This article does not consider the equal protection arguments.

[86] E.g. Grundfest 2018.

[87] We note that such a challenge to the statute would likely occur in a California court as a defense to California's effort to enforce the fines applicable under the statute to firms that fail to comply.

[88] See, e.g., Del. Gen. Corp. L. §141(a) (providing that corporations are managed by or under the direction of the board of directors); Bainbridge 2003, p. 560 ("it is the board of directors that personifies the corporate entity").

[89] Dodd-Frank Wall Street Reform and Consumer Protection Act Pub. L. No. 111-203, §§951-953, 124 Stat. 1376, 1899-904 (2010) (codified as amended at 15 U.S.C.§§78j-3, 78l, 78n to 78n-1).

[90] We further note that nothing in SB 826 directly conflicts with Delaware or any other state's regulation of corporate boards. Nothing in the Delaware statute, for example, addresses the topic of gender diversity or imposes a different threshold than the California statute. Indeed, Delaware expressly authorizes corporations to adopt charter and bylaw provisions establishing director qualifications, and some corporations have done so. See Cain et al. 2016. Similarly, the NYSE and Nasdaq establish mandatory thresholds for director independence, and those requirements are generally viewed as supplementing rather than conflicting with Delaware law.

improves corporate performance. Section 1 of the statute explicitly references a number of independent research studies that, according to the statute, find that "publicly held companies perform better when women serve on their boards of directors."[91] The problem with this justification is that it is not clear that the statute is really about improving corporate economic value.

First, despite the claims in the statute, the results of empirical studies evaluating the relationship between female board representation and corporate economic performance have been "largely inconclusive."[92] Although some empirical studies have found a positive relationship between board diversity and economic performance,[93] others have found no relationship[94] or even, in some cases, a negative correlation.[95] Establishing a causal relationship is even more difficult – studies generally compare existing corporations with different levels of female board representation,[96] but it may be the case that those companies with more female directors are different from their peers.[97] As a result, the case that there is a causal relationship between board diversity and firm value simply has not been made, and it is difficult to defend the California statute in terms of its anticipated impact on firm economic performance.

Concededly empirical studies support the claim that, whether or not corporations perform better with more female board representation, corporations with women on boards are run differently, although again, the studies fail to demonstrate a causal relationship. There is evidence that female board representation is associated with greater corporate social responsibility.[98] Empirical results indicate that companies that have female directors take fewer risks, engage in less securities fraud, contribute more to charity[99] and provide greater recognition of the interests of diverse corporate stakeholders.[100] Even if these associations were causal, they would support the potential for gender diversity to enhance general social welfare rather than shareholder value. Indeed, some commentators have expressly acknowledged that there is "no business case for—or against—appointing women to corporate boards" and that efforts to increase women's representation should be based on "fairness and equality."[101]

Second, the text of SB 826 demonstrates that a substantial motivation of the legislation was to address social welfare considerations. One of these considerations is increasing the

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[91] See SB 826 §1.
[92] *See, e.g.,* Broome, et al. 2011, p. 765 (observing that "the empirical literature on corporate board diversity also yields largely inconclusive results.").
[93] *See, e.g.,* Adams and Ferreira 2009 (noting better performance metrics of companies with more female directors)
[94] See Rhode and Packel 2014, pp. 383-85 (reviewing empirical literature).
[95] E.g., Shehata, et al. 2017.
[96] But see Matsa and Miller 2013 (comparing firms subject to Norway's mandatory quota with unaffected firms and finding lower short-term profits in affected firms). Ahern and Dittmar document a similar impact on Tobin's q. Ahern and Dittmar 2012.
[97] See Broome, et al. 2011 (noting that "even in those studies that have been able to establish a correlation, the direction of causality is unclear.").
[98] E.g., id.; Boulouta 2013; Zhang et al. 2013.
[99] *See, e.g.*, Marquis and Lee 2013 (finding a positive and significant relationship between the "proportion of female board members [and] overall philanthropy.").
[100] Again, these studies measure correlation not causation.
[101] *See, e.g.*, Klein 2017.

representation of women in positions of leadership. As section 1 observes, despite constituting approximately half of the workforce, women are substantially underrepresented in positions of leadership in corporate America. In 2018, women held only 17.7% of board seats on Russell 3000 companies in the US.[102] As of November 2018, half of these companies had no women directors or only a single woman director.[103] According to ISS, only 10% of lead independent directors are women, and women comprise only 4% of board chairs.[104] In 2018, women were CEOs of just 4.8% of Fortune 500 companies.[105] According to some commentators, a key tool for increasing female representation in the C-suite is by increasing the number of women on boards.[106] Anna Berringer at Catalyst argues, for example, that "In order for boards to appoint more female CEOs, there first have to be more female board members to vote for them."[107] This observation is supported by research finding that gender diversity on boards plays an important role in both the appointment and success of women as CEOs.[108]

Studies also report that female board representation is correlated with greater gender diversity throughout a corporation.[109] Other research indicates that the presence of women directors is associated with better professional employment opportunities and gender equality practices in their corporations.[110] Supporters of the California legislation justify the legislation in terms of creating greater opportunities for women in the workplace and leading to corporations with stronger corporate governance and social responsibility.[111] Increasing the number of female corporate leaders can also be seen as a response to potential #MeToo problems, at least to the extent that women can influence corporate culture and promote the values of diversity and inclusion.[112]

We further note that the structure of SB 826 is poorly tailored to the objective of maximizing firm economic value. For one thing, the statute's jurisdictional scope is weakly tied, at best, to the economic interests of the state of California. The jurisdictional reach of the statute is not based on the number of a corporation's California shareholders. Nor does SB 826 apply to corporations that conduct a substantial percentage of their operations in the state, provide a substantial number of jobs to California residents or furnish California with substantial tax or other revenue. Instead, the jurisdictional hook of a corporation's principal executive office is a statement about corporate leadership and visibility. Regulation of the public companies that are

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[102] 2018 Gender Diversity Index Key Findings, https://www.2020wob.com/companies/2020-gender-diversity-index
[103] *2020 Women on Boards Reports Half of Russell 3000 Companies Lack Women Directors on Boards, IPOs Fare Worse*, Businesswire, Nov. 8, 2018, https://www.businesswire.com/news/home/20181108005102/en/2020-Women-Boards-Reports-Russell-3000-Companies
[104] Fuhrmans 2018.
[105] Stewart 2018.
[106] Carpenter 2018.
[107] Id.
[108] Cook and Glass 2015.
[109] See, e.g., Glass Lewis 2017, p. 2 ("Both theoretically and empirically, it appears that increasing female representation on boards begets more gender diversity throughout the organization")
[110] De Celis, et al. 2015.
[111] SB 826, section 1.
[112] See, e.g., Levick 2018 (describing ways in which female directors can assist corporations in addressing issues of sexual harassment).

subject to SB 826 serves the California's political objectives. Regulating the diversity of their leadership is consistent with California's reputation as a progressive leader, a role in which California can be particularly effective given its size and the number of businesses that operate within the state.[113] California has frequently led the way in adopting progressive legislation, and other states often follow its initiatives.[114]

As such, we argue that SB 826 is better understood as promoting the interests of women executives, employees, and members of society and, as such, is directed to the promotion of societal value rather than shareholder wealth.[115] This analysis challenges the traditional scope of the internal affairs doctrine. Although we do not claim that protecting stakeholders is necessarily inconsistent with or even orthogonal to shareholder value, this objective reflects a broader conception of corporate purpose and corporate objectives.[116] Importantly, we do not intend, in making this claim, to take a position as to whether these objectives are normatively desirable or whether it is appropriate to use corporate law to attempt to achieve the social objectives of diversity through board quotas.

Although SB 826 offers an opportunity to consider the relationship of the shareholder primacy norm to calls for a broader conception of corporate purpose and responsibilities, it is not the only such example. Similar questions are implicated by the ongoing debate over corporate sustainability and ESG.[117] Commentators continue to question the extent to which sustainability considerations affect economic performance.[118] Indeed, the SEC has long opposed requiring sustainability disclosure as part of issuer financial reporting on the basis that it addresses issues that are not economically material to shareholders.[119] Similarly the Department of Labor has cautioned public pension funds that the consideration of societal and stakeholder interests in their investment and governance decisions may conflict with their responsibilities to their beneficiaries.[120]

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[113] See, e.g., Sin 2018 (identifying the perspective that the absence of women on the boards of California-headquartered companies is disappointing given the reputation of "California as progressive and a leader on social issues" and that "an economy as big as California's ought to "set an example globally for enlightened business practice.")

[114] See, e.g., von Meyerinck 2019 (observing that "examples of California leadership involve renewable energy, sentencing reform, and legalization of marijuana usage.").

[115] See Peirce 2018 (describing SB 826 as "embrac[ing] a stakeholder approach . . . Shareholders are mentioned, but the list of beneficiaries features stakeholders prominently").

[116] Indeed, the recognition that the interests of shareholders might not be perfectly aligned with the interests of other stakeholders has led a number of states to adopt legislation explicitly authorizing corporate boards to consider non-shareholder interests. See Geczy, et al. 2015 (describing constituency statutes and examining their effect on institutional investors' investment decisions).

[117] *See id.* (describing the California legislation as "one piece of a broader set of ideas encapsulated by the snappy acronym ESG").

[118] Compare Unruh et al. 2016 (describing mounting evidence "that sustainability-related activities are material to the financial success of a company over time.").with Canary 2018 (expressing skepticism that, in most cases, sustainability considerations are economically material).

[119] Fisch 2019.

[120] Canary 2018.

Some commentators have argued forcefully that non-shareholder interests are not properly within the purview of corporate law and should be addressed elsewhere.[121] These positions raise questions about the extent to which state and shareholder efforts that are concerned with such interests should be understood to address internal corporate affairs.

These questions will not be confined to the legitimacy of SB 826. Other states may follow California's example and adopt board diversity requirements.[122] A bill mandating both gender and racial diversity on corporate boards is currently under consideration by the Illinois legislature.[123] A similar bill is already making its way through the New Jersey legislature.[124] Community leaders in Michigan are debating whether Michigan should follow suit.[125] Moreover, SB 826 may reflect a state trend not merely to regulate board diversity but to extend state corporate law to address a broader range of ESG issues. State legislators are unlikely to limit such laws to businesses incorporated in the state.

Finally, the extent to which social welfare issues constitute part of a corporation's internal affairs has implications for the scope of private ordering that can be effected through firm-specific charter and bylaw provisions. According to a recent Delaware decision, legitimacy of such provisions depends in part on the scope of the internal affairs doctrine. In *Salzberg*, VC Laster invalidated a forum selection bylaw on the grounds that, because it addressed the litigation of securities fraud claims brought pursuant to §11 of the Securities Act of 1933, it was beyond the legal bounds of a corporations' bylaw authority under the Delaware statute.[126] The court reasoned that a corporation's bylaws can only address internal corporate affairs. We note that some shareholders have sought to use the shareholder proposal rule to address social welfare issues, and the extent to which such efforts are legitimate depends in part on the scope of the internal affairs doctrine. [127]

Simply put, SB 826 provides reason to reconsider the scope of the internal affairs doctrine. To the extent that SB 826 reflects an extension of corporate law to address a broader range of interests and a more expansive conception of corporate purpose, the traditional

[121] See, e.g., Friedman 1970, p. 32. See also Armour et al., 2017 (considering extent to which non-economic issues are beyond the boundaries of corporate law and terming such regulation "external corporate law").
[122] As noted above, several states followed California's prior adoption of a non-binding board diversity resolution. See tan __.
[123] Bainbridge 2019.
[124] Green and Vittorio 2018
[125] Cain 2018 (considering whether Michigan should "follow California's lead and enact a law requiring publicly-held corporations to have at least one female board member").
[126] Sciabacucchi v. Salzberg, 2018 Del. Ch. LEXIS 578 (2018). More recently, the SEC has faced a debate over whether proposals seeking to adopt certain forum selection bylaws are within the scope of shareholders' bylaw authority. Clayton, 2019.
[127] It is noteworthy that at least one commentator has argued that shareholder activism is a more appropriate vehicle for increasing board diversity than SB 826. Grundfest 2018. In the early 1990s shareholders sought to use Rule 14a-8 to address board diversity. The effort had limited success, in part because the SEC allowed issuers to exclude binding shareholder initiatives on the grounds that they might violate federal civil rights law. See, e.g., In Apple Computer, Inc. (Oct. 15, 1992); Wang Laboratories, Inc. (Aug. 11,1992); Transamerica Corporation (Mar. 3,1992) and Sears, Roebuck & Company (Mar. 3, 1992).

justifications for deference to the law of the state of incorporation are less compelling and the forum state's interests are more acute.

Similarly, regulatory competition is less desirable with respect to issues for which the capital markets are poorly positioned to discipline firm choices. SB 826 can be understood as a response to this problem. If the reasons for increased board diversity are both non-economic and non-firm-specific, the capital markets are unlikely to encourage firms to increase board diversity through private ordering. Stock prices will reward corporations for increased board diversity (or punish corporations for the lack thereof) if and only if board diversity is tied to shareholder value. Indeed, a recent empirical study of SB 826 finds that affected firms suffered a negative price effect upon the legislation's adoption, suggesting that market participants did not view the statute (or similar non-economic legislation) as likely to improve the economic performance of those firms.[128] More generally, capital market discipline might actually undermine the ability of corporations to use private ordering to pursue non-economic objectives through increased board diversity because, to the extent that board diversity sacrifices shareholder value in favor of the interests of other constituencies, the effect on stock price creates an incentive for shareholders to respond through their voting power.[129]

Finally, SB 826 is distinctive both because it is the first effort by a US state to mandate board diversity and because it represents an unprecedented effort by a state to extend its corporate law rules to address matters of societal rather than purely economic concerns. As such, it highlights the fact that, for the most part, differences in US corporate law among the states are relatively small.[130] Historically, even in circumstances in which a state has adopted an innovative provision, a number of other states are likely to follow suit.[131] As a consequence, regulatory competition in the United States should be understood less in terms of issuer choice than in terms of imposing pressure toward convergence.

4. **Implications for EU Regulatory Competition**

What does this analysis tell us about the potential for regulatory competition in Europe after *Centros*? First, it suggests that even at the time of the *Centros* decision, its potential impact in terms of enabling regulatory competition was likely overstated. US regulatory competition is premised on the norm of shareholder primacy, and European corporate law does not have the same focus. "[M]ost European countries have corporate laws that expressly state that the

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[128] Von Meyerinck, et al., 2019.

[129] Cf. Buccola 2018 (observing that the internal affairs doctrine is best understood as protecting against opportunistic behavior by shareholders).

[130] See Carney 1997 (demonstrating how competition has led to relative uniformity in U.S. corporate law.).

[131] For example, Delaware adopted the pioneering §102(b)(7) authorizing limits on director personal liability in the wake of the Delaware Supreme Court's decision in Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985). Del. Gen. Corp. L. §102(b)(7). As Bill Carney shows, "Led by Delaware's legislature in 1986, forty-two states passed virtually identical legislation within eight years permitting corporate charters to elect to exculpate directors from all liability for negligence, while six other states either placed ceilings on liability or simply removed such liability by statute." Carney 1997, p. 734.

corporation's managers have a duty to consider all the stakeholders of the corporation, not just stockholders, when managing the enterprise.[132] European officers and directors must manage their corporations in the interests of non-shareholder stakeholders and society as a whole.[133] Similarly, considerations of sustainability and ESG are an accepted component of EU corporate responsibility,[134] while in the US, the impact that such considerations should have upon corporate operations remains hotly debated.[135]

Because of this difference in focus, the extent to which the internal affairs doctrine, at least as understood in US terms, would require EU states to defer to the law of a corporation's state of incorporation remains unclear. Many components of EU company law focus on protecting stakeholder interests or societal values. These provisions blur the line between internal and external affairs and, under our theory of the internal affairs doctrine, offer a less compelling case for deference to the law of the state of incorporation.

An example is the German codetermination requirement. Germany requires corporations above a minimum size to provide employee representation on the corporation's board of directors, with the level of such representation depending upon the number of corporate employees.[136] For the corporations with at least 2000 employees, parity between worker and shareholder representatives is required. In addition, codetermination mandates a minimum size for the supervisory board, again depending on company size.[137] Although, as with other governance measures, it is difficult to analyze the relationship between codetermination and firm value empirically, commentators have raised questions about impact of worker representation on decision-making efficiency.[138] In addition, studies suggest that the large board sizes, such as those required under codetermination, are associated with lower firm value.[139] Accordingly, German codetermination, like SB 826, seems to be less about shareholder or economic value

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[132] Strine 2016.

[133] See, e.g. Hopt 1994, p. 208 ("Maximization of shareholders' wealth has hardly ever been the objective of German stock corporations … ."); Roe 2003 (French corporate law "is said to encourage managers to run the firm in the general social interest, for all the players in the firm."); Raaijmakers and Beckers 2015, p. 293 (the Netherlands "Corporate Governance Code is based on the principle that a company is a long-term alliance between the various parties involved in the company, such as employees, shareholders and other investors, suppliers, customers, the public sector and public interest groups.").

[134] See, e.g., Directive 2014/95, of the European Parliament and Council, art. 1, 2014 O.J. (L 330/1) 1, 5 (EU) (imposing sustainability reporting requirement); Baselli 2019 (reporting that Northern Europe is home to the leading corporations with respect to sustainability practices).

[135] See, e.g., Peirce 2018 (criticizing SB 826 and "government attempts to remake corporations for the benefit of so-called stakeholders."); Trevor Sutherland (2018) Corporate Sustainability Need Not be Controversial, Trane, https://www.trane.com/commercial/north-america/us/en/about-us/newsroom/blogs/corporate-sustainability-need-not-be-controversial.html (reporting that "ESG goals are a new and somewhat controversial tool in corporate governance").

[136] See Ebke 2915, p. 1031 n. 68 (explaining codeterminaton).

[137] Roe 1999, p. 202 n. 7 ("Companies with more than 20,000 employees must have a twenty-person board; those with less than 10,000 must have a twelve-person board; and those between 10,000 and 20,000 get a sixteen-person board.").

[138] I.e. Davies and Hopt 2013, p. 344.

[139] Eisenberg et al. 1998; Yermack 1996.

than about protecting worker and societal interests.[140] Indeed, the argument was made in the *Erzberger* case that "the arrangement and conduct of German Supervisory Board elections reflect legitimate economic and social policy choices, which are a matter for the Member States."[141]

SB 826 also raises the issue of whether regulations concerned with the protection of stakeholder or shareholder interests can be better justified than economic regulation in terms of the home state's interests. Under the Restatement of Conflicts or common law interest analysis, a court's choice of law may properly reflect the public policies of the local jurisdiction, and a state is entitled to apply local law when it has a sufficient interest in doing so. To the extent that EU company law is focused on protecting a broader range of interests than those of shareholders, a state may justifiably claim an interest in applying local law that protects those interests.

In considering this point, it is worth noting that the European Corporation or Societas Europaea (SE) offers corporations a mechanism for obtaining increased flexibility and mobility.[142] Available since the early 2000s, the SE enables corporations that operate in more than one European state to obtain partial relief from the differences in local law. For German corporations, the SE allows a corporation to "freeze" both the size of its board and its level of employee representation even if it subsequently grows to the point that it would become subject to higher thresholds and allows new companies to avoid the codetermination requirement entirely.[143] Eidenmueller et al. find strong evidence that corporations use the SE to avoid mandatory codetermination rules.[144] Although the fact that German firms have the option of forming an SE may appear to limit the claim that Germany has a compelling public policy interest in applying codetermination to local corporations, an alternative explanation is that, Germany also has an interest in encouraging the growth of supranational corporations and promoting European unity.

Despite these advances, the degree of corporate harmonization present in the US is less likely in Europe, at least in the near term. European corporate law differs among the various European countries to a much greater degree than US corporate law differs among the states.[145] These differences have persisted despite many years of harmonization efforts.[146] Indeed, the ambitious European Model Company Act highlighted both the differences among jurisdictional approaches and the strong local policy considerations behind those differences.[147] Even on matters in which EU corporate law appears to have converged, differences in ownership patterns

[140] See also Erzberger v TUI AG (2017) C-566/15 (concluding that EU law did not prevent Germany from limiting codetermination rights to those workers of a German firm that were based in Germany).
[141] Keijzer, et al. 2017, p. 10.
[142] Kadi 2012; Bouloukos 2007.
[143] Davies and Hopt 2013.
[144] Eidenmueller et al. 2009.
[145] *See, e.g.,* Deakin 2006.
[146] *See, e.g.,* Gordon 2018 (observing that "that the corporate governance regimes of the EU Member States still exhibit significant divergence [and asking] Why isn't there a fully harmonized company law after more than 20 years of trying?"); Enriques 2017, p. 777 (observing that "EU Member States' company laws are not uniform, despite half a century of harmonization measures, and will most likely never be.").
[147] See, e.g., Andersen 2018.

and institutional structures lead to significant differences in function.[148] Importantly, a substantial component of the policy differences stem from strong nationalist identities and ambivalence about political integration that do not have a clear analogue in the United States.[149] As one commentator has observed, "cultural and political factors make corporate migrations 'less frictionless' in Europe than in the United States, and thus reduce the level of competition and convergence in the field of European company law."[150]

That these differences persist despite *Centros* reinforces the claim that, in Europe, company law reaches more broadly than shareholder value and internal corporate affairs. The breadth of national interests continues to provide compelling motivation for member states to resist uniformity. This fact is illustrated by the EU approach to company law, in which a variety of Directives impose mandatory norms or minimum standards but in which individual member state implementation allows preservation of substantial differences.[151]

Conclusion

Centros was viewed as a landmark decision. At least some commentators celebrated its potential to provide US-style corporate regulatory competition to EU corporations via the internal affairs doctrine. But this outcome has not come to fruition. *Centros* has served a levelling function with respect to some aspects of corporate law, but it has not created a market in corporate mobility, nor has it spurred wholesale change to corporate codes.

This is not surprising. In the United States, the internal affairs doctrine has had a greater harmonizing effect because of the role of US-style notions of shareholder primacy in shaping the internal affairs doctrine. As such, we argue that in the US, the internal affairs doctrine is really a rule of internal ordering of shareholder economic relations. Whether we call them corporate law or something else, laws like SB 826 that are primarily directed to social welfare fall outside the scope of a corporation's internal affairs. This theory is consistent with views of regulatory competition and efficiency that allow parties to select into their optimal governance law.

The lack of significant harmonization in Europe is explained by the fact that significant parts of European corporate law, like SB 826, are really about social rather than economic ordering. As such, corporate law incorporates national and societal values that individual corporations are unwilling to reject by incorporating elsewhere.[152] German corporations, for example, generally accept, rather than seeking to avoid, the representation of labor interests reflected in codetermination. SB 826 thus highlights the limited scope and potential for harmonization of corporate law in Europe. It also explains *Centros'* limited effects and the effort to curb those effects by shifting pieces of legislation to areas explicitly outside corporate law.

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[148] Gordon terms these "partial convergence and divergence-within-convergence." Gordon 2018.
[149] See id. (noting that "strength of national identity and the comparative weakness of European identity is the ultimate hindrance to corporate law convergence in the EU").
[150] Doré 2014, p. 332.
[151] See generally Carney 1997, pp. 318-19 (describing general structure of EU Company Law Directives).
[152] See also Pollman 2019 (identifying the effectiveness of social constraints at limiting regulatory arbitrage).

Ironically, the ultimate conclusion from this analytical journey is that -- with the adoption of SB 826 and the realistic prospect that other states will follow California's lead -- the US may beheading more towards a European style of governance, than vice versa. SB 826 and its effects, thus inform our view of *Centros*, but also point to a US future in which legislatures increasingly impose social-type legislation on US companies regardless of their state of incorporation as the US moves away from its historical emphasis on shareholder primacy.[153] The extent to which such legislation can be understood as outside traditional corporate law and therefore beyond the limits of the internal affairs doctrine will pose a challenge for US regulatory competition.

[153] This conclusion may explain the finding of von Meyernick, et al. 2019 that public companies headquartered in more liberal states more prone to adopt this type of legislation experienced more negative share declines upon the enactment of SB 826.

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