CHOICE OF LAW: NEW FOUNDATIONS

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Abstract

This Article develops a new approach to choice of law. Founded on economic principles rather than the notions of sovereignty that are typically used by choice of law scholars, it seeks to build new foundations for choice of law scholarship. The analysis in the Article makes it possible to discuss alternative choice of law rules in terms of their impact on the well-being of individuals. In other words, it makes it possible to consider questions of efficiency within a choice of law discussion.

The Article traces how the self-interested behavior of nations is at odds with globally efficient rules, and shows how choice of law rules can impact the incentives of countries. The analysis yields eight “choice of law lessons” that help explain the impact of choice of law rules. From these lessons emerge several policies that provide countries with an incentive to regulate more efficiently.

The Article then applies its analysis to several specific substantive law topics – bankruptcy, securities, and antitrust – demonstrating how the framework of the Article can be applied in particular cases. The role of international institutions is also examined. It is shown that they represent an effective tool to facilitate negotiations over choice of law issues in certain cases, but not in others. This discussion informs a variety of current issues. For example, it explains why negotiations over international competition policy and environmental policy should be carried out within the WTO rather than in a separate forum.
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I. INTRODUCTION

This Article seeks to restructure the way in which we think about choice of law.¹ To do so, it abandons the traditional and almost universal reliance on notions of sovereignty as a normative justification for choice of law rules and focuses instead on the welfare of the parties affected by those rules. By focusing on the welfare of individuals, the analysis identifies policies that can lead to a more efficient regulation of cross-border activity and, therefore, the maximization of human welfare.

Although the notions of sovereignty that form the basis of traditional choice of law scholarship may represent values worth considering, it is striking that choice of law scholarship has paid virtually no attention to how individuals and their behavior are affected by the chosen rules.² The most accurate characterization of the sovereignty-based approach may be that it is the product of the long history of choice of law scholarship rather than a deliberately chosen framework within which to address the regulation of international activity. This approach is difficult to defend from an economic point of view, and suffers from the fact that our notions of sovereignty change rapidly. For example, in the early part of the century virtually any form of extraterritorial jurisdiction was considered an infringement on the sovereignty of other nations, a principle enunciated by the Supreme Court in the

² One arguable exception is surveyed in Lea BRILMAYER, CONFLICT OF LAWS 219-263 (2d ed. 1995) (discussing a rights based approach).
famous American Banana case. The famous American Banana case.³ Today, however, the extraterritorial application of laws is widely accepted and sovereignty issues arise only with the most aggressive attempts to extend jurisdiction, a fact most dramatically evidenced by the adoption of the “effects test” in U.S. v. Aluminum Co. of America (“Alcoa”).⁴ The shifting definition of sovereignty is, therefore, an unstable foundation upon which to build a body of choice of law scholarship. When a particular conception of national sovereignty underlies choice of law, the choice of law edifice is sure to crumble when different notions of sovereignty are adopted.

In the place of the traditional approach, this Article adopts an economic perspective on choice of law questions. It begins with the view that the objective of a choice of law regime should be to provide a legal ordering that goes as far as possible toward maximizing global welfare.⁵ This objective may seem unremarkable to readers familiar with the economic analysis of law, but those familiar with traditional choice of law scholarship will recognize that efficiency analysis in general and law and economics in particular has, to date, had only a minor impact on choice of law.⁶ The fact that global welfare represents the objective of the policy analysis, however, does not imply that individual countries will or should pursue that

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⁴ 148 F.2d 416 (2d Cir. 1945).
⁵ The maximization of global welfare should be a non-controversial assumption because the manner in which global welfare is calculated is not specified. The only restriction on the global welfare function is that it must involve some form of aggregation of national welfare functions (which are, themselves, not specified). Thus, for example, if the protection of the environment is an important concern, it can be included as part of the global welfare function simply by including it in appropriate individual welfare functions. See Kaplow & Shavell, Any Non-Welfarist Method of Policy Assessment Violated the Pareto Principle, mimeo.
same objective. Indeed, the challenge for choice of law is the fact that nations--the actors in the international arena--typically do not share this or any other common objective. Rather, each country determines its policies based on its own objectives. In contrast to the domestic context, there is no institution authorized to create a comprehensive set of binding rules at the international level. If the globally efficient result is to be achieved, therefore, it is necessary to find a way to align national interests with those of the global community. This alignment of incentives is at the heart of the theory developed herein.

In the course of developing a new foundation for choice of law scholarship, the Article produces a number of useful conclusions. First, it calls into question many of the most fundamental views of choice of law scholars and courts, contradicting many widely held views and confirming others. For example, the analysis shows that the Supreme Court decision in Hartford Fire Ins. Co. v. California, holding that forum law should always be applied if it is possible to comply with both local and foreign law, undermines the efficiency of the choice of law regime.

Second, the Article develops a set of “choice of law lessons” that provide guidance regarding the optimal way in which to construct a choice of law regime. These lessons do not purport to resolve all choice of law issues--indeed the first lesson is that it is impossible to achieve an efficient resolution of all choice of law questions without substantive international cooperation. Instead, the lessons offer guidelines for the construction of an efficient choice of law regime. The lessons are helpful to judges, legislators, and international negotiators who shape choice of law rules.


Third, the general model can be applied to specific subject areas, where it yields more precise prescriptions for policymakers. The Article sketches the analysis that emerges from the framework in three areas – bankruptcy, securities, and antitrust. The framework, however, also could be applied usefully to a number of other legal issues, including but not limited to contract, torts, environmental law, labor law, intellectual property, tax, banking law, and commercial law.

Fourth, several policy implications emerge from the analysis. The first such implication is supportive of the presumption against extraterritoriality. Though it is a longstanding canon of statutory construction, courts have not followed the presumption against extraterritoriality with any regularity. It is shown that applying the presumption would improve the international regulatory system. The second recommended policy is national treatment for foreign plaintiffs, which would reduce the incentive of countries to adopt rules that externalize the costs of regulation. Finally, it is recommended that private rights of action be encouraged in order to reduce the risk of discrimination between local and foreign parties.

Finally, the Article seeks to bring together two previously independent lines of research. Choice of law scholars have long debated the question of how to allocate jurisdiction when activities cross borders. This line of scholarship, however, has reaped little benefit from the insights of law and economics in general and the lessons of the regulatory competition literature in particular. The regulatory competition literature addresses essentially the same question as the choice of law literature – how should jurisdiction be allocated? Although the former tends to address the question as a statutory or regulatory matter while the latter focuses more on judicial decisions, the substance of the two inquiries is
the same. The regulatory competition literature has produced useful analyses of several topics, most notably corporate law, securities regulation, antitrust, and bankruptcy. The results that emerge from the regulatory competition literature as well as the economic approach used therein have the potential to revolutionize the way in which we think about choice of law. Despite its success in those areas of law on which it has focused, however, the regulatory competition literature has failed to provide a general treatment of the jurisdictional question. The choice of law literature, on the other hand, has sought to frame a set of general principles according to which such questions can be answered. Scholars interested in regulatory competition can benefit from a broader understanding of the questions that arise in international transactions – questions that have long been present in the choice of law literature.

Although this Article deals with choice of law problems, it is different in style from most of the existing choice of law literature because it does not focus exclusively on the role of courts. In addition to courts, legislatures, administrative agencies, and international

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organizations all have a role in resolving choice of law questions, and the analysis presented here is relevant to each of these bodies. For example, courts seeking to interpret the Sherman Act, a statute that is silent as to its extraterritorial scope, must determine the appropriate jurisdictional reach of rules. To do so effectively, courts must understand the implications of their decisions. In many cases, however, legislatures choose to specify the jurisdictional reach of a statute, and when they do so they must take into account how that decision will affect relevant private activities. Similarly, administrative bodies preparing rules and interpretive releases relating to jurisdiction should be aware of the economic implications of their decisions. For example, when the SEC adopts rules relating to the reach of Section 5 of the Securities Act (such as Regulation S), it is important that the impact of such rules be understood. Thus, the lessons and their implications should inform decisions regarding the jurisdictional reach of law no matter where such decisions are made.

The Article also differs from traditional choice of law scholarship in that it focuses on international regulatory issues. There is nothing uniquely international or regulatory about choice of law, of course. A great deal of choice of law scholarship adopts a primarily domestic focus that considers choice of law among states. This Article adopts an international


14 Regulation S consists of Rules 901-904
regulatory focus for two reasons. First, the questions most directly addressed in this Article are business law questions such as antitrust, securities, and bankruptcy. The choice of law issues relevant to these questions have largely been resolved within the United States by the adoption of federal laws or the use of uniform choice of law principles.\textsuperscript{15} No analogous solution currently exists for international choice of law problems. The second reason to focus on international issues is that it is becoming more important with each passing year. The growth in international activity over the last generation has been staggering, and there is every indication that it will continue. Without a better understanding of how international choice of law issues impact international business, the legal regime that governs such transactions will stand in the way of economic development and growth rather than promote them.\textsuperscript{16}

Despite the focus on international regulatory issues, however, the analysis applies to all choice of law problems. For this reason, even choice of scholars interested in the more traditional areas examined by that field should find this Article informative and relevant to their own work.

The Article proceeds as follows. Part II provides a brief review of existing choice of law scholarship in order to establish the necessary backdrop for the discussion that follows. Part III explains why the only jurisdictional touchstone that should be used is that of effects. It also explains that the appropriate definition of effects differs from the traditional definition because it includes the effect of a transaction on the parties to the transaction. Part IV develops the basic framework that is used throughout the Article. Part V presents the choice of law lessons that emerge from that framework. Part VI discusses three policy implications.

\textsuperscript{15} For example, choice of law questions in commercial law have been addressed in the Uniform Commercial Code.

\textsuperscript{16} Once one looks to the international arena, regulatory issues naturally emerge as the focus as these are
that flow from the choice of law lessons. Part VII extends the model to incorporate public choice issues and part VIII applies the prior analysis to the question of when choice of law agreements should be pursued, when are international institutions needed, and the appropriate choice of law rules for specific legal topics.

II. EXISTING CHOICE OF LAW THEORIES

Despite a large literature spanning centuries, the choice of law field lacks a coherent theoretical foundation or set of rules to resolve problems. Put simply, as a body of rules, the choice of law field is deeply unsatisfying from both academic and practical perspectives. Although a great deal of ink has been spilled on the subject, there is little agreement on how choice of law problems should be resolved. The conceptual structures that exist are widely criticized, though the critics rarely offer preferable alternatives. The two traditional approaches are discussed below.

A. Joseph Beale’s Vested Rights Theory

Beale’s vested rights approach, which can be traced to Joseph Story, is based on a view that every state has exclusive jurisdiction over its territory. From this principle, Beale advanced the argument that “only the law of the state where the rights vested may be properly
applied to adjudicate the private dispute.” To apply the law of any other state would be an infringement on the sovereignty of the state under whose laws the right vested. Furthermore, once the rights of a party have vested, they must be respected by other states. Thus, if a particular right vests in state A, it can be enforced in state B. Beale’s approach enjoyed considerable success, appearing in the Restatement of Conflict of Laws, for which Beale was the reporter, and finding its way into the jurisprudence of the Supreme Court, most notably in Slater v. Mexican National Railroad.

Beale’s vested rights approach has been widely criticized and the details of these criticisms can be found elsewhere. It is enough to mention the most prominent criticisms. In order to apply the vested rights approach, it is necessary to identify the moment at which rights vest, and the law under which that takes place. Rights were considered to have vested in the jurisdiction where the last act necessary to complete the cause of action occurred. As a result, the relevant jurisdiction depended heavily on the chosen cause of action. For example, the law of the place where the contract was made would govern a suit on a contract, but the law of the place of performance would govern suits relating to performance.


19 See JOSEPH STORY, COMMENTARIES ON THE CONFLICTS OF LAWS § 18, at 19 (1834).
20 See Joseph H. Beale, 1 A TREATISE ON THE CONFLICT OF LAWS 311-312 (1935) (“the power of the state is supreme within its own territory. . . . It follows generally that no statute has force to affect any person, thing, or act . . . outside the territory of the state that passed it.”); BRILMAYER, supra note 2 at 22.
21 Restatement (First) of Conflict of Laws (1934).
22 194 U.S. 120 (1904) (“[T]he only source of this obligation is the law of the place of the act.”).
24 BRILMAYER, supra note 2, at 24.
assignment of jurisdiction based on vested rights requires that a single place be identified as the location of an activity. This is problematic because activities that cross-jurisdictional boundaries are likely to involve a variety of events spread across boundaries. The identification of the “last act” upon which to base jurisdiction was perceived as arbitrary. A second criticism emerged from the legal realists, who argued that there were no “vested rights” until such time as a judge declared them as such. In other words, until one answers the choice of law question, it is impossible to know the substantive law that will determine the location of the last act, frustrating the attempt to solve the choice of law problem.

B. Brainerd Currie’s “Governmental Interest Analysis”

Currie’s interest analysis began with the view that courts should, in general, apply forum law to cases. The law of a foreign jurisdiction would be applied only if the local forum had no interest. If the local forum had an interest, however, it would apply its own law, even if the other state also had an interest in the case. The group of cases in which both states had an interest was referred to as “true conflicts.” Currie argued that forum law should apply in true conflict cases because courts are ill suited to the task of balancing competing interests. At least in applying forum law, a state can be sure of advancing its own policies and interests as embodied in domestic laws.

27 Currie, supra note 26, at 119.
Much has been written on the question of exactly what Currie meant when he referred to a “government interest.”\(^{28}\) For the purposes of this paper, it is sufficient to use the definition provided by Currie:

An ‘interest’ as I use the term is the product of (a) a governmental policy and (b) the concurrent existence of an appropriate relationship between the state having the policy and the transaction, the parties, or the litigation.”\(^{29}\)

In other words, a legislative enactment alone does not create a governmental interest. Three additional elements are necessary: (1) a factual relationship must exist between the state and the transaction or the parties; (2) the factual relationship must implicate a governmental policy; and (3) the policy must be a legitimate one, i.e., the relationship is appropriate.\(^{30}\)

In implementing Currie’s approach, courts must examine a law’s purpose. Ascertaining the purpose of the law is the same as identifying the government policy (the purpose underlying the substantive rules in question) and is to be accomplished by conventional normal methods of legislative interpretation. If the court determines that both states assert a legitimate governmental interest, then the “insoluble problem” of true conflicts arises. Currie viewed the central problem of choice of law as one of deciding which laws shall yield. He recognized that his proposal to apply forum law was an imperfect solution, but considered it the best option available. One justification for Currie’s proposal is that the “court can at least be sure it is consistently advancing the policy of its own state. It should apply its own law... simply because a court should never apply another law except when there

\(^{28}\) A careful discussion of the question can be found in Kay, supra note 23, at 105-111.

\(^{29}\) BRAINERD CURRIE, SELECTED ESSAYS ON THE CONFLICT OF LAWS 621 (1963). A detailed discussion of this quote and other issues relating to Currie’s definition of governmental interest in contained in Kay, supra
is a good reason for doing so.’”\textsuperscript{31} Moreover, in Currie’s view, courts are not competent to choose between two laws because it requires balancing of incommensurate interests.

Currie enunciated the following summary of his approach in 1964.\textsuperscript{32} If only one state has an interest (known as a “false conflict”), that state’s law applies. When a court is asked to apply the law of a foreign state, it should inquire into the policies underlying the respective laws and into the circumstances in which it would be reasonable for the state to assert the policy. If an apparent conflict emerges, the court should attempt a “moderate” or “restrained interpretation” of the competing policies to resolve the conflict. How a court should go about defining a policy with moderation and interpreting an interest with restraint is unclear. If the conflict is unavoidable, forum law applies. If the forum is disinterested, but a true conflict exists between two other states the forum should attempt to dismiss on forum non conveniens grounds, or failing that, step into legislative shoes and resolve the conflict in accord with how it thinks the legislature would decide which interest would yield.

Although Currie’s government interest analysis was in substantial part adopted in the Restatement (Second) of Conflicts,\textsuperscript{33} and remains dominant in choice of law scholarship today, it has not escaped criticism.\textsuperscript{34} Critics argue that interest analysis is unpredictable, difficult to apply in practice, and that it has no meaningful foundation. Aside from supporting

\textsuperscript{30} See Kay, supra note 23, at 54.
\textsuperscript{31} Currie, supra note 26 at 119.
the notion that choice of law should turn on the rights of parties rather than government interests, however, these critiques have failed to produce an alternative approach.35

III. THE PRIMACY OF EFFECTS

The existing choice of law literature has generated a broad range of proposals in part because it fails to define the object of the choice of law exercise. The goals pursued by proposed choice of law rules are difficult to identify, and when they can be identified, are difficult to justify. Why are we interested in protecting what Currie refers to as a “government interest?” What is lost if the “wrong” choice of law rule is used? Exactly what are the notions of sovereignty that lie and the foundation of the analyses that focus on protecting government interests? Such questions are not addressed in the existing scholarship, making it difficult to identify the goals of choice of law scholarship and, therefore, difficult to evaluate alternative proposals.

This Article takes an entirely new approach to choice of law problems. The first step in the analysis is to identify the measure by which any particular choice of law rule will be

35 See Larry Kramer, Rethinking Choice of Law, 90 COLUM. L. REV. 277, 278-79 (1990). Several variations on Currie’s work have been proposed in an effort to determine how to handle “true conflicts.” The first of these is the “comparative impairment” approach. See William Baxter, Choice of Law and the Federal System, 16 STAN. L. REV. 1 (1963). Professor Baxter suggested that in order to resolve true conflicts, the forum should determine which state’s policies would be more impaired if its law were not applied. One important advantage of this approach is that it does not turn on the choice of forum – assuming that courts are not biased in favor of their own forum. Moreover, the approach avoids the difficulty of weighing conflicting policies. The court undertakes no balancing, but rather asks only which state can better afford not to have its law applied in the particular case. Another modification, proposed by Professor Leflar, offers a set of choice-influencing factors a court should use to resolve true conflicts. See Robert Leflar, Conflicts Law: More on Choice Influencing Considerations, 54 CAL. L. REV. 1584 (1966). These considerations are (a) predictability of results; (b) the maintenance of the interstate or international order; (c) simplification of the judicial task; (d) advancement of the state’s governmental interests; and (e) application of the better rule of law. The approach contemplates courts undertaking an objective inquiry into which law is the most just and reasonable. There are obvious problems with such an approach - judges tend to be biased in favor of local law; courts lack the competence to evaluate the merits of conflicting laws; and there may be no meaningful criteria to identify the better law, especially if the underlying competing policies are incommensurable. See Brilmayer, Interest Analysis, supra note 34; Brilmayer, Methods and Objectives, supra note 34.
measured. Consistent with an economic approach, this Article will take as its objective the maximization of global welfare. This implies that only the welfare of individuals matter and that traditional choice of law concepts such as national interests or comity will be relevant only to the extent that they affect welfare.

Adopting maximization of global welfare as the objective immediately leads to the conclusion that the only basis of jurisdiction to be considered is the impact of rules on the welfare of individuals. That is, factors that have no effect on human well-being are ignored. This approach is a departure from much of the existing literature and its focus on “state interests,” and other sovereignty-based criteria.36 Where such concerns are irrelevant to the interests of human beings, this Article ignores them.37

Focusing on the well being of individuals, of course, is equivalent to focusing on the effect actions have on individuals. In other words, the only basis of jurisdiction to be considered is “effects.” Where an activity has no effect on any person within a jurisdiction, that jurisdiction has no reason to regulate the activity. Similarly, if an activity has an effect on residents of a jurisdiction, that jurisdiction has, at the very least, an interest in regulating the activity. Whether it should do so is the subject of the balance of this Article.

IV. FRAMEWORK

The choice of law problem is analyzed through the use of a simple, though fairly general, transaction that implicates a choice of law decision. This framework yields a number of useful results yet remains general enough to apply to a wide range of choice of law issues.

36 See supra note 26; Kay, supra note 23, at 53-59, 105-111.
37 For a defense of this approach, see Steven Shavell & Louis Kaplow, supra note 5.
There are two classes of individuals. The first includes all parties who are consensual, informed parties to the transaction. These are referred to as the parties to the transaction or “direct parties.” The second class includes third parties who are affected by the transaction but who are not themselves party to it. Throughout the paper, unless specified otherwise, it is assumed that the parties to the transaction act in their own self-interest. Specifically, it is assumed that they will not voluntarily enter into a transaction unless that transaction increases their well-being. This assumption is convenient for analytical purposes, but might be criticized because it implicitly assumes that government has no role in protecting individuals from making bad decisions. It is possible to take governmental protections of this sort into account, however, simply by renaming the relevant parties. Imagine, for example, that our model transaction takes place between parties $a$ and $b$, located in countries $A$ and $B$ respectively. Suppose further that $a$ is considered incompetent to enter into such a transaction. The analysis developed in the Article can be adapted to this situation simply by labeling $a$ as a third party rather than a party to the transaction. In other words, the assumption that $a$ is unable to protect himself is equivalent for our purposes to the assumption that $a$ is affected by the actions of one or more other parties without $a$’s consent. With this minor modification, the analysis presented below remains valid even in situations where one or more parties need some form of government intervention to protect them from entering into

38 This Article takes no view on whether government action to protect individuals in this way – through laws such as the doctrine of unconscionability, mandatory securities laws, minimum wage laws, and so on – is desirable in any given situation. Whether or not one believes that such rules are appropriate, the framework of the paper can be applied to analyze the choice of law problem.  
39 This may be so for a host of reasons, including the fact that $a$ is a minor, or is protected by a consumer protection statute, or is a married woman who is not permitted to enter into a contract without the consent of her husband, as in the famous case, *Milliken v. Pratt*. The justification for governmental intervention in this situation is not the subject of this paper. Rather, if such intervention is deemed to be justified, the analysis presented in the paper must be adapted accordingly.

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certain kinds of voluntary arrangements.\textsuperscript{40} For ease of exposition, the term “third parties” is used throughout to include these individuals who are unable to protect their own interests.

It is assumed that there are many countries and that parties to the transaction and third parties may be located in any of these countries. The government of each country is assumed to maximize the domestic welfare of local residents. The framework can also accommodate a situation in which governments pursue objectives different from those that would maximize welfare, and the model is extended to take such public choice issues into account in Part VII. No additional assumptions are made regarding the transaction.

The first step in the analysis is to identify the costs and benefits to be taken into account. Consider the parties to the transaction. These individuals experience an increase in welfare as a result of the transaction – otherwise they would not participate. The benefit enjoyed by the parties to the transaction will be referred to as “direct effects.” We also must take into account the third party effects of the transaction, which will be referred to as “indirect effects.” These effects are felt, potentially, by individuals located in every country, whether or not parties to the transaction are present within that country. Indirect effects may be positive or negative.

Within each country, the total effect of the transaction on national welfare is the sum of direct and indirect effects. Because the direct effects are always positive, and the indirect effects may be positive or negative, the total effect on a country may be positive or negative. The total impact of this transaction on global welfare is simply the sum of all direct and

\textsuperscript{40} In the securities context, for example, regulation is often justified with reference to third party effects. See Frank H. Easterbrook & Daniel R. Fischel, \textit{Mandatory Disclosure and the Protection of Investors}, 70 VA. L. REV. 669, 675 (1984); Fox, \textit{Globalizing Markets supra} note 9; or by the presence of uniformed participants and markets that are not efficient, see Andrew T. Guzman, \textit{Capital Market Regulation in Developing Countries: A Proposal}, 39 VA. J. INT’L L. 607 (1999). The model developed here can be applied in both of these situations.
indirect effects felt worldwide, and can be positive or negative depending on the magnitude of the direct and third party effects.\(^{41}\) In framing choice of law rules, the objective should be to identify and implement rules that will permit transactions to take place when the total impact on welfare is positive, and prevent transactions from taking place when the total impact on welfare is negative.

There are two ways in which a choice of law rule may influence global welfare. First, the choice of law rule may lead to the selection of an inferior rule. As between two or more potential rules, one will often be superior to the others in the sense that it leads to more desirable outcomes. Much of the academic literature on legal issues deals with the question of which rules are the best in one context or another. For a variety of reasons, however, resolving choice of law issues by attempting to identify the better law is an unsatisfactory approach. When dealing with a problem, local lawmakers typically have selected the laws in question. In other words, the policymakers in the two jurisdictions have adopted different rules. Within each jurisdiction, however, the decision has already been made that the chosen laws represent the best way to achieve the objectives being pursued by the policymakers. Thus, the very existence of a conflict demonstrates that the relevant jurisdictions have different views on which is the best law, so the governments will be unable to reach consensus on which law is better.\(^{42}\) Attempts to choose the better law from an objective perspective also face tremendous practical difficulties. There is often no consensus on which

\[\sum_{i=1}^{N} \pi_i + \sum_{i=1}^{N} f_i.\]

\(^{41}\) If \(\pi_i\) represents the direct effects of the transactions on country \(i\), and \(f_i\) represents the indirect or third party effects felt by country \(i\), we can express the impact of the transaction on national welfare as:

laws best achieve any particular objective, let alone which is best once we accept that
different governments may have different objectives. An inquiry into which is the best law,
therefore, may yield no clear answer. In addition, where courts resolve the question, one
would expect significant local bias. Even a court seeking to be impartial is made up of judges
that are steeped in the legal and intellectual traditions of their own jurisdiction. In attempting
to identify the best law, therefore, one would expect them to have views that are similar to the
views of their own legislature. Furthermore, a “better law” approach leaves the court with
tremendous discretion – giving it ample opportunity to favor the law of its own jurisdiction.
Ultimately, the difficulties inherent in any attempt to resolve conflicts by selecting the better
law are insurmountable, and another approach must be adopted.

Second, choice of law rules may influence global welfare through their effect on the
laws adopted by governments. In other words, the substantive laws chosen by a country may
be influenced by the applicable choice of law rules. A government making rules for a closed
economy takes into account all of the costs and benefits associated with those rules. In an
open economy, however, some of the costs and benefits may be felt outside the government’s
jurisdiction. To the extent that governments are able to externalize the costs or unable to
internalize the benefits of activities, laws passed to regulate those activities will tend to be
undesirable from a global perspective because national governments will not take into account
the costs and benefits felt by foreigners. As a result, the chosen rules will be distorted
relative to what would be chosen in a closed economy as governments try to externalize costs
and internalize benefits. For example, a government will permit activities whose impact on

43 The government may not weigh these costs and benefits appropriately, a concern that is addressed in
Part VII.
44 See Guzman, Is International Antitrust Possible?, supra note 10 (discussing this issue in the antitrust
global welfare is negative if the costs are borne by foreigners and the benefits are enjoyed locally. Where possible, therefore, choice of law rules should be crafted to force governments to internalize the costs of their actions (and to allow them to internalize the benefits). Where this effort succeeds, governments will pass laws that represent, in the rule maker’s judgment, the best possible rule, taking all costs and benefits into account. This relationship between choice of law rules and government conduct, which has received little attention in the choice of law literature, is the focus of this Article. An efficient choice of law regime eliminates, whenever possible, the difference between national laws and the globally optimal set of laws.

A. The Globally Efficient Policy

The analysis begins by establishing the globally efficient substantive law – the global optimum. This is the set of substantive policies that would exist if a single benevolent and well-informed global policy maker were able to establish laws. Once the global optimum is established, the Article analyzes the behavior of countries trying to maximize their own


46 Implicitly, this Article leaves to national governments the question of which law will best advance the objectives of their country. The choice of law rules are simply intended to encourage countries to internalize the costs and benefits of their rules. To the extent that the choice of law rules are successful, governments will face incentives that allow them to pursue their objectives, but do not allow them to do so at the expense of other countries.
welfare and draws lessons from the relationship between the policies put into place by these countries and the globally efficient policy.

Because the framework established above is quite general, the best possible global policy is easily stated. A global lawmaker would seek to allow all transactions for which the net effect on total world welfare is positive, and would seek to prevent activities for which the net effect on total welfare is negative. In other words, where the sum of direct effects and third party effects is positive, an activity would be allowed but where that sum is negative the activity would be prevented.\footnote{Formally, if there are N countries, the global policy maker would allow activities for which: \( \sum_{i=1}^{N} \pi_i + \sum_{i=1}^{N} f_i \geq 0. \)}

From the perspective of a global planner, the distribution of the costs and benefits of an activity are not at issue. For example, if an activity reduces the welfare of some individuals or even some countries, but increases worldwide welfare, the activity should be permitted. This is so because a global policy maker can satisfy any distributional objectives through lump sum transfers between countries or individuals. In practice, of course, such transfers are very difficult to achieve. In the absence of transfers there may be instances in which efficiency can be traded off against distributional concerns. In order to isolate the efficiency effects of various choice of law rules, however, distributional effects are ignored when evaluating the global optimum. When considering national behavior, of course, the distributional issues will be relevant. In certain instances, for example, a globally optimal policy may cause a net loss in one or more countries when compared to the non-cooperative,
sub-optimal outcome. In those cases, the losing countries will prefer the sub-optimal outcome, frustrating efforts to achieve an efficient international regime.\textsuperscript{48}

\textbf{B. Non-Cooperative National Behavior}

As individual countries pursue their own self-interest, they will be influenced by a variety of factors, including the choice of law rules in place. Although the actions of other countries may affect a country’s policy decisions by affecting the costs and benefits felt by residents of the country, it is assumed that no country cares about the impact of its decisions on other countries.

Under our assumptions, a national government will allow a transaction to take place if and only if the transaction yields a net benefit to the residents of that country.\textsuperscript{49} It is clear that the actions of an individual country will not, in general, coincide with the global welfare maximizing policy described in Part IV.A. This is so because the country takes into account only the interests of its own residents, ignoring the impact of the transaction on non-residents. If the costs and benefits of an activity are distributed unevenly across countries, therefore, national policies will diverge from the global optimum. The policy of an individual government may be either more or less permissive than the global optimum, depending on the distribution of these costs and benefits. Consider the following examples.

\textbf{Example.} Imagine a transaction that yields a payoff of 1 to each participant, with a single participant in each country. Assume that there are no third party effects, with the

\textsuperscript{48} See Andrew T. Guzman, \textit{Is International Antitrust Possible?}, 73 N.Y.U. L. REV. 1501 (1998) (arguing that cooperation in international antitrust policy is unlikely because the distribution of the gains and losses from such cooperation would leave some countries worse off – even if there is an overall increase in welfare).

\textsuperscript{49} The country’s policy can be stated formally as allowing transactions if and only if:

\[ \pi + f_i \geq 0. \]
exception of country i, which contains a person who stands to suffer a loss of 2 as a result of the transaction. If there are N countries, the global effect of this activity is to increase global welfare by N-2, implying that for any N>2, the global benefits of this activity outweigh its costs. In formulating its own policy, however, country i will consider only the domestic costs and benefits. Because the residents of country i, taken as a group, stand to suffer a loss of 1, that country will not permit the activity. Country i’s rule will be less permissive than the global optimum. Assuming that i has jurisdiction over this activity, and assuming that it has the power to prevent the transaction from taking place, it will do so. All other countries will take into account only the payoff of 1 that each of them stands to gain and will permit the activity to go forward.

Example. Now imagine a different transaction, again with one participant in each country, that offers each participant a payoff of 1. Suppose that third party effects impose a cost of 2 on each country, with the exception of country i. For all N>2, this transaction is globally welfare reducing. In formulating its policy, country i will ignore the effect of the transaction on non-residents – implying that from the perspective of country i the transaction yields a net benefit of 1. If country i has exclusive jurisdiction over the transaction, country i will allow it to take place, despite the fact that it is welfare reducing from a global perspective. Country i’s policy in this example is more permissive than the global optimum.

Because choice of law rules determine which countries’ laws govern a particular transaction, they can influence the efficiency of the global legal system. Consider the above examples. In both examples, if the rules permit the laws of country i to govern, the result will be inefficient – too strict in the first example, not strict enough in the second. On the other

50 For concreteness, one can imagine the transaction as a cooperative venture among a group of firms to launch a new product that will compete with a product produced by a firm in country i.
hand, if choice of law rules prevent country i from exercising jurisdiction, the efficient outcome is achieved.

To evaluate choice of law rules more generally, this Article lays out a series of “lessons” that inform us regarding the connection between choice of law rules and the overall efficiency of the international legal system. Although it is not possible to construct a complete set of choice of law rules that will yield an efficient result in every instance, these lessons shed light on many choice of law problems. The guidelines also demonstrate a variety of misconceptions in existing choice of law rules and scholarship as generally understood in the United States.

V. Choice of Law Lessons

A. Lesson #1: Non-Cooperative Approach is Inefficient

If governments behave in a non-cooperative fashion, no single government has an incentive to implement a domestic legal regime that is globally efficient.

The intuition behind this lesson is clear. A government seeking to maximize the welfare of its own residents will fail to take into account an activity’s costs and benefits to the extent they are felt outside the borders of the country. The two examples above offer simple demonstrations of this lesson.

Because no country has the correct incentives, a choice of law rule that grants exclusive jurisdiction to one and not the other will lead to a sub-optimal level of regulation. To illustrate this point, imagine a transaction involving two countries, A and B. Each country is home to parties to the transaction who enjoy the direct effects of the transaction, and third parties who are subject to third party effects. The best global policy would be to allow the
transaction if and only if the sum of direct and third party effects is greater than zero.\textsuperscript{51} If country A decided whether or not the transaction would go ahead, however, it would only take into account the direct and third party effects felt by residents of A.\textsuperscript{52} The impact of the transaction on individuals in country B would be ignored. Similarly, country B would ignore the impact of the transaction on individuals in country A.\textsuperscript{53} Because neither country takes into account the costs and benefits felt by the other country, there is no reason to expect either of these countries to regulate in a globally efficient fashion.

This lesson may seem self-evident to some readers, but it bears noting that the choice of law literature often overlooks this point. For example, one often hears calls to allocate jurisdiction to the country where a harm is suffered.\textsuperscript{54} This lesson demonstrates that such an approach is not justified without further information. The mere fact that harm occurs in a particular jurisdiction does not imply that the country is suited to regulate the activity. For the same reason, a choice of law rule that adopts the law most favorable to the plaintiff, as was advanced by Professor Weintraub, is undesirable.\textsuperscript{55} To adopt such an approach would systematically favor liability-producing laws, leading to over-regulation.

Up to this point, the analysis has been on a transaction-by-transaction basis. In most areas of law, of course, transactions are not reviewed individually, but rather are permitted or forbidden based on a set of clear rules. The creation of these rules is, in turn, affected by the

\[ 0 >+++ \begin{bmatrix} \pi_A & + & \pi_B & + & f_A & + & f_B \end{bmatrix} > 0 \]

\[ \text{Country A would allow the transaction if and only if: } \pi_A + f_A > 0. \]

\[ \text{Country B would allow the activity if and only if: } \pi_B + f_B > 0. \]

\textsuperscript{51} That is, if and only if: \[ \pi_A + \pi_B + f_A + f_B > 0 \]

\textsuperscript{52} Country A would allow the transaction if and only if: \[ \pi_A + f_A > 0. \]

\textsuperscript{53} Country B would allow the activity if and only if: \[ \pi_B + f_B > 0. \]

\textsuperscript{54} See, e.g., Diane Wood, \textit{A Cooperative Framework for National Regulators}, 72 CHI.-KENT L. REV. 521, 530 (1996) (“I think that the optimal enforcer for any competition case is the country whose consumers are harmed by the particular practice in question.”); Eleanor M. Fox, \textit{Competition Law and the Millennium Round}, 2 J. INT’L ECON. L. 665, 666 (1999) (advocating an international agreement to address the “blockage of markets and to provide a robust procedural system of public and private enforcement [under which] the law of the excluding nation would apply.”).
country’s local perspective.\textsuperscript{56} For example, in formulating a country’s intellectual property law, a country that engages in a large amount of innovation that is exported around the world (such as the United States) prefers strict protections for intellectual property rights. On the other hand, a country that imports such innovations but tends to develop few new technologies (Chile, for example), will prefer a weak intellectual property law which allows its own firms to copy innovations developed abroad. Neither country has the proper incentives. The innovating country fails to take into account the increased welfare that would be enjoyed by foreign consumers if intellectual property rules were relaxed while the importing company does not take into account the welfare gain that would be enjoyed by the innovator if such laws were strengthened.

**B. Lesson #2: Extraterritoriality Leads to Over-Regulation**

*The non-cooperative outcome, coupled with extraterritoriality, leads to over-regulation.*

Imagine a transaction that is undesirable from a global perspective, implying that the worldwide sum of direct and third party effects is negative. For this to be so, it must be the case that at least one country is worse off as a result of the transaction. If that country is able to prevent the transaction, it will do so in order to prevent the welfare loss within its borders. This means that if every country applies its law extraterritorially, every transaction that

\textsuperscript{55} See Russell J. Weintraub, Commentary on the Conflict of Laws 360 (3d ed. 1986).

\textsuperscript{56} In fact, there is often much more review of individual transactions than the above text suggests. This is the case when administrative agencies review individual transactions and are vested with the discretion to determine which cases to pursue. Regulators in this situation have the opportunity to pursue those cases that impose more costs than benefits on the country.
reduces global welfare will be regulated.\footnote{For the purposes of this Article, it is sufficient to define extraterritoriality as the intention and ability to compel firms operating abroad to comply with domestic law. Territoriality, on the other hand, can be defined as an inability or unwillingness to apply one’s laws to conduct abroad. These terms are obviously polar positions on a spectrum, and it is possible for the application of law to lie between pure extraterritoriality and territoriality. This does not affect the results of the analysis. As one moves toward greater extraterritoriality, the level of regulation will increase and as one moves toward territoriality it will decrease.}{57} In other words, if all countries act extraterritorially, a non-cooperative approach to choice of law will never lead to under-regulation because for every globally inefficient transaction there is at least one country with an incentive to prevent it.\footnote{The generality of this result can be shown through a more formal presentation. In a world with N countries, country j will choose to prevent an activity if and only if:}{58}

Consider the other possible scenario – in which the activity is efficient from a global perspective and therefore should be permitted. To be globally efficient it must be that the worldwide sum of direct and indirect effects is greater than zero. If every country applies its laws extraterritorially, each country will have the ability to prevent the transaction. A country will prevent the transaction if and only if the \textit{local} sum of direct and indirect effects is negative. This means that for the transaction to be permitted, being globally efficient is not enough, it must improve the welfare of every country.\footnote{Treating countries as the relevant unit of analysis, the transaction must be Pareto improving rather than merely Kaldor-Hicks efficient. Once again, we can demonstrate this result formally. A transaction is globally efficient and should be allowed if and only if:}{59}

\[ \sum_{i=1}^{N} (\pi_i + f_i) > 0. \]

If every country applies its laws extraterritorially, however, the transaction will be regulated somewhere unless \( \pi_i + f_i > 0 \), for all i. This condition is much more restrictive than the condition for global efficiency given above.
welfare but that harm even a single country will be prevented.\textsuperscript{60} This implies that there will be too much regulation – globally efficient activities will be prevented. In fact, the problem is even worse than is suggested by this discussion. It is not only the case that the most restrictive applicable law will govern a transaction, it is also true that the most restrictive component of each applicable law governs. The following example illustrates this point.

\textbf{Example.} Imagine an issuance of securities that has effects on countries A, B, and C. Suppose that all three countries regulate the transaction, with country A’s laws being the most restrictive and C’s the most permissive. Extraterritoriality allows country A to apply its law to the transaction even if doing so is inefficient from a global perspective – this is the general result from this lesson.

The situation is worse once we recognize that the securities laws of a country involve a complex regulatory scheme. Assume that, while A’s laws are considered the most demanding, it is not the case that every element of the law is more demanding than what exists in countries B and C. To be precise, assume that A’s disclosure requirements are more demanding than those of country B or C, that country B’s antifraud liability is stricter than A or C’s, and that C’s rules governing insider trading and self-dealing are tougher than those in A or B. In this situation, assuming all countries apply their laws extraterritorially, an issuer must not only comply with the laws of A – the strictest regime – it must comply with the disclosure requirements of A, the antifraud regime of B, and the self-dealing regulations of C. In other words, the issuer must comply with the strictest component of each law. In effect, the issuer is subject to a legal regime consisting of a medley of the strictest elements from the interested countries. No individual country has chosen to

\textsuperscript{60} See Andrew T. Guzman, \textit{Is International Antitrust Possible?}, supra note 59 (discussing this result in the context of antitrust).
regulate its issuers as restrictively as does the international regime. By any measure, this is excessive regulation.

In principle, the problem of over-regulation presented in this lesson could be resolved through transfers among countries. Specifically, countries that stand to gain from a transaction could compensate those that stand to lose and in exchange the would-be losers could allow the activity. In the international arena, however, significant transactions costs often prevent such transfers, leading to systematic over-regulation where there is widespread use of extraterritoriality. In some contexts, facilitating these transfers may be an appropriate use of international organizations and international cooperation, an issue that is discussed in Part VIII.C.

**Application of Lesson # 2: The “Governmental Interest Approach” leads to over-regulation.**

The government interest approach, developed by Currie and supported by many choice of law commentators, calls for the application of forum law to cases in which the forum has an interest. This, of course, amounts to a form of extraterritoriality – governments are permitted to extend the reach of their laws as long as the local forum has an interest – consisting of a governmental policy and a sufficient relationship between the state and the transaction. Lesson #2 demonstrates that this approach will lead to over-regulation. An activity that harms one country will be prevented even if that harm is outweighed by the benefits enjoyed by other countries. Although this approach successfully prevents all welfare reducing activities from taking place, it also prevents many welfare increasing activities.

From an efficiency perspective, therefore, government interest analysis -- the dominant approach to choice of law analysis -- is flawed because it leads to systematic over-

61 See supra TAN 29.
regulation. It should not surprise us that the government interest approach fails to resolve conflicts in a fashion that promotes efficiency. The development of the government interest approach was based on preserving notions of state sovereignty, rather than creating an appropriate environment in which cross-border activity can take place. In fact, because the government interest approach is so dedicated to preserving territorial notions of sovereignty, it was perhaps inevitable that it lead to over-regulation. Where a transaction impacts many jurisdictions, the pro-sovereignty bias of the government interest approach leads to regulation by all affected jurisdictions.

C. Lesson #3: Territoriality Leads to Under-Regulation

*Where countries cannot (or do not) apply their laws extraterritorially there will be under-regulation.*

Until relatively recently, there was consensus in the United States that the proper approach to jurisdiction was a “territorial” one in which acts beyond a nation’s borders were not within the jurisdiction of the courts.62 This Lesson demonstrates that the territorial approach leads to systematic under-regulation.

If a country chooses to regulate an activity, but is unable or unwilling to do so extraterritorially, it still has the option of preventing its own residents from participating. Regulating local but not foreign actors reduces the return to those local residents who would otherwise have participated. In many cases, such action will reduce the payoff to zero or even cause losses to those individuals. For example, an agreement among a group of firms to

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62 See, e.g., American Banana Co. v. United Fruit Co., 213 U.S. 347, 357 (1909) (“[T]he character of an act as lawful or unlawful must be determined wholly by the law of the country where the act is done.”) Id. at 356.
engage in a strategy of predatory pricing might generate profits in expected value terms to those firms that participate, while imposing losses on other firms in the industry. If a local firm is prevented from participating in this activity, it may find itself the target of a predatory pricing strategy rather than a participant. In other cases, the fact that the transaction is taking place abroad may generate some increase in return for locals. For instance, if local firms are forbidden from participating in a merger, they may still benefit from an increase in market power and profits if the merger goes forward without them. In either case, however, the fact that local firms want to participate indicates that preventing them from doing so reduces their expected profits.

Although the local government is able to prevent local firms from participating in the activity, local consumers remain exposed to the consequences of the activity. As long as a country engages in trade, it will be importing goods and services affected by the activity, and local individuals will feel third party effects. Therefore, when a country selects a policy in the absence of extraterritoriality, its choice set is restricted to either (a) preventing local firms from participating in the activity while still suffering at least some of the third party effects; or (b) permitting local firms to engage in the activity. Policy makers facing this choice will sometimes choose to permit an activity that reduces national welfare because the alternative of preventing local firms from participating while still exposing one’s consumers to the harms involves a greater loss. In certain cases, therefore, transactions that are globally welfare

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63 The assumption that a country cannot act extraterritorially implies an assumption that it is, in some way, exposed to the effects of the activity. In principle, of course, all countries can impose their laws extraterritorially by refusing to permit the importation of goods that have violated local law. The assumption in this lesson, therefore, is that the costs of imposing laws extraterritorially exceed the benefit of doing so.
reducing will be permitted to go forward. This result is demonstrated in the following example.\textsuperscript{64}

**Example.** Imagine a country that does not apply its laws extraterritorially either because it is unable to do so effectively (as is the case for many small countries) or because it chooses not to do (as was the case for antitrust policy in the United States until 1945\textsuperscript{65} and Europe until 1988.\textsuperscript{66}) Suppose that a group of local firms plans to participate in an

\begin{align*}
&\text{To demonstrate this result in a more formal context, recall that if the government permits the activity, the impact on the national welfare of country } i \text{ is given by:} \\
&\pi_i + f_i \\
&\text{If the government prevents local firms from participating, there are two effects, as discussed in the text. First, the prohibition on participation by local firms reduces the profits enjoyed by these firms to a fraction, } \delta \text{ of what they otherwise would be, where } \delta \leq 1. \text{ Second, the impact of the activity on local third parties may be reduced because local producers are no longer able to participate. Denote by } \phi \text{ the fraction of the impact on third parties that remains despite the government prohibition, where } 0 < \phi < 1. \text{ If the government chooses to regulate the activity, the impact on welfare is, therefore, represented by:} \\
&\delta \pi_i + \phi f_i \\
&\text{The government permits an activity if and only if local residents are better off when local firms participate, which can be expressed as:} \\
&\delta \pi_i + \phi f_i \leq \pi_i + f_i \\
&\text{The above inequality holds as long as:} \\
&(\delta - 1)(1 - \phi) \leq f_i / \pi_i \\
&\text{When this inequality is satisfied, the government will permit local participation in the activity. It will allow such participation even if the activity’s net impact on national welfare is negative. It is clear from the above inequality that an activity is more likely to be permitted if third party effects are positive and large relative to local profits. Similarly if } \delta \text{ the impact of regulation on profit, is small relative to } \phi \text{ the impact of regulation on third party effects, the activity is more likely to be permitted.} \\
&\text{The relative size of } \delta \text{ and } \phi \text{ can be thought of as measures of the degree to which a country is able to regulate extraterritorially. A complete absence of extraterritoriality would imply that local firms (if any) can be prevented from participating, but local consumers suffer the same third party effects (i.e., } \phi \neq 1). \text{ In that case, the impact from regulating the activity would be:} \\
&\delta \pi_i + f_i \\
&\text{Comparing this result to the impact on the country if it allows the activity } (\pi_i + f_i) \text{ shows that it will never be in the country’s interest to regulate. In other words, a complete absence of extraterritoriality – by which is meant a total inability to affect the impact of an activity on consumer welfare – implies that a country will never seek to regulate an activity. On the other hand, an ability to regulate extraterritorially implies that by preventing the activity a government can fully insulate local consumers from the third party effects } (\phi = 0). \\
&\text{More generally, as the impact of regulation on local profits } (\delta) \text{ gets smaller relative to the impact of regulation on local third party effects } (\phi), \text{ governments are less likely to regulate cross-border transactions because their producers are denied the benefits of the activity while their consumers are not protected from its harmful effects.} \\
\textsuperscript{65} \text{U.S. v. Aluminum Co. of America } ("\text{Alcoa}"), \text{ 148 F.2d 416 } (2d \text{ Cir. 1945}). \\
\textsuperscript{66} \text{A. Ahlstrom Osakeyhty v. Commission } ("\text{Wood Pulp}"), \text{ 1988 E.C.R. 5193, 4 Common Mkt. Rep. (CCH) S 14,491, at 18,612 (Sept. 27, 1988).}
international cartel arrangement intended to both increase market power through a strategy of collusive pricing and force competitors out of the industry through predatory pricing, tying arrangements, and so on. The government must decide whether to permit the activity to go forward or prevent its local firms from participating. If the government prevents local firms from participating, there are two effects. First, the prohibition on participation by local firms reduces the profits enjoyed by these firms. The extent to which local profits are hurt depends on the details of the transaction. We know that the firms will suffer at least some reduced profits relative to what they would earn if they participated – otherwise they would not seek to participate. It is possible that the cartel arrangement will benefit them even if they are not included because the new cartel may set prices high and local firms may be able to simply follow suit and increase profits. On the other hand, being excluded from the cartel may reduce their profits below the pre-cartel level of profits. This could occur, for example, if the cartel succeeds in excluding local firms from suppliers, distributors, and so on.

In addition to the firms, local third parties may also stand to lose from the transaction. In the most extreme form of territoriality, the exclusion of local firms would fail to shield local third parties who would suffer the same loss regardless of whether or not local firms are permitted to participate. If this is so, the country would clearly be better off by allowing local firms to participate. At the other extreme, if by preventing local firms from participating a country could cause the entire transaction to fail, it would be better off to regulate any transaction that yields a net loss to locals. In this case, however, we are in practice no longer dealing with a strictly territorial policy.

The intuition behind this lesson is that a country that does not apply its laws extraterritorially can use regulation to reduce the profits enjoyed by local firms, but cannot directly influence the magnitude of third party effects. As a result, a government may permit a transaction that reduces the welfare of the country because the alternative of preventing
local firms from participating while leaving third parties exposed to loss would yield an even greater welfare loss. More generally, as the impact of regulation on local profits gets larger relative to the impact of regulation on local third party effects, governments are less likely to regulate cross-border transactions because their producers are denied the benefits of the activity while their consumers are not protected from its harmful effects. Thus, an absence of extraterritoriality leads to under-regulation because local residents feel the full impact of the third party effects but local business will enjoy only a fraction (or perhaps none) of the benefits from the activity.

The relationship among European countries and their competition (i.e., antitrust) policies prior to the unification of Europe provides a clear example of this lesson. Prior to unification, European countries did not apply their competition laws extraterritorially, and national competition laws were uniformly permissive. Following unification, authority over competition policy was passed to the European, rather than national, level. As compared to the competition laws of any single member country, a European law more effectively prevents or reduces the impact of potentially anti-competitive behavior on consumers because it is better able to regulate the entire transaction rather than just a small portion. In a similar fashion, European regulation is more effective at reducing the impact of a transaction on the profits of non-participants. As the prior discussion predicts, the European Union adopted a European competition law that was much stricter than the national laws it replaced. Because individual countries had not applied their laws extraterritorially, they had been under-regulating in the competition policy area.

67 Note that this ratio represents a reasonable measure of extraterritoriality.
68 This has the effect of reducing $\phi$ in note 64.
69 This is equivalent of bringing $\delta$ closer to unity in note 64.
One implication of Lessons #2 and #3 is that the extraterritorial application of law can be neither embraced nor condemned as a general matter. Neither territorial nor extraterritorial application of law is efficient, and the question of which is more efficient is impossible to answer without more information about the details of a particular transaction or industry. Thus, for example, European objections to the extraterritorial application of American antitrust laws from the late 1940’s until the 1980s cannot be supported without a much more complex discussion and analysis than was ever advanced.

D. Lesson #4: Contracting for Choice of Law

*In the absence of third party effects, the parties to the transaction should be permitted to choose the applicable law through contract.*

This lesson is a recognition of, and deference to, private ordering. It is well established in the legal literature, and no claim of originality is made here. The lesson is presented for two reasons. First, it is done to demonstrate that the model is consistent with this most basic of intuitions regarding choice of law. Second, because a brief discussion of this simple lesson improves our understanding of other, less obvious ones.

Because private parties are assumed to engage in transactions only when it is in their interest to do so, it must be that the direct effects of a transaction are positive for every country. If there are no third party effects under our framework, then private welfare and social welfare are equivalent. The transactions that parties choose to make will be both welfare increasing and value maximizing because the parties to the transaction will seek the

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70 See, e.g., MICHAEL TREBILCOCK, THE LIMITS OF FREEDOM OF CONTRACT (1993). For an explicit argument in favor of this lesson in the choice of law context, see O’Hara & Ribstein, supra note 6.

71 Recall that the impact of a transaction on parties considered to be incompetent is treated as third party
highest possible return. One way in which they will seek to maximize their return is by selecting the legal regime that is best suited to their needs. As this also maximizes the societal return, there is no reason to prevent such a selection.

This lesson implies that parties should be permitted to choose from the law of any jurisdiction or even agree on a set of custom rules to govern the transaction entirely through contract. This approach is fundamentally what drives debates in both the securities and bankruptcy fields. In securities, proposals have been made to allow issuers of securities to select the law that will apply to their issue. The basic premise of these arguments is that only the parties to the transactions are affected and they are able to judge the worth of alternative choice of law clauses. In the bankruptcy context, with respect to both domestic bankruptcy law and transnational bankruptcies, proposals have been made to give firms the ability to select the applicable bankruptcy law. These proposals argue that if the law is chosen before the firm accumulates any debt, creditors will be able to adjust the terms of their lending to take the bankruptcy regime into account. As a result, the firm will have an incentive to choose the most efficient regime in order to ensure that it can get access to capital at the lowest possible cost.

effects.


Professor LoPucki has responded that the existence of non-adjusting creditors, who are not represented in the standard models of international bankruptcy, make a contracting regime undesirable. See Lynn M. LoPucki, Cooperation in International Bankruptcy: A Post-Universalist Perspective, 84 CORNELL L. REV. 696 (1999). But see Rasmussen, Transnational Insolvencies, supra note 73, at 21-22 (arguing for limits on contracting in order to take these creditors into account).
In both the securities and bankruptcy contexts, therefore, there are strong arguments that there are no significant third party effects that need to be considered. In both areas, however, some commentators believe that such effects exist and should be taken into account through restrictions on the choice available to the parties to the transaction. In the securities context there are two primary concerns. The first is that managers – who ultimately make the decisions – will seek private benefits at the expense of shareholders, generating a loss to the firm. For example, a manager might wish to engage in self-dealing to the detriment of shareholders, who are treated as third parties. A second concern is that investors, although consensual parties to the transaction, may not be able to judge the value of a security. In efficient markets, this is not a serious concern because investors enjoy the protection provided by the market. In inefficient markets, however, there may be a more serious problem. In such a situation, investors may not be able to assess the value of the chosen legal regime which may lead to a race to the bottom as issuers seek regimes with low protections and regulators seek to accommodate the desires of issuers in order to attract securities. In essence, certain parties to the transaction are treated as third parties because they are unable to determine if a transaction is in their own interest. In the bankruptcy context, it is argued that certain creditors are unable to adjust the terms of their lending at the time of contract. This may be so because they are non-consensual lenders, such as tort claimants, or because they are unable to alter the terms of their lending to take into account the risks they face.


There is a temptation to expand Lesson #4 to include the proposition that a country should not be permitted to exercise jurisdiction over a transaction if it feels no third party effects, even if some other countries do experience third party effects. This conclusion, however, is not accurate, as demonstrated by Lesson #5 blow.

E. Lesson #5: Identifying Interested Jurisdictions

Any country for which either direct or third party effects exist may have an interest in the transaction and may wish to exercise jurisdiction. A country should not be excluded from exercising jurisdiction simply because there are no third party effects felt within the jurisdiction.

To carry out a choice of law analysis in a particular case, we must first determine whether a particular jurisdiction has an interest in the transaction. That is the role of this lesson. Once we have identified those jurisdictions that have an interest, it becomes necessary to evaluate the jurisdictional claims of each. This second step is difficult and in many cases no satisfactory solution exists. It is, nevertheless, worth identifying those countries that have an interest in the transaction as this often simplifies the problem.

For our purposes, a jurisdiction is interested in a transaction if the transaction has an effect on a jurisdiction. A transaction has effects within a country if there are parties to the transaction located in the country, if third party effects are felt within it, or both.

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77 In fact, this might even be expanded to claim that country i should not exercise subject matter jurisdiction as long as local third party effects are positive ($f_i \geq 0$).

78 In theory, a participant to a transaction may face a benefit of zero. It may, for example, be participating because a refusal to participate would lead to a loss. It is also possible that the benefits enjoyed by the parties to a transaction exactly offset the costs borne by third parties. In both of the above theoretical situations, there are no net effects felt by the country, and it has no serious claim to jurisdiction. Because both of these situations are unlikely, and because they will be very difficult to observe in practice, they are not discussed.
If a country faces no third party effects, it will permit the activity if and only if the
direct effects felt within the country are positive. As has already been mentioned, this means
that it will permit any activity that firms wish to undertake. If, on the other hand, third party
effects affect the citizens of another country, they will permit the activity if and only if the
sum of direct effects and third party effects within their country is positive. Although it is
ture that the first country will not regulate optimally, the same can be said of the second
country. Without additional information, it is impossible to know which country’s regulation
will be closest to the optimum. If countries which feel no third party effects are excluded
from jurisdiction, there will be a bias toward over-regulation because those countries are the
least likely to impose burdensome regulations. Consider the following example.

Example. Suppose that only two countries are affected by a transaction. In country
A, there are many firms participating in the transaction, and they stand to enjoy a total
increase in profits of $100. There are no third party effects in A. In country B, on the other
hand, there is only one firm participating, and it stands to gain $10. In country B, however,
there are also third parties who will be harmed by the transaction. They face a cost of $50 if
it goes forward.

It is clear that this transaction is value increasing from a global perspective. If
country A has exclusive jurisdiction, it will permit the transaction to take place and
worldwide surplus will increase by $40. If country B has jurisdiction (and is able to exercise
it extraterritorially), however, it will prevent the activity, frustrating this value creating
transaction.
F. Lesson #6: The Hartford Fire Case is Wrong

Where two countries have a jurisdictional claim, the fact that the law of one country is silent on the issue should not imply that the other country’s law governs.

This Lesson is perhaps the most controversial in the Article in as much as it is in direct conflict with the views of both the Supreme Court and many prominent choice of law commentators. Contrary to the lesson presented here, it is a commonly, though not universally, held view that there is no “true conflict” between the laws of two or more jurisdictions when only one of those jurisdictions proscribes the activity. In the absence of a “true conflict,” the dominant view is that the country whose laws deal with the activity in question should apply. The Supreme Court adopted this view in the well-known Hartford Fire case.

In Hartford Fire Ins. Co. v. California, nineteen American States and many private plaintiffs filed suit against a group of defendants consisting of primary insurers, reinsurance companies, and trade associations. The plaintiffs claimed that the defendants had violated the Sherman Act by engaging in conspiracies intended to affect the American insurance market. The actions of the defendants were apparently legal under British law. “[The British]
Parliament has established a comprehensive regulatory regime over the London reinsurance market and . . . the conduct alleged here was perfectly consistent with British law and policy.”

Based on the legality of the conduct in Britain, defendants argued that U.S. courts should decline to exercise jurisdiction under principles of international comity. The Supreme Court, however, held that there was no “true conflict” between British and American law. “Since the London reinsurers do not argue that British law requires them to act in some fashion prohibited by the law of United States or claim that their compliance with the laws of both countries is otherwise impossible, we see no conflict with British law.” In other words, because British law permits but does not compel the conduct, there is no conflict between that law and a U.S. law that prohibits the conduct.

The Supreme Court’s approach in *Hartford Fire* is consistent with the view taken by the Restatement (Third) of Foreign Relations Law, which states that “where a person subject to regulation by two states can comply with the laws of both” there is no conflict, “even where the foreign state has a strong policy to permit or encourage such conduct.” The same view is advanced by the mainstream of American conflicts scholars. Professor Kramer, for example, writes that “[a] choice of law problem exists only if the different laws relied on by the parties can plausibly be construed to govern the case.” Kramer begins his discussion with purely domestic cases, noting that even when only one jurisdiction is involved, there

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83 *Id.* at 798.
84 *Id.* at 799.
85 Restatement (Third) of Foreign Relations Law § 415, Comment e. The Hartford Fire Court quotes this exact language in its opinion. 509 U.S. at 799.
86 Kramer, *Rethinking Choice of Law*, supra note 35, at 283. Although the above quote refers to a dispute within a single jurisdiction, his point is that the same analysis applies in multistate cases. In the multistate context, he writes, “the court should first examine the laws in issue to determine whether both apply, i.e., if there is a conflict. If there is a conflict, the court should then employ some second order rule of
may be choice of law questions. The parties, for example, may each cite law that supports their own position, and it is then up to the court to determine which law applies. In such a domestic setting governed by a single legislative body, Kramer is correct in his conclusion that if only one law applies to the plaintiff’s claim, the choice of law question is resolved. In the interstate setting, however, Kramer’s view is problematic. Where the laws of two jurisdictions are implicated, the fact that only one law proscribes an activity should not be considered conclusive because one must allow for the possibility that the other jurisdiction has an interest in permitting the conduct of the defendant. This is not an issue in the domestic setting because a single legislative institution is responsible for the legal rules. In the domestic setting, a policy of permitting an activity to proceed without regulation can be applied simply by avoiding such regulation. In the interstate context, however, no single legislature is able to bring about a permissive policy in the face of regulation by another state. For this reason, silence on an issue should be viewed as permissive.

The current debate about “true conflicts” fails to take sufficient note of the fact that a jurisdiction often has an interest in permitting – but not mandating – an activity. Because it is unusual for a country to enact statutes declaring a particular activity permissible, it is not enough to look simply to the statutes of a jurisdiction in order to determine if there is a conflict with the laws of another jurisdiction. In many cases the absence of proscriptive law will be the result of a national interest in permitting the activity.

To demonstrate the point, imagine an activity that is welfare improving from a global perspective and from the national perspective of every country except country A. In country A, the activity causes a reduction in welfare. In every country other than A, the activity is interpretation to choose between these laws.”  

*Id.* at 291.
welfare increasing and there is no reason for the government to impose regulatory restrictions. Nor is there any need to compel participants to undertake the activity because they will choose to do so of their own accord. The laws of every country other than country A, therefore, are likely to be silent with respect to this transaction. Country A, however, will seek to prevent the transaction in order to avoid a loss of welfare. Under the *Hartford Fire* approach, a court charged with settling a conflicts issue between country A and one or more of the other countries would note that only country A has laws that deal with the issue, and, therefore, there is no true conflict.

Lesson #2 above indicates that the non-cooperative outcome will lead to systematic over-regulation because it is the laws of the most restrictive interested country that will bind private actions. Adopting the *Hartford Fire* approach compounds this problem of over-regulation. It causes choice of law rulings to systematically favor more, rather than less, regulation by always selecting a regime with regulation over one without.

This Lesson demonstrates that a different analysis of the *Hartford Fire* case is needed. The fact that British law is silent on the question should be taken to imply that British policy is permissive with respect to such activity. This would generate a “true conflict” with U.S. law. The question of which law should govern is problematic because neither country has an incentive to adopt the globally optimal set of regulations, a point that is presented in Lesson 1. The *Hartford Fire* approach admittedly reduces the number of true conflicts, but it does so in a manner that undermines the efficiency of the choice of law system.87

87 Obviously the mere fact that an approach reduces the number of conflicts cannot be sufficient grounds for adoption because one could eliminate all conflicts by, for example, flipping a coin. Although this would resolve conflict problems, it is not a desirable policy.
It is true that silence may also imply indifference to regulation and, in such cases, it would be harmful to frustrate the efforts of other countries to regulate an activity. For this reason, it may be desirable to give the parties an opportunity to present evidence regarding the interests of the silent jurisdiction. Where it appears that a jurisdiction has no interest in allowing the activity, the *Hartford Fire* rule could be applied. The presumption, however, should be that a silent country whose laws are implicated has an interest in permitting the activity.\(^{88}\)

The difference between this Lesson and the *Hartford Fire* approach is a product of the difference between the economic approach adopted in this paper and the more traditional doctrinal approach taken in most conflicts scholarship. Unlike the approach adopted by the Supreme Court, the Restatement, and traditional conflicts scholars, the exercise proposed in this paper is not merely to determine if “some rule of positive law confers a right to recovery,”\(^{89}\) but rather to contribute to the development of a set of background rules that increase the efficiency of the international system and encourage legislatures to adopt optimal rules.

### G. Lesson #7: The Location of the Parties and Domicile Tests

*That a resident or domiciliary of a jurisdiction is a party to a transaction justifies the presumption that the jurisdiction has an interest in permitting the activity but does not, by itself, justify application of regulation by the jurisdiction.*

\(^{88}\) At issue here is the question of whether a jurisdiction has enacted a substantive rule to regulate an activity. This is different from the question of whether a jurisdiction has chosen to extend the reach of its laws
If a resident or domiciliary from country A is a party to the transaction, jurisdiction A may have an interest in allowing that activity, as shown in Lesson 6. In other words, there should be a presumption that A’s regulatory scheme be considered.

If there are no third party effects felt in A, however, there is no justification for applying A’s regulatory scheme if it is “stricter” than the regulatory scheme of other affected countries. In other words, the fact that A has an interest in permitting an activity does not necessarily mean that A has an interest in regulating it. This lesson, therefore, can help to resolve cases in which more than one country has an interest in the transaction.

Imagine, for example, a U.S. issuer that issues securities in France and sells only to French investors. The United States may have an interest in permitting this activity, but it has no identifiable interest in regulating it. Because the French rules are less stringent than the rules of the United States, there is no reason for the United States to seek to exercise jurisdiction over the transaction. The individuals whose interests are protected by the regulation (the investors) are all French so there is no reason to apply any law other than French law.

Although residence and domicile play only a small role in the choice of law question, they have the advantage of being easy to observe and verify. To the extent that they are closely related to the location of effects, therefore, they may serve as proxies for effects.\textsuperscript{90} Recall that the definition of “effects” used in this Article includes effects on the parties to a transaction. The fact that domicile and residence are often so closely connected to effects felt beyond its own borders, an issue taken up in Part VI.A.

\textsuperscript{89} Kramer, supra note 35, at 290.

\textsuperscript{90} The relative importance of domiciliary and territorial factors has been, and continues to be much debated. Beale’s vested rights approach suggested that territoriality was the better approach, while Currie’s interest analysis recommends a domiciliary approach. As this paper indicates, neither approach is conceptually
by the parties to the transaction means that their use as a basis of jurisdiction will normally pose no serious problems. However, it should be remembered that it is not the domicile itself that justifies jurisdiction, but rather the effects of the transaction.

The ability to use domicile or residence as a proxy for effects may explain the historical use of these doctrines. At a time when the vast majority of transactions were local, there would have been relatively few cases in which effects crossed jurisdictional borders. A test based on residence may have been the most efficient option because one based on the location of effects would risk over-reaching by courts and would lead to costly litigation to identify effects. In today’s world, however, the frequency and magnitude of cross-border transactions requires the use of different jurisdictional touchstones.

Our focus on effects helps to clarify another important question regarding domicile—whether it should be viewed as an exclusive basis for jurisdiction. Once it is recognized that domicile is useful because it proxies for effects, it is clear that it should not be an exclusive basis for jurisdiction. Other jurisdictions in which the effects of the transaction are felt may also have a strong claim to jurisdiction.

**H. Lesson #8: The Conduct Test**

*Because we are only interested in effects, the location of the activity, the place of contracting and the place where the action is brought are not relevant to the choice of law question.*

Among the tests commonly used to determine jurisdiction is what is termed the “conduct test.” This test bases jurisdiction on the location of the relevant conduct and correct, but both may serve as proxies for effects in certain instances. *See LEA BRILMAYER, CONFLICT OF LAWS*
represents one of the most traditional bases for jurisdiction.\(^91\) The conduct test is commonly used in order to determine, for example, whether U.S. securities laws have jurisdiction over alleged violation of antifraud rules.\(^92\)

Although tests based on the location of activity are widely used, they have no direct bearing on the impact of behavior on welfare. They should, therefore, represent neither necessary nor sufficient conditions for jurisdiction. Suppose, for example, that a non-American issuer of securities engages in activities that would constitute fraud under American securities laws, and the activities in question take place in New York City. Assume that the securities are sold to an investor who is not a resident of the United States, but the transaction also takes place in New York City. Under these facts, the transaction would almost certainly be regulated under the existing laws of the United States.\(^93\) Notice, however, that the transaction has no effect on U.S. residents. Absent such an effect, there is no reason for American regulatory authorities to take an interest in the case and, therefore, no reason for the United States to have jurisdiction over the transaction.

One common justification for the regulation of this sort of transaction under U.S. securities laws is that the laws exist not only to protect individual investors, but also to protect the integrity of capital markets in the United States. If transactions such as the one outlined above are deemed to be beyond the regulatory reach of U.S. securities laws, the argument goes, market participants will be unable to distinguish between transactions that are protected by American law and those that are not so protected.

\(^1\) (1995).  
\(^92\) See Choi & Guzman, supra note 13 at 215-19.  
\(^93\) See Schoenbaum v. Firstbrook, 405 F.2d 200 (2d Cir. 1968); Bersch v. Drexel Firestone, 519 F.2d 974 (2d Cir. 1975).
Professor Choi and I have argued elsewhere that the market will, in fact, be able to distinguish between those securities that are subject to U.S. law and those that are not. Regardless of one’s view on the question of whether the above transaction would undermine the integrity of local capital markets, however, it is not the location of the conduct that justifies the jurisdictional claim. Justifying regulation in this case requires the claim that the transaction harms local capital markets, which amounts to a claim that the transaction has a negative impact on third parties who are participants in U.S. securities markets. This amounts to an effect on U.S. capital market participants, including many U.S. residents. The justification for regulation, therefore, is based on effects felt by residents of the United States, not on the location of the transaction.

Notice that the same concerns may arise in a securities transaction that takes place in a location outside the United States. Imagine a Japanese issuer of securities who sells securities to U.S. investors. Assume that the transaction takes place in Japan. As is the case with the previous example, the location of the transaction is not enough to determine jurisdiction. We must, once again, inquire as to the effects of the transaction on U.S. residents. First, the fact that the investor is from the United States may be sufficient to establish effects within the United States, although Lesson 4 suggests that the parties should be permitted to select the applicable law. Alternatively, if one assumes that the investor is unable to protect his interests, then the investor himself should be treated as a third party to the transaction, implying that the transaction has an effect within the United States. In either case, these

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94 Choi & Guzman, supra note 9.
95 Given the state of modern communication technology, of course, it may not always be clear exactly what is required for a transaction to “take place” in a particular location. In the transaction mentioned, for example, it is possible for the investor to be in Los Angeles, while his broker is in New York, and the issuer and its underwriter are in Japan. We put the complexities of the location of the transaction aside for the purposes of
effects, felt within the United States, imply that the United States has an interest in the transaction. These examples are not intended to establish the appropriate jurisdictional reach of the securities laws. They are simply intended to demonstrate that the location of the transaction is not a useful test for the jurisdictional reach of the laws.

Although the location of the transaction does not itself serve as an appropriate basis for jurisdiction, it may serve as a proxy for effects. The location of a transaction may be a useful proxy for effects where the impact of a transaction is likely to be felt by those who are close to the location of the transaction, and where a judicial inquiry into the presence of effects is costly and/or inaccurate. By using the location of the transaction, as a proxy one avoids the costs and uncertainty of an effects-based test. These benefits may outweigh the costs generated by the fact that location is an imperfect proxy for effects.

Two points are worthy of note, however. First, the location of the transaction is becoming a less reliable proxy. Technological advances in communication often allow the parties to a transaction to select the location in which it will take place. This location may be far removed from the site of the effects of the transaction. For example, a securities transaction can be structured to take place – in the sense that documents are signed and exchanged – almost anywhere in the world. Similarly, firms engaged in activities in violation of antitrust laws can arrange to meet and discuss their intentions in a location of their choosing. The low cost of travel and communication implies that the location of their meetings and discussion will be a poor proxy for the effects of their actions. Even more dramatic, of course, is the Internet, which allows immediate worldwide dissemination of information, making it possible to locate certain transactions virtually anywhere in the world.

this example and simply assert that, regardless of the manner in which the location of the transaction is defined,
Second, if the location of the transaction is to be used as a proxy for effects, it is important that it be understood as such. In certain contexts, the location itself assumes importance that is not merited by its role as a proxy for effects. This is the case, for example, in the securities context. The debate over whether to regulate such a transaction, therefore, should focus not on the location of the transaction, but on the question of whether or not such third party effects exist. If they do there is at least some basis for jurisdiction.

Many current jurisdictional debates focus on the question of whether a territorial approach is better or worse than a contractual approach. Sophisticated proponents of a territorial approach to jurisdiction rely on the role of territorialism as a proxy for third party effects. Those who argue for a contractual approach believe that such third party effects are small. If there are no third party effects, then the contractual choice of law should be honored. In corporate law, there is ongoing debate about the advantages and disadvantages of a system that allows firms to select, through their place of incorporation, the applicable corporate law. Those that support this approach argue that shareholders choose the place of incorporation efficiently because they internalize the costs and benefits of their choice. Those that critique the existing system claim that the principal-agent problem between shareholders and managers prevents the latter from taking all costs and benefits into account when they choose a jurisdiction on behalf of shareholders.96

Notice that both sides of the debate would agree that there is nothing inherent in the place of incorporation that should determine jurisdiction. Rather, the debate asks whether there are third party effects that make it inappropriate to allow the firm and its managers to choose the applicable law.

the transaction takes place in Japan.
The debate over the proper jurisdictional reach of American securities regulation takes place along largely the same lines. Once again, the location of any particular conduct is not at issue. Commentators focus instead on whether there are third party effects and the probable location of those effects. Professor Merritt Fox, for example, argues for a territorial approach to the regulation of international securities offerings. He does so not because territoriality represents a meaningful basis for jurisdiction, but rather because he believes that territoriality provides a good proxy for the location of third party effects.

In the bankruptcy area, there is an ongoing debate about how to allocate jurisdiction over a bankrupt enterprise. Some commentators propose a system that would allow firms to choose the applicable bankruptcy regime at the time of their incorporation. As long as all creditors are aware of this choice and able to adjust, we should allow debtors and creditors to select the legal regime that will govern a bankruptcy. Those who oppose this view do so on the grounds that there are third party effects for which mandatory bankruptcy rules are more appropriate. In the international sphere, a related debate exists. Most commentators believe that bankruptcies should be wound up under the laws of a single jurisdiction. The opposing view is territorial in nature – the location of the assets should determine jurisdiction. The better versions of the latter argument rely on the presence of creditors whose location is

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96 See supra note 8.
97 See supra note 9.
98 Fox, supra note 9.
99 See supra note 73.
100 See LoPucki, supra note 8.
correlated with the location of the assets and who are unable to adjust to bankruptcy rules other than those present in the local jurisdiction.102

VI. POLICY IMPLICATIONS

A. The Presumption Against Extraterritoriality

Where a statute is silent as to its extraterritorial effect, it should be interpreted as being strictly territorial.

Many statutes are silent as to their extraterritorial effect. It often falls to the courts to determine the reach of such statutes. A long-standing canon of statutory interpretation states “that legislation of Congress, unless a contrary intent appears, is meant to apply only within the territorial jurisdiction of the United States.”103 In order to overcome the presumption, a party must show “the affirmative intention of Congress clearly expressed.”104 This interpretative principle was pivotal in the antitrust case, American Banana Co. v. United Fruit Co.,105 in which Justice Holmes penned perhaps the most famous statement of the rule, “the general and almost universal rule is that the character of an act as lawful or unlawful must be determined wholly by the law of the country where the act is done.”106

Although the presumption against extraterritoriality remains part of the legal landscape, it has suffered a significant loss of influence. In the antitrust area, for example, the

105 213 U.S. 347, 357 (1909) (“The foregoing would lead, in case of doubt, to a construction of any statute as intended to be confined in its operation and effect to the territorial limits over which the lawmaker has
American Banana precedent was avoided by courts for many years and ceased to be the applicable law by the mid 1940s. The presumption has been overlooked in other areas of law as well, including securities law. Reflecting the decline of the presumption against extraterritoriality, the Restatement (Second) of Foreign Relations Law states that the presumption exists but applies “only to conduct occurring within, or having an effect within, the territory of the United States.” The Restatement (Third) went so far as to state that Justice Holmes’ statement of the presumption against extraterritoriality, “though still often quoted, does not reflect the current law.” Finally, the Supreme Court failed to apply the presumption against extraterritoriality in Hartford Fire Insurance Co. v. California, an antitrust case decided in 1993.

Despite its decline the presumption against extraterritoriality has not completely vanished. In recent years it has been applied to a variety of cases before the Supreme Court, most prominently, E.E.O.C. v. Arabian Oil Co. (“Aramco”). In the Aramco case the Court refused to apply Title VII extraterritorially in the case of discrimination by an American company against an American employee abroad.

From the perspective of a court, of course, it would be preferable if every statute specified the extent to which it should apply extraterritorially. Where such instruction is

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106 Id. at 356.
109 Restatement (Second) of Foreign Relations Law § 38 (1965).
absent, however, the objective of achieving a globally efficient choice of law regime is best served through application of the presumption against extraterritoriality. The alternative presumption—that silence implies extraterritorial effect—will not only increase the frequency of conflicts, it will also lead to over-regulation, as demonstrated in Lesson #2.

The presumption against extraterritoriality is the subject of some debate in academic circles. Some commentators argue that whatever role the presumption has played in the past, it is no longer an appropriate canon of interpretation. In fact, it is more appropriate than ever because there are more international contacts and more conflicts, increasing the value of rules to resolve conflicts in efficient ways.

Sovereign States can, of course, choose to have their laws apply extraterritorially. If the benefit to the country of having the law apply extraterritorially is substantial, the legislature can apply the law to conduct that takes place abroad, and it can define the precise reach of the statute. This provides guidance to the courts and to the parties to the transaction which increases predictability—a good in itself. More importantly, in those situations in which a country has little or no interest in the extraterritorial application of its laws a legislature is least likely to specify the extraterritorial reach. These are also the contexts in which one or more other countries are likely to have a greater interest in regulating a transaction. In other words, the presumption against extraterritoriality is a mechanism to eliminate conflicts where one country has very little interest—and therefore should probably not exercise jurisdiction. Although not a perfect filter for cases in which the jurisdiction has little interest, this approach serves to combat the tendency toward over-regulation.

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It is true that a presumption against extraterritoriality tends to bias the international system toward less, rather than more, regulation. In particular, Lesson #3 points out that territoriality leads to under-regulation, implying that a presumption in favor of territoriality might lead to under-regulation. Although there is some merit to this concern, the presumption against extraterritoriality remains a valuable choice of law tool. Concern for under-regulation brought about because of the presumption is overstated primarily because the costs of too little regulation fall on local residents. Thus, if there is under-regulation, the country that bears the cost can correct the problem by specifying the reach of its laws. If the country chooses not to correct the problem of under-regulation, it is because the costs are small. In this sense, there is an automatic correction mechanism in place. It is also useful to note that the alternatives – a presumption in favor of extraterritoriality or case-by-case determination by courts – also come with significant costs. In either case, courts are likely to extend the jurisdictional reach of a statute more than is globally optimal either because doing so is in the national interest or because the court is concerned about a particular plaintiff in a particular case. If this is done, Lesson #2 demonstrates that the result is over-regulation. In this context, however the costs of the over-regulation are borne by foreigners, so there is no reason for the legislature to alter the jurisdictional reach of the law. There is no mechanism in place to correct the over-regulation that results when the presumption of extraterritoriality is ignored.

B. National Treatment of Foreign Plaintiffs

*National Treatment of foreign plaintiffs should be required.*

Governments typically legislate with respect to a broad class of transactions. This fact reduces the distortion of the legal rules resulting from strategic behavior because rather than
evaluating each individual transaction in terms of its effect on national welfare, policy makers must adopt rules that apply to groups of transactions. This grouping of transactions makes it more likely, though by no means certain, that the domestic gains from adopting a globally efficient rule outweigh the gains from adopting less efficient alternatives.

Imagine, for example, an activity that yields benefits to the participants but has negative third party effects. If a detailed review of the direct and third party effects of a transaction is not possible, legislators will adopt a rule that maximizes the total national benefit from those transactions. The rule will not be perfect for every transaction because a general rule is necessarily more crude than case-by-case review. If, on the other hand, it were possible to review each transaction separately, the law would permit a transaction based on the costs and benefits of that transaction. Such a rule would allow the jurisdiction to prevent any transaction that is not advantageous to local residents.

A separate review of the costs and benefits of each transaction is obviously better from the perspective of national welfare because it tailors the regulation much more closely to the question of whether or not a transaction increases national welfare. One of the effects of this review, however, is that it allows countries to discriminate between residents and foreigners. The following example illustrates this point.

**Example.** Imagine a transaction between two parties, each of whom stands to gain 100. There are also third party effects that impose a total cost of 150. Assume that this same transaction takes place frequently, though with different parties each time. It is clear that the transaction is welfare increasing and, from a global perspective, should be allowed. Assume that there are two countries, A and B. If country A can evaluate the costs and benefits of each transaction individually, it will enact laws that permit the transaction when the local benefits exceed the local costs. If the entire transaction takes place in A, it will be permitted.
If one of the parties to the transaction is located in B while the other party and all the third party effects are in A, it will be prevented. Country A’s ability to evaluate the transaction on a case-by-case basis gives it the opportunity to discriminate against residents of B. As a result, some efficient transactions are prevented.

Now suppose that country A cannot evaluate the costs and benefits of each transaction. Instead, it must adopt a law either permitting or preventing all such transactions. Assuming that country A gets the benefits from the transaction as often as it gets the losses, it will choose to allow the transaction. From the perspective of country A some permitted transactions will cause a national welfare loss, but when taken as a group the transactions will lead to a welfare gain. More importantly, notice that A has adopted a rule that is consistent with the efficient regime. It has done so because it was unable to discriminate against residents in B.

If national lawmakers and regulators are unable to discriminate between locals and foreigners, they will have to treat all transactions of a certain type in the same way, even when it is foreigners who stand to benefit. This restriction encourages more efficient rules. If locals are as likely to gain or lose from a transaction as are foreigners, the best law from a national perspective is the same as the best law from a global perspective. For any specific transaction locals may win or lose, but if legislators are unable to discriminate among policies ex post, their ex ante policies will be globally optimal.114

Consider, for example, the U.S. Bankruptcy Code, which permits U.S. creditors to prevent the turnover of local assets to a foreign jurisdiction by showing prejudice or inconvenience.115 Such legislation instructs courts to make a choice of law decision in order

114 The assumption that the costs and benefits are distributed across countries according to the same distribution is strong. It is relaxed below.
to advance the interests of local creditors. It is widely agreed that this policy is inefficient, but
it is defended on the grounds that it protects local creditors in those individual cases in which
the gains from refusing turnover outweigh the costs.\textsuperscript{116}

Imagine how the law might be different if such discrimination were not permitted.\textsuperscript{117}
A national treatment standard of this sort gives every creditor—and not only local creditors—the option of preventing the turnover of assets and ensuring their distribution under local law.
Because the distribution of assets in bankruptcy is a zero sum game,\textsuperscript{118} it is likely that at least
some creditor prefers distribution under local law.\textsuperscript{119} Assuming that foreign creditors are as
likely as U.S. creditors to prefer distribution under local law, § 304 would be as likely to harm
the interests of U.S. creditors ex post as it would be to advance those interests.

As a result, the incentives of legislators would be changed. Local interests would not
be served, in expectation, by the prevention of the turnover of assets. Because the effect of
multiple adjudication is to increase the cost of the bankruptcy (and potentially frustrate a
reorganization), a law that permits a party to prevent the turnover of assets would have, in
expectation, a negative impact on local welfare and legislators would have no incentive to
adopt such a rule. Notice that, in this case, once national treatment is required, national
interests become identical to global interests.\textsuperscript{120}

\textsuperscript{116} See LoPucki, supra note 8.
\textsuperscript{117} That is, imagine that creditors from any jurisdiction could prevent the turnover of assets on the same
terms as U.S. creditors.
\textsuperscript{118} For simplicity assume that we are dealing with a liquidation proceeding rather than a reorganization,
which need not be zero sum.
\textsuperscript{119} Because it is costly to all concerned to litigate in multiple fora, it is possible that in some cases no
creditor will seek to block the turnover of assets. Nevertheless, national treatment will greatly increase the
frequency with which some parties will object to the turnover.
\textsuperscript{120} I use § 304 of the Bankruptcy Code merely for purposes of illustration. There is an existing debate
regarding the value of that provision and my views on that debate are expressed elsewhere. See Bebchuk &
Guzman, supra note 8; Andrew T. Guzman, International Bankruptcy: In Defense of Universalism, MICH. L.
REV. (forthcoming 2000). In particular, I am convinced that § 304 as currently constructed is welfare reducing
This proposal also prevents a variety of regulations that are designed to permit local actors to enjoy the benefits of an activity while exporting the harm. The most conspicuous example of this sort of activity is export cartels, which are explicitly excluded from the antitrust laws. If the requirements of these exemptions are met, foreign parties injured by activities that take place within the U.S. have no remedy available under U.S. law. Obviously such a rule is inefficient as it allows globally inefficient activities to take place.

As presented above, a national treatment standard prevents a jurisdiction from distinguishing between local and foreign plaintiffs. If the potential defendants are within the jurisdiction, all costs and benefits are internalized once we allow foreign plaintiffs to sue on the same terms as local plaintiffs. It remains possible, however, for the jurisdiction to adopt substantive rules that favor locals when potential defendants are abroad. For example, imagine a case in which there are no U.S. parties to the transaction, but negative third party effects are felt in the United States. Because there are no benefits within the United States, there remains an incentive to over-regulate the transaction, as discussed in Lesson #2. For this reason, although national treatment is desirable, it alone does not solve all choice of law problems.

for both the United States and the world. For the purposes of this illustration, however, I have assumed that there is some value for the United States in the current construction of the rule.


122 In order to get full internalization of costs in all cases, it is necessary to vest exclusive jurisdiction in the country that enjoys the positive effects from the transaction. For example, if all parties to the transaction are in Australia, and if there are no positive third party effects, a combination of national treatment of plaintiffs and exclusive jurisdiction in Australia would lead to an efficient outcome because Australia would internalize all costs.
C. Private Rights of Action

Wherever possible, private rights of action should be allowed.

National treatment provides an important mechanism to prevent governments from attempting to externalize the costs of local activity. Even with national treatment, however, there may be concern that regulatory agencies will pursue the interests of locals more vigorously than those of foreigners.

Administrative agencies can frustrate the goals of national treatment by simply moving the discrimination against non-residents to a different level of government. Rather than having legislators discriminate in favor of locals—as is done with the Webb-Pomerene Act, for example—regulators can discriminate in the choice of cases they pursue or the vigor with which they prosecute suspected offenders.\(^{123}\) This is precisely the criticism that is often leveled at Japan in the area of antitrust. Japan has antitrust laws on the books that appear to be quite strict. Many observers, however, believe that the enforcement of those laws is weak and favors local actors.

The private right of action provides a partial solution to the problem of discrimination by administrative agencies. If, in addition to administrative review of transactions, there is a private remedy available, parties that have suffered damages as a result of a transaction can pursue their remedies in local court.\(^{124}\) It should be noted that other factors, not discussed in

\(^{123}\) Regulators may also be able to discriminate through their rule making authority. For our purposes, this authority should be subject to the same national treatment requirement that is discussed in the previous section.

\(^{124}\) While it is true that the courts may also discriminate against foreign parties, the presence of a private right of action gives an additional remedy to those who bear the costs of an action—implying that either the administrative agency or the courts can protect them. Furthermore, courts are less likely to be explicitly discriminatory in their decisions if they do not have a statutory basis for such an action. If foreign plaintiffs are entitled to national treatment, therefore, they may be better protected by courts than by regulators. Finally, what little evidence there is on discrimination by courts in the U.S. suggests that courts are more even-handed than is
this Article, affect the costs and benefits of private rights of action. A discussion of these factors is beyond the scope of this paper. When one is considering the adoption of a private right of action, however, the role of such a right in improving the efficiency of the choice of law regime should be taken into account.

The combination of national treatment and a private right of action to recover for damages caused by a transaction improves the efficiency of the global system.\textsuperscript{125} Because individuals can seek recovery for their third party losses, firms must internalize the full costs of their decisions more often. Where all costs are internalized, of course, the transaction will take place if and only if it is welfare enhancing from a global perspective.\textsuperscript{126}

\textsuperscript{125} Even with national treatment and private rights of action, several issues prevent the global system from achieving the efficient outcome. First, there are transactions costs associated with bringing a private suit, and these costs are higher when a case must be brought in a distant forum. Second, the substantive laws themselves may not be optimal. Finally, national treatment of plaintiffs and private rights of action work reasonably well to force firms to internalize the costs of their actions but they do not provide a mechanism to allow the internalization of benefits. Some transactions that promise third party benefits, therefore, may not be pursued because the firm is unable to capture the full value of the transaction.

\textsuperscript{126} The combination of national treatment and a private right of action to recover for damages caused by a transaction implies that the benefits to country \( i \) from an activity are given by:

\[
\pi_i + f_i = \sum_{j=1}^{N} \Lambda_{ij} + \sum_{j=1}^{N} \Lambda_{ji}
\]

where \( 7_{ij} \) represents the amount paid by participants in country \( i \) to plaintiffs from \( j \) as damages for violations of local rules. The above equation simply states that the returns to country \( i \) include the profit to the parties to the transaction, plus the third party effects felt by residents, minus the amount local parties to the transaction pay out in damages, plus the amount local residents receive in damages from abroad. Assuming that damages are calculated accurately (and that third party effects are negative):

\[
f_i = -\sum_{j=1}^{N} \Lambda_{ji}.
\]

In other words, the damages received by locals equals the third party effects that they have suffered. Therefore, it is possible to restate the benefits received by a country as:

\[
\pi_i = \sum_{j=1}^{N} \Lambda_{ji}.
\]

The benefit to country \( i \) is given by the benefit to participants in country \( i \) minus the damages that must be paid out by the local participants. More importantly, this is also the benefit to the participants to the transaction. Because parties to the transaction will pursue transactions that offer a positive return, any transaction for which this sum is greater than zero will take place. This is also true at the country level, where
VII. INCORPORATING PUBLIC CHOICE

Up to this point, the Article has assumed that governments pursue the national interest. Public choice theory, however, views government decisions as the product of interest group politics which do not, in general, maximize national welfare. Under a public choice view, regulators are modeled as individuals pursuing their own objectives rather than as faithful agents of their constituencies, and are viewed through the same lens as other economic activity. Government maintains a monopoly on regulatory power, which legislators supply to special interests capable of providing political, financial, or other private benefits in return. The result is regulation designed and operated primarily for the regulated industry's benefit, which creates barriers to entry and limits competition. In turn, regulated industries are able to charge higher prices to consumers at large and a portion of the profits are passed on to legislators in the form of contributions.

transactions will take place if and only if:

\[ \pi_i > \sum_{j=1}^{N} \Lambda_{ij} \]

Because this must be true for all countries, at the global level we have:

\[ \sum_{i=1}^{N} \pi_i - \sum_{i=1}^{N} \sum_{j=1}^{N} \Lambda_{ij} > 0. \]

But

\[ \sum_{j=1}^{N} \sum_{i=1}^{N} \Lambda_{ij} = \sum_{i=1}^{N} f_i, \]

so we have that:

\[ \sum_{i=1}^{N} \pi_i + \sum_{i=1}^{N} f_i > 0. \]

Thus, the transaction will take place if and only if it is welfare enhancing from a global perspective.

Public choice theory views consumers at large as inherently disadvantaged in their ability to compete with special interests in the political marketplace. Not only are special interest groups composed of smaller numbers of people who are better able to organize, but they are also motivated by the large payoff favorable regulatory decisions will have on their special interests. Smaller group size and motivation lead to a well-organized, well-funded special interest lobby which is effective in influencing legislators. By contrast, individuals in the general population lack equivalent incentives to lobby because they capture only a small fraction of the benefits from such lobbying but bear all the costs of time, effort and money. In many situations, consumers may not even be aware of the effects of adverse regulation. Even if consumers are aware, the reward to any one consumer for taking action is negligible. Voting is another avenue of legislative involvement for the general population, but it is seen as a limited and ineffective means of participation. Not only is the vote typically for an elected position and not over a specific issue, but individuals also suffer from a lack of information about the candidates. Therefore, those interest groups with the most at stake in a regulatory decision will work most aggressively to influence that decision, and are likely to succeed in doing so.

One of the merits of public choice is its ability to provide a positive account of regulation and government activity that is difficult to explain through more traditional models.

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129 Id.
of government behavior. The difficulty in applying public choice to normative analyses, however, is that the outcome of interest group politics is very difficult to predict. It is, therefore, difficult to construct a model of government decision making – even if one focuses on relatively well defined areas of law such as antitrust or securities. Once one adds an international dimension to the problem, the task is even more difficult. Thus, while this Article does not challenge the importance of public choice, the difficulties with applying it to the analysis cannot be ignored.

Public choice theory can be incorporated into the model developed in Parts IV-VI in three different ways. First, the Article could simply ignore the problem and implicitly assume that governments behave in the national interest. This is the strategy adopted in prior sections, and it is the approach most often adopted in choice of law discussion and, indeed, most international law debates. It should come as no surprise that this approach is the dominant one. In most areas of law, there is no consensus regarding the impact of public choice on decision-making. It is, therefore, impossible to turn to existing domestic law scholarship in order to understand how public choice issues impact a particular regulatory area, let alone regulation in general.

The second alternative is to make a different assumption regarding the public choice factors to be considered. For example, one could simply assume that the direct effects

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discussed in the paper systematically dominate the third party effects. This position is
defensible because it will generally be parties to a transaction that are best able to lobby for
their preferred regulation. Having made that assumption, it would be possible to carry out an
analysis that parallels the one completed above and that reaches comparable, though not
identical conclusions. This alternative has the significant disadvantage of featuring an
arbitrary weighing of different interest. In this sense it is not materially superior to an
assumption that regulators pursue the public good.

The third alternative, which is explored in this section, is to relax the assumption that
regulators pursue the public good and instead make a much more general assumption. The
advantage of a more general approach is that it can accommodate a broad range of public
choice assumptions. The disadvantage is that it leads to conclusions that are necessarily less
forceful.

In order to address public choice issues in a generalized way, then, the assumption that
the benefits enjoyed by parties to the transaction are weighted equally with the impact on third
parties is relaxed. Under the most conventional account of public choice, the targets of
regulation are typically in a better position to organize and lobby than are the individuals who
are protected by regulation. This view implies that the parties to a transaction will influence
legislation and achieve results that favor their concerns over those of third parties. For
example, in antitrust it is often claimed that well organized firms have a systematic advantage
over the dispersed consumers that antitrust attempts to protect. One could, however,

137 See, e.g., William F. Shughart II, Jon D. Silverman, & Robert D. Tollison, Antitrust Enforcement
and Foreign Competition, in THE CAUSES AND CONSEQUENCES OF ANTITRUST 179-187, 180 (Fred S. McChesney
& William F. Shughart II, eds 1995) ("antitrust . . . serves as means by which some firms . . . can obtain
protection from the forces of effective competition. If antitrust can be usefully characterized as an interest group
bargain . . . then trade protectionism and enforcement of the Sherman, Clayton, and FTC Acts may represent
imagine an alternative view under which it is consumers who dominate the process either because their ability to vote is of great interest to decision makers or because they manage to organize themselves successfully.

Rather than weigh the benefits to the parties and the impact on third parties equally, a public choice approach weighs these variables according to their influence on the political process. The analysis then proceeds in largely the same manner as above, but with the \textit{weighted} sum of direct benefits and third party benefits as the key decision variable. Thus, countries are expected to regulate activities if and only if this weighted sum is less than zero. This decision rule is then compared to the global optimum in order to generate lessons and policy implications much like those in Parts V and VI. Analyzing the choice of law problem under these more general assumptions leaves all of the lessons intact, though some require modification, as discussed below.

It is clear that the inclusion of public choice considerations does nothing to change \textit{Lesson #1} -- that the non-cooperative approach to choice of law is inefficient. The argument here is identical to that made under public interest assumptions. The interests of individual countries are simply not the same as those of global efficiency and only a happy coincidence would lead to an efficient outcome. The fact that governments are pursuing private objectives in addition to the public interest does not make it any more likely that they will have efficient incentives.

\textit{complementary} policies for transferring wealth to groups that have a comparative advantage in rent-seeking activities."); Louis De Alessi, \textit{The Public-Choice Model of Antitrust Enforcement, in THE CAUSES AND CONSEQUENCES OF ANTITRUST} 189-200, 197 (1995) (“[T]he legislation enabling antitrust sought political objectives rather than consumer welfare.”)

138 This change can be incorporated in a more formal model by including a coefficient that takes account of the possibility that direct and third party effects will receive different weights. The weighted sum of direct and third party effects would then determine each country’s decision. For example, country i would
Lesson #2 – that extraterritoriality leads to over-regulation remains true over at least a wide range of assumptions. It is clear that the lesson remains clear if the weight given to third party effects is greater than the weight given to direct effects. In this situation, harmful third party effects cause governments to regulate some transactions in which even their own residents enjoy an overall welfare gain. If we assume instead that it is the interests of parties to the transaction that are weighted more heavily, extraterritoriality will lead to over-regulation in some cases and under-regulation is others. As compared to the public interest approach, an assumption that direct effects are weighted more heavily than indirect effects always leads to less regulation. Consider the following examples.

Example. Imagine that the direct effects of a transaction are weighed twice as heavily as the indirect effects. Assume that there are two countries, A and B. The direct effects felt by the parties to the transaction are distributed such that country A enjoys direct benefits in the amount of 30, and B enjoys direct benefits of 5. The third party effects, however, are distributed differently – country A suffers third party harms of 5 while B suffers harms of 15. It is clear that this transaction should be allowed because it yields global benefits of 35 and harms of 20, implying a net gain of 15. It is also clear, however, that country B has an incentive to regulate the transaction even though the direct effects are weighted more heavily than the third party effects. In evaluating the transaction, B will weigh the direct benefits felt by its residents at twice their actual value – implying that the benefit of 5 is weighted as if it were 10. This is compared to the loss of 15, leading to regulation of this globally desirable transaction by country B.

\[ \pi_d + \beta f_d > 0; \quad \text{where } \beta \geq 0. \] 

Note that this formulation allows any relative weighting of direct and third party benefits – in particular, it allows either one to dominate the decision process.

Imagine, for example that there are 6 participating firms in A and one in B and that each firm gains 5.
Example. Continue to assume that direct benefits are weighed twice as heavily as third party effects. Imagine that both countries, A and B, feel direct benefits of 10 from a transaction. Assume further that they each suffer third party harms of 15. It is clear that this transaction should be regulated because the harms of 30 outweigh the benefits of 20. It is also clear that neither country will regulate. Because the direct benefits are given greater weight than the third party effects, the weighted benefits to each country are 20 while the harms are only 15.

Lesson #3 – that territoriality leads to under-regulation -- remains true under public choice assumptions. This is most obvious if one assumes that direct effects are weighted more heavily than third party effects. Under this assumption, the analysis of the public interest model is strengthened because some cases that would be regulated under that model despite the pressure toward under-regulation will not be regulated because the direct effects outweigh the third party effects.

If one assumes that the direct effects are weighted less heavily than the third party effects, then there will be more regulation than in the public interest model. Nevertheless, there will remain a tendency to under-regulate. This is most clearly true under a strictly territorial scheme, where local parties to the transaction feel the full effect of regulation while local consumers get only a fraction of the benefits. Even a country that weighs third party effects more heavily than direct effects will sometimes allow a welfare reducing transaction to proceed because regulation would be even more costly. That said, it is worth noting that one can imagine cases in which there is over-regulation under assumptions of territoriality and heavily weighted third party effects. To make this point clear, imagine that a

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141 These benefits will exist only if the withdrawal of local firms from the transaction reduces the
country does not care about direct effects at all. For whatever reason, third party effects are all that matter. In this case, there will clearly be over-regulation because anytime a country faces negative third party effects it will engage in local regulation of the transaction.

Lesson #4 remains true regardless of one’s public choice assumptions. In the absence of third party effects, the most efficient outcome is obtained when the direct parties to the transaction choose the applicable law. Assuming government regulators act in their own self-interest, however, they may have a perverse incentive not to allow direct parties to contract for their chosen law. By regulating or threatening to regulate, governmental regulators increase the private benefits that they can extract as a result of their regulatory monopoly. Consequently, direct parties to the transaction may be required to pay for favorable regulation in an area where governmental intervention is not efficient.

Lessons #5 (the definition of a “governmental interest”), #6 (the Hartford Fire case), #7 (location of the parties test), #8 (conduct test) and #9 (the domicile test) all remain true because they represent normative conclusions regarding how choice of law rules should be structured rather than positive accounts of how countries behave.

More specific assumptions about one’s public choice beliefs would allow for a more complete analysis, but the above discussion makes clear that even under a very general public choice assumption, most of the results remain. Because it is impossible to consider every conceivable set of public choice variables, the above analysis is necessarily not exhaustive. Nevertheless, it demonstrates that the public interest approach is not a necessary condition for either the use of this framework or the validity of most of the results.

impact on third parties since by assumption the country is unable to alter the behavior of foreign parties.
Finally, it is worth noting that even more general public choice assumptions are imaginable and could be incorporated into this analysis. For example, it may be the case that certain interest groups are international in character and, therefore, cross national boundaries. If this is so, the impact on the group may be relevant to the decision making process in countries other than the one in which the impact is felt. Another possibility is that policymakers have a bias in favor of regulation. In that case one would expect regulation even when the impact of a transaction is positive but small. This could be taken into account by modeling country behavior differently. A country would be presumed to regulate unless the benefits from an activity exceeded some positive threshold.

The modeling of national decision-making is a field unto itself and a comprehensive account of government policy making is beyond the scope of this Article. It is simply impossible to discuss the incentives generated by alternative choice of law regimes while simultaneously considering every possible model of government. What this Article has done, therefore, is twofold. First, it has provided a detailed discussion of the impact of choice of law under the conventional assumption of governments behaving in the national interest. This is the assumption that is used, implicitly or explicitly, in the vast majority of policy discussions, and in the entire choice of law literature. Second, the Article advances a model that can be adapted to account for a wide range of models of government behavior. Once such a model is specified, one can compare government behavior to the global optimum in order to evaluate the desirability of choice of law rules.

142 See supra Part II.
VIII. APPLICATIONS

A. International Choice of Law Agreements

This Article has approached the choice of law issues from a global perspective. Although it is recognized that countries seek their own self-interest, the Article treats global efficiency as the ultimate objective. If the choice of law lessons developed herein and the policy implications that flow from those lessons are adopted internationally, global efficiency will be enhanced. The adoption of these lessons, however, requires international cooperation. For example, the decision in Hartford Fire, which is criticized in Lesson #6, may be optimal for the United States acting unilaterally because it biases the choice of law system in favor of American law. The United States would have an incentive to adopt Lesson #6 and reverse Hartford Fire only if other countries agreed to do the same.

Viewed in terms of international cooperation in choice of law, the Article makes two important contributions. First, it outlines some of the choice of law issues that should be considered when negotiating an international agreement—hopefully providing a blueprint for such negotiations. Second, by focusing on choice of law rather than substantive agreements, the Article draws attention to a more promising form of negotiations. Agreement over substantive areas of law has proven to be extremely difficult to achieve. turning the attention of international cooperative efforts toward the more procedural question of choice of law may yield agreement more easily. Because a choice of law agreement would operate across all areas of regulation, countries that stand to lose in one area may nevertheless be

143 For example, in bankruptcy, securities, and antitrust there are virtually no significant international agreements regarding substantive law. There has been some agreement in the intellectual property field, though it is far from perfect and many doubt its efficacy. A noticeable exception, of course, is international trade in
willing to participate in order to get the gains available in other areas. Put differently, if negotiations take place at a more general level, and if those negotiations yield global efficiency gains, the need for international transfer payments may be eliminated because within any country industries that gain from the agreement can compensate those that lose. The transfer payment problem, therefore, is pushed down to the national level where such transfers are more easily arranged.

B. Negotiation over Substantive Topics

If countries decide to negotiate with respect to substantive topics rather than choice of law rules, this Article provides important guidance for both the forum in which the negotiations take place and the content of the agreements.

Note first that it is generally easier to undertake actions at the national level than it is to achieve international cooperation. It is also easier to achieve procedural cooperation at the international level than it is to achieve substantive cooperation.\textsuperscript{144} Finally, where it is possible to achieve agreement over an issue without transfer payments, negotiations over the issue are most likely to be successful when they take place in isolation from other, potentially distracting, issues. On the other hand, if agreement requires transfer payments, the negotiations should take place in a forum that allows for such payments. The importance of this point can be seen in the intellectual property area. Negotiations over intellectual property were initially centered in the World Intellectual Property Organization (WIPO), whose mandate was limited to intellectual property. In order to get an agreement between developed goods, which has seen dramatic and widespread international cooperation to reduce tariff barriers.\textsuperscript{144} For example, in the securities area countries have been successful in signing “Memoranda of Understanding” (MOUs), which provide for information sharing and some procedural cooperation. There has been no success, however, in achieving international cooperation over substantive rules.
and developing countries, however, it was necessary to conduct negotiations within the WTO. This was eventually done and the result was the Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPs). The agreement was made possible by the granting of trade concessions by developed countries in exchange for developing countries’ promises to protect intellectual property rights.\(^\text{145}\)

Negotiation over international business issues should obviously be carried out in the manner most likely to lead to the adoption of efficient rules. The analysis developed in the Article makes it possible to determine the level of international cooperation needed in order to achieve the desired result and, therefore, the manner in which negotiations should be structured. Examples from three different fields illustrate this point.

1. Bankruptcy

In the international bankruptcy context, there is general agreement that each transnational bankruptcy should be administered by a single national court system – an approach termed universalism.\(^\text{146}\) One can imagine several ways to achieve this goal. For example, one could imagine an international bankruptcy court with its own substantive rules that would take control over the debtor’s assets and distribute them to creditors. Alternatively, one could have the assets all turned over to a single national court system – such as the court system of the debtor’s home country – for distribution. From the point of view of negotiating an agreement, the second of these solutions is clearly preferred. It requires no negotiation over the substantive law to be applied (let alone the procedural rules to go with that law), no construction of a supra-national agency, and no coordination between

such an agency and domestic institutions. All that is required is agreement on choice of law rules to determine the appropriate jurisdiction and procedural rules to provide for the turnover of assets. In fact, as Professor Bebchuk and I have argued elsewhere, careful analysis of the problem demonstrates that an efficient bankruptcy regime could be achieved through unilateral action coupled with a reciprocity requirement.\textsuperscript{147} Because third party effects are small,\textsuperscript{148} and because universalism offers overall efficiency gains, all countries would benefit from the global adoption of universalism. The one hurdle to unilateral adoption of universalism is the fact that each individual country does better if it is territorialist—meaning that it refuses to turn over assets located within its jurisdiction to the adjudicating jurisdiction. There is, therefore, a collective action problem—each country would prefer for all other countries to adopt universalism, but no country will do so on its own. International cooperation in the form of an agreement to adopt universalism could solve this problem, but an even simpler solution would be unilateral action coupled with a reciprocity requirement. If country A adopts universalism subject to a reciprocity requirement, it is adopting a choice of law rule stating that when there is an interaction between country A and B, country B’s choice of whether or not to adopt universalism determines the law applied by A. Country B, therefore, has an incentive to adopt universalism because it receives universalism in return from A. In the case of bankruptcy, therefore, it is possible to achieve an efficient outcome through the self-interested unilateral action of individual countries.

\textsuperscript{146} See supra note 11.
\textsuperscript{147} Bebchuk & Guzman, supra note 10.
\textsuperscript{148} Every creditor is considered a party to the transaction because they contract with the debtor for a loan with an understanding of the background bankruptcy rules.
2. Securities

Consider next the international securities context. There is an ongoing debate about the appropriate international regulatory regime for securities, and it is beyond the scope of this paper to provide a full account of this debate.\textsuperscript{149} For our purposes it is enough to note that if there are no third party effects in the securities context, then party choice represents the best regulatory strategy. Under party choice, the efficient outcome can be achieved without any more than procedural cooperation at the international level. Each country would adopt local rules specifying that issuers of securities are free to choose the legal regime that governs their securities, and that those securities can then be sold in the domestic market. International cooperation would be limited to the sharing of information, enforcement of judgments, and other procedural issues.

3. Antitrust

Finally, consider international antitrust. Unlike bankruptcy and securities, the analysis of antitrust transactions must take into account third parties, and significant choice of law issues arise as a result. To begin with, many countries have at least a claim to jurisdiction (Lessons #5 and 6). Any jurisdiction that is home to a party to the transaction or a third party that feels the effects of the transaction has an “interest” in the transaction. Given that the United States and the EU both apply their laws extraterritorially, however, allowing every country with such an interest to regulate the transaction will lead to over-regulation (Lesson #2). Nor will a ban on extraterritoriality solve the problem as this will simply cause under-regulation (Lesson #3). Even from the perspective of global welfare, it is difficult to

\textsuperscript{149} See supra note 9.
determine how jurisdiction should be allocated without more information about the specifics of the transaction.

In the absence of transfer payments, international negotiations over antitrust may be hampered by the distribution of the costs and benefits of antitrust regulation. For example, developing countries may have relatively few firms with international market power, implying that they have little to lose from stronger international antitrust regulation. Those same countries, however, have many consumers who would benefit from regulations that, for example, prevent firms from forming international cartels. Developed countries, on the other hand, may be less enthusiastic about negotiations because they have many firms that would prefer a world without significant international antitrust policy. As a result, it may be impossible to achieve a negotiated solution of international antitrust without transfer payments.\textsuperscript{150} If this is so, attempts at negotiating an international competition policy should proceed accordingly. Specifically, they should be structured in a fashion that would allow transfer payments to take place. This implies that a stand-alone international antitrust committee, as advocated by some scholars, is ill advised.\textsuperscript{151} Instead, negotiations should be carried out in an environment that allows for transfer payments. One possibility would be to place the negotiations within the context of the WTO – an approach that worked for intellectual property.

\textbf{C. When Are International Institutions Needed?}

This Article’s approach to choice of law problems also offers suggestions about when international institutions should be established, and when international cooperation should

\textsuperscript{150} See Guzman, \textit{International Antitrust, supra} note 10.
instead be left to individual countries. Situations in which globally inefficient domestic laws can be corrected through a choice of law agreement between nations do not call for an international organization. All that is needed in such a situation is the agreement among countries on the applicable choice of law rule. Achieving agreement on such a rule may be difficult, but it should normally be easier than achieving agreement on either substantive rules or the establishment of an international organization. For example, one would expect it to be easier to reach agreement on a universalist choice of law rule for transnational bankruptcies than to arrive at a deal governing substantive bankruptcy rules.

In other circumstances, agreement on a set of choice of law rules may not be enough to achieve the global optimum. These are situations in which Lesson #1 – the observation that no single country has an incentive to draft optimal laws – applies. In intellectual property, for example, countries that produce a great deal of intellectual property are likely to prefer strong protections for the rights of innovators, while countries that are consumers rather than producers of intellectual property will adopt weaker protections. In the absence of a choice of law solution to the problem of international intellectual property, it is necessary to turn to negotiation over substantive rules. Here again, however, divergent national incentives pose a problem. How can producers and consumers agree on a set of substantive rules? In the absence of transfer payments, it may be impossible to reach an agreement on the rules to govern intellectual property. If transfer payments are possible, however, countries are able to negotiate to the efficient level of protection and make transfers among themselves to distribute the gains.

One of the important roles that can be played by international organizations, therefore, is the creation of a forum for the negotiation of substantive issues and the facilitation of transfer payments. For example, one of the interpretations of the TRIPs agreement that was reached at the Uruguay Round of trade negotiations was that developing countries agreed to enforce intellectual property rights in exchange for concessions in other trade areas. Without some form of transfer payment, consumers of intellectual property such as developing countries would have little reason to accept an agreement. This would lead to under-regulation. The ability to offer concessions in other areas gave countries the tools necessary to achieve agreement on TRIPs.

International institutions, therefore, can play an important role in bringing countries to the negotiating table and in reducing the costs of transfer payments among countries. When choice of law rules alone are not enough to achieve an efficient outcome, international negotiation within an international institution may help resolve the issues. Transfer payments will often be easier within a broad-based international organization rather than through narrowly tailored negotiations because the former allow the granting of concessions in unrelated areas. For example, the TRIPs agreement may not have been achieved within the World Intellectual Property Organization (WIPO) because negotiators were not able to offer trade concessions in exchange for an agreement. Without such transfers, the TRIPs agreement may have been impossible.

At a slightly more abstract level, international institutions can be of most use in those situations where the parties are least likely to achieve the global optimum by themselves. First, where there are no third party effects, international institutions are least important

152 See supra note 145.
because the parties can reach the efficient outcome through contract. Second, where transactions have overwhelmingly local effects, international organizations have little to offer because domestic lawmakers face appropriate incentives. Third, where parties have roughly proper incentives despite international activity, there is no need for cooperation. This might be the case, for example, if the direct effects are distributed in the same fashion as the third party effects, in which case individual countries will face incentives that are the same as if they internalized all costs and benefits.\footnote{If a country, for instance, enjoys 25\% of the benefits from a transaction and faces 25\% of the total costs, then that country has optimal incentives.}

Applying the above conclusions about international institutions sheds light on many of the current questions facing the international system. For example, there is an ongoing debate about the appropriate role of the WTO in dealing with certain issues that have traditionally not been trade issues, specifically competition policy and environmental issues. Should these issues be included in a new WTO round of negotiations or should they be dealt with in some other way?

The objective of competition policy, at least in the United States,\footnote{The stated objective of competition policy varies from country to country. See Guzman, supra note} is to protect the market from monopolies and monopolistic conduct. In the competition policy context, consumers represent third parties who are affected by firm decisions. National policy making regarding competition policy can be distorted if the losses and gains from monopolization tend to fall in different countries. In that setting, those that stand to gain from global monopolies (the home countries of the firms involved) will tend to under-regulate while those that stand to lose (countries with a high consumer to firm ratio) will tend to over-regulate to the extent that they are able to do so. If the latter group of countries cannot apply their laws
extraterritorially, there will be persistent under-regulation. The market will not correct this problem because there is no reason for the producer countries to agree to any form of international agreement. 155 In order to improve the quality of regulation it is necessary to offer the producer countries a transfer payment to account for the losses they stand to suffer if they agree. The WTO can facilitate such transfers in a way that a stand-alone competition policy organization could not. For this reason, including competition in WTO negotiations represents the best mechanism through which to pursue an agreement.

Environmental issues feature externalities that in some ways resemble those of competition policy. Polluting countries have little reason to adopt regulations that are optimal because they enjoy all the benefits from their pollution and only a portion of the harms. In order to achieve an agreement between countries that are net “exporters” of environmental damage and those that are net “importers,” transfer payments are needed. These payments need not be in cash or in the environmental arena. By including environmental issues within the framework of the WTO, transfers of that sort are made possible.

IX. CONCLUSION

The growth in international business activity raises the stakes for those that establish jurisdictional rules, whether they are courts, administrative agencies, or legislatures. Traditional choice of law scholarship has failed to produce a theory that can effectively address the pressing regulatory challenges that face the international community as

10, at 1539.
155 This result applies most forcefully in the North-South context because imperfectly competitive industries are concentrated in developed countries. As between, say, the United States and Europe, it is possible that each country receives benefits from competition policy that are roughly proportional to costs, implying that a negotiated agreement might benefit both.
globalization continues. This Article has laid out a new structure upon which to build a choice of law theory.

Recognizing that countries can be expected to pursue their own interests, and establishing that these interests will, in general, not coincide with the best global policy represents the first step toward understanding today’s most important choice of law issues. Efforts to achieve an efficient international regulatory structure can only succeed if the interests of individual nations are somehow aligned with global interests. This Article advances our understanding of the problem in three ways. First, it presented a framework with which one can consider choice of law questions. Using this framework, the Article developed eight choice of law lessons that provide guidance for the formulation of a choice of law regime. Several of these lessons are contrary to accepted choice of law scholarship and the conventional wisdom of the field. If one accepts the premise that the legal regime, including the choice of law regime, should seek to maximize human welfare, existing scholarship is difficult to defend.

Second, the Article developed policy implications that provide a partial answer to the question of how to achieve a more efficient system. A presumption against extraterritoriality, national treatment of foreign plaintiffs, and private rights of action each represent a step that will reduce the distortions created by sub-optimal choice of law rules. They also represent policies that can be agreed to by countries seeking to improve the international system but unable to agree on harmonization of substantive rules.

Third, the Article discusses some of the many applications of the proposed approach. Although international cooperation is necessary to improve the efficiency of the international regulatory system, some forms of cooperation are easier than others. Cooperation and
coordination with respect to choice of law rules, for example, is easier than substantive cooperation because the latter implicates domestic laws and policies more directly. Negotiation over choice of law rules, therefore, may prove a more fruitful avenue. Because not all substantive laws feature the same characteristics, however, the general analysis of the paper must be applied to particular issues before one can determine how to structure international negotiations. The Article carries out such an application in three important areas – bankruptcy, securities, and antitrust – showing that efficient regulation requires a different approach for each. The framework is, of course, not limited to these three areas. It could be applied to virtually any cross border issue.

Finally, the Article addresses an important contemporary question regarding the role of international institutions. It is demonstrated that when the interests of countries are such that agreement on a choice of law rule is enough to get the efficient outcome, and where all parties stand to enjoy a share of the benefits from such an outcome, no international institution is needed. Indeed, negotiations may proceed more easily if they are carried out in an ad hoc fashion that is removed from the distractions of other, more contentious issues that may be part of an institutional setting. On the other hand, where the efficient choice of law rule is not sought by all countries, or where substantive changes are needed in addition to the selection of appropriate choice of law rules, negotiations become more complex and a broader institutional setting such as the WTO may prove useful. In particular, negotiations should be conducted at the WTO or within some other international organization when the efficient result can be achieved only through the use of transfer payments from one group of countries to the other. Such payments are difficult to achieve in any setting, but are at least possible when gains in one area can be traded off against concessions in other areas. Such bargains
can be struck within, for example, the WTO, much more easily than in ad hoc negotiations dedicated to a single issue.