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Citation: 90 Geo. L.J. 883 2001-2002



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# Choice of Law: New Foundations

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#### INTRODUCTION

Growth in international activity and dramatic technological change have greatly increased the frequency with which national legal systems must interact. Most obviously, the Internet allows information to flow across borders without cost and beyond the control of governments. Indeed, even the owner of the information cannot easily prevent it from being received by individuals in foreign countries. That individual, therefore, may find herself and her actions subject to foreign laws. Similarly, a business that operates in several countries is potentially subject to the laws of each. As international activity increases, domestic legal regimes must find a way to work together to regulate that activity in desirable ways. At present, domestic legal systems do a poor job of resolving conflicts amongst themselves. That is, they do not have an effective and efficient choice-of-law system. This is unlikely to change without a better understanding of choice-of-law regimes and their impact on the well being of individuals. Improving our understanding in this area is the goal of this Article.

Put differently, this Article seeks to restructure the way in which we think about choice of law.<sup>1</sup> To do so, it abandons the traditional and almost universal reliance on notions of sovereignty as a normative justification for choice-of-law

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1. Despite the many attempts to improve on this existing approach to choice of law, the field is widely considered to be unsatisfactory. See Lea Brilmayer, *Methods and Objectives in the Conflict of Laws: A Challenge*, 35 MERCER L. REV. 555, 555 (1984); Larry Lessig, *The Zones of Cyberspace*, 48 STAN. L. REV. 1403, 1407 (1996); William L. Prosser, *Interstate Publication*, 51 MICH. L. REV. 959, 971 (1953); William L. Reynolds, *Legal Process and Choice of Law*, 56 MD. L. REV. 1371, 1371 (1997); Kermit Roosevelt III, *The Myth of Choice of Law: Rethinking Conflicts*, 97 MICH. L. REV. 2448, 2448 (1999); Joel P. Trachtman, *Conflict of Laws and Accuracy in the Allocation of Government Responsibility*, 26 VAND. J. TRANSNAT'L L. 975, 978 (1994).

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 so little attention to how individuals and their behavior are affected by the chosen rules.<sup>2</sup> 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 it suffers from the fact that our notions of sovereignty change rapidly. For example, in the early part of the twentieth 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 famous *American Banana* case.<sup>3</sup> 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 *United States v. Aluminum Co. of America (ALCOA)*.<sup>4</sup> 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.<sup>5</sup> 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

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2. One arguable exception is surveyed in LEA BRILMAYER, *CONFLICT OF LAWS* 219–63 (2d ed. 1995) (discussing a rights-based approach).

3. *Am. Banana Co. v. United Fruit Co.*, 213 U.S. 347, 357–59 (1909) (adopting a jurisdictional test in which only conduct that occurs within the United States is subject to American antitrust laws).

4. 148 F.2d 416, 444 (2d Cir. 1945) (stating that U.S. antitrust laws reached acts outside the United States "if they were intended to affect imports and did affect them."). The Supreme Court explicitly adopted the *ALCOA* standard in *Continental Ore Co. v. Union Carbide & Carbon Corp.*, 370 U.S. 690, 704 (1962); see also *Steele v. Bulova Watch Co.*, 344 U.S. 280, 288 (1952) (adopting a similar test with reference to the Lanham Trademark Act, 15 U.S.C. §§ 1051 et seq. (1946)).

5. The maximization of global welfare should be a noncontroversial 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.

minor impact on choice of law.<sup>6</sup> The fact that global welfare represents the objective of the policy analysis, however, does not imply that individual countries will or should pursue that 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, this 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 Insurance Co. v. California*,<sup>7</sup> holding that forum law always should be applied if it is possible to comply with both local and foreign law, undermines the efficiency of the choice-of-law regime.

Second, this 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, legislatures, and international negotiators who shape choice-of-law rules.

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6. Existing choice-of-law literature that could be characterized as being in the law and economics tradition includes RICHARD A. POSNER, *ECONOMIC ANALYSIS OF LAW* 645–46 (5th ed. 1998) (arguing that choice-of-law decisions should be based on each state’s comparative regulatory advantage); William H. Allen & Erin A. O’Hara, *Second Generation Law and Economics of Conflict of Laws: Baxter’s Comparative Impairment and Beyond*, 51 STAN. L. REV. 1011 (1999); William F. Baxter, *Choice of Law and the Federal System*, 16 STAN. L. REV. 1 (1963); Patrick J. Borders, *The Choice-of-Law Revolution: An Empirical Study*, 49 WASH. & LEE L. REV. 357 (1992); Bruce L. Hay, *Conflicts of Law and State Competition in the Product Liability System*, 80 GEO. L.J. 617 (1992); Larry Kramer, *Rethinking Choice of Law*, 90 COLUM. L. REV. 277 (1990); Erin A. O’Hara, *Opting Out of Regulation: A Public Choice Analysis of Contractual Choice of Law*, 53 VAND. L. REV. 1551 (2000); Erin A. O’Hara & Larry E. Ribstein, *From Politics to Efficiency in Choice of Law*, 67 U. CHI. L. REV. 1151, 1153 (2000) [hereinafter O’Hara & Ribstein, *From Politics to Efficiency*] (recommending that courts adopt a default rule in favor of contractual choice-of-law provisions); Erin A. O’Hara & Larry E. Ribstein, *Interest Groups, Contracts and Interest Analysis*, 48 MERCER L. REV. 765 (1997); Michael E. Solimine, *An Economic and Empirical Analysis of Choice of Law*, 24 GA. L. REV. 49 (1989) (comparing the Restatement of Conflict of Laws (1934) to more modern approaches); Stuart E. Thiel, *Choice of Law and the Home Court Advantage: Evidence*, 2 AM. L. & ECON. REV. 291 (2000); Joel P. Trachtman, *Externalities and Extraterritoriality: The Law and Economics of Prescriptive Jurisdiction*, in *ECONOMIC DIMENSIONS IN INTERNATIONAL LAW* 642–83 (Jagdeep S. Bhandari et al. eds., 1997).

7. 509 U.S. 764, 797–99 (1993).

Third, 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. The analysis shows 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. A third recommendation is that private rights of action be encouraged to reduce the risk of discrimination between local and foreign parties.

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

Fifth, this Article discusses the appropriate role for international institutions in lowering the transaction costs of international negotiation. This 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 from 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?<sup>8</sup> 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,<sup>9</sup> securities regulation,<sup>10</sup> antitrust,<sup>11</sup> and

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8. See Joel P. Trachtman, *Regulatory Competition and Regulatory Jurisdiction*, 3 J. INT'L ECON. L. 331, 334 (2000) ("Indeed the arguments for regulatory competition are really arguments for increased regulatory competition by virtue of adjustment of choice of law rules.").

9. See, e.g., ROBERTA ROMANO, *THE GENIUS OF AMERICAN CORPORATE LAW* (1993); Lucian A. Bebchuk, *Federalism and the Corporation: The Desirable Limits on State Competition in Corporate Law*, 105 HARV. L. REV. 1435 (1992); Ralph K. Winter, Jr., *State Law, Shareholder Protection, and the Theory of the Corporation*, 6 J. LEGAL STUD. 251 (1977).

10. See, e.g., Stephen J. Choi & Andrew T. Guzman, *Portable Reciprocity: Rethinking the International Reach of Securities Regulation*, 71 S. CAL. L. REV. 903 (1998); Merritt B. Fox, *Retaining Mandatory Securities Disclosure: Why Issuer Choice Is Not Investor Empowerment*, 85 VA. L. REV. 1335 (1999) [hereinafter Fox, *Mandatory Securities Disclosure*]; Merritt B. Fox, *Securities Disclosure in a Globalizing Market: Who Should Regulate Whom*, 95 MICH. L. REV. 2498 (1997) [hereinafter Fox, *Globalizing Market*]; Roberta Romano, *Empowering Investors: A Market Approach to Securities Regulation*, 107 YALE L.J. 2359 (1998).

11. See, e.g., Andrew T. Guzman, *Is International Antitrust Possible?*, 73 N.Y.U. L. REV. 1501 (1998).

bankruptcy.<sup>12</sup> 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. This Article 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, other bodies such as legislatures, administrative agencies, and international organizations have roles 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,<sup>13</sup> a statute that is silent as to its extraterritorial scope, must determine the appropriate jurisdictional reach of the rules.<sup>14</sup> To do so effectively,

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12. See, e.g., Lucian A. Bebchuk & Andrew T. Guzman, *An Economic Analysis of Transnational Bankruptcies*, 42 J.L. & ECON. 775 (1999); Andrew T. Guzman, *International Bankruptcy: In Defense of Universalism*, 98 MICH. L. REV. 2177 (2000); Lynn M. LoPucki, *Cooperation in International Bankruptcy: A Post-Universalist Approach*, 84 CORNELL L. REV. 696 (1999) [hereinafter LoPucki, *Cooperation in International Bankruptcy*]; Lynn M. LoPucki, *The Case for Cooperative Territoriality in International Bankruptcy*, 98 MICH. L. REV. 2216 (2000) [hereinafter LoPucki, *Cooperative Territoriality*]; Robert K. Rasmussen, *A New Approach to Transnational Insolvencies*, 19 MICH. J. INT'L L. 1 (1997) [hereinafter Rasmussen, *New Approach*]; Robert K. Rasmussen, *Resolving Transnational Insolvencies Through Private Ordering*, 98 MICH. L. REV. 2252 (2000) [hereinafter Rasmussen, *Resolving Transnational Insolvencies*]; Jay Lawrence Westbrook, *A Global Solution to Multinational Default*, 98 MICH. L. REV. 2276 (2000) [hereinafter Westbrook, *A Global Solution*]; Jay Lawrence Westbrook, *Choice of Avoidance Law in Global Insolvencies*, 17 BROOK. J. INT'L L. 499 (1991) [hereinafter Westbrook, *Choice of Avoidance*]; Jay Lawrence Westbrook, *Theory and Pragmatism in Global Insolvencies: Choice of Law and Choice of Forum*, 65 AM. BANKR. L.J. 457 (1991) [hereinafter Westbrook, *Theory and Pragmatism*].

13. 15 U.S.C. §§ 1–7 (2000). Although currently covered by administrative releases, the reach of the Sherman Act has a long and well-known history in U.S. courts. See, e.g., *Hartford Fire Ins. Co. v. California*, 509 U.S. 764, 795–98 (1993) (applying the effects test and downplaying the role of international comity); *Am. Banana Co. v. United Fruit Co.*, 213 U.S. 347, 359 (1909) (adopting a strict territorialist rule); *United States v. Aluminum Co. of Am.*, 148 F.2d 416, 443–45 (2d Cir. 1945) (setting out the “effects test”); U.S. DEP’T OF JUSTICE & FED. TRADE COMM’N, ANTITRUST ENFORCEMENT GUIDELINES FOR INTERNATIONAL OPERATIONS, 3 DEPT. OF JUSTICE MANUAL, § 7-5.220F, tit. 792–820 (1995).

14. Another example is interpretation of the antifraud provisions of the Securities Exchange Act. See Securities Exchange Act of 1934, Pub. L. No. 73-291, § 10, 48 Stat. 881, 891 (Rule 10b-5); 17 C.F.R. § 240.10b-5 (2001). The Securities Exchange Act of 1934 limits the reach of the antifraud rules only through the requirement that there be some use of interstate commerce. See 15 U.S.C. § 78j(b) (2000). For a more detailed discussion of the extraterritorial reach of the antifraud rules, see *Zoelsch v. Arthur Andersen & Co.*, 824 F.2d 27, 29–34 (D.C. Cir. 1987); *SEC v. Kassar*, 548 F.2d 109, 112–16 (3d Cir. 1977); *Bersch v. Drexel Firestone, Inc.*, 519 F.2d 974, 984–93 (2d Cir. 1975); *Schoenbaum v. Firstbrook*, 405 F.2d 200, 206–09 (2d Cir. 1968); and Stephen J. Choi & Andrew T. Guzman, *The Dangerous Extraterritoriality of American Securities Law*, 17 NW. J. INT’L L. & BUS. 207, 215–19 (1996).

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),<sup>15</sup> 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.

This 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 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 largely have been resolved within the United States by the adoption of federal laws or the use of uniform choice-of-law principles.<sup>16</sup> No analogous solution currently exists for international choice-of-law problems. The second reason to focus on international issues is that they are 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.<sup>17</sup> Despite the focus on international regulatory issues, however, the analysis applies to all choice-of-law problems. For this reason, even choice-of-law scholars interested in the more traditional areas examined by that field should find this Article informative and relevant to their own work.

This Article proceeds as follows: Part I provides a brief review of existing choice-of-law scholarship to establish the necessary backdrop for the discussion that follows. Part II 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 III develops the basic framework that is used throughout the Article. Part IV presents the choice-of-law lessons that emerge from that framework. Part V discusses three policy implica-

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15. 17 C.F.R. §§ 230.901-904 (2001).

16. For example, choice-of-law questions in commercial law have been addressed in the Uniform Commercial Code. *See* U.C.C. § 1-105.

17. Once one looks to the international arena, regulatory issues naturally emerge as the focus as these are the issues of greatest current concern.



tions that flow from the choice-of-law lessons. Part VI applies the prior analysis to the question of when choice-of-law agreements should be pursued, when international institutions are needed, and what the appropriate choice-of-law rules are for specific legal topics.

## I. 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 unsatisfying from both academic and practical perspectives.<sup>18</sup> 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 criticized widely, though the critics rarely offer preferable alternatives. The primary existing approaches are discussed below.<sup>19</sup>

### A. VESTED RIGHTS

The "vested rights" approach, which is most commonly associated with Joseph Beale, can be traced to Joseph Story. It is based on a view that every state has exclusive jurisdiction over its territory.<sup>20</sup> 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."<sup>21</sup> To apply the law of any other state would be an infringement on the sovereignty of the state under whose laws the right vested.<sup>22</sup> Furthermore, once the rights of a party have vested, they must be respected by other states.<sup>23</sup> Thus, if a particular right vests in state A, it can be enforced in state B. Beale's approach enjoyed considerable

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18. See, e.g., Joel P. Trachtman, *Conflict of Laws and Accuracy in the Allocation of Government Responsibility*, 26 VAND. J. TRANSNAT'L L. 975, 978 (1994) ("Conflict of laws is a source of constant embarrassment to lawyers, judges, and scholars.").

19. In the interest of brevity, only a very brief sketch of choice-of-law scholarship is included here. A more detailed treatment can be found in BRILMAYER, *supra* note 2. Among the key contributions that are not discussed here are ALBERT A. EHRENZWEIG, *CONFLICT OF LAWS*, PART I (1959); WILLIS L.M. REESE ET AL., *CASES AND MATERIALS ON CONFLICT OF LAWS* (9th ed. 1990); ARTHUR TAYLOR VON MEHREN & DONALD THEODORE TRAUTMAN, *THE LAW OF MULTISTATE PROBLEMS* (1965); Lea Brilmayer, *Interest Analysis and the Myth of Legislative Intent*, 78 MICH. L. REV. 392 (1980) [hereinafter Brilmayer, *Interest Analysis*]; Lea Brilmayer, *Rights, Fairness, and Choice of Law*, 98 YALE L.J. 1277 (1989); Larry Kramer, *More Notes on Methods and Objectives in the Conflict of Laws*, 24 CORNELL INT'L L.J. 245 (1991); Kramer, *supra* note 6, at 277; Larry Kramer, *Return of the Renvoi*, 66 N.Y.U. L. REV. 979 (1991).

20. See JOSEPH STORY, *COMMENTARIES ON THE CONFLICTS OF LAWS* § 18, at 19 (1834).

21. See 1 JOSEPH H. BEALE, *A TREATISE ON THE CONFLICT OF LAWS* 311-12 (1935) ("[T]he power of a 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.").

22. See BRILMAYER, *supra* note 2, at 22 (asserting that, under Beale's approach, application of any law other than that of the state in which rights have vested would violate state sovereignty).

23. See *id.*

success, appearing in the *Restatement (First) of Conflict of Laws*,<sup>24</sup> 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 Co.*<sup>25</sup>

Although Beale's vested rights approach has been criticized widely, it is enough to mention only the most prominent criticisms here.<sup>26</sup> First, 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.<sup>27</sup> 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.<sup>28</sup> Second, the assignment of jurisdiction based on vested rights requires that a single place be identified as the location of an activity.<sup>29</sup> This is problematic because activities that cross jurisdictional boundaries are likely to involve a variety of events spread across boundaries.<sup>30</sup> The identification of the "last act" upon which to base jurisdiction was perceived as arbitrary and unpredictable.<sup>31</sup> A third 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.<sup>32</sup>

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24. See RESTATEMENT (FIRST) OF CONFLICT OF LAWS (1934).

25. 194 U.S. 120, 126 (1904) ("[T]he only source of this obligation is the law of the place of the act.").

26. Early critiques of Beale appeared before the Restatement. See, e.g., Walter W. Cook, *The Jurisdiction of Sovereign States and the Conflict of Laws*, 31 COLUM. L. REV. 368, 369-72 (1931) (criticizing the reasoning underlying Beale's vested rights approach as illogical); Walter W. Cook, *The Logical and Legal Bases of the Conflict of Laws*, 33 YALE L.J. 457, 461-64 (1924) (same); Ernest G. Lorenzen, *Territoriality, Public Policy and the Conflict of Laws*, 33 YALE L.J. 736, 737-38 (1924) (criticizing the maxims associated with exclusive sovereignty and jurisdiction in conflict of laws as vague and misleading); Hessel E. Yntema, *The Hornbook Method and the Conflict of Laws*, 37 YALE L.J. 468, 476 (1928) (asserting that "the so-called territorial theory of vested rights . . . imports a terminology inept to describe the factors involved in legal problems and a technique inadequate either to state accurately the practices of courts or to control their decisions"). A more recent summary of these critiques can be found in a number of sources. See, e.g., BRILMAYER, *supra* note 2, at 25-46; LAURA KALMAN, *LEGAL REALISM AT YALE, 1927-1960*, at 25-26, 47-48 (1986); Herma Hill Kay, *A Defense of Currie's Governmental Interest Analysis*, 215 RECUEIL DES COURS 9, 28-35 (1989-III); Trachtman, *supra* note 18, at 998-1005.

27. See BRILMAYER, *supra* note 2, at 21-22.

28. See *id.* at 24.

29. See *id.* at 25.

30. See *id.* at 25-29.

31. See *id.*

32. See, e.g., David F. Cavers, *A Critique of the Choice-of-Law Problem*, 47 HARV. L. REV. 173, 176 n.10 (1933) (asserting that "what the operative facts are depend on the rules for choice of law adopted").

## B. INTEREST ANALYSIS

Most modern choice-of-law scholars dismiss vested rights analysis as theoretically unsatisfactory.<sup>33</sup> In its place, many conflicts scholars have promoted interest analysis.<sup>34</sup> Interest analysis itself has been developed in several different ways by conflicts scholars. In the interests of space, what is provided below is a brief sketch of the most prominent versions. The most important point to note for our purposes is that each of the theories focuses on the interests of governments rather than the interests of individuals.

The most prominent form of interest analysis is that of Brainerd Currie. He adopts 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.<sup>35</sup> 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.<sup>36</sup>

Currie enunciated the following summary of his approach in 1964.<sup>37</sup> If only one state has an interest (known as a "false conflict"), that state's law applies.<sup>38</sup> 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.<sup>39</sup> If an apparent conflict emerges, the court should attempt a "moderate" or "restrained interpretation" of the competing policies to resolve the conflict.<sup>40</sup> 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.<sup>41</sup> If the forum is

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33. See BRILMAYER, *supra* note 2, at 25-31; O'Hara & Ribstein, *From Politics to Efficiency*, *supra* note 6, at 1169.

34. See BRAINERD CURRIE, *SELECTED ESSAYS ON THE CONFLICT OF LAWS* 183-84 (1963); Baxter, *supra* note 6, at 4-22; Kay, *supra* note 26; Kramer, *supra* note 6, at 277.

35. CURRIE, *supra* note 34, at 183-84.

36. *Id.* at 119. Much has been written on the question of exactly what Currie meant by a "governmental interest." 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." In other words, a legislative enactment alone does not create a governmental interest. Three additional elements are necessary: First, a factual relationship must exist between the state and the transaction or the parties. Two, the factual relationship must implicate a governmental policy. Finally, the policy must be a legitimate one. That is, the relationship must be appropriate. A detailed discussion of this issue is contained in Kay, *supra* note 26, at 50-58, 105-11.

37. Brainerd Currie, *Selected Essays on the Conflict of Laws*, in ELLIOTT E. CHEATHAM ET AL., *CASES AND MATERIALS ON CONFLICT OF LAWS*, 477-78 (5th ed. 1964).

38. *Id.* at 478.

39. *Id.*

40. *Id.*

41. *Id.*

disinterested, but a true conflict exists between two other states, the forum should attempt to dismiss on forum non conveniens grounds, or if that fails, 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 governmental interest analysis was in substantial part adopted in the *Restatement (Second) of Conflicts*,<sup>42</sup> and remains dominant in choice-of-law scholarship today, it has not escaped criticism.<sup>43</sup> Critics argue that interest analysis is unpredictable, difficult to apply in practice, and that it has no meaningful foundation. For example, the focus on governmental interests is criticized because it requires that courts determine the intent of the legislature, which, it is argued, is impossible. Because legislatures are not monolithic, they cannot be said to have a coherent intent that goes beyond the adoption of the particular legislation.<sup>44</sup>

Several conflicts scholars have sought to reform Currie's approach in response to the criticisms. Professor Baxter agreed with Currie that the inquiry should focus on governmental interests, but 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.<sup>45</sup> One important advantage of this approach is that it 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. There remain, however, problems of predictability as it is often difficult to know, *ex ante*, which jurisdiction's laws will be judged to face greater impairment.

Professor Robert Lefflar offers a set of choice-influencing factors a court should use to resolve true conflicts.<sup>46</sup> 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.<sup>47</sup> The approach contemplates courts undertaking an objective inquiry into which law is the most just and reasonable.<sup>48</sup> 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 competing

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42. RESTATEMENT (SECOND) OF CONFLICTS OF LAWS § 6 (1971). The creation of the *Restatement (Second)* is discussed in Kay, *supra* note 26, at 35–37; Willis L.M. Reese, *Conflict of Laws and the Restatement Second*, 28 LAW & CONTEMP. PROBS. 679, 680–81 (1963).

43. See, e.g., Brilmayer, *Interest Analysis*, *supra* note 19, at 392; Brilmayer, *supra* note 1, at 555.

44. See O'Hara & Ribstein, *From Politics to Efficiency*, *supra* note 6, at 1170.

45. See Baxter, *supra* note 6, at 42.

46. See Robert A. Lefflar, *Conflicts Law: More on Choice-Influencing Considerations*, 54 CAL. L. REV. 1584, 1585 (1966).

47. See *id.* at 1586–87.

48. Professor Lefflar's approach has been adopted in several U.S. states. See Symeon C. Symeonides, *Choice of Law in the American Courts in 1997*, 46 AM. J. COMP. L. 233, 253 (1998).

policies are incommensurable.<sup>49</sup>

## II. FRAMEWORK

### A. THE PRIMACY OF EFFECTS

The goals pursued by choice-of-law proposals are often 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 “governmental interest”? What is lost if the “wrong” choice-of-law rule is used? Exactly what are the notions of sovereignty that lie at the foundation of the analyses that focus on protecting governmental interests? Such questions are addressed inadequately by existing scholarship, making it difficult to identify the goals of choice-of-law scholarship and, therefore, difficult to evaluate alternative proposals.

This Article takes a different approach to choice-of-law problems.<sup>50</sup> The first step in the analysis is to identify the measure by which any particular choice-of-law rule will be evaluated. 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 matters. Traditional choice-of-law concepts such as national interests or comity are relevant only to the extent that they affect global welfare.

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.” When 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 the 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.

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.

For our purposes, individuals can be divided into two classes. The first class 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 Article, 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

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49. See BRILMAYER, *supra* note 2, at 70–73. Professor Kramer proposes that courts adopt a set of canons of statutory construction to help resolve conflicts. Like Baxter and Leflar’s approaches, Kramer’s proposal reduces the role of forum law and attempts to find some relatively objective procedure for dealing with true conflicts. Kramer, *supra* note 6.

50. See *supra* note 6.

convenient for analytical purposes, but may be criticized because it implicitly assumes that government has no role in protecting individuals from making bad decisions.<sup>51</sup> It is possible to take governmental protections of this sort into account, however, simply by renaming the relevant parties. Imagine, for example, a transaction 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.<sup>52</sup> 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 certain kinds of voluntary arrangements.<sup>53</sup> 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. To proceed, it is necessary to make at least an initial assumption about how government policy is formed. In the interests of expositional ease, the paper begins with the most traditional and common assumption—that the government of each country maximizes the domestic welfare of local residents. This assumption is not made because it is realistic, but rather because it helps the presentation and because there is no consensus on what other assumption would be appropriate in this context. Fortunately, the public-interest assumption is not necessary for the framework or for the conclusions presented. The results of the model are largely independent of the choice of assumption. In other words, the model is capable of dealing with public-choice concerns, as discussed in Part II.B, and as is demonstrated at various points throughout the paper.

The first step in the analysis is to identify the costs and benefits to be taken

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51. 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.

52. 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, as in the famous case, *Milliken v. Pratt*, 125 Mass. 374 (1878), is a married woman who is not permitted to enter into a contract without the consent of her husband. 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.

53. In the securities context, for example, regulation is often justified with reference to third-party effects. See, e.g., Frank H. Easterbrook & Daniel R. Fischel, *Mandatory Disclosure and the Protection of Investors*, 70 VA. L. REV. 669, 675 (1984). Alternatively, regulation is justified by the presence of uninformed participants and markets that are not efficient. See Andrew T. Guzman, *Capital Market Regulation in Developing Countries: A Proposal*, 39 VA. J. INT'L L. 607, 627–28 (1999). The model developed here can be applied in both of these situations.

into account. Consider the parties to the transaction. The benefit enjoyed by the parties to the transaction will be referred to as "direct effects." Direct effects are always positive because individuals only participate in transactions that increase their welfare. 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. The total impact of this transaction on global welfare is simply the sum of all direct and indirect effects felt worldwide, and can be positive or negative depending on the magnitude of the direct and third-party effects.<sup>54</sup> 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, it may lead to the selection of the less desirable national law. As between two or more potential substantive rules, one will often be superior to the others in the sense that it leads to more desirable outcomes. 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. Within each jurisdiction, however, the decision has already been made that the chosen laws represent the best way to achieve the objectives of 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.<sup>55</sup> Attempts to choose the better law from an objective perspective also face tremendous practical difficulties. There is often no consensus on which 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

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54. If there are  $N$  countries and 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:

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

55. See Baxter, *supra* note 6, at 7–8.

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 substantive laws adopted by governments. A government making substantive 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 governments are able to externalize the costs or are 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.<sup>56</sup> 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 global welfare is negative if the costs are borne by foreigners and the benefits are enjoyed locally.<sup>57</sup> When possible, therefore, choice-of-law rules should be crafted to encourage governments to internalize the costs of their actions (and to allow them to internalize the benefits). When this effort succeeds, governments will pass laws that represent, in the rulemaker’s judgment, the best possible substantive 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.<sup>58</sup> An efficient choice-of-law regime eliminates, whenever possible, the difference between national laws and the globally optimal set of laws.

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56. See Guzman, *supra* note 11 (discussing this issue in the antitrust context).

57. An example of such a policy is the U.S. policy on export cartels. The Webb-Pomerene Act, codified at 15 U.S.C. §§ 16–66 (1994), exempts trade associations formed “for the sole purpose of engaging in export trade” from the reach of the Sherman Act. 15 U.S.C. § 62. Title III of The Export Trading Act of 1982, codified as amended at 15 U.S.C. §§ 4011–4021 (1994), sought to broaden the availability of the exemption for export cartels. For further discussion of export cartels, see George E. Garvey, *Exports, Banking, and Antitrust: The Export Trading Company Act—A Modest Tool for Export Promotion*, 5 Nw. J. INT’L L. & BUS. 818 (1983); Eleanor Roberts Lewis, *Title III of the Export Trading Company Act: A Case Study in Interagency Coordination to Promote Exports*, 5 J.L. & COM. 451 (1985); Dennis Unkovic, *Joint Ventures and the Export Trading Company Act*, 5 J.L. & COM. 373 (1985); A. Paul Victor, *Export Cartels: An Idea Whose Time Has Passed*, 60 ANTITRUST L.J. 571 (1991); Donald Zarin, *The Export Trading Company Act: Reducing Antitrust Uncertainty in Export Trade*, 17 GEO. WASH. J. INT’L L. & ECON. 297 (1983).

58. 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.



## B. 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 policymaker were able to establish laws. Once the global optimum is established, the Article analyzes the behavior of countries trying to maximize their own 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 world welfare is negative.<sup>59</sup> In other words, when the sum of world direct effects and third-party effects is positive, an activity would be allowed but when that sum is negative the activity would be prevented.<sup>60</sup>

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 policymaker 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

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59. In reality, of course, states do not merely permit or prohibit transactions. They might, for example, impose constraints on the activity that force the parties to behave differently than they otherwise would. Even if the jurisdiction simply requires the payment of a fine to account for the losses caused by the activity, the analysis is the same because the magnitude of the fine will only take into account local costs and benefits. Thus, unless countries that benefit from the activity provide some form of compensation for undertaking the activity, the presence of fines in the countries that lose as a result of the activity will increase costs beyond what is globally optimal.

60. Formally, if there are  $N$  countries, the global policymaker would allow activities for which:

$$\sum_{i=1}^N \pi_i + \sum_{i=1}^N f_i \geq 0.$$

Two points are worth mentioning with respect to this summation. First, it treats the welfare of each country as being equal. In some contexts, one may wish to weigh the interests of different countries differently. For example, one might believe that a given increase in welfare is more important for the poorest countries than for the rich. Or one might believe that countries with values that are offensive to the observer, such as the enslavement of a portion of the population or the prohibition of interracial marriages, should be weighted less heavily. Such adjustments can be made within the context of this model, but attempting to include them in this general treatment would greatly increase the complexity of the exposition. The easiest way to incorporate such concerns is to redefine  $\pi_i$  and  $f_i$  to be the effect of a transaction on a state, adjusted to reflect the desired weighting. Second, it should be noted that the above calculus implicitly includes dynamic considerations because the impact of a transaction on the welfare of a state includes the impact of the transaction on the future of that state. For example, a policy that imposes costs now but yields benefits later will have those benefits taken into account because today's actors care about tomorrow.

efficiency can be traded off against distributional concerns. 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 noncooperative, sub-optimal outcome. In those cases, the losing countries will prefer the sub-optimal outcome, frustrating efforts to achieve an efficient international regime.<sup>61</sup>

### C. NONCOOPERATIVE 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 each country is indifferent to the impact of its decisions on other countries.<sup>62</sup>

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.<sup>63</sup> It is clear that the actions of an individual country will not, in general, coincide with the global-welfare-maximizing policy described in Section II.B. This is so because the country takes into account only the interests of its own residents, ignoring the impact of the transaction on nonresidents. If the costs and benefits of an activity are distributed unevenly across countries, 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.

Example: Imagine a transaction that yields a payoff of one to every participant, with a single participant in every country. Assume that there are

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61. See Guzman, *supra* note 11, at 1501 (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).

62. The assumption that is necessary here is simply that governments care more about their own citizens than about foreigners. See Alan O. Sykes, *Externalities in Open Economy Antitrust and Their Implications for International Competition Policy*, 23 HARV. J.L. & PUB. POL'Y 89, 92 (1999) ("[F]rom a positive perspective, it is exceptionally unlikely that the welfare of foreign citizens will be weighted equally with the welfare of domestic citizens in the domestic political process. Foreign citizens do not vote in domestic elections, they cannot be taxed, they generally do not donate money to foreign politicians, and so on.").

63. The country's policy can be stated formally as allowing transactions if and only if:  $\pi_i + f_i \geq 0$ . If we adopt a public choice perspective, government policy can be modeled 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 permit an activity if and only if:  $\pi_A + \beta f_A > 0$ ; 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.

no third-party effects, with the exception of country *i*, which contains a person who stands to suffer a loss of two as a result of the transaction.<sup>64</sup> 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 one, 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 one 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 every country, that offers each participant a payoff of one. Suppose that third-party effects impose a cost of two 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 nonresidents—implying that from the perspective of country *i* the transaction yields a net benefit of one. 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 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" in Part III that inform us of 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 lessons also demonstrate a variety of misconceptions in existing choice-of-law rules and scholarship as generally understood in the United States.

#### D. INCORPORATING PUBLIC CHOICE ISSUES

Although the assumption that governments act in the public interest is convenient for expository purposes, it is often unrealistic either because governments pursue other objectives or because governments disagree on what

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64. 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*.

represents the national interest.<sup>65</sup> The alternative is to assume that governments pursue some set of objectives other than what is best for their country and that different states have different objectives. Public choice theory 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.<sup>66</sup> 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.<sup>67</sup>

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 large payoffs that favorable regulatory decisions will have on their special interests. Smaller group size and motivation lead to a well-organized, well-funded special interest lobby that is effective in influencing legislators.<sup>68</sup> 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.<sup>69</sup> In many situations, consumers may not even be aware of the effects of adverse regulation.<sup>70</sup> Even if consumers are aware, the

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65. If governments disagree on what is best we cannot compare the objective functions of one government with those of another, making a general assumption that governments pursue the national interest—which implicitly assumes that they are all pursuing the same definition of national interest—inaccurate.

66. See JAMES M. BUCHANAN & GORDON TULLOCK, *THE CALCULUS OF CONSENT: LOGICAL FOUNDATIONS OF CONSTITUTIONAL DEMOCRACY* (1962); DANIEL A. FARBER & PHILIP P. FRICKEY, *LAW & PUBLIC CHOICE: A CRITICAL INTRODUCTION* 17 (1991); MANCUR OLSON, *THE LOGIC OF COLLECTIVE ACTION* 5–7 (1965); Michael E. Levine & Jennifer L. Forrence, *Regulatory Capture, Public Interest, and the Public Agenda: Toward a Synthesis*, 6 J.L. ECON. & ORG. 167, 169 (1990) (“[Public choice] analysts postulate that people should be expected to act no less rationally or self-interestedly as politicians or bureaucrats than they do in the course of their private exchanges in markets.”); Richard A. Posner, *Theories of Economic Regulation*, 5 BELL J. ECON. & MGMT. SCI. 335, 335–36 (1974); George J. Stigler, *The Theory of Economic Regulation*, 2 BELL J. ECON. & MGMT. SCI. 3, 3–4 (1971).

67. This public choice model accommodates the assumption that governments have different objectives regardless of whether those government objectives are the result of legitimate differences in opinion or merely differences in the strength of interest groups from one country to the other. In the interest of convenience, the balance of the discussion assumes that it is differences in power of interest groups that is at issue.

68. See GEORGE J. STIGLER, *Can Regulatory Agencies Protect the Consumer?*, in *THE CITIZEN AND THE STATE: ESSAYS ON REGULATION* 178, 187 (1975).

69. *Id.*

70. See Ralph K. Winter, Jr., *Economic Regulation vs. Competition: Ralph Nader and Creeping Capitalism*, 82 YALE L.J. 890, 894 (1973).

reward to any one consumer for taking action is negligible.<sup>71</sup> 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.<sup>72</sup> 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.<sup>73</sup>

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 of government behavior.<sup>74</sup> 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 decisionmaking—even if one focuses on relatively well-defined areas of law such as antitrust or securities.<sup>75</sup> 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 could be addressed in three different ways. First, one 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.<sup>76</sup> 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 decisionmaking. It is, therefore, impossible to turn to existing domestic law scholarship 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 discussed in the paper systematically dominate the third-party effects. This position is defensible because generally it will be the parties to a transaction that are best able to lobby for their preferred regulation. Having

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71. See Stigler, *supra* note 66, at 4.

72. See Steven P. Croley, *Theories of Regulation: Incorporating the Administrative Process*, 98 COLUM. L. REV. 1, 38 (1998).

73. See Posner, *supra* note 6, at 343.

74. See, e.g., Warren F. Schwartz & Alan O. Sykes, *Toward a Positive Theory of the Most Favored Nation Obligation and Its Exceptions in the WTO/GATT System*, 16 INT'L REV. L. & ECON. 27 (1996); Alan O. Sykes, *Protectionism as a "Safeguard": A Positive Analysis of the GATT "Escape Clause" with Normative Speculations*, 58 U. CHI. L. REV. 255 (1991).

75. See Croley, *supra* note 75, at 41–56 (providing a thoughtful critique of public choice theory).

76. See, e.g., CURRIE, *supra* note 34; Choi & Guzman, *supra* note 10; Fox, *Globalizing Market*, *supra* note 10; Jack L. Goldsmith & Eric A. Posner, *A Theory of Customary International Law*, 66 U. CHI. L. REV. 1113 (1999); Rasmussen, *New Approach*, *supra* note 12; Romano, *supra* note 10; Kenneth J. Vandewelde, *U.S. Bilateral Investment Treaties, The Second Wave*, 14 MICH. J. INT'L L. 621 (1993); Westbrook, *Theory and Pragmatism*, *supra* note 12.

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 interests. 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 and within each of the "Choice-of-Law Lessons" that follow, 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. To address public choice issues in a generalized way, then, the public interest 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.<sup>77</sup> One could, however, imagine an alternative view under which it is consumers who dominate the process either because their ability to vote is of great interest to decisionmakers 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 of a policy then proceeds in much the same manner as it would under a public interest assumption, but with the *weighted* sum of direct benefits and third-party benefits as the key decision variable. This decision rule is then compared to the global optimum to generate lessons and policy implications much like those in Parts III and IV below. As is shown in the lessons that follow, analyzing the choice-of-law problem under the more general public choice assumptions leaves all of the lessons intact, though some require modification. The incorporation of public-choice considerations expands the potential range of government behavior and, therefore, inevitably makes the conclusions of the analysis less precise. Nevertheless, the lessons

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77. See, e.g., Louis De Alessi, *The Public-Choice Model of Antitrust Enforcement*, in *THE CAUSES AND CONSEQUENCES OF ANTITRUST* 189, 197 (Fred S. McChesney & William F. Shughart II eds., 1995) ("[T]he legislation enabling antitrust sought political objectives rather than consumer welfare."); William F. Shughart II et al., *Antitrust Enforcement and Foreign Competition*, in *THE CAUSES AND CONSEQUENCES OF ANTITRUST*, *supra*, at 179, 180 ("[A]ntitrust . . . 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 *complementary* policies for transferring wealth to groups that have a comparative advantage in rent-seeking activities." (citation omitted)).

presented below stand up remarkably well in the face of a public-choice analysis. Furthermore, more specific assumptions about one's public-choice beliefs would allow for a more complete analysis with more precise conclusions. What is clear is 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.

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 decisionmaking 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 decisionmaking is a field unto itself and a comprehensive account of government policymaking 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 does, therefore, is twofold. First, it provides a detailed discussion of the impact of choice of law under the conventional assumption that governments behave 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.<sup>78</sup> 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 to evaluate the desirability of choice-of-law rules.

### III. CHOICE-OF-LAW LESSONS

#### A. LESSON #1: THE NONCOOPERATIVE APPROACH IS INEFFICIENT

*If governments behave in a noncooperative 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 described 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 state will lead to a sub-optimal level of

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78. See *supra* Part I.

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.<sup>79</sup> If country *A* decided whether the transaction would go ahead, however, it would only take into account the direct and third-party effects felt by residents of *A*.<sup>80</sup> 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*.<sup>81</sup> 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.<sup>82</sup> 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,<sup>83</sup> is undesirable. To adopt such an approach would systematically favor liability-producing laws, leading to overregulation.

Up to this point, the analysis has been on a transaction-by-transaction basis. In many areas of law, of course, rules are not adjusted for each individual transaction, but rather activities are permitted or forbidden based on a set of clear rules. The creation of these rules is, in turn, affected by the country's local perspective.<sup>84</sup> 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 that allows its own firms to copy innovations developed abroad. Neither country has the proper incentives. The innovating country

79. That is, if and only if:  $\pi_A + \pi_B + f_A + f_B > 0$ .

80. Country *A* would allow the transaction if and only if:  $\pi_A + f_A > 0$ .

81. Country *B* would allow the activity if and only if:  $\pi_B + f_B > 0$ .

82. See, e.g., Eleanor M. Fox, *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."); Diane Wood, *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.").

83. See RUSSELL J. WEINTRAUB, COMMENTARY ON THE CONFLICT OF LAWS 360 (3d ed. 1986).

84. 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.



fails to take into account the increased welfare that would be enjoyed by foreign consumers if intellectual property rules were relaxed while the importing country does not take into account the welfare gain that would be enjoyed by the innovator if such laws were strengthened.

It is clear that the inclusion of public-choice considerations does nothing to change Lesson #1—that the noncooperative approach to choice of law is inefficient. The argument here is identical to that made under public interest assumptions. The interests of individual countries simply do not align with 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.

#### B. LESSON #2: EXTRATERRITORIALITY LEADS TO OVERREGULATION

*The noncooperative 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 to prevent the welfare loss within its borders. This means that if every country applies its law extraterritorially, every transaction that reduces global welfare will be regulated.<sup>85</sup> In other words, if all countries act extraterritorially, a noncooperative approach to choice of law will never lead to underregulation because for every globally inefficient transaction there is at least one country with an incentive to prevent it.<sup>86</sup>

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85. 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. Conversely, as one moves toward greater territoriality, it will decrease.

86. 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:

$$\pi_j + f_j < 0.$$

If it is also the case that:

$$\sum_{i=1}^N (\pi_i + f_i) < 0.$$

then the activity is undesirable from a global point of view. For the second inequality to hold it must be

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 *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.<sup>87</sup> Transactions that increase world welfare but that harm even a single country will be prevented. 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.

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*'s 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,

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true that the first inequality holds for some *j*, ensuring that at least one country will wish to regulate the activity. Thus, any globally inefficient transaction will be regulated by at least one country.

87. There is an implicit assumption here that other jurisdictions are unwilling or unable to offer payment to those jurisdictions that suffer a loss from the transaction. This assumption is reasonable in light of the practical difficulties with negotiating such transfers between states on either a case-by-case basis or over an entire issue-area. 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:

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

If every country applies its laws extraterritorially, however, the transaction will be regulated somewhere unless it satisfied the much more restrictive condition that  $\pi_i + f_i > 0$ , for all *i*.

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 regulate its issuers as restrictively as does the international regime. By any measure, this is excessive regulation.

In principle, the problem of overregulation 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 transaction costs often prevent such transfers, leading to systematic overregulation 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 Section V.C.

This lesson demonstrates that the most popular choice-of-law approach among academics, the “governmental interest approach,” will lead to systemic overregulation. The governmental interest approach 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.<sup>88</sup> 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, governmental interest analysis—the dominant approach to choice-of-law analysis—is flawed because it leads to systematic overregulation. It should not surprise us that the governmental interest approach fails to resolve conflicts in a fashion that promotes efficiency. The development of the governmental 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 governmental interest approach is so dedicated to preserving territorial notions of sovereignty, it was perhaps inevitable that it would lead to overregulation. Where a transaction impacts many jurisdictions, the pro-sovereignty bias of the governmental interest approach leads to regulation by all affected jurisdictions.

Examining the impact of extraterritoriality under public choice assumptions is slightly more complex than it is under public interest assumptions, and the results are somewhat modified. Nevertheless, the claim that extraterritoriality leads to overregulation remains true over a wide range of public choice assump-

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88. See CURRIE, *supra* note 34, at 557.

tions. 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 overregulation in some cases and underregulation in 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 thirty, and *B* enjoys direct benefits of five.<sup>89</sup> The third-party effects, however, are distributed differently—country *A* suffers third-party harms of five while *B* suffers harms of fifteen. It is clear that this transaction should be allowed because it yields global benefits of thirty-five and harms of twenty, implying a net gain of fifteen. 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 five is weighted as if it were ten. This is compared to the loss of fifteen, leading to regulation of this globally desirable transaction by country *B*.

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 ten from a transaction. Assume further that they each suffer third-party harms of fifteen. It is clear that this transaction should be regulated because the harms of thirty outweigh the benefits of twenty. 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 twenty while the harms are only fifteen.

### C. LESSON #3: TERRITORIALITY LEADS TO UNDERREGULATION

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

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

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89. Imagine, for example, that there are six participating firms in *A* and one in *B* and that each firm gains five.

nation's borders were not within the jurisdiction of the courts.<sup>90</sup> This approach leads to systematic underregulation. 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 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, a transaction 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, that local firms wish 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.<sup>91</sup> 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. Policymakers 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-reducing will be permitted to go forward. This result is demonstrated in the following example.<sup>92</sup>

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90. See, e.g., *Am. 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.

91. 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 benefits of doing so.

92. 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  $i$  is given by:  $\pi_i + f_i$ . 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,  $\delta$ , of what they otherwise would be, where  $\delta \leq 1$ . Second, the impact of the activity on local third parties may be reduced because local producers are no longer able to participate. Denote by  $\phi$  the fraction of the impact on third parties that remains despite the government prohibition, where  $0 \leq \phi \leq 1$ . If the government chooses to regulate the activity, the impact on welfare is, therefore, represented by:

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 so (as was the case for antitrust policy in the United States until 1945<sup>93</sup> and Europe until 1988<sup>94</sup>). Suppose that a group of local firms plans to participate in an international cartel arrangement intended to both increase market power through a strategy of collusive pricing and to 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 precartel level of profits. This could occur, for example, if the cartel succeeds in excluding local firms from suppliers, distributors, and so on.

Second, in addition to the firms, local third parties may also stand to lose from the transaction. The exclusion of local firms would not shield local third parties who would suffer a loss regardless of whether or not local firms are permitted to participate. If this is so, the country would be clearly 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

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$\delta\pi_i + \phi f_i$ . The government permits an activity if and only if local residents are better off when local firms participate, which can be expressed as:  $\delta\pi_i + \phi f_i \leq \pi_i + f_i$ . The above inequality holds as long as:  $(\delta - 1)/(1 - \phi) \leq f_i/\pi_i$ . 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  $\delta$ , the impact of regulation on profit, is small relative to  $\phi$ , the impact of regulation on third-party effects, the activity is more likely to be permitted.

The relative size of  $\delta$  and  $\phi$  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 (that is,  $\phi = 1$ ). In that case, the impact from regulating the activity would be:  $\delta\pi_i + f_i$ . Comparing this result to the impact on the country if it allows the activity ( $\pi_i + f_i$ ) shows that it will never be in the country's interest to regulate. In other words, a complete absence of extraterritoriality—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 ( $\phi = 0$ ). More generally, as  $\delta$  gets smaller relative to the impact of regulation on local third-party effects ( $\phi$ ), 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.

93. *United States v. Aluminum Co. of Am.*, 148 F.2d 416, 443 (2d Cir. 1945).

94. Case 89/85, *A. Ahlström Osakeyhtiö v. Commission*, 1988 E.C.R. 5193, 4 Common Mkt. Rep. (CCH) ¶ 14,491, 18,612 (1988).

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,<sup>95</sup> 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 underregulation 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 with respect to their competition 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.<sup>96</sup> As compared to the competition laws of any single member country, a European law more effectively prevents or reduces the impact of potentially anticompetitive behavior on consumers because it is better able to regulate the entire transaction rather than just a small portion.<sup>97</sup> In a similar fashion, European regulation is more effective at reducing the impact of a transaction on the profits of nonparticipants.<sup>98</sup> As the prior discussion predicts, the European Union adopted a European competition law that was much more strict than the national laws it replaced.<sup>99</sup> Because individual countries had not applied their laws extraterritorially, they had been underregulating in the competition policy area.

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

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95. Note that this ratio represents a reasonable measure of extraterritoriality.

96. Guzman, *supra* note 11, at 1537–38.

97. This has the effect of reducing  $\phi$  in note 95.

98. This is equivalent of bringing  $\delta$  closer to unity in note 92.

99. Guzman, *supra* note 11, at 1537–38.

late 1940s until the 1980s cannot be supported without a much more complex discussion and analysis than was ever advanced.

This lesson remains true even if one adopts public choice assumptions regarding government behavior. 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 underregulation, 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.<sup>100</sup> 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 overregulation under assumptions of territoriality and heavily weighted third-party effects. To make this point clear, imagine that a country does not care about direct effects at all. For whatever reason, the country is concerned only with third-party effects. In this case, there will be overregulation because anytime a country faces negative third-party effects it will engage in local regulation of the transaction.

#### 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,<sup>101</sup> 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, it is included 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

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100. These benefits will exist only if the withdrawal of local firms from the transaction reduces the impact on third parties because, by assumption, the country is unable to alter the behavior of foreign parties.

101. 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, *From Politics to Efficiency*, *supra* note 6.



positive for every country.<sup>102</sup> 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 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 to 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.<sup>103</sup> 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.<sup>104</sup> 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.<sup>105</sup> 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.<sup>106</sup> As a result, the firm will have an incentive to choose the most efficient regime to ensure that it can get access to capital at the lowest possible cost.<sup>107</sup>

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

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102. Recall that the impact of a transaction on parties considered to be incompetent is treated as a third-party effect.

103. See Choi & Guzman, *supra* note 10; Romano, *supra* note 10.

104. Choi & Guzman, *supra* note 10, at 917–18; Romano, *supra* note 10, at 2366–67.

105. See Robert K. Rasmussen, *Debtor's Choice: A Menu Approach To Corporate Bankruptcy*, 71 TEX. L. REV. 51 (1992); Rasmussen, *New Approach*, *supra* note 12 (presenting an international version of a menu-choice approach); Rasmussen, *Resolving Transnational Insolvencies*, *supra* note 12; Alan Schwartz, *A Contract Theory Approach to Business Bankruptcy*, 107 YALE L.J. 1807 (1998).

106. Rasmussen, *supra* note 106, at 66–68; Schwartz, *supra* note 106, at 1819–20.

107. Professor LoPucki has responded that the existence of nonadjusting creditors, who are not represented in the standard models of international bankruptcy, make a contracting regime undesirable. See LoPucki, *Cooperation in International Bankruptcy*, *supra* note 12, at 739–42. But see Rasmussen, *New Approach*, *supra* note 12, at 21–22 (arguing for limits on contracting in order to take these creditors into account).

to judge the value of a security.<sup>108</sup> 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 to attract securities.<sup>109</sup> 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 nonconsensual 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.<sup>110</sup>

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.<sup>111</sup> This conclusion, however, is not accurate as demonstrated by Lesson #5 below.

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 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.

#### 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. Once we have identified those jurisdictions that have an interest, it becomes necessary to evaluate the jurisdictional claims of each. This second step is

108. See Choi & Guzman, *supra* note 10, at 941–42.

109. See Fox, *Globalizing Market*, *supra* note 10, at 2626–27; Fox, *Mandatory Securities Disclosure*, *supra* note 10, at 1392; Guzman, *supra* note 53, at 614.

110. See LoPucki, *Cooperation in International Bankruptcy*, *supra* note 12, at 709–13.

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

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.<sup>112</sup> 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 been mentioned already, this means that it will permit any activity that firms wish to undertake. If, on the other hand, third-party effects impact the citizens of another country, that country will permit the activity if and only if the sum of direct effects and third-party effects within that country is positive. Although it is true 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 overregulation because those countries are 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, 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 dollars 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 \$60 dollars. However, if country B has jurisdiction (and is able to exercise it extraterritorially), it will prevent the activity, frustrating this value-creating transaction.

#### F. LESSON #6: THE HARTFORD FIRE CASE IS WRONG

*When 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

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112. 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.

choice-of-law commentators. 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.<sup>113</sup> 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.<sup>114</sup>

In *Hartford Fire Insurance Co. v. California*,<sup>115</sup> 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<sup>116</sup> by engaging in conspiracies intended to affect the American insurance market.<sup>117</sup> The actions of the defendants were apparently legal under British law.<sup>118</sup> "[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."<sup>119</sup> Based on the legality of the conduct in Britain, defendants argued that United States courts should decline to exercise jurisdiction under principles of international comity.<sup>120</sup> The Supreme Court, however, held that there was no "true conflict" between British and American law.<sup>121</sup> "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."<sup>122</sup> In other words, because British law permits but does not compel the conduct, there is no conflict between that law and a United States 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

113. *Hartford Fire Ins. Co. v. California*, 509 U.S. 764 (1993); CURRIE, *supra* note 34, at 477-78; Kay, *supra* note 26, at 59; Kramer, *supra* note 6 at 307.

114. Many commentators have written on the *Hartford Fire* decision, and many of those commentaries are critical. The criticisms, however, are different from the one advanced herein. See Kenneth W. Dam, *Extraterritoriality in an Age of Globalization: The Hartford Fire Case*, 1993 SUP. CT. REV. 289 (arguing in favor of comity analysis); Robert C. Reuland, *Hartford Fire Insurance Co., Comity, and the Extraterritorial Reach of United States Antitrust Laws*, 29 TEX. INT'L L.J. 159 (1994) (warning that *Hartford Fire* threatens U.S. foreign relations); James P. Rhatican, *Hartford Fire Insurance Co. v. California: A Mixed Blessing for Insurance Antitrust Defendants*, 47 RUTGERS L. REV. 905 (1995) (criticizing the Court for its abandonment of comity). But see Varun Gupta, Note, *After Hartford Fire: Antitrust and Comity*, 84 GEO. L.J. 2287, 2288, 2316-18 (1996) (arguing in favor of the elimination of comity).

115. 509 U.S. at 764.

116. 15 U.S.C. § 1 (1994).

117. *Hartford Fire*, 509 U.S. at 769.

118. *Id.* at 798-99.

119. *Id.* at 798.

120. *Id.* at 797.

121. *Id.* at 799.

122. *Id.*

both" there is no conflict, "even where the foreign state has a strong policy to permit or encourage such conduct."<sup>123</sup> 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."<sup>124</sup> Kramer begins his discussion with purely domestic cases, noting that even when only one jurisdiction is involved, there may be choice-of-law questions.<sup>125</sup> 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 a domestic setting governed by a single legislative body it makes sense to conclude that when only one law applies to the plaintiff's claim, the choice-of-law question is resolved. In the interstate setting, however, this view is problematic.<sup>126</sup> When 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 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

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123. RESTATEMENT (THIRD) OF FOREIGN RELATIONS LAW § 415, cmt. j (1987). The *Hartford Fire* Court quotes this exact language in its opinion. 509 U.S. at 799.

124. Kramer, *supra* note 6, at 283. Although the above quote refers to a dispute within a single jurisdiction, Kramer's point is that the same analysis applies in multistate cases. *Id.* In the multistate context, he writes, "the court should first examine the laws in issue to determine whether both apply, i.e., whether there is a conflict. If there is a conflict, the court should then employ some second-order rule of interpretation to choose between these laws." *Id.* at 291; see also Larry Kramer, *Extraterritorial Application of American Law after the Insurance Antitrust Case: A Reply to Professors Lowenfeld and Trimble*, 89 AM. J. INT'L L. 750, 754-55 (1995) ("Justice Souter [in *Hartford Fire*] stated very clearly that without the requisite conflict there is 'no need . . . to address other considerations . . . of international comity.' In this respect, at least, I agree with the Court.").

125. Kramer, *supra* note 6, at 283.

126. In fairness to Professor Kramer, he has not explicitly stated that the lack of a true conflict should be determinative in the international arena, although some of his writing suggests this conclusion. See Kramer, *supra* note 130, at 755.

activity causes a reduction in welfare. In every country other than A, the activity is 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 to avoid a local 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 noncooperative outcome will lead to systematic overregulation 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 overregulation. 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 United States 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.<sup>127</sup>

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. When 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.<sup>128</sup>

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

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127. 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.

128. 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 beyond its own borders, an issue taken up in section IV.A *infra*.

determine if “some rule of positive law confers a right to recover,”<sup>129</sup> but rather to contribute to the development of a set of background rules that increases 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.*

If a resident or domiciliary from country A is a party to the transaction, A may have an interest in allowing that activity, as shown in Lesson #5. 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 United States issuer of securities that issues 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.<sup>130</sup> 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 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

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129. Kramer, *supra* note 6, at 290.

130. The relative importance of domiciliary and territorial factors has been, and continues to be, much debated. See BRILMAYER, *supra* note 2, at 19. Beale’s vested rights approach suggested that territoriality was the better approach, while Currie’s interest analysis recommends a domiciliary approach. *Id.* As this paper indicates, neither approach is conceptually correct, but both may serve as proxies for effects in certain instances. *Id.*

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 overreaching 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 IS NOT RELEVANT

*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 represents one of the most traditional bases for jurisdiction.<sup>131</sup> The conduct test is commonly used to determine, for example, whether federal securities laws have jurisdiction over alleged violation of antifraud rules.<sup>132</sup>

Although tests based on the location of activity are used widely, 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 United States 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 fall within the jurisdictional reach of U.S. securities law.<sup>133</sup> Notice, however, that the transaction has no effect on United States 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 United States securities laws is that the laws exist not only to protect individual

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131. See *Am. Banana Co. v. United Fruit Co.*, 213 U.S. 347 (1909).

132. See Choi & Guzman, *supra* note 14, at 215–19.

133. See *Bersch v. Drexel Firestone*, 519 F.2d 974 (2d Cir. 1975); *Schoenbaum v. Firstbrook*, 405 F.2d 200 (2d Cir. 1968).



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 United States securities laws, the argument goes, market participants will be unable to distinguish between transactions that are protected by United States law and those that are not so protected.

Professor Choi and I have argued elsewhere that the market will, in fact, be able to distinguish between those securities that are subject to United States law and those that are not.<sup>134</sup> Regardless of one's view on 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 United States securities markets. This amounts to an effect on United States capital market participants, including many United States 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 United States investors. Assume that the transaction takes place in Japan.<sup>135</sup> 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 United States 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 her interests, then the investor 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 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 when the impact

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134. See Choi & Guzman, *supra* note 10.

135. 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 this example and simply assert that, regardless of the manner in which the location of the transaction is defined, the transaction takes place in Japan.

of a transaction is likely to be felt by those who are close to the location of the transaction and when a judicial inquiry into the presence of effects is costly 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.

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.<sup>136</sup> Those who argue for a contractual approach believe that such third-party effects are small.<sup>137</sup> If there are no third-party effects, it is widely agreed that 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 firms choose the place of incorporation efficiently because shareholders internalize the costs and benefits of that choice.<sup>138</sup> 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

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136. *See, supra* note 53.

137. *See, e.g.*, Choi and Guzman, *supra* note 10, at 941–45 (arguing that portable reciprocity imposes few third-party effects on shareholders).

138. *Id.* at 923–24.

when they choose a jurisdiction on behalf of shareholders.<sup>139</sup> 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 debate over the proper jurisdictional reach of federal securities regulation takes place along largely the same lines.<sup>140</sup> 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.<sup>141</sup>

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 are able to adjust, we should allow debtors and creditors to select the legal regime that will govern a bankruptcy.<sup>142</sup> Those who oppose this view do so on the grounds that there are third-party effects for which mandatory bankruptcy rules are more appropriate.<sup>143</sup> In the international sphere, a related debate exists. Most commentators believe that bankruptcies should be wound up under the laws of a single jurisdiction.<sup>144</sup> 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 correlated with the location of the assets and who are unable to adjust to bankruptcy rules other than those present in the local jurisdiction.<sup>145</sup>

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

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139. See sources cited *supra* note 9.

140. See sources cited *supra* note 10.

141. Fox, *Globalizing Market*, *supra* note 110, at 2609–11.

142. See sources cited *supra* note 106.

143. See LoPucki, *Cooperative Territoriality*, *supra* note 12.

144. See generally Bebchuk & Guzman, *supra* note 12; Guzman, *supra* note 12; Rasmussen, *New Approach*, *supra* note 12; Rasmussen, *Resolving Transnational Insolvencies*, *supra* note 12; Westbrook, *Choice of Avoidance*, *supra* note 12; Westbrook, *Theory and Pragmatism*, *supra* note 12.

145. See LoPucki, *Cooperative Territoriality*, *supra* note 12.

## IV. POLICY IMPLICATIONS

## A. THE PRESUMPTION AGAINST EXTRATERRITORIALITY

*When 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 longstanding 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."<sup>146</sup> To overcome the presumption, a party must show "the affirmative intention of Congress clearly expressed."<sup>147</sup> This interpretative principle was pivotal in the antitrust case, *American Banana Co. v. United Fruit Co.*,<sup>148</sup> 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."<sup>149</sup>

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 *American Banana* precedent was avoided by courts for many years and ceased to be the applicable law by the mid-1940s.<sup>150</sup> The presumption has been overlooked in other areas of law as well, including securities law.<sup>151</sup> 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 effect within, the territory of the United States."<sup>152</sup> The *Restatement (Third)* went so far as to state that Justice Holmes's statement of the presumption against extraterritoriality, "though still often quoted, does not reflect the current law."<sup>153</sup> Finally, the Supreme Court failed to apply the presumption against extraterritoriality in *Hartford Fire*

146. *EEOC v. Arabian Am. Oil Co. (ARAMCO)*, 499 U.S. 244, 248 (1991) (quoting *Foley Bros. v. Filardo*, 336 U.S. 281, 285 (1949)). One can find references to the presumption as early as 1818. See *United States v. Palmer*, 16 U.S. 610, 628 (1818).

147. *ARAMCO*, 499 U.S. at 248 (quoting *Benz v. Compania Naviera Hidalgo, S.A.*, 353 U.S. 138, 147 (1957)).

148. 213 U.S. 347, 357 (1909) ("The foregoing considerations 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 general and legitimate power. 'All legislation is prima facie territorial.'").

149. *Id.* at 356.

150. See *United States v. Sisal Sales Corp.*, 274 U.S. 268, 275-76 (1927); *United States v. Aluminum Co. of Am.*, 148 F.2d 416, 443 (2d Cir. 1945).

151. See *Schoenbaum v. Firstbrook*, 405 F.2d 200 (2d Cir. 1968) (effects). But see *SEC v. Kasser*, 548 F.2d 109 (3d Cir. 1977) (conduct); *Bersch v. Drexel Firestone*, 519 F.2d 974 (2d Cir. 1975) (same).

152. *RESTATEMENT (SECOND) OF THE FOREIGN RELATIONS LAW OF THE UNITED STATES* § 38 (1965).

153. *RESTATEMENT (THIRD) OF THE FOREIGN RELATIONS LAW OF THE UNITED STATES* § 415, Reporters' Note 2 (1987).

*Insurance Co. v. California*,<sup>154</sup> 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, *EEOC v. Arabian American Oil Co. (ARAMCO)*.<sup>155</sup> In *ARAMCO*, the Court refused to apply Title VII extraterritorially in the case of discrimination by an American company against an American employee abroad.<sup>156</sup>

From the perspective of a court, of course, it would be preferable if every statute specified the extent to which it should apply extraterritorially. When such instruction is 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 overregulation, 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.<sup>157</sup> 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 when 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 overregulation.

It is true that a presumption against extraterritoriality tends to bias the

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154. 509 U.S. 764 (1993).

155. 499 U.S. 244 (1991). The Court has also applied the presumption to the Foreign Sovereign Immunities Act, the Federal Tort Claims Act, and the Immigration and Nationality Act. William S. Dodge, *Understanding the Presumption Against Extraterritoriality*, 16 BERKELEY J. INT'L L. 85, 87 (1998).

156. *ARAMCO*, 499 U.S. at 249.

157. See Gary B. Born, *A Reappraisal of the Extraterritorial Reach of U.S. Law*, 24 LAW & POL'Y INT'L BUS. 1, 59–79 (1992); Larry Kramer, *Vestiges of Beale: Extraterritorial Application of American Law*, 1991 SUP. CT. REV. 179, 184.

international system toward less, rather than more, regulation. In particular, Lesson #3 points out that territoriality leads to underregulation, implying that a presumption in favor of territoriality may lead to underregulation. Although there is some merit to this concern, the presumption against extraterritoriality remains a valuable choice-of-law tool. Concern for underregulation brought about by the presumption is overstated, primarily because the costs of underregulation fall on local residents. Thus, if there is underregulation, 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 underregulation, 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 in a way that is globally sub-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 overregulation. In this context, however, the costs of the overregulation 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 overregulation that results when the presumption against 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 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, policymakers 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 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 at least 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.<sup>158</sup>

Consider, for example, the United States Bankruptcy Code, which permits United States creditors to prevent the turnover of local assets to a foreign jurisdiction by showing prejudice or inconvenience.<sup>159</sup> Such legislation instructs courts to make a choice-of-law decision 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

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158. Here the assumption that the costs and benefits are distributed across countries according to the same distribution is strong. It is relaxed below.

159. 11 U.S.C. § 304(c) (1994).

gains from refusing turnover outweigh the costs.<sup>160</sup>

Imagine how the law might be different if such discrimination were not permitted.<sup>161</sup> 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,<sup>162</sup> it is likely that at least some creditor prefers distribution under local law.<sup>163</sup> Assuming that foreign creditors are as likely as United States creditors to prefer distribution under local law, the existing rule would be as likely to harm the interests of United States 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. 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.<sup>164</sup>

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 United States antitrust laws.<sup>165</sup> If the requirements of these exemptions are met, foreign parties injured by activities that take place within the United States have no remedy available under United States 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

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160. See, e.g., LoPucki, *Cooperation in International Bankruptcy*, *supra* note 12, at 728.

161. That is, imagine that creditors from any jurisdiction could prevent the turnover of assets on the same terms as U.S. creditors.

162. For simplicity, assume that we are dealing with a liquidation proceeding rather than a reorganization, which need not be zero sum.

163. 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.

164. I use section 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 12; Guzman, *supra* note 12. In particular, I am convinced that section 304 as currently constructed is welfare-reducing 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.

165. See Export Trading Company Act of 1982, 15 U.S.C. §§ 4011–4021 (2000); Webb-Pomerene Act, 15 U.S.C. §§ 16–66 (2000). For a more detailed discussion of export cartels, see Guzman, *supra* note 11, at 1533–34.



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 United States 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 overregulate 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.<sup>166</sup>

### C. PRIVATE RIGHTS OF ACTION

*Whenever 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 nonresidents to a different level of government. Rather than having legislators discriminate in favor of locals—as is done with the Webb-Pomerene Act<sup>167</sup>—regulators can discriminate in the choice of cases they pursue or the vigor with which they prosecute suspected offenders.<sup>168</sup> 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.<sup>169</sup> Many observers, however, believe that the enforcement of those laws is weak and favors local actors.<sup>170</sup>

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.<sup>171</sup> It should be noted that other factors, not discussed in this Article, affect

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166. 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.

167. See John F. McDermid, *The Antitrust Commission and the Webb-Pomerene Act: A Critical Assessment*, 37 WASH. & LEE L. REV. 105 (1980).

168. Regulators may also be able to discriminate through their rulemaking authority. For our purposes, this authority should be subject to the same national treatment requirement that is discussed in the previous section.

169. See generally Abbott B. Lipsky, *Current Developments in Japanese Competitive Law*, 60 ANTITRUST L.J. 279 (1991).

170. See, e.g., J. Mark Ramseyer, *The Costs of the Consensual Myth: Antitrust Enforcement and Institutional Barriers to Litigation in Japan*, 94 YALE L.J. 604 (1985).

171. 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

the costs and benefits of private rights of action.<sup>172</sup> A discussion of these factors is beyond the scope of this Article. 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.<sup>173</sup> Because individuals can seek recovery for their third-party losses, firms must internalize the full costs of their decisions more often. When all costs are internalized, of course, the transaction will take place if and only if it is welfare-enhancing from a global perspective.<sup>174</sup>

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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 United States suggests that courts are more even-handed than is generally believed. See Kevin M. Clermont & Theodore Eisenberg, *Xenophilia in American Courts*, 109 HARV. L. REV. 1120, 1121–22 (1996).

172. See, e.g., James T. O'Reilly, *Deregulation and Private Causes of Action: Second Bites at the Apple*, 28 WM. & MARY L. REV. 235, 261 (1987) (noting that marginal benefits from private rights of action are often offset by high costs).

173. 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.

174. 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  $\Lambda_{ij}$  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, then:

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

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:

$$\pi_i - \sum_{j=1}^N \Lambda_{ij}.$$

## V. APPLICATIONS

## A. COOPERATION ON CHOICE OF LAW

This Article has approached the choice-of-law issue 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 these 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*, but 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—perhaps providing a blueprint for such negotiations. Second, by focusing on

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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 in the transaction. Because parties 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 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

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

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.

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.<sup>175</sup> 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 willing to participate 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 it is more easily arranged.

#### B. COOPERATION ON 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, 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.<sup>176</sup> Finally, when 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 initially were centered in the World Intellectual Property Organization (WIPO), whose mandate was limited to intellectual property.<sup>177</sup> To get an agreement between developed and developing countries, however, it was necessary to conduct negotiations within the WTO.<sup>178</sup> This was eventually done and

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175. 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 goods, which has seen dramatic and widespread international cooperation to reduce tariff barriers.

176. 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. See Amir Licht, *International Diversity In Securities Regulation: Roadblocks On The Way To Convergence*, 20 CARDOZO L. REV. 227, 280 (1998). There has been no success, however, in achieving international cooperation over substantive rules.

177. See Frederick M. Abbott, *The Future of the Multilateral Trading System in the Context of TRIPs*, 20 HASTINGS INT'L & COMP. L. REV. 661, 665-666 (1997).

178. See Andrew T. Guzman, *International Antitrust and the WTO: the Lessons from Intellectual Property*, VA. J. INT'L L. (forthcoming 2003).

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.<sup>179</sup>

Negotiation over international business issues obviously should be carried out in the manner most likely to lead to the adoption of efficient rules. The analysis developed in this Article makes it possible to determine the level of international cooperation needed 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.<sup>180</sup> 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 supranational 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.<sup>181</sup> Because third-party effects are small,<sup>182</sup> 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

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179. See J.H. Reichman, *Universal Minimum Standards of Intellectual Property Protection Under the TRIPs Component of the WTO Agreement*, 29 INT'L LAW. 345 (1995).

180. See, e.g., Bebchuk & Guzman, *supra* note 12, at 775, 778.

181. *Id.* at 804–06.

182. 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.

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.

## 2. Securities

There is an ongoing debate about the appropriate international regulatory regime for securities, and it is beyond the scope of this Article to provide a full account of this debate.<sup>183</sup> 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 with nothing 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

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 may have at least a claim to jurisdiction (Lessons #5 and #6).<sup>184</sup> 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. However, given that the United States and the European Union both apply their laws extraterritorially, allowing every country with such an interest to regulate the transaction will lead to overregulation (Lesson #2). Nor will a ban on extraterritoriality solve the problem as this will simply cause underregulation (Lesson #3). Even from the perspective of global welfare, it is difficult to 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

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183. *See supra* note 10.

184. *See supra* sections III.E and III.F.

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.<sup>185</sup> If this is so, attempts at negotiating an international competition policy agreement should proceed accordingly. Specifically, the policy agreement 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.<sup>186</sup> 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.

### 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 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 that govern intellectual property. If transfer payments are possible, however, countries can then negotiate to the efficient level of protection and make transfers among themselves to distribute the gains.

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185. See Guzman, *supra* note 11, at 1542.

186. See, e.g., Fox, *supra* note 82, at 665.

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.<sup>187</sup> 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 underregulation. 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 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 most useful in those situations where the parties are least likely to achieve the global optimum by themselves. First, when there are no third-party effects, international institutions are least important because the parties can reach the efficient outcome through contract. Second, when transactions have overwhelmingly local effects, international organizations have little to offer because domestic lawmakers face appropriate incentives. Third, when parties have roughly proper incentives despite international activity, there is no need for cooperation. This may 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.<sup>188</sup>

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 traditionally have not been trade issues, such as 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?

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187. See generally Reichman, *supra* note 179.

188. If a country, for instance, enjoys twenty-five percent of the benefits from a transaction and faces twenty-five percent of the total costs, then that country has optimal incentives.



The objective of competition policy, at least in the United States,<sup>189</sup> is to protect the market from monopolies and monopolistic conduct. In the competition policy context, consumers represent third parties who are affected by corporate decisions. National policymaking 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 underregulate while those that stand to lose (countries with a high consumer-to-firm ratio) will tend to overregulate 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 underregulation. The market will not correct this problem because there is no reason for the producer countries to agree to any form of international agreement.<sup>190</sup> 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 globally optimal because they enjoy all the benefits from their pollution and only a portion of the harms. 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 nor need they even be in the environmental arena. By including environmental issues within the framework of the WTO, transfers of that sort are made possible.

#### 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 address effectively the pressing regulatory challenges that face the international community as globalization continues. This Article has laid out a new structure, based upon efficiency and welfare concerns, through which to build a choice-of-law theory.

Recognizing that countries can be expected to pursue their own interests and establishing that these interests generally will not coincide with the best global

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189. The stated objective of competition policy varies from country to country. *See* Guzman, *supra* note 11, at 1539.

190. 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.

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 several 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 this Article must be applied to particular issues before one can determine how to structure international negotiations. This 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, this Article addresses an important contemporary question regarding the role of international institutions. It demonstrates that when the interests of countries are such that agreement on a choice-of-law rule is enough to get the efficient outcome, and when 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, when individual states lack an incentive to enact efficient choice-of-law rules, or when 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 an international organization such as the WTO much more easily than in ad hoc negotiations dedicated to a single issue.