ARTICLES

THE UNEASY CASE FOR TOP-DOWN CORPORATE LAW HARMONIZATION IN THE EUROPEAN UNION

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ABSTRACT

This Article considers whether there is a case for further harmonization of European Community ("EC") corporate law. If one treats corporate law harmonization as a real-world phenomenon, looking at its record thus far and scrutinizing its various rationales, the answer is that there is not. First, the possible justifications for harmonization in the corporate law area do not stand close scrutiny: with no European "Delaware" in sight, it is premature to impose rules to prevent a race to the bottom among European Union ("EU") jurisdictions. Even if harmonization can be justified in theory to correct market failures that Member States are unable or unwilling to correct by themselves, and provided that the new harmonized rules would make society better off (also taking the costs arising from them into account), this Article argues that there

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Sections 2 and 3 of this Article draw heavily from Luca Enriques, *Company Law Harmonization Reconsidered: What Role for the EC?*, *in* EUROPEAN COMPANY LAW IN ACCELERATED PROGRESS 59 (Steef M. Bartman ed., 2006). We wish to thank Paulo Câmara, Blanaid Clarke, Ronald Gilson, Henry Hansmann, Reinier Kraakman, Stefano Lombardo, Ettore Scimemi, and Jaap Winter for their helpful comments to an earlier draft. Usual disclaimers apply.

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is no reason to believe that EC institutions are any better positioned than national lawmakers to tackle market failures. Further, we analyze the rationales for the objective of market integration and argue that in the real world, negative harmonization (i.e. the removal of barriers to the four freedoms) is generally bundled with positive harmonization, so that what can be gained in terms of greater freedom of establishment is usually lost in terms of decreased flexibility. The Article criticizes the level playing field rationale for corporate law harmonization and argues that, far from lowering transaction costs, real-world harmonization has thus far raised them and can hardly be expected to do otherwise in the future. Finally, we dismiss the arguments from scale economies in law production and the correction of national governments' failures as either implausible with regard to corporate law or unconvincing.

This Article goes on to highlight the drawbacks of harmonization. Corporate law harmonization substitutes a single lawmaker for twenty-five different ones, or in other words a monopolist for twenty-five competitors, implying a higher risk of excessive regulation and innovation and a lower degree of experimentation. Also, uniform law precludes taking divergent expectations and preferences into account at the national level. Further, real-world harmonization increases the complexity and uncertainty of national corporate laws. Moreover, EC corporate law rules are hard to change and therefore not adaptable to economic or technological developments. Finally, the harmonization process itself is costly in terms of lobbying expenditures and the rent extraction opportunities it grants EC officials and politicians.

After testing the proposed general framework by providing an analysis of certain recent initiatives by the EC in the field of corporate law (namely those on shareholder rights, differential voting structures, pyramids, and cross-border mergers), the Article concludes that, ideally, the European Community should restrict its action in this field to simply reducing the barriers to corporations' freedom of movement.

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1. INTRODUCTION: TOWARD A GENERAL FRAMEWORK FOR THE ASSESSMENT OF CORPORATE LAW HARMONIZATION INITIATIVES

In the aftermath of financial scandals at the beginning of this century, policymakers around the world have enacted or proposed sweeping corporate and securities law reform. In legal systems with more than one level of government, this drive raises an obvious and delicate question: who should be the reformer? Should the laws be enacted at the central (federal) level or at the state level?

The American story is well known. U.S. corporate law is generally produced at the state level[1] and, over the years, Delaware has maintained a predominant position.[2] Scholars disagree as to whether Delaware's primacy is a good or a bad thing. Supporters of the "race to the top" theory hold that companies elect to incorporate in states where the rules maximize their value through the optimal mix of shareholder protection and deference to management's business judgment.[3] Those who embrace the "race to the bottom" view counter that states craft corporate laws to accommodate only the interests of those who decide where to incorporate, namely managers; as a result, their theory goes, the ultimate result of federalism is weak shareholder protection.[4] While "race to the

[1] Over the years Congress has enacted a number of measures in corporate law. *See* Mark J. Roe, *Delaware's Competition*, 117 HARV. L. REV. 588, 610–34 (2003) (discussing examples of federal regulation of corporate law, such as securities and takeover laws). For a critical view of federal intervention in corporate governance issues, see Stephen M. Bainbridge, *The Creeping Federalization of Corporate Law*, 26 REGULATION, Spring 2003, at 26 (stating that federal regulation implemented in response to the Enron and WorldCom accounting scandals is deeply flawed and interferes excessively with state law).

[2] *See, e.g.*, Robert Daines, *The Incorporation Choices of IPO Firms*, 77 N.Y.U. L. Rev. 1559, 1570–71 (2002) (finding that over half of a sample of corporations going public between 1978 and 2000 were incorporated in Delaware).

[3] *See* Ralph K. Winter, Jr., *State Law, Shareholder Protection, and the Theory of the Corporation*, 6 J. LEGAL STUD. 251 (1977) (arguing that regulation by states is generally preferable to federal action); *cf.* Daniel R. Fischel, *The "Race to the Bottom" Revisited: Reflections on Recent Developments in Delaware's Corporation Law*, 76 NW. U. L. REV. 913 (1982) (criticizing the "race to the bottom" thesis). *See generally* ROBERTA ROMANO, THE GENIUS OF AMERICAN CORPORATE LAW (1993) (analyzing both "race to the bottom" and "race to the top" arguments).

[4] For a description of the "race to the bottom" approach, which opened the debate on corporate law production more than thirty years ago, see William L. Cary, *Federalism and Corporate Law: Reflections upon Delaware*, 83 YALE L.J. 663 (1974); Lucian Arye Bebchuk, *Federalism and the Corporation: The Desirable Limits on State Competition in Corporate Law*, 105 HARV. L. REV. 1435 (1992).

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top" theorists stress that decentralized production of corporate law by states works efficiently,[5] other authors call for centralized production of corporate law, at least in those fields where incorporation choices are distorted by the private benefits that managers can extract.[6] Leaving aside normative analyses, it is a well-established fact that federal law intervenes in several corporate matters: the Sarbanes-Oxley Act of 2002[7] is only the latest of a series of interventions by Washington in corporate rulemaking.[8] In recent years, Professor Roe has argued that Delaware's main competitor in making corporate law has in fact been the federal government.[9]

A centralized versus decentralized option also exists for corporate and securities law in the European Union. Both corporate and securities law is produced at the Member State level, but national Member States' rulemaking faces restrictions, as it is subject to top-down harmonization by the European Community. The EC has

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[5] Some authors argue that a decentralized system, as with state regulation of corporate law, would be preferable with respect to securities law as well. *See generally* ROBERTA ROMANO, THE ADVANTAGE OF COMPETITIVE FEDERALISM FOR SECURITIES REGULATION (2002) (arguing for an expanded state role in securities regulation); Roberta Romano, *Empowering Investors: A Market Approach to Securities Regulation*, 107 YALE L.J. 2359 (1998) (advocating a state-based, market approach to securities regulation in which issuers would choose the state whose law would govern their securities transactions); Stephen J. Choi & Andrew T. Guzman, *Portable Reciprocity: Rethinking the International Reach of Securities Regulation*, 71 S. CAL L. REV. 903 (1998) (discussing a portable reciprocity system, under which issuers would choose the legal regime to govern their securities but would still be free to select a state of incorporation). For a critique of this view, see generally Merritt B. Fox, *Retaining Mandatory Securities Disclosure: Why Issuer Choice Is Not Investor Empowerment*, 85 VA. L. REV. 1335 (1999) (criticizing the decentralized approaches set out by Choi and Romano).

[6] *See, e.g.*, Lucian Ayre Bebchuk & Allen Ferrell, *Federalism and Corporate Law: The Race to Protect Managers from Takeovers*, 99 COLUM. L. REV. 1168 (1999) (discussing the manager-friendly tilt of state takeover law and arguing that state competition in this area is likely to fail).

[7] Sarbanes-Oxley Act of 2002, Pub. Law No. 107-204, 116 Stat. 745 (codified as amended in scattered sections of 11, 15, 18, 28, and 29 U.S.C.).

[8] In addition to the Sarbanes-Oxley Act, the federal government has also enacted rules on proxy fights, corporate takeovers, and going private transactions. *Cf.* Roe, *supra* note 1, at 610–34 (discussing federal corporate regulation, such as shareholder voting, takeovers, and going private transactions).

[9] *See id.* Recent scholarship contends that, Delaware aside, states make efforts to be attractive in the market for corporate charters. *See* Marcel Kahan & Ehud Kamar, *The Myth of State Competition in Corporate Law*, 55 STAN. L. REV. 679 (2002) (discussing ways in which states compete for corporate charters, the benefits they receive, and the implications of this competition).

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enacted more than fifty directives and regulations[10] touching upon a very broad range of corporate and securities law issues, such as formation of companies, distributions to shareholders, new issues of shares, mergers, divisions, accounting, auditing, mandatory disclosure, insider trading, takeovers, and so on.

This Article rebuts the case for harmonization of EU corporate law and the EC's role in corporate lawmaking. This position may seem anachronistic in light of recent developments and current trends. In fact, the EC is ever more exclusively the lawmaker in the field of issuer securities regulation. With Regulation 2002/1606,[11] it plays a key role in the area of accounting. The EC has recently issued new measures on cross-border mergers,[12] auditing,[13] and information on annual and consolidated accounts.[14] Further, it is engaged in an ambitious action plan covering core corporate law areas such as shareholders' rights and corporate governance.[15]

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[10] A directive is a legislative act which, according to article 249 of the EC Treaty, "shall be binding, as to the result to be achieved, upon each Member State to which it is addressed, but shall leave to the national authorities the choice of form and methods." Treaty Establishing the European Community, Nov. 10, 1997, 1997 O.J. (C 340) 3, art. 249 [hereinafter EC Treaty]. National authorities have to transpose directives, which means introducing domestic laws and regulations consistent with them. In practice, the content of directives is often so specific as to leave national authorities little or no choice of form and methods. A regulation is a legislative act that, again, according to article 249 of the EC Treaty, "shall have general application" and "shall be binding in its entirety and directly applicable in all Member States." *Id.*

[11] Council Regulation 1606/2002, Application of International Accounting Standards, 2002 O.J. (L 243) 1 (EC).

[12] Council Directive 2005/56, On Cross-Border Mergers of Limited Liability Companies, 2005 O.J. (L 310) 1 (EC).

[13] Council Directive 2006/43, On Statutory Audits of Annual Accounts and Consolidated Accounts, 2006 O.J. (L 157) 87 (EC) (amending Council Directives 78/660/EEC and 83/349/EEC and repealing Council Directive 84/253/EEC).

[14] Directive 2006/46/EC of the European Parliament and of the Council, 2006 O.J. (L224) 1 (EC) (amending Council Directives 78/660/EEC on the Annual Accounts of Certain Types of Companies, 83/349/EEC on Consolidated Accounts, 86/635/EEC on the Annual and Consolidated Accounts of Banks and Other Financial Institutions and 91/674/EEC on the Annual and Consolidated Accounts of Insurance Undertakings).

[15] *Commission Proposal for a Directive of the European Parliament and of the Council on the Exercise of Voting Rights by Shareholders of Companies Having their Registered Office in a Member State and Whose Shares are Admitted to Trading on a Regulated Market and Amending Directive 2004/109/EC*, COM (2005) 685 final (Jan. 5, 2006) [hereinafter *Shareholders' Rights Proposal*]; *see also Communication from the Commission to the Council and the European Parliament, Modernising Company Law and Enhancing Corporate Governance in the European Union–A Plan to Move Forward*, COM (2003) 284 final (May 21, 2003) [hereinafter *Action Plan*].

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It is precisely the expanding role of EC institutions in many areas of corporate law and the EC's ambition to extend its reach into new ones that makes it more important than ever to ask whether there is indeed a role for the EC to play in this field. All the more so, considering how unimpressive the EC's achievements in this area have been so far, which makes any sort of more effective (and efficient) intervention in this field doubtful at best.[16]

This Article treats corporate law harmonization as a real-world phenomenon instead of an idealized objective that by hypothesis can only make things better. The hardly exciting results of real-world harmonization to date are the best evidence of built-in problems with corporate law harmonization. Of course, one can learn from past mistakes and failures, and this must be true also for EC lawmakers, but both past experience and basic notions of public choice theory suggest that optimistic expectations in this area are misplaced.

This Article provides a general framework in which to assess harmonization initiatives in the area of corporate law (broadly defined to comprise accounting law and issuer securities regulation as well). We then use the framework to address certain specific issues in corporate law that have been, currently are, or may become the target of harmonization initiatives.

Our analysis begins with the possible justifications for the harmonization of corporate law. With no European "Delaware" in sight, rules to prevent a race to the bottom are premature. We doubt that EC institutions can deal with market failures better than national lawmakers. As to the rationale of integrating the internal market by eliminating national barriers, we note that in the real world negative harmonization is most often bundled with positive or procedural harmonization: what is gained in freedom of establishment is normally lost in flexibility of rules. We also criticize the level playing field concept as a rationale for corporate law harmonization and argue that, far from lowering transaction costs, to date real-world harmonization has raised them and can hardly be expected to do otherwise in the future. Finally, we dismiss the ra-

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[16] As one of the authors has argued elsewhere, despite the many harmonization measures enacted, the EC corporate law harmonization program has had little impact on core aspects of EU corporations' governance and management. *See* Luca Enriques, *EC Company Law Directives and Regulations: How Trivial Are They?*, 27 U. PA. J. INT'L ECON. L. 1 (2006) (providing a detailed explanation of this view). The relevant point here is that it is highly questionable whether the current efforts to further harmonize EU corporate laws can be any more effective than past ones.

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tionale based on scale economies in law production as implausible for corporate law and that based on the correction of national governments' failures as unconvincing, as the EC is also prone to producing excessively rigid corporate law rules and to changing them too frequently. We highlight that a prima facie case can only be made for purely negative harmonization measures that remove barriers to the free movement of corporations and capital, i.e. to corporations' mobility and to cross-border mergers and acquisitions. The same holds for the setting of standards in the (arguably few) areas where the benefits of uniformity are much greater than the content of the rule itself or where diversity impedes market integration. In all other cases, there is no prima facie case for harmonization.

Obviously, the case for harmonization is even harder if it entails costs. In this respect, we show that harmonization substitutes a single lawmaker for twenty-five different ones, or, in other words, a monopolist for twenty-five competitors, implying a greater risk of over-regulation, excessive innovation, and a lower degree of experimentation. A uniform law also precludes taking divergent expectations and preferences at the national level into account. Further, real-world harmonization turns out to increase the complexity and uncertainty of national corporate laws; in addition, EC corporate law rules are hard to change or repeal and therefore not readily adaptable to new economic or technological developments. Finally, the harmonization process itself is costly in terms of lobbying expenditures and rent extraction opportunities by officials and politicians.

The Article proceeds as follows: Section 2 provides a critical assessment of the various rationales for EC intervention in the corporate law area. Section 3 highlights the drawbacks. Section 4 tests the proposed general framework with an analysis of some recent EC corporate law initiatives (either already adopted or simply proposed) in the field of corporate law. Section V concludes.

2. RATIONALES FOR HARMONIZATION

The legal basis for corporate law harmonization is found in Article 44(2)g (formerly Article 54) of the Treaty Establishing the European Community ("EC Treaty"),[17] according to which the European institutions should promote freedom of establishment

[17] EC Treaty art. 44.

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"by coordinating to the necessary extent the safeguards which, for the protection of the interests of members and other, are required by Member States of corporations or firms within the meaning of the second paragraph of Article 48 with a view to making such safeguards equivalent throughout the Community," and in Article 95 of the EC Treaty, requiring European institutions to "adopt the measures for the approximation of the provisions laid down by law, regulation or administrative action in Member States which have as their object the establishment and functioning of the internal market."[18]

Most EC provisions in the field of corporate and securities law refer to the former in their preamble, a few to the latter only (e.g., Regulation 1606/2002/EC and Directive 2003/6/EC[19]) and some to both (as in the case of Directives 2001/34/EC,[20] 2003/71/EC,[21] and 2004/109/EC[22]). In the corporate law harmonization debate, these legal bases (or harmonization aims) are declined in various ways: Article 44's objective of equal protection for Members and others is also viewed as supporting the thesis that a race to the bottom among Member States should be avoided, and/or the idea that market failures should be corrected; Article 95 aims at removing barriers to free movement within the EU and at providing a single set of rules in order to get rid of the costs arising from doing business under twenty-five different business laws (twenty-eight, if we consider the European Economic Area).[23]

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[18] EC Treaty arts. 48 & 95.

[19] European Parliament and Council Directive 2003/6, On Insider Dealing and Market Manipulation (Market Abuse), 2006 O.J. (L 96) 16 (EC).

[20] European Parliament and Council Directive 2001/34, On the Admission of Securities to Official Stock Exchange Listing and on Information to be Published on Those Securities, 2001 O.J. (L 184) 1 (EC).

[21] European Parliament and Council Directive 2003/71, On the Prospectus to be Published When Securities are Offered to the Public or Admitted to Trading and Amending Directive 2001/34/EC, 2003 O.J. (L 345) 64 (EC) [hereinafter Prospectus Directive].

[22] European Parliament and Council Directive 2004/109, On the Harmonisation of Transparency Requirements in Relation to Information About Issuers Whose Securities are Admitted to Trading on a Regulated Market and Amending Directive 2001/34/EC, 2004 O.J. (L 390) 38 (EC).

[23] Pursuant to an agreement between the European Free Trade Association, the EC, and EU Member States, the European Economic Area ("EEA") allows countries belonging to the European Free Trade Association to participate in the internal market without being EU Member States. Agreement on the European Economic Area, May 2, 1992, 1994 O.J. (L 1) 3. Currently, the EEA comprises Iceland, Liechtenstein, and Norway, the twenty-five Member States, and the EC.

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These rationales, together with two others—scale economies in law production and the correction of the failures of national governments—will be discussed below. Although these additional rationales are rarely referred to in the corporate law harmonization debate, they are discussed in the more general debate on EU harmonization of laws.

2.1. *Preventing a Race to the Bottom*

The most traditional and popular justification for harmonization is that EC corporate law is needed to avoid the race to the bottom that would purportedly result from Member States' unchecked freedom to regulate (or deregulate) corporations as they wish.[24]

The issues of whether anything like a race to the bottom can develop within the EU and whether European Delaware might emerge are currently the subject of a wide debate among legal scholars. Like others,[25] one of us has taken the view that no such race is likely to develop, at least with respect to listed corporations, not only because it is doubtful that its direction would be towards the bottom,[26] but also, and more fundamentally, because no Member State is likely to enter the market for incorporations—i.e., to ac-

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Given that, pursuant to the Agreement, the EEA is based on the four "freedoms," and non-EU members of the EEA have agreed to enact corporate law directives, references to EU Member States' freedom to migrate and to their corporate laws shall be intended to be made to the whole EEA.

[24] *See, e.g.*, Jan Wouters, *European Company Law:* Quo Vadis?, 37 COMMON MKT. L. REV. 257, 269 (2000) (reporting that "[h]istorically, [the prevention of a Delaware effect in the EC] . . . seems . . . to be the most important motive for including Article 44(3)(g) in the EC Treaty . . .: a number of delegations . . . insisted on harmonization at the time the Treaty was being negotiated, as a *quid pro quo* for the liberal grant of a right of establishment to companies"); *id.* at 289 (arguing that if a charters market is in place within the EU, more harmonization will be needed in order to protect investors, creditors, and employees); *see also* VANESSA EDWARDS, EC COMPANY LAW 3 (1999) (discussing a European "Delaware effect").

[25] *See, e.g.*, Tobias H. Tröger, *Choice of Jurisdiction in European Corporate Law—Perspectives of European Corporate Governance*, 6 EUR. BUS. ORG. L. REV. 3, 59 (2005) (concluding that "a race to the bottom is not too likely in the European context"); Martin Gelter, *The Structure of Regulatory Competition in European Corporate Law*, J. CORP. L. STUD. 247, 251-52 (2005) (arguing that it is unlikely that a situation parallel to Delaware's will arise in Europe).

[26] For an extended and thorough critique of the race-to-the-bottom thesis in the EU context, see STEFANO LOMBARDO, REGULATORY COMPETITION IN COMPANY LAW IN THE EUROPEAN COMMUNITY 134-200 (2002).

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tivate in order to become a corporate law haven attracting foreign corporations.[27]

On the demand side, there are still certain legal and tax obstacles to firms' free choice of corporate law,[28] which cannot be expected to vanish any time soon.[29] Further, there are economic, cultural, and political pressures against reincorporations that, however hard to gauge, are certainly not negligible.[30] More importantly, on the supply side—venturing into the charters market to attract reincorporations could be politically unwise—the rewards for success would be limited and long-term, while the investment would be relatively large and immediate.[31] Additionally, judges, except in the smallest States, would undoubtedly oppose the creation of a specialized court.[32] Finally, the risk of failure would be substantial.[33]

At most, the greater freedom to shop for a friendlier corporate law, resulting from recent ECJ case law on freedom of establishment,[34] could marginally increase regulatory arbitrage by Euro-

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[27] Luca Enriques, *EC Company Law and the Fears of a European Delaware*, 15 EUR. BUS. L REV. 1259, 159-60 (2004).

[28] *Id.* at 1260–61 (mentioning the real seat doctrine and the tax treatment of cross-border mergers and transfers of seat as disincentives for regulatory arbitrage by firms other than start-ups).

[29] Any move in this direction by the ECJ would be so bold as to appear unlikely. *See* Wolfgang Schön, *Playing Different Games? Regulatory Competition in Tax and Company Law Compared*, 42 COMMON MKT. L. REV. 331, 359–60 (2005) (arguing that the ECJ is unlikely to ban exit taxes for corporations); *see also* Eddy Wymeersch, *About Techniques of Regulating Companies in the European Union*, *in* REFORMING COMPANY AND TAKEOVER LAW IN EUROPE 145, 170 n.77 (Guido Ferrarini et al. eds., 2004) (highlighting that a unanimous vote of the EU Member States is required for tax harmonization to occur).

[30] *See* Enriques, *supra* note 27, at 1264–66 (mentioning conflict of interests of local lawyers, language barriers, and the absence of a uniform business culture around the EU as obstacles to reincorporations); *see also* José M. Garrido García, *Company Law and Capital Markets Law*, 69 RABELS ZEITSCHRIFT: FÜR AUSLÄNDISCHES UND INTERNATIONALES PRIVATRECHT 761, 784–85 (2005) (detailing the pressures against reincorporation).

[31] Enriques, *supra* note 27, at 1270–71.

[32] *Id.* at 1271–72.

[33] *Id.* at 1273.

[34] *See* Case C-212/97, Centros Ltd v. Erhvervs- og Selskabsstyrelsen, 1999 E.C.R. I-1459, 8 (holding that it is not an abuse of the right of establishment for a national of a Member State to set up a company in the Member State he believes has the least restrictive laws); Case C-208/00, Überseering BV v. Nordic Constr. Co. Baumanagement GmbH, 2002 E.C.R. I-9919 (holding that a Member State may not refuse to recognize a foreign entity with its head office in its territory); Case C-167/01, Kamer van Koophandel en Fabrieken voor Amsterdam v. Inspire Art

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pean corporations. National legislatures might consequently feel pressure to emulate other jurisdictions' friendlier rules. The outcome could therefore be a sort of "defensive regulatory competition," no country seeking to attract reincorporations but all countries intent on retaining their own corporations. This resembles what happens in the United States today,[35] except that Europe would have no Delaware.

According to some scholars, regulatory competition would entail interjurisdictional externalities (or at any rate undesirable rules), because the attractive jurisdiction would be one that takes into account only the interests of managers and dominant shareholders (i.e., those making the decision to reincorporate).[36] In fact, investors and creditors would be in other jurisdictions and would therefore have no political clout in a European Delaware.[37] However, in the absence of a European Delaware, defensive regulatory competition can raise no such worry, because Member States, given the need to consider the broader spectrum of interests of their constituencies (which normally include investors and creditors), would internalize the effects of any corporate law reform of

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Ltd., 2003 E.C.R. I-10155, 22 (holding that some provisions extending the application of Dutch corporate law rules to pseudo-foreign corporations unduly restricted the EC Treaty's freedom of establishment); Case C-411/03, *re* SEVIC Systems AG, 2005 O.J. (C 36/08) (precluding refusal of registration of a merger where one of the involved companies is established in another Member State).

[35] *See* Daines, *supra* note 2, at 1575 (describing the "bimodal pattern" in which most U.S. firms, which are free to incorporate anywhere, choose either their home state or Delaware); Lucian Ayre Bebchuk & Assaf Hamdani, *Vigorous Race or Leisurely Walk: Reconsidering the Competition over Corporate Charters*, 112 YALE L.J. 553, 575 (2002) (describing the view that all U.S. states are potentially competing for the incorporation of firms within their boundaries).

[36] *See* Wouters, *supra* note 24, at 289, 294 (noting that externalities could "result from competition between jurisdictions").

[37] Consider regulatory competition in the United States. A common view among scholars who, albeit with different approaches, do not support the race-to-the-top story is that Delaware has essentially only two constituencies to care about: the Delaware bar and managers of Delaware corporations. Since investors and other stakeholders are located elsewhere, and thus have no impact in any electoral round, the Delaware legislature does not have to be responsive to their agenda. *See* Bebchuk, *supra* note 4, at 1452 (noting that Delaware does not have a direct interest in the effects of its corporate law on shareholder value because its citizens hold an insignificant fraction of the shares of Delaware corporations); Mark J. Roe, *Takeover Politics*, *in* THE DEAL DECADE: WHAT TAKEOVERS AND LEVERAGED BUYOUTS MEAN FOR CORPORATE GOVERNANCE 321, 340-41, 353 (Margaret M. Blair ed., 1993) (arguing that by the end of the 1980s Delaware took some antitakeover steps in response to threats from corporate targets to reincorporate elsewhere).

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this kind and because, even before that, the interests of relevant stakeholders would be taken into account no less than in any prior corporate law reform effort.[38]

To be sure, if both the legal and the tax obstacles to reincorporation are ever removed, dominant shareholders (and managers) might reincorporate in order to take advantage of corporate laws allowing them to increase private benefits and/or transfer value from weak, nonadjusting creditors[39] to shareholders.[40] This could "capture the regulatory competition process,"[41] i.e., prompt Member States to adopt the corporate law most attractive in those respects.

With regard to issues involving the relationship between creditors and shareholders, one may think that this is exactly what has been happening lately: continental firms are said to be incorporating in the U.K. in large numbers[42] to escape minimum capital provisions for private limited corporations and thus to transfer value from nonadjusting creditors to shareholders. However, as many scholars now agree, legal capital rules and especially minimum capital rules hardly protect creditors, no matter how weak and nonadjusting they are.[43]

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[38] *See* Enriques, *supra* note 27 at 1274 (showing that Member States consider the interests of their constituencies); Tröger, *supra* note 25, at 62 (arguing that Member States would not necessarily neglect corporate constituents' interests in the absence of a European Delaware).

[39] Nonadjusting creditors are those that do not adjust the terms of their claims to anticipate or take into account the effects of new developments. *See generally* Lucian Ayre Bebchuk & Jesse M. Fried, *The Uneasy Case for the Priority of Secured Claims in Bankruptcy*, 105 YALE L.J. 857, 864 (1996) (providing examples of nonadjusting creditors).

[40] *See* Gelter, *supra* note 25, at 273-74.

[41] *Id.* at 274.

[42] *See* John Armour, *Who Should Make Corporate Law? EC Legislation* Versus *Regulatory Competition, in* 58 CURRENT LEGAL PROBLEMS 2005 369, 386 & fig.1 (Jane Holder & Colm O'Cinneide eds., 2006) (showing the increasing number of so-called "GmbH limiteds," i.e., German businesses incorporated as English private limited companies); *see also* Marco Becht, et al., Corporate Mobility Comes to Europe: The Evidence 9-13 (2005) (unpublished manuscript, on file with the authors) (providing evidence on other Member States' businesses' incorporations in the U.K.).

[43] *See* John Armour, *Share Capital and Creditor Protection: Efficient Rules for a Modern Company Law*, 63 MOD. L. REV. 355, 377 (2000) (arguing that the present minimum capital regime is too sporadic to prevent shareholders from using limited liability companies to insulate themselves from liability for risky decisions); *see also* Luca Enriques & Jonathan R. Macey, *Creditors Versus Capital Formation: The Case Against the European Legal Capital Rules*, 86 CORNELL L. REV. 1165, 1185–88

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Further, one may seriously doubt whether it is realistic to expect that the EC (or any other policymaker, for that matter) can take the interests of weak creditors to heart and adopt effective measures to protect them. Thus far, harmonization measures aimed at protecting creditors have proven, on closer inspection, to be simply tools to protect or increase the rents of professionals and corporate law service providers across the EU.[44] Intuitively, weak, nonadjusting creditors cannot coalesce to prompt EC action in their favor, while, in light of past corporate lawmaking experience,[45] well-organized interest groups that might be harmed by rules that effectively protect weak creditors, such as super-priority in bankruptcy,[46] could block any such course of action by the EC.

With respect to reincorporations aimed at exploiting minority shareholders, it is impossible to anticipate what features a jurisdiction would need to attract foreign corporations seeking private benefits. One might think of absolute freedom to separate cash flow rights from voting rights, or lack of enforcement against fraudulent self-dealing by dominant shareholders, or other features that no one can now predict.

If it is impossible to know what the attractive features might be, then the harmonizing authority may either pick a few potential ones (perhaps missing those that will actually prove attractive) or else try to ban all possible attractive features. In either case, and

(2001) (arguing that the current minimum capital rules are trivial, ineffective, disproportional, uninformative to creditors, and subject to discretion and bias); Friedrich Kübler, *The Rules of Capital Under Pressure of the Securities Markets*, *in* CAPITAL MARKETS AND COMPANY LAW 95, 100–01 (Klaus J. Hopt & Eddy Wymeersch eds., 2003) (comparing the rules on corporate capital with capital adequacy requirements imposed on banks, and arguing that the former are much less demanding); Peter Mülbert & Max Birke, *Legal Capital: Is There a Case Against the European Legal Capital Rules?*, 3 EUR. BUS. ORG. L. REV. 695 (2002) (showing that even weak and nonadjusting capital rules fail to protect creditors); Wolfgang Schön, *The Future of Legal Capital*, 5 EUR. BUS. ORG. L. REV. 429 (2004) (arguing that "[t]he existence of a minimum capital requirement . . . does not do much to help creditors").

[44] *See* Enriques & Macey, *supra* note 43, at 1202–03 (identifying five interest groups that stand to benefit from retaining the Second Directive's legal capital rules); Enriques, *supra* note 16, at 47 (arguing that, in the aggregate, EC corporate law rules inflate demand for professional services, even though they impose only a trivial burden on any particular company).

[45] *See* Enriques, *supra* note 16, at 59–60 & n.242 (describing the influence of interest groups on the production of EC corporate law).

[46] *See, e.g.*, David W. Leebron, *Limited Liability, Tort Victims, and Creditors*, 91 COLUM. L. REV. 1565, 1643–49 (1991) (discussing priority in bankruptcy among secured creditors, unsecured creditors, and tort claimants).

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especially in the latter, there will be a high degree of inflexibility, imposing significant costs on corporations throughout the EU.

In fact, as to differential voting structures, no legal device exists that can ban all inefficient ownership structures while permitting all efficient ones, essentially because what is inefficient for corporation A may well be efficient for corporation B. Similarly, on related-party transactions, it is impossible to conceive of a legal device that can outlaw all value-decreasing transactions while permitting all value-increasing ones, if only because courts' errors are inevitable in judging whether transactions are good or bad.

In the EC context, this is truer still, given decentralized enforcement of corporate law, which makes it pointless to tackle dominant shareholders' and managerial opportunism through broad, open-ended standards that by definition "leave the precise determination of compliance to adjudicators after the fact,"[47] so that judges in a corporate law haven that seeks to attract incorporations may simply apply them leniently, with extremely low risk of successful reaction by EC institutions.

However, if standard-based legislation is not a viable route,[48] the tools of the EC legislature are inherently limited. A race to the bottom driven by the desire to maximize private benefits could be prevented only by *rules* and better still, in order to avoid their lenient interpretation by national judges, by bright-line rules. But as Jonathan Macey has pointed out, the problem with rules is that especially in corporate governance "policymakers cannot benefit shareholders by developing rules that successfully regulate whole classes of corporate transactions,"[49] since these will inevitably be either over- or under-inclusive—i.e., costly and/or ineffective.

In short, to reduce the likelihood that a prospective evil may materialize, harmonization to prevent a race to the bottom would have an immediate negative impact on corporations by decreasing

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[47] Henry Hansmann & Reinier Kraakman, *Agency Problems and Legal Strategies*, *in* REINIER KRAAKMAN ET AL., THE ANATOMY OF CORPORATE LAW: A COMPARATIVE AND FUNCTIONAL APPROACH 21, 23 (2004).

[48] It is well known that the use of standards is one of the distinctive features of Delaware law when it comes to judicial review over the extraction of private benefits of control. For a thorough analysis of the inner mechanics of how Delaware judges apply standards and how the business community perceives them, see Edward B. Rock, *Saints and Sinners: How Does Delaware Corporate Law Work?*, 44 UCLA L. REV. 1009 (1997).

[49] Jonathan R. Macey, *Courts and Corporations: A Comment on Coffee*, 89 COLUM. L. REV. 1692, 1697 (1989).

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the degree of flexibility in their management and governance. Furthermore, past experience with EC corporate lawmaking shows how hard—perhaps impossible—it would be to overcome the resistance of dominant shareholders and managers to EC legislation reducing private benefits.[50] As the history of the takeover directive has instructively shown,[51] at best the European Commission and the European Parliament can *threaten* to enact provisions that would reduce corporate insiders' rents or quasi-rents, but in the end, they usually capitulate to the Council's tendency to heed those interest groups' concerns.

2.2. Correcting Market Failures

Apart from the danger of a race to the bottom, harmonization could be justified if three conditions are met: first, that there are market failures to correct; second, that Member States alone are unable or unwilling to correct them; and third, that the harmonized rules would indeed correct them by increasing societal welfare, even considering the costs of the new rules.[52]

Of course, no thorough answer to whether there can be instances in which all three conditions are met in the corporate law field is possible, because it would entail an analysis of the very foundations of corporate law and each of its policy issues. While it

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[50] *Cf.* Lucian Ayre Bebchuk & Mark J. Roe, *A Theory of Path Dependence in Corporate Ownership and Governance*, 52 STAN. L. REV. 127, 165 (1999) ("European officials have thus far failed in their efforts to end differences in corporate rules" due to opposition by corporate insiders from the various Member States.).

[51] *Cf.* Enriques, *supra* note 16, at 63-64 (describing the EC's unsuccessful attempts to impose takeover rules that would have eroded the rents or quasi-rents of dominant shareholders across Europe).

[52] To be sure, even a race to the bottom would encompass a market failure, namely a failure in the market for the production of corporate law, a market in which jurisdictions compete. Compared to the market failures described in this Section, which address failures in the supply by corporations of contractual arrangements to investors, a race to the bottom would represent an inter-jurisdictional market failure at a different (and higher) level. True, one can say that in both cases investors end up choosing sub-optimal arrangements; however, while in the case of an inter-jurisdictional failure, such as one generated by a Member State's race to the bottom, intervention at the EC level would be at least theoretically justified by the fact that the EC would really be the sole political body able to correct States' inefficient choices; in a purely domestic market failure it is harder to make a case for EC action. As we will highlight in the text, not only are national legislatures in a better position to intervene, but the benefits of the correction, which are captured by the corporations located in the relevant jurisdiction, are likely to be offset by the costs arising from harmonization, which in turn affect all corporations EU-wide.

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cannot be altogether ruled out that all three conditions may be satisfied on some specific issues, a general argument can be made that the EC lawmaker is not a good candidate for the task of correcting market failures that Member States are unable to tackle. Inefficient policy choices at the national level—here, the failure to correct market failures by regulation—can be the outcome of interest group pressures, policymakers' bounded rationality (perhaps ineptitude), or path dependence.[53]

On interest group pressures, the EC could do better than national policymakers if the relevant interest groups were only local and therefore unable to lobby effectively at the EC level. But it is unlikely the EC would ever bother to introduce harmonized rules to trump the idiosyncratic corporate law provisions granting rents to local interest groups in one or even a few Member States.[54] The EC would likely take issue with inefficient national policy choices favoring interest groups in a large number of Member States. Past experience suggests, however, that the EC will be unable to eliminate those rents or correct those inefficient national policies, as local interest groups are powerful enough to block any such initiative.[55] It has, in fact, usually done the opposite—i.e., introduced rules that have protected or actually increased those rents.[56]

A similar line of argument applies to path dependence: if only one nation is locked into a suboptimal equilibrium due to path de-

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[53] As argued above, Member States should internalize the effects of any corporate law policy choice they make, thus making it implausible that non-correction of market failures will be due to an ability to externalize the costs. *See supra* Section 2.1.

[54] In any event, interest groups at the national level appear to be as effective as interest groups represented by a European association in getting access to Members of the European Parliament. *See* Pieter Bouwen, *The Logic of Access to the European Parliament: Business Lobbying in the Committee on Economic and Monetary Affairs*, 42 J. COMMON MKT. STUD. 473, 489-91 (2004) (discussing the results of a survey showing that national associations and European associations have equal access to Members of the European Parliament's powerful Committee on Economic and Monetary Affairs).

[55] *But see* Henry Hansmann & Reinier Kraakman, *The End of History for Corporate Law*, 89 GEO. L.J. 439, 454 (2000) ("At most . . ., once the consensus for adoption of the standard model has become sufficiently strong, harmonization may serve as a convenient pretext for overriding the objections of entrenched national interest groups that resist reform of corporate law within individual states.").

[56] *See* William J. Carney, *The Political Economy of Competition for Corporate Charters*, 26 J. LEGAL STUD. 303, 317 (1997) (noting that EC corporate law provisions can be seen as aiming to protect the rents extracted by interest groups in individual Member States by eliminating the risk of domestic corporations' (re)incorporating in other EC jurisdictions without such rules).

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pendence, the EC is unlikely to bother. If the problem is common to many countries, it is hard to see how the EC could overcome the Member States' likely resistance to (costly) change. To be sure, it is well known that when national politicians are unable to adopt long-needed reforms due to internal opposition by well-organized interest groups, they sometimes resort to the EC in order to have those reforms imposed from above. But frankly it is quite hard to read any of the EC corporate law measures adopted thus far as the product of this phenomenon, so one should be generally suspicious toward measures said to overcome national resistance, if only because the genuine reasons for such measures probably lie elsewhere.

As for inefficient policies that are the outcome of policymakers' bounded rationality or ineptitude, it is also hard to see why EC policymakers should be any less prone to these flaws than national legislators. EC policymakers are less accountable to voters and public opinion[57] and less exposed to yardstick competition than national legislators.[58] This suggests that wrong policy choices would be (and arguably are) at least as frequent at the EC level as at the national level.

Another reason to resist this approach is that the aim of remedying inefficient policies in some Member States should not impair efficient policies in others. Even assuming that a given EC policy might be beneficial for stakeholders in countries with "bad" corporate laws, such a policy would most likely come at the cost of greater rigidity in nations with "good" laws.

2.3. *Market Integration*

A very broad rationale for corporate law harmonization is market integration: if obstacles to the EC Treaty's fundamental freedoms can be found to exist in national corporate laws or if they arise from the simple coexistence of divergent corporate law regimes, then there is a prima facie case for harmonization.

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[57] *See infra* Section 3.1.1.

[58] *See generally* Pierre Salmon, *Political Yardstick Competition and Corporate Governance in the European Union* (Eur. Corp. Governance Inst., Working Paper No. 38/2005, 2005), *available at* http://papers.ssrn.com/sol3/ppers.cfm?abstract_d=730385 (applying the concept of yardstick competition to EU corporate governance developments).

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2.3.1. Corporate law obstacles to the four freedoms

Some national corporate law provisions do limit freedom of establishment and free movement of capital. It is much harder to find any such provision having more than an "indirect and uncertain" impact on the free movement of goods and persons.[59] Harmonization aimed at banning such provisions is justified, provided of course that the costs are no greater than the benefits. We will deal with the costs related to harmonization extensively in Section 3. Here, let us merely note that in most cases, real-world harmonization measures do not just curb Member States' freedom to impose restrictions ("negative harmonization"), they also impose certain positive mandatory procedures for the exercise of corporations' freedom to move cross-border (safeguards for employees, creditors and so forth "procedural harmonization") and/or certain substantive common rules ("positive harmonization"). Both procedural and positive harmonization can reduce the scope for regulatory competition that could result from simple removal of barriers. Realistically, in the absence of procedural and/or positive harmonization, the removal of barriers would be politically very difficult (if not impossible). So in practice even the best-intentioned efforts at harmonization may generate inefficient outcomes. This will be the case whenever the political price for the removal of barriers[60] is an excessively rigid set of common rules or an over-strict curb on regulatory arbitrage.

A case in point is the Prospectus Directive: while making mutual recognition of prospectuses easier, the Directive has reduced the scope of regulatory competition in primary securities markets to an arguably excessive degree. In fact, with no reasonable justifi-

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[59] *See* L.C.B. Gower, *Discussion Regarding Corporate Law, in* EUROPEAN BUSINESS LAW 199, 219 (Richard M. Buxbaum et al. eds., 1991), ("[H]armonization of corporate law is almost totally irrelevant to the completion of the single European market"); Richard Buxbaum, *Discussion Regarding Corporate Law, in* EUROPEAN BUSINESS LAW 199, 219 (Richard M. Buxbaum et al. eds., 1991) ("[T]raditional company law is not a priority item" and "has a very attenuated and indirect relationship to the equal starting point issues concerning the Common Market.").

[60] The removal of barriers to freedom of establishment is usually coupled with anticompetitive measures of positive harmonization parallels, and in a way stems from the fact that harmonization itself is "a *quid pro quo,* the price asked by some delegations during the EEC Treaty negotiations for their agreement to grant the right of establishment also to companies." Christian Timmermans, *Methods and Tools for Integration, in* EUROPEAN BUSINESS LAW 129, 132 (Richard M. Buxbaum et al. eds., 1991).

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cation, it has banned "goldplating" (Member States' enactment of stricter or additional rules) even for purely domestic offerings (where no cross-border issue can by hypothesis be identified),[61] and has ruled out regulatory competition among securities authorities altogether by requiring that prospectuses for equity offerings[62] be approved by the competent authority of the home state, i.e., the state where the issuer has its registered seat, regardless whether the issuer intends to offer its securities in that State.[63]

Intuitively, corporate law provisions raising obstacles to the cross-border offering and trading of financial instruments are good candidates for harmonization.[64] Not surprisingly, these are areas where the EC has already legislated, albeit with very limited results to date in terms of market integration.[65] National rules that hinder cross-border mergers and acquisitions, by making it very difficult and costly for corporations from different Member States to merge or by creating barriers to hostile takeovers, are also good candidates for negative harmonization.[66] Finally, rules which make it more difficult or less attractive to transfer the real seat or to reincorporate (and therefore to shop for a better corporate law) hinder corporations' mobility within the EU, and thus should, of course, be primary targets for harmonization. Interestingly, little has been achieved in this area, although one must add that the di-

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[61] To be sure, Member States with a stronger tradition in this area of law than others may find ways around the prohibition on goldplating. *See, e.g.*, EILIS FERRAN, BUILDING AN EU SECURITIES MARKET 145 (2004) (suggesting that additional requirements for public offers may be introduced as requirements for listing on a stock exchange).

[62] *See generally id.* (listing offerings of financial instruments other than those listed in Prospectus Directive).

[63] Prospective Directive, supra note 21, art. 13. *See generally* Frederick Tung, *Passports, Private Choice, and Private Interests: Regulatory Competition and Cooperation in Corporate, Securities, and Bankruptcy Law*, 3 CHI. J. INT'L L. 369, 381-82 (2002).

[64] It is doubtful, however, whether there are still obstacles to cross-border trading or to cross-border listings. *See* Guido Ferrarini, *The European Regulation of Stock Exchanges: New Perspectives*, 36 COMMON MKT. L. REV. 569, 577 (1999) (describing efforts to facilitate cross-border trading).

[65] *See* FERRAN, *supra* note 61, at 36-41 (describing the limited efficacy of disclosure laws and other regulation mechanisms in European countries).

[66] *See* Klaus J. Hopt, *Company Law in the European Union: Harmonisation and/or Subsidiarity?*, 1 INT'L & COMP. CORP. L.J. 41, 52 (1999) ("European legal harmonization is particularly appropriate where individual Member States use their legal systems to erect or maintain barriers to market access.").

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rective on cross-border mergers has finally been adopted[67] and that, as is well-known, the European Company Statute can serve the purpose of reincorporation in another EU jurisdiction.[68]

As to cross-border acquisitions, the national provisions deserving the attention of the EC from a market integration standpoint should be those *imposing* barriers to takeovers rather than those just enabling private parties to adopt them. In fact, EC provisions to ban private antitakeover arrangements, rather than correct any protectionism against (foreign) hostile takeovers, would actually tackle a market failure (the fact that corporations spontaneously adopt purportedly inefficient antitakeover measures). Therefore, any attempt to ban such arrangements at the EC level would be justified only if the three conditions outlined above for market-failure-correcting intervention were satisfied.[69]

2.3.2. Divergence as an obstacle to market integration

Harmonization may serve four additional purposes. First, it may level the playing field, i.e. rule out the possibility that corporations from a given state are in a better position in the market due to corporate law rather than more efficient delivery of products or services. Second, it may lower transaction costs in intercorporate business relations, as well as in the relationships between corporations and (prospective) investors. Third, it may achieve uniformity in areas where the value of a single set of rules is much greater than the content of the rule itself. And fourth, it may replace certain local provisions that practically impede the creation of an integrated European market. These four aims are sometimes referred to under the single heading of standardization. We treat them separately because each refers to distinct features of a standardized set of rules.

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[67] *See infra*, Section 4.2.4. (discussing the EC Directive on Cross-Border Mergers).

[68] *See, e.g.*, Luca Enriques, *Silence is Golden: The European Company as a Catalyst for Company Statute Law Arbitrage*, 4 J. CORP. L. STUD. 77 (2004) (showing that the European Company can be used to reincorporate in a different jurisdiction, by permitting establishment of a shell company into which the migrating company merges).

[69] *See supra*, Section 2.2. (listing the three conditions that justify harmonization).

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2.3.2.1. *Level playing field*

In an environment in which firms are not free to choose their corporate law and relocation of plants and/or headquarters is costly, it would seem unfair that corporations from Member States where corporate laws are inflexible or generally unfavorable to business must compete with those from States with more flexible and business-friendly corporate laws.[70] In other words, the latter States' corporate laws could be seen as a sort of state aid.

This line of reasoning is troubling because it is far from self-evident that laxer rules are always less efficient. Clearly, if some laxer rules were found to be more efficient, any EC action to ban them in the name of the level playing field rationale would be simply foolish. In other words, the above rationale would first require determining which laws are the wrong ones that the EC should ban, but tells us nothing about the direction the lawmaker should take in leveling the playing field: whether the leveling should be towards the bottom, a "leveling-down" imposing deregulation on all Member States, or towards the top, a "leveling-up" imposing regulation. Leveling-up should be warranted, again, only in the presence of the three conditions under which harmonization to correct market failures is justified. Leveling-down, though quite unheard of in this area, would seem to be justified unless of course there are good idiosyncratic reasons for a given jurisdiction to impose more stringent rules than others.[71] In any event, the more free corporations are to choose their corporate law, the less convincing the level-playing-field rationale for harmonization.[72]

2.3.2.2. *Lower transaction costs?*

Differences in national corporate laws are said to bring higher transaction costs for cross-border trading and investment.[73] At a

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[70] *See* Gisbert Wolff, *The Commission's Programme for Company Law Harmonisation: The Winding Road to a Uniform European Company Law?*, *in* EC FINANCIAL MARKET REGULATION AND COMPANY LAW 19, 27 (Mads Andenas & Stephen Kenyon-Slade eds., 1993) (indicating that directives may impose more burdens on only some countries as compared to others).

[71] *See infra*, Section 3.2. (highlighting that uniformity's drawbacks in case of different preferences across the EU).

[72] *See* Tröger, *supra* note 25, at 57 (arguing that the grant of rights to incorporators to choose the jurisdiction in which they will do business has "rendered mute" the level playing field justification).

[73] If corporations, for whatever reason, prefer to establish separate subsidiaries in other Member States (as they appear to do despite differences in national

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minimum, a private party from one Member State must learn the relevant corporate law before contracting with a corporation in another state or investing in its securities.[74]

Even leaving aside the compelling counterargument that a single set of rules possibly embracing all the main aspects of corporate law would result in dramatic inefficiencies,[75] this rationale is not convincing if we look at real-world harmonization. It is well-known that EC harmonization has made the corporate law framework highly complex and uncertain, perhaps even more than it would have been if left alone. As Brian Cheffins put it, "the changes that have taken place have often made it more difficult for a resident of a Member State to know what the situation is with his own legislation while doing little to inform him about what the law is in other EU countries."[76] Since it is totally unrealistic to expect exhaustive and maximum harmonization of this area of law, the set of harmonized rules is bound to be patchy, leading to uncertainties as to the boundaries between the areas now covered by EC law and those still covered by national law.[77] Further, Member States often construe directives and regulations according to their own tradi-

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corporate laws), and if they have to choose the host Member State law in order to do so, persistent differences in national corporate laws also hinder freedom of establishment. Note, however, that after *Centros* and its progeny of cases, it is no longer true that the subsidiary has to be set up according to the host Member State corporate law, so this concern should not be overestimated.

[74] Hopt, *supra* note 66, at 51 ("A failure of harmonization within an internal market has direct disadvantages,, for example ... uncertainty about the legal situation in other parts of the internal market and about the delineation between European and national law.").

[75] *See, e.g.*, *infra* Section 3.1.2. (arguing that harmonization discourages local experimentation).

[76] BRIAN R. CHEFFINS, COMPANY LAW: THEORY, STRUCTURE AND OPERATION 448 (1997). *See also* Roger Van den Bergh, *Subsidiarity as an Economic Demarcation Principle and the Emergence of European Private Law*, 5 MAASTRICHT J. EUR. & COMP. L. 129, 146–47 (1998) (arguing that harmonization of private law at the EC level will not produce the certainty sought by legal scholars, and may even increase legal uncertainty).

[77] *See generally* Uriel Procaccia & Uzi Segal, *Thou Shalt Not Sow Thy Vineyard with Divers Seeds? The Case Against the Harmonization of Private Law*, *in* CAPITAL MARKETS AND COMPANY LAW 639, 650 (Klaus J. Hopt & Eddy Wymeersch eds., 2003) ("Given the reluctance of alien jurisdictions to abandon their legal independence, harmonization officials are constrained to offer them incomplete legal arrangements, which allows the jurisdictions to fill the *lacunae* in conformity with their old traditions.").

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tions or laws[78] and may fail to enforce violations of EC law by their own corporations.[79] Therefore, considering how harmonization has actually worked and can reasonably work in practice, top-down harmonization is unsuited to the general aim of reducing transaction costs.

Moreover, the freer the choice of corporate law by private parties, the less relevant the problem of harmonization.[80] Private parties may spontaneously converge to the most appealing jurisdiction, thus making cross-country differences a less common issue for cross-border trade and investment. Further, this development should induce bottom-up harmonization; that is, it should prompt the unattractive jurisdictions to adopt the main features of the preferred ones.[81] Therefore, a better way to deal with the problem of transaction costs would seem to be to promote free choice of corporate law.[82]

Finally, top-down harmonization is not the only vehicle of convergence. There is significant spontaneous harmonization in corporate governance practices,[83] as well as standardized practices in the securities markets (e.g., contents of disclosure documents in private placements).[84] In short, driven by regulatory emulation and private-ordering, convergence occurs irrespective of top-down harmonization measures.

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[78] *See* Van den Bergh, *supra* note 76, at 146–47 (stating that Member States may interpret laws differently due to differences both in language and in the "traditions, structures and understandings of values . . . ").

[79] *See* Enriques, *supra* note 16, at 12-17 (arguing that EC corporate law is ineffective, in part because Member States sometimes have failed to enforce EC rules).

[80] *Cf.* Bebchuk, *supra* note 4, at 1494 (noting that the existence of multiple systems of governance does not necessarily preclude the benefits of harmonized laws, as in the United States, where Delaware's primacy has led to a convergence of state laws, with other states "either responding to the same structural incentives or simply following Delaware's lead").

[81] *See* Van den Bergh, *supra* note 76, at 134 (stating that legislative competition can lead to voluntary harmonization, and may achieve a larger scope of harmonization than central rulemaking).

[82] *See* Jens C. Dammann, *Freedom of Choice in European Corporate Law*, 29 YALE J. INT'L L. 477, 533–37 (2004) (discussing the potential benefits of having free choice of corporate law as opposed to forced harmonization).

[83] *See, e.g.*, Hansmann & Kraakman, *supra* note 55, at 454–55 (discussing convergence of governance practices in the United States, Japan, and Europe).

[84] *See* Howell E. Jackson & Eric J. Pan, *Regulatory Competition in International Securities Markets: Evidence from Europe in 1999 – Part I*, 56 BUS. LAW. 653, 685–87 (2001) (describing the increased use of standardized, high-quality disclosure documents, based on United States and British practices, in "International-style Offerings" in European capital markets).

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2.3.2.3. *Standard-setting*

Even if it is unrealistic to expect a reduction in transaction costs through corporate law harmonization, there may still be specific areas in which it would be worthwhile to impose a single standardized solution (a "focal point rule")[85] across the EU, specifically within matters where the benefits of uniformity are great, while the content of the rule has little impact on efficiency.[86]

The problem with this rationale for harmonization is simply the need for rigor in identifying the issues for which uniformity has the greatest benefits compared to the intrinsic merits of the harmonized rules. One can easily agree that the choice among accounting conventions "is arbitrary,"[87] so what really matters is that the content of an accounting convention be known to market analysts and other users of accounting data. A uniform language allows greater comparability and eliminates the cost of finding out what accounting conventions are used in different States.[88]

Much more questionable is that "'rules of the road' for corporate decisionmaking,"[89] for example, "rules on such matters as annual elections of directors, periodic board meetings, majority rule on boards, and so forth,"[90] also fall in this category.[91] According to

[85] *See* David Charny, *Competition Among Jurisdictions in Formulating Corporate Law Rules: An American Perspective on the "Race to the Bottom" in the European Communities*, 32 HARV. INT'L L.J. 423, 442 (1991) (identifying "focal point" rules).

[86] *See id.* (stating that, by definition, for "focal point" rules, uniformity is more important than the content of the rules).

[87] *Id.* at 442–43.

[88] *Id.* at 443. Intuitively, if investors are not familiar with certain accounting standards, they will insist on risk premiums. *See* Donald T. Nicolaisen, *A Securities Regulator Looks at Convergence*, 25 NW. J. INT'L L. & BUS. 661, 663 (2005). It is quite another matter of course to judge whether the Accounting Directives, with all the options they allow for Member States and individual corporations, have achieved any degree of uniformity in their area. *See, e.g.*, Enriques, *supra* note 16, at 26-27 (describing the multiple choices for Member States and individual companies in the Accounting Directives). Of course, greater uniformity would seem to have been achieved for listed corporations with Regulation 2002/1606/EC. *See* Council Regulation 1606/2002, *supra* note 11. But it is far from sure that the consolidated accounts of corporations from different Member States will indeed become more comparable after the adoption of International Financial Reporting Standards ("IFRSs"). Isabel Castelão Silva, a member of the Portuguese Accounting Board, the national accounting regulator, recently declared: "[w]hen you read a standard in English it means one thing, and when you read the Portuguese translation it means another." Barney Jopson, *An Uncomfortable Ride on the Standards Roadshow*, FIN. TIMES (Eur.), July 21, 2005, at 18.

[89] Charny, *supra* note 85, at 443.

[90] *Id.*

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David Charny, the important task of such rules "is to spare parties the costs of verifying what any given corporation is actually doing, and of trying to decide whether reported differences among corporations actually reflect differences in the fundamental value of their shares .... Rather than put the analysts to these costs, legal decisionmakers should simply specify a uniform rule."[92] The problem with this reasoning, as Charny acknowledges in general terms, is that "[t]he hard question is whether a *mandatory* rule is required."[93] And the idea that mandatory rules are justified on issues such as those Charny labels "rules of the road" is unconvincing. Quite apart from the fact that few Member States require annual election of directors[94] and that some do not require periodic board meetings,[95] such rules may prove sensible for some corporations and totally unjustified for others. Should the EC provide for uniform rules of this kind, they might prove sensible for most corporations in State A and cumbersome or counterproductive in State B. For example, the public limited liability company form may be adopted mainly by publicly listed corporations in State A and by closely-held corporations in State B.[96]

Nor should the benefits of uniformity and standardization be overestimated. They tend to decline as the size of a firm's market capitalization increases: the larger the capitalization, the sharper the market's attention toward its operations and thus the wider the spreading of informational costs among analysts and investors. Thus, gathering the relevant information with respect to the governance regime applicable to a listed corporation would not appear to carry prohibitive costs. One should bear in mind that what in-

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[91] *See id.*

[92] *Id.*

[93] *Id.* at 444.

[94] For England, see PAUL L. DAVIES, GOWER & DAVIES' PRINCIPLES OF MODERN COMPANY LAW 307 (7th ed. 2003) (stating that there is no maximum term required by law); for Italy, see Codice civile [C.c.] art. 2383 (imposing a maximum term is three years); for France, see Code de commerce [C. COM.] art. L. 225-18 (imposing a maximum term is six years); and for Germany, see Aktiengesetz [AktG] [Stock Corporation Act], Sept. 6, 1965, BGBl. III at § 84 (imposing a maximum term of five years).

[95] This is the case in Germany, for instance.

[96] *See* Angel Rojo, *La sociedad anónima como problema, in* IL DIRITTO DELLE SOCIETÀ PER AZIONI: PROBLEMI, ESPERIENZE, PROGETTI 1, 4-8 (Pietro Abbadessa & Angel Rojo eds., 1993) (highlighting that public limited corporations and corresponding legal forms are used mainly by listed corporations in the UK and in Germany, while they are widely used even by smaller businesses in Latin countries).

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vestors ultimately want is a good investment, regardless of its intricacies, so long as they are in a position to understand its underlying mechanics. Therefore, if the concern of harmonization advocates is to help investors understand what they are buying or selling, disclosure is a cheaper solution.[97] A plain-language description of the corporation's governance structure in its annual accounts would clearly be better[98] than imposing a lame standardized product.[99]

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[97] EC law actually endorses, at least partially, such an approach. *See* Council Directive 2004/25, art. 10, 2004 O.J. (L 142) 12, 19 (EC) [hereinafter Takeover Directive] (requiring Member States to ensure that corporations subject to the Directive publish, in their annual reports, detailed information on a set of issues affecting their contestability in the market for corporate control). Similarly, see Directive 2006/46/EC of the European Parliament and of the Council, *supra* note 14, at 4-5 (requiring listed corporations to include in their annual accounts a corporate governance statement containing, among other things: information on the corporate governance code applied by the corporation; its level of compliance and an explanation of the parts of the code from which the corporation departs and the reasons for doing so; a description of the corporation's internal control and risk management systems; information on the operation of the shareholders' meeting, its key powers and a description of shareholder's rights; and information on the composition and operation of the board and its committees).

[98] It can be debated whether such a solution should be imposed top-down by mandatory requirements from the EC imposed by Member States, as suggested by the *Report of the High Level Group of Company Law Experts on a Modern Regulatory Framework for Company Law in Europe*, at 45–47 (Brussels, Nov. 4, 2002), *available at* http://ec.europa.eu/internal_market/company/docs/modern/report_en.pdf, or left to corporations' freedom of contract. EC provisions in this field might be justified by the absence of a single European stock exchange, or as a second-best alternative to the imposition of a standardized regime of substantive rules. For the view that "a regime of mandatory disclosure permits immediate standardization without waiting for it to evolve through private ordering," see Gerard Hertig, Reinier R. Kraakman & Edward Rock, *Issuers and Investor Protection*, *in* THE ANATOMY OF CORPORATE LAW, *supra* note 47, at 205, which notes that "information is of less value to investors—and hence incentives to disclose are weaker—to the extent that it is idiosyncratic, without standardized format, content, and quality." *But cf.* Eilís Ferran, *The Role of the Shareholder in Internal Corporate Governance: Shareholder Information, Communication and Decision-Making*, *in* REFORMING COMPANY AND TAKEOVER LAW IN EUROPE, *supra* note 29, at 424–25 (warning that, for matters on which convergence has not arisen yet, central imposition of uniform disclosure requirements is likely to have potential drawbacks in some jurisdictions).

[99] Furthermore, for certain transactions, uniformity of substantive rules would cut only a tiny fraction of the costs that market players have to incur to complete the deal. Consider takeovers: supporters of a mandatory adoption of the passivity rule in the Takeover Directive claim that such a rule, among other things, would be beneficial because it would signal to the market the standard regime applicable to target corporations throughout Europe. *See, e.g.*, Joseph A. McCahery et al., *The Economics of the Proposed European Takeover Directive*, *in* REFORMING COMPANY AND TAKEOVER LAW IN EUROPE, *supra* note 29, at 575, 633-35. As one of us has already pointed out, the advantages of uniformity in such a con-

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Finally, as we anticipated, standardization may well emerge as a result of spontaneous convergence through regulatory emulation and/or companies' freedom to adopt the best arrangements.

2.3.2.4. *Repealing fragmented local provisions that impede the creation of an integrated market*

National laws can thwart market integration in various ways. A Member State's rules can raise explicit barriers to foreign players, for example, by prohibiting mergers with companies not incorporated in accordance with its laws.[100] As we have seen, these rules are likely to be put on the Commission's blacklist.[101] And local rules can impede market integration more subtly as well, such as when the laws of two or more jurisdictions, whose relevant provisions conflict or are mutually inconsistent, govern different aspects of a single cross-border transaction. A typical example is the uncertainties and inconsistencies of clearing and settlement activities in connection with cross-border securities transactions.[102]

text are of minor importance if we only think of who promotes this kind of deal: large investors, who are sufficiently sophisticated and well-advised to assess, from a structural and legal standpoint, the strengths and weaknesses of their target. *See* Matteo Gatti, *Optionality Arrangements and Reciprocity in the European Takeover Directive*, *in* 6 EUR. BUS. ORG. L. REV. 553, 562-63 (2005). Also, the number of transactions of this kind is low. Standardization and uniformity are crucial when the number of transactions that market players complete every day is high or when the players lack the time, skills or experience to evaluate all the aspects of the transaction. Corporate control transactions are planned long before they are eventually announced and at that later stage bidders know (or at least should know) all about the ownership structure of their targets, including the applicable regime for pre-bid and post-bid defenses. Given that the intricacies in connection with ascertaining the applicable law are just one of the many issues that a bidder must solve before stepping into a takeover battle, it would be quite naïve to believe that a uniform regime for targets would have generated a significant reduction of costs in connection with takeover planning.

[100] *Cf.* Case C-411/03, Reference for a Preliminary Ruling from the Landgericht Koblenz in Proceedings Against SEVIC Systems AG, 2006 O.J. (C 36) 5 (holding that "registration in the national commercial register of a merger by dissolution without liquidation of one company and transferring the whole of its assets to another company cannot be refused in general in a Member State where one of the two companies is established in another Member State . . .").

[101] *See supra* Section 2.3.1. (discussing how cross-border transactional barriers placed by Member States are the primary targets of EC harmonization initiatives). Often, the EC legislature eventually intervenes only once the ECJ has already struck down the relevant rules, with the consequence that newly-enacted EC rules end up being far less market-friendly than applicable EC judge-made law.

[102] *See, e.g.*, *Communication from the Commission to the Council and the European Parliament, Clearing and Settlement in the European Union – The way forward*, at 22-26,

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Likewise, cross-border voting could be affected by similar uncertainties and potential conflicts.[103] The more complicated the legal treatment of the cross-border transaction, the higher the transaction costs and less the market integration.

The problem with this line of argument is that on closer inspection, not only is it very hard to single out the cross-border transactions that are actually impeded,[104] but it is also far from clear whether a uniform set of substantive rules, given the costs, would be the best possible remedy.[105] In other words, before harmonizing diverging national rules that are said to obstruct integration, the EC policymaker should make sure that the divergence among local rules really does impede market integration. If the ultimate problem turns out to be that different regulations, rather than impeding the consummation of cross-border activities, simply produce a complex legal framework, then harmonization will be unwarranted, if only because it is far from certain that less complexity will be the outcome.

2.4. *Scale Economies in Law Production?*

A possible, general justification for harmonized lawmaking is that a single lawmaker can achieve scale economies in the supply of rules. As Esty and Geradin put it, "[w]hen regulatory economies of scale are present, centralized standard-setting procedures may . . . be . . . efficient."[106] This is especially true with respect to

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COM (2004) 312 final (Apr. 28, 2004) (mentioning, among other things: the nature of rights relating to securities held in an account with an intermediary; the transfer of these rights; and discrepancies in the rules governing corporate actions such as the determination of the exact moment in which the purchaser of securities is entitled to dividend distributions).

[103] *See generally* Jaap Winter, *Cross-Border Voting in Europe*, *in* CAPITAL MARKETS AND COMPANY LAW, *supra* note 43, at 399-408 (describing the relationships amongst a cross-border chain of intermediaries, their respective voting rights, and their effect on the shareholdings); *Expert Group on Cross-Border Voting in Europe, Final Report* (Amsterdam, Aug. 2002), *available at* http://www.wodc.nl/eng/Images/on2002-6_Full%20text_tcm12-4917.pdf (making a number of recommendations to alleviate obstructions in European cross-border transactions).

[104] This is not the case for cross-border voting. *See infra* Section 4.2.1. (describing the Shareholders' Rights Proposal introduced by the EC, which includes registration provisions).

[105] Conflict of laws rules could in fact solve the problem in a smoother way, that is, without repealing national provisions that can be traumatic for a Member State to replace.

[106] Daniel C. Esty & Damien Geradin, *Regulatory Co-opetition*, 3 J. INT'L ECON. L. 235, 243 (2000).

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those "aspects of regulation [that] are more technically complicated or analysis-intensive, making them susceptible to economies of scale,"[107] and even more so for elements of regulation that "are driven heavily by 'facts' that do not vary geographically—e.g. the safe level of human exposure to carcinogens."[108] Therefore, in Roger Van den Bergh's words, "[i]f the data needed to formulate and/or enforce legal rules are relevant for the entire European Community, centralization may save on information costs,"[109] and more generally on lawmaking costs.

With regard to corporate law, this line of argument is unconvincing.[110] First of all, corporate law can hardly be grouped among technical, fact-intensive sets of rules, possibly with the exceptions of issuer securities regulation and accounting law. Second, there is recurring evidence of regulatory emulation, i.e., that Member States tend to reproduce other States' innovations, so that new rules are seldom the product of efforts to devise better rules from scratch.[111] Third, as we shall see in the next Section, it is far from clear that the facts to ascertain and the rules to be adopted fit the diverse corporate environments of the various Member States equally well. It is arguably due to this diversity that the harmonization measures adopted thus far are mostly directives (as opposed to regulations) and leave plenty of space for Member States' choices at the implementation stage. Hence, the costs related to the search for the best rules by national regulators at the implementation stage will be at best reduced, not eliminated.[112] To be sure, this is less true with regard to accounting law following Regulation 2002/1606/EC (for listed corporations only) and to securities regulation following the use of the Lamfalussy method,[113] i.e., in light of the increased role of comitology, level-2 measures and coordination in implementation and enforcement. However, one may well argue that, at least with respect to issuer securities regulation, due

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[107] *Id.*

[108] *Id.*

[109] Van den Bergh, *supra* note 76, at 135.

[110] *See* Dammann, *supra* note 82, at 535 (comparing the potential results of free choice and harmonization for corporate law).

[111] *Id.*

[112] *See id.* at 536 (noting that Member States are also involved in the EC lawmaking process, so that their "legislative costs" will not be reduced much anyway).

[113] See *infra* Section 3.3.1. (describing the Lamfalussy method).

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to the differences in the structures of the various markets and in their actors' sophistication, a unique set of rules does not properly account for the diversity among Member States.[114]

2.5. *Correcting Government Failures*

In theory, one may also justify harmonization on the grounds that national policymakers have a monopoly power in the production of corporate law and that they may abuse it by excessive regulation[115] (perhaps in order to grant rents to specific interest groups) or excessive innovation.[116] For new companies, such monopoly power has been greatly reduced, of course, by *Centros, Überseering* and *Inspire Art.* But with regard to existing corporations, as we hinted above, it is still practically intact.

Still, it is hard to see how the EU could be better off by substituting a centralized monopolist supplier for twenty-five decentralized suppliers whose market power is already being eroded by the ECJ's negative harmonization efforts. Further, as we shall see, abuse of market power is to be feared, and can indeed be observed, even at the EC level.[117]

Of course, the case is different when the EC issues directives or regulations that enable private parties to do something that is not allowed by national laws or, similarly, when it introduces a twenty-sixth regime that Member States must offer as an alternative to their own and that private parties can freely choose.[118] The best example of this is the European Company Statute, which is

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[114] *See infra* Section 3.2. (arguing that national preferences with respect to corporate law issues are different).

[115] *See* Stephen Woolcock, *Competition Among Rules in the Single European Market, in* INTERNATIONAL REGULATORY COMPETITION AND COORDINATION: PERSPECTIVES ON ECONOMIC REGULATION IN EUROPE AND THE UNITED STATES 289, 301 (William Bratton et al. eds., 1996) (noting that countries may feel pressure to enact legislation equivalent to that of other countries, causing excessive levels of regulation); Jeanne-Mey Sun & Jacques Pelkmans, *Regulatory Competition in the Single Market,* 33 J. COMMON MKT. STUD. 67, 85-86 (1995) (arguing that national policymakers may abuse their monopoly power in corporate lawmaking through excessive regulation).

[116] *Cf.* Ian Ayres, *Supply-Side Inefficiencies in Corporate Charter Competition: Lessons from Patents, Yachting and Bluebooks,* 43 U. KAN. L. REV. 541, 558-59 (1995) (suggesting that Delaware may engage in excessive innovation of its corporate law thanks to its market power).

[117] *See* Section 3.1. (describing the EC corporate lawmaker as a monopolist).

[118] *But see infra* note 250 and accompanying text (discussing the riskiness of the EC imposing limits on Member States' ability to enact mandatory provisions).

purely enabling in character, although a corporation choosing it has to comply with a number of mandatory rules that make it less attractive.

2.6. *Summary*

In the foregoing we have analyzed the possible justifications for corporate law harmonization, arguing that with no European Delaware in sight, rules to prevent a race to the bottom are premature. We also cast doubt on the superiority of EC institutions over national lawmakers in tackling market failures. Examining the rationales related to market integration, we have noted that, in the real world, negative harmonization is most often bundled with positive. In most cases, what is gained in freedom of establishment is lost in flexibility of rules. We have criticized the level playing field as a rationale for corporate law harmonization and argued that, far from lowering transaction costs, real-world harmonization has thus far raised them and can hardly be expected to do otherwise. Finally, the rationales relating to scale economies in law production and to the correction of national governments' failures were dismissed: the former as implausible in this field and the latter as unconvincing, given the EC's own tendency to enact over-rigid rules and to change them too frequently.

To conclude, a prima facie case can be made only for purely negative harmonization measures to remove barriers to the free movement of corporations and of capital, i.e., to cross-border relocations and mergers and acquisitions. Also justified may be rules setting standards in the (arguably few) areas where the benefits of uniformity are much more important than the content of the rule itself or where diversity impedes market integration. In all other cases, no prima facie evidence for harmonization can be found. If there are costs attaching to it, then the case for harmonization is even harder. Section 3 shows that these costs exist, and that they can be substantial.

3. THE DRAWBACKS OF HARMONIZATION

Harmonization does not come cheap; in assessing its merits in corporate law, a number of problems deserve attention. These problems are described below with reference to mandatory rules for EU corporations via harmonization. The analysis, therefore, applies only marginally to rules that are purely enabling (i.e., rules that require Member States to allow freedom of contract in a given

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area) or that merely remove barriers to cross-border movement of capital and corporations.[119] Unfortunately, such rules are seldom the outcome of harmonization measures and the analysis that follows thus encompasses most real-world harmonization efforts.

3.1. *Harmonization as a Cartel*

Harmonized lawmaking can be viewed as a cartel among national legislatures.[120] Viewed in this perspective, there are at least two types of problems: over-regulation and excessive innovation on the one hand and less experimentation on the other.

3.1.1. *Over-regulation, excessive innovation*

First, the risk exists that, like any monopolist, the EC lawmaker may abuse market power by excessive regulation or excessive, wasteful innovation. Many features of the community lawmaking process make excessive regulation (i.e., the imposition of more rules than are economically justified) a likelier outcome in the EC than in individual states. For various reasons, the EC lawmaker has, in fact, stronger market power than individual states.

First of all, the targets of harmonized rules within the EU will find escape from the EC's regulatory reach even more difficult than escape from the regulations of the Member States.[121] This is even more so in the post-*Centros* world, in which some degree of intra-EU regulatory arbitrage is available to EU firms. Second, the EC lawmaking process is generally less transparent than at the national level.[122] Similarly, few could dispute that the accountability of EC officials and of EU politicians for matters decided in Brussels is weaker than at the national level.[123] Third, the EC level of regu-

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[119] More precisely, only the problems described in Section 3.4. also apply to these kinds of rules.

[120] *See generally* Enriques, *supra* note 16, at 41; Timmermans, *supra* note 60, at 132.

[121] *See* Carney, *supra* note 56, at 310–11 (stating that regulations of individual states are avoidable while federally imposed regulations better preserve the desires of interest groups).

[122] Directives and regulations are adopted by the Council, whose meetings are not open to the public. The same applies to "level 2" measures which are adopted by the European Commission, whose meetings are likewise not open to the public. *See* EC Treaty, *supra* note 16, art. 207, para. 3 (describing the conditions under which Council documents would be publicly available).

[123] *See* Paul B. Stephan, *Accountability and International Lawmaking: Rules, Rents and Legitimacy*, 17 NW. J. INT'L L. & BUS. 681, 681 (1996) (explaining the view that

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lation may work as a catalyst for EU-wide interest groups. It enables them to concentrate their lobbying effort at the EC level, thereby securing the desired outcome in each of the Member States.[124] Finally, lobbying at the EC level is likely to be more costly for the local interest groups or firms that are not as organized and that oppose the legislation that the EU-wide interest groups want,[125] such that the latter will encounter less opposition in Brussels than at the state level.

For these reasons, the EC lawmaker has greater leeway to engage in excessive regulation that is more prone to influence from interest groups. But why, one may naïvely ask, should a less constrained lawmaker want to impose excessive regulation favoring specific interest groups? Public choice theory provides a convincing explanation. For one thing, the wider the scope of EC intervention and the more powerful its impact on businesses, the greater the power and prestige of EC policymakers.[126] Given a choice between a laissez-faire approach and a pro-regulation one, they will naturally incline toward the latter.[127] Further, they will tend to hear only the voices of well-organized interest groups whose lob-

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international lawmakers are not held accountable for their decisions made in an international arena); Van den Bergh, *supra* note 76, at 148 (lamenting the "lack of democratic accountability of the institutions" involved in the harmonization process).

[124] Jonathan R. Macey, *Federal Deference to Local Regulators and the Economic Theory of Regulation: Toward a Public-Choice Explanation of Federalism*, 76 VA. L. REV. 265, 271 (1990).

[125] *See* Bruno S. Frey & Reiner Eichenberger, *To Harmonize or to Compete? That's Not the Question*, 60 J. PUB. ECON. 335, 338 (1996) ("Harmonization weakens the individuals' incentives to raise voice against increases in taxation, as voice will be the more costly, the more centralized the political process.").

[126] *See* Paul B. Stephan, *The Political Economy of Choice of Law*, 90 GEO. L.J. 957, 961 (2002) ("[P]eople who negotiate international agreements, as well as the people who serve the institutions that promote these negotiations, have powerful incentives to achieve some kind of agreement regardless of substantive outcome. Association with a concluded agreement brings prestige, opportunities to offer interpretation, and invitations to participate in subsequent negotiations."); Van den Bergh, *supra* note 76, at 149 ("The power given to the Council of Ministers and to the Commission . . . to harmonize all sorts of policy areas may be used by the European bureaucrats to increase their power and prestige . . . .").

[127] Unsurprisingly, they usually select policy advisers who share, for whatever reasons, the same inclination. *See, e.g.*, Frey & Eichenberger, *supra* note 125, at 339–40 (finding that economists who prefer a pro-regulatory approach to taxes are naturally favored by politicians); Van den Bergh, *supra* note 76, at 149 ("When advisory commissions are composed, there is a selection effect working in favour of lawyers who propose that laws should be harmonized.").

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bying efforts will produce studies and analyses in favor of a given regulation whenever it can protect or raise their rents, in addition to which these interest groups may well contribute to the campaigns of politicians who have a say in EC corporate law matters.[128]

These features help explain the tendency of EC lawmakers to accommodate interest groups' requests for rules that will protect or raise their rents. As is argued elsewhere, the main impact of EC corporate law measures to date has, in fact, been to safeguard or increase the rents of some well-identified interest groups.[129]

A good illustration of the way the EC monopoly power may be used to engage in excessive innovation is the current wave of securities legislation, with over-active EC institutions issuing new measures and guidelines every other month or so, leaving no realistic prospect that this will be a transitory phenomenon.[130]

An ever-changing legal environment greatly increases compliance costs. Businesses have to implement the organizational and operational changes required by every regulatory update, and their consultants must advise on them.

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[128] Implicit in this analysis is, of course, the assumption that EC and national officials and politicians deciding on EU matters do not behave differently from bureaucrats and politicians in general (i.e., that the EC dimension does not alter the human nature of those working in it). The assumption that bureaucrats and politicians tend to maximize their private utility, as opposed to social welfare, simply derives from the intuition that politicians and bureaucrats are human beings like anyone else. This is not to say that altruism is alien to human nature. The point is only that politicians and bureaucrats cannot be assumed to be systematically more altruistic than other human beings. *Cf.* Jonathan R. Macey, *Regulation and Disaster: Some Observations in the Context of Systemic Risk*, *in* BROOKINGS-WHARTON PAPERS ON FINANCIAL SERVICES 405, 407 (Robert E. Litan & Anthony M. Santomero eds., 1998) ("[T]he public interest theory of regulation assumes that public servants take action . . . because they are benevolent. By contrast, the public choice theory of legislation . . . makes the same basic assumptions about self-interest for politicians and bureaucrats that standard economic analysis makes for private sector actors.").

[129] *See* Enriques, *supra* note 16, at 49–50 ("EC intervention in this area is like a cartel aiming to protect or increase the monopolistic rents of well-defined interest groups . . . .").

[130] *See When in Doubt Just Do Nowt: McCreevy Must Subject New EU Financial Rules to Tough Tests*, FIN. TIMES (London), Jan. 24, 2005, at 16 (reporting the Internal Market Commissioner's pledge not to issue important legislative proposals in 2005 in the financial markets area, but also citing a report by Houston Consulting, a company that tracks the Financial Services Action Plan, according to which "78 EU financial services measures are in the pipeline").

3.1.2. *Less experimentation*

From a dynamic perspective, in harmonized areas, experimentation by individual jurisdictions with new regulatory solutions is difficult if not impossible,[131] while the monopolist lawmaker is unlikely to engage in fruitful innovation. In fact, "[j]ust as monopolistic markets tend to be inflexible and unresponsive to consumer demands, so, by analogy, a single set of harmonized rules is less responsive [to change] than competition among rules and a 'market for regulation.'"[132] Further, with twenty-five even marginally different solutions to a given policy issue, as Rodolfo Sacco has noticed, we shall have "[as many] new solutions with wide possibilities for experimentation, transplant, and so on. If, to the contrary, the point of departure were only one . . . we would have to look for the new solution from only one perspective so that our chances of effective innovations would be much reduced."[133]

With reference to corporate law harmonization in particular, the Second Company Law Directive is commonly viewed as a measure that has chilled innovation in various areas of corporate law such as creditor protection[134] and takeover defenses.[135]

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[131] *See* LOMBARDO, *supra* note 26, at 77 ("The centralized regulation would furthermore eliminate the big advantage of decentralized regulations in terms of the discovery mechanism . . . ."); ROMANO, *supra* note 3, at 132 (stating that harmonization reduces any returns one gets from competition or innovation); Bainbridge, *supra* note 1, at 31 ("[O]usting the states from their traditional role as the primary regulators of corporate governance would eliminate a valuable opportunity for experimentation with alternative solutions to the many difficult regulatory problems that arise in corporate law."). Experimentation in corporate law by individual states in the United States is the subject of empirical analysis. *See generally* Roberta Romano, *The States as a Laboratory: Legal Innovation and State Competition for Corporate Charters*, 23 YALE J. ON REG. 209 (2006) (describing the process of experimentation in state corporate law).

[132] Woolcock, *supra* note 115, at 299.

[133] Rodolfo Sacco, *Diversity and Uniformity in Law*, 49 AM. J. COMP. L. 171, 180 (2001).

[134] *See* Tunc, *supra* note 59, at 208-09 (arguing that the Second Directive provides a good illustration of how harmonization curbs innovation with respect to measures aimed to protect creditors).

[135] *See* MATTEO GATTI, OPA E STRUTTURA DEL MERCATO DEL CONTROLLO SOCIETARIO 100-07 (2004); *see, e.g.*, Jeffrey N. Gordon, *An American Perspective on Anti-Takeover Laws in the EU: The German Example*, *in* REFORMING COMPANY AND TAKEOVER LAW IN EUROPE, *supra* note 29, at 551 n.23 (describing German antitakeover laws).

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3.2. What Price Uniformity?

People's preferences vary across the EU, and the more so the larger the Union becomes. Financial markets and ownership structures are also different across the EU. In general, a strong argument against harmonization is that a uniform set of rules will necessarily be less able to satisfy people's preferences or to prove adequate to divergent economic features than a decentralized system in which laws are made at the State or local level.[136]

Is corporate law an area in which harmonization can create problems of this kind? The answer is yes. Not only are financial markets far from uniformly well-developed within the EU and ownership structures far from equally dispersed, but even national preferences with respect to corporate law issues are different. For instance, private benefits of controls are tolerated much more in Italy than in the UK,[137] so that a lenient regime for self-dealing transactions is acceptable in Italy and inconceivable in Britain. In continental Europe and especially in Germany, the role of stakeholders in corporate governance has also been far more central than in the U.K. Similarly, in continental Europe there is a widespread consensus, arguably absent or far weaker elsewhere, that stakeholders should be protected through corporate law. Shareholder value maximization is a steady concept in English corporate governance, whereas in the rest of Europe it has been little more than a fad in the last decade. Investor education levels differ and, therefore, the need for rules protecting investors is also different.[138]

[136] *See* David W. Leebron, *Lying down with Procrustes: An Analysis of Harmonization Claims, in* FAIR TRADE AND HARMONIZATION 41, 88 (Jagdish Bhagwati & Robert E. Hudec eds., 1996) (explaining the value of localism as opposed to harmonization); Anthony Ogus, *Competition Between National Legal Systems: A Contribution of Economic Analysis to Comparative Law*, 48 INT'L & COMP. L.Q. 405, 416 (1999) (noting the argument that harmonization fails to recognize diverse preferences across jurisdictions); Van den Bergh, *supra* note 76, at 130-34 (discussing the arguments in favor of decentralization of private law over harmonization).

[137] *See* Luca Enriques, *Bad Apples, Bad Oranges: A Comment from Old Europe on Post-Enron Corporate Governance Reforms*, 38 WAKE FOREST L. REV. 911, 915 (2003) (arguing that in some European countries the public reaction to some forms of self-dealing is much more tolerant than elsewhere).

[138] *See* Luigi Guiso, Michael Haliassos & Tullio Jappelli, *Household Stockholding in Europe: Where Do We Stand and Where Do We Go?*, 2003 ECON. POL'Y 123, 157 (comparing investor literacy in the United States and several European states).

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3.3. *The Problems with Real-World Corporate Law Harmonization*

Looking at how corporate law harmonization has worked out over the decades, a number of further drawbacks emerge.

3.3.1. *Greater complexity and uncertainty*

As we have hinted, EC corporate law increases the complexity of national corporate laws.[139] Secondary EC corporate law adds two layers of rules to those at the national level. Member States' law must be consistent with EC directives and regulations, which in turn must be consistent with the EC Treaty. And for securities law directives and regulations adopted under the Lamfalussy approach, the picture is more complex still. Here we have two layers of secondary EC law: level 1, or framework, directives and regulations contain the main principles and rules; level 2 measures contain more detailed provisions and, thanks to the smoother legislative process, can be modified more often to adapt to market and technological changes. In addition, the Lamfalussy approach provides for a third level of "quasi-law", in which the Committee of European Securities Regulation ("CESR") issues guidelines for the implementation and uniform interpretation of level 1 and level 2 measures.[140] Arguably, the documents produced by CESR to fulfill its level 3 duties also have to be taken into account by national securities regulators and, as a consequence, by lawyers construing national rules.

Further, as Harald Halbhuber has noticed, EC corporate law directives raise "myriad new and highly technical domestic legal issues."[141] In Germany, this has led to "numerous academic controversies about the exact implications of certain directives for specific provisions of German company law,"[142] "thereby adding po-

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[139] *See supra* Section 2.3.2.2.

[140] *See, e.g.*, FERRAN, *supra* note 61, at 61-84 (providing a more detailed description of the Lamfalussy approach); *see also id.* at 100 (predicting that level 3 standards and guidelines will "move more into the foreground" once the level 1 and level 2 measures implementing the Financial Services Action Plan are adopted, possibly also extending to areas not covered by secondary EC legislation).

[141] Harald Halbhuber, *National Doctrinal Structures and European Company Law*, 38 COMMON MKT. L. REV. 1385, 1412 (2001).

[142] *Id.* at 1408 n.119.

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tential arguments to the arsenal of sophisticated German commercial lawyers in purely domestic disputes."[143]

Finally, like all international lawmaking, EC legislation is compromise-prone, with a high risk that the outcome will be vague, obscure, or downright unreasonable on politically sensitive issues.[144] Complexity, obscurity and uncertainty entail costs, including fees that EU corporations have to pay for legal advice.

3.3.2. *Petrification and poor adaptability*

Once approved, an EC measure is notoriously hard to repeal or modify.[145] This petrification effect is well-illustrated by the amount of time it has taken to get rid of the numerous Second Company Law Directives' provisions widely held to be obsolete and excessively rigid.[146] Petrification is a problem because it preserves rules that technological or market developments have superseded. Worse, rules that were unjustified from the outset will take a long time to repeal (i.e., regulatory mistakes become very hard to correct).[147]

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[143] *Id.* at 1408.

[144] *See generally* Ronald J. Daniels, *Should Provinces Compete? The Case for a Competitive Corporate Law Market*, 36 McGILL L.J. 131, 144 (1991); Leebron, *supra* note 136, at 66.

[145] *See* RICHARD M. BUXBAUM & KLAUS J. HOPT, LEGAL HARMONIZATION AND THE BUSINESS ENTERPRISE: CORPORATE AND CAPITAL MARKET LAW HARMONIZATION POLICY IN EUROPE AND THE U.S.A. 243 (1988) (discussing the difficulty of amending or repealing directives); Matthias Baudisch, *From Status to Contract? An American Perspective on Recent Developments in European Company Law*, *in* L'UNION EUROPÉENNE ET LA GOUVERNANCE 23, 27 (F. Snyder ed., 2003) ("[T]he decision-making process on the European level [makes] it extremely difficult to replace the rules laid down in the directive even if they are widely recognized as unsatisfactory."); Mathias M. Siems, *The Case Against Harmonisation of Shareholder Rights*, 6 EUR. BUS. ORG. L. REV. 539, 542 (2005) ("[C]hanging existing company law directives is a very slow process and that law may thus become deficient.").

[146] A study by a group of experts appointed by the EU Commission containing proposals aimed to simplify the Second Directive dates back to 1999. *See* Eddy Wymeersch, *European Company Law: The "Simpler Legislation for the Internal Market" (SLIM) Initiative of the EU Commission* 3 (Fin. L. Inst. Working Paper Series, WP 2000-09, 2000), *available at* http://www.law.ugent.be/fli/WP/WP2000-pdf/wp2000-09.pdf (reviewing the main proposals). A proposal to amend the Directive made in October 2004 came into force in September 2006. *See* Council Directive 2006/68/EC of the European Parliament and of the Council of 6 September 2006 Amending Council Directive 77/91/EEC as regards the Formation of Public Limited Liability Companies and the Maintenance and Alteration of their Capital, 2006 O.J. (L 264) 32.

[147] *See* Bainbridge, *supra* note 1, at 31 (arguing that the uniformity imposed by the Sarbanes-Oxley Act will preclude experimenting with better regulations).

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One may counter that, for securities law, the problem is being solved by the Lamfalussy method, which could be extended to the core of corporate law. As we suggested earlier, however, the Lamfalussy method has its own drawbacks, namely the danger of overregulation and excessive innovation.[148]

3.4. The Costs of the Harmonization Process

EC corporate lawmaking is a flourishing industry itself, employing a number of national and EC officials, advisers, and lobbyists, and offering opportunities for rent extraction by national as well as EC politicians.[149] While the benefits of real-world harmonization measures in this field are highly uncertain, in light of their triviality and drawbacks, simply maintaining this "industry" obviously has costs, especially in terms of lobbying by EU enterprises and other vested interests. Not only does EC legislation create an additional level of lobbying[150] (or possibly even more, as in the case of securities regulation nowadays), but, since it usually requires implementation, it provides a further opportunity for lobbying over the implementing measures and over whether to amend existing laws even in areas not covered by the relevant EC measures, possibly under the pretext of better coordination with the new regime.[151]

[148] Enriques, *supra* note 16, at 52 n.217.

[149] *See id.* at 55–58 (cataloguing and discussing groups that stand to benefit from the flourishing of EC corporate law legislation).

[150] *Cf.* Mary E. Kostel, Note, *A Public Choice Perspective on the Debate over Federal Versus State Corporate Law*, 79 VA. L. REV. 2129, 2153–54 (1993) (arguing that the federalization of corporate law in the United States would create an additional layer of lobbying activity which would be a pure loss for society as a whole).

[151] In Italy, this was the case with the First Investment Services Directive. First implemented in 1996, its implementing rules were then consolidated into Decreto Legislativo [Legislative Decree] No. 58, Feb. 24, 1998, II/1998 Racc. Uff. 576, *published in* Gazz. Uff. Mar. 26, 1998, No. 71, supp. ord. No. 52/L, which included matters not covered at all in the relevant Directive, such as mutual funds, tied agents, and listed corporations. The domino effect of the Investment Directive further led to an overall reform of Italian corporate law that was said to be needed following the 1998 changes in the law of listed corporations. *See* Luca Enriques, *Scelte Pubbliche e Interessi Particolari Nella Riforma Delle Società di Capitali* [*Public Choices and Private Interests in the Reformed Corporate Laws*], 7 MERCATO CONCORRENZA REGOLE [MARKET, COMPETITION, AND RULES] 145, 152–55 (2005).

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3.5. Summary

This Section has shown that corporate law harmonization comes at a cost: harmonization substitutes a single lawmaker for twenty-five different ones, or a monopolist for twenty-five competitors, creating a greater risk of excessive regulation and innovation and a lower degree of experimentation. A uniform law also precludes taking account of divergent expectations and preferences at the national level. In the real world, harmonization increases the complexity and uncertainty of national corporate law; in addition, EC corporate law is hard to change or repeal, hence not easily adaptable to economic or technological developments. Finally, the harmonization process itself is costly in terms of lobbying expenditures and rent extraction opportunities by EC officials and politicians.

4. ASSESSING CURRENT EC INITIATIVES IN THE FIELD OF CORPORATE LAW

Following the wave of U.S. corporate scandals and the prompt, tough response by Congress with the Sarbanes-Oxley Act of 2002,[152] the European Commission decided it needed to play a major role in reforming corporate governance to restore public confidence.[153] In May 2003, the Commission released a comprehensive action plan, *Modernising Company Law and Enhancing Corporate Governance in the European Union* (the "Action Plan"), containing twenty-four proposed measures, some of which have already been enacted and the rest of which are expected mainly before 2009.[154] In December 2005, the European Commission launched a public consultation on the future priorities of the Action Plan.[155]

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[152] Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified in scattered sections of 11, 15, 18, 28, and 29 U.S.C.).

[153] "Earning the right to be recognised as at least 'equivalent' alongside other national and international rules is," in the Commission's view, "a legitimate and useful end in itself." *Action Plan, supra* note 15, at 5.

[154] The Action Plan contains a set of short-term (2003-05), medium-term (2006-08) and long-term (2009 onwards) measures. By the end of 2005, only seven out of twelve short-term measures had been formally adopted, four of which were in the form of legislation.

[155] *Consultation on Future Priorities for the Action Plan on Modernising Company Law and Enhancing Corporate Governance in the European Union, available at* http://europa.eu.int/comm/internal_market/company/docs/consultation/consultation_en.pdf (last visited Nov. 10, 2006).

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Before going into the analysis of the main issues raised by the Action Plan, let us start with a critical overview of the reasons and the key policy objectives for which, as the Commission put it, now "is the right time to give a fresh and ambitious impetus to the EU company law harmonisation process."[156]

4.1. *An Overview of the Reasons and the Key Policy Objectives of the EC Action Plan*

In the European Commission's view, there are a number of reasons for new EC initiatives.[157] First, the growth in cross-border transactions within the EU requires rules to facilitate freedom of establishment and cross-border restructuring. Second, to better integrate capital markets, investors should have the confidence that the corporations they invest in have equivalent corporate governance frameworks. Third, modern technologies should be fully exploited to make corporations more efficient. Fourth, the enlargement of the EU calls for a review of EU corporate law, as new Member States will increase the diversity of national regulatory frameworks, underscoring "the importance of a principles-based approach able to maintain a high level of legal certainty in intra-Community operations."[158] Fifth, financial scandals call for the restoration of confidence through new EC initiatives.

While it is easy to agree with the first rationale, as there is no doubt that the EC is actually the most appropriate political body for the removal of national barriers to cross-border activity, the others raise significant doubts. The second rationale echoes a need for uniformity in corporate law that, as we have seen, represents a groundless policy.[159] As to the technology rationale, given that what is new today is obsolete tomorrow, this is the typical kind of issue that politicians and lawyers should handle with extreme care and possibly refrain from doing anything more than allowing corporations to fully exploit new technologies for as long as they want to. Unless EC officials are eager to acknowledge that previous legislation has been largely ineffective, the fourth rationale, according to which new initiatives are needed due to the EU enlargement, makes even less sense, as the content of corporate law is not af-

[156] *Action Plan*, *supra* note 15, at 6.

[157] *See id.* at 6–7 (listing five such reasons).

[158] *Id.* at 7.

[159] *See supra* Section 2.3.2.3.

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fected by the number of Member States that must adopt the rules (and, therefore, the number of corporations affected). As to restoration of confidence, there is no real need for harsh regulations or "'me-too' reforms"[160] solely for the sake of showing that the EC has muscle; as the Sarbanes-Oxley Act can tell us, emotive political reactions are likely to generate ill-conceived law.[161]

Turning to the objectives of the Action Plan, the Commission's focus is on strengthening shareholder rights and third party protections while fostering business efficiency and competitiveness.[162] On the first objective, the Commission believes that "[m]aintaining efficient protection of members and third parties will be even more important in the future, in view of the increasing mobility of companies within the EU,"[163] which clearly indicates that EC officials

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[160] Gerard Hertig, *On-Going Board Reforms: One Size Fits All and Regulatory Capture*, 21 OXFORD REV. ECON. POL'Y 269, 270 (2005).

[161] *See* Roberta Romano, *The Sarbanes-Oxley Act and the Making of Quack Corporate Governance*, 114 YALE L.J. 1521 (2005) (arguing that the Sarbanes-Oxley Act was enacted in a frantic political environment and thus ignored the literature at odds with its policy). Currently, the European Commission does not appear to feel so strongly about this rationale because the importance of investors' confidence, which was strongly emphasized in the Action Plan, has been replaced by other drivers for reform:

> [B]ecause of market and regulatory evolutions, the context for medium term phase of the Action Plan is different from that of spring 2003. After the corporate scandals of the beginning of this century, restoring investor confidence was the main driver for action and reform in the field of company law and corporate governance. The impetus for future action at EU level must now be more the tandem of improving the competitiveness of EU companies and better regulation.

Consultation on Future Priorities for the Action Plan on Modernising Company Law and Enhancing Corporate Governance in the European Union, *supra* note 155, at 5. Given the (fortunately) limited number and minor importance of the reforms that the EC has passed after the Action Plan, one might be tempted to conclude that the emphasis of the Action Plan on investors' confidence, rather than a well-reasoned driver for reform, was more simply a product of post-Enron anxiety. *See* Hertig, *supra* note 160, at 270 ("[R]eformers generally battle past scandals rather than future market failures, their main purpose being the short-term rebuilding of investor confidence or the soothing of voter anger prior to the next election."); Bainbridge, *supra* note 1, at 28 ("There is nothing a politician wants more than to persuade upset investors that he or she is 'doing something' and being 'aggressive' in rooting out corporate fraud.").

[162] *See Action Plan*, *supra* note 15, at 7-9 (designating the key policy objectives of the EC).

[163] *Id.* at 8. To this end, the Commission intends to introduce measures to enhance shareholders' rights, clarify management responsibilities and modernize creditor protection. *See infra* Section 4.2.

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are concerned that greater mobility of corporations may give rise to a race to the bottom.[164]

As to the second objective, business efficiency and competitiveness should be promoted through: (a) initiatives addressing cross-border issues (such as cross-border mergers or transfer of registered office and elimination of cross-border impediments to the exercise of shareholders' rights); and (b) a certain degree of harmonization to reduce legal uncertainties.[165]

Initiatives to facilitate cross-border mobility and restructuring are in fact good policy, so long as the benefits of negative harmonization (where the EC is indeed the best-suited political body to eliminate national barriers) are not jeopardized by cumbersome positive harmonization.[166] However, contrary to the Commission's belief, no EC action would be justified on the sole basis of reducing legal uncertainties, other than a mere "explain" approach requiring corporations to describe their (different) governance regimes in their annual reports.[167]

To sum up, the Action Plan appears to be directed to three bottom-line goals: (1) removing national barriers; (2) avoiding a race to the bottom; and (3) promoting uniformity to reduce the information costs currently borne by investors. In our view, only the first deserves the attention of EC officials; the other two would, in all likelihood, lead to undesirable regulation.

4.2. *The Initiatives of the EC Action Plan*

This Section will evaluate a set of initiatives (adopted or simply proposed) that have been put on the table by the Action Plan.[168] Our focus will be on the proposed measures on shareholders' vot-

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[164] For a critical assessment of how the greater mobility of corporations affects harmonization, see *supra*, Section 2.1.

[165] *See Action Plan*, *supra* note 15, at 9 (describing specific measures necessary to promote general efficiency and competitiveness policies).

[166] *See supra* Section 2.3.1.

[167] *See supra* Section 2.3.2.3.; *see also* notes 97–99 and accompanying text.

[168] With the exception of the "one share, one vote" principle (*see infra*, Section 4.2.2.), we will not focus our attention on the non-binding recommendations, their potential drawbacks are palpably smaller than the inefficiencies that would be triggered by mandatory provisions. *See* Klaus J. Hopt, *European Company Law and Corporate Governance: Where Does the Action Plan of the European Commission Lead?* (European Corporate Governance Institute, Working Paper No. 52/2005, 2005), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=863527 (providing a comprehensive description of the Action Plan and EC initiatives).

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ing rights, the announced battle against differential voting structures and pyramids, and the provisions on cross-border mergers.

4.2.1. Shareholders' rights

Drawing on the report by the High Level Group of Company Law Experts,[169] the European Commission set as one of its top priorities the improvement of a series of shareholders' rights in listed corporations, such as the "right to ask questions, to table resolutions, to vote in absentia, [and] to participate in general meetings via electronic means."[170] The Action Plan also intended to solve some specific problems affecting cross-border voting.

After an open consultation process launched in 2004 by the Internal Market Directorate General ("DG MARKT")[171] on January 9, 2006, the European Commission presented the Shareholders' Rights Proposal.[172] It contains measures governing shareholders' meetings and voting, including: (i) requirements with respect to notice general meetings;[173] (ii) the right to add items to the agenda and to table draft resolutions, with the introduction of the maximum thresholds permissible under EC law if Member States subordinate the exercise of such rights to possession of a certain amount of shares;[174] (iii) provisions concerning admission to meet-

169 *Report of the High Level Group of Company Law Experts on a Modern Regulatory Framework for Company Law in Europe, supra* note 98, at 47–59. *See* Ferran, *supra* note 98, at 436–453 (providing a thorough analysis of the report with respect to the initiatives on shareholders' rights); *see also* Siems, *supra* note 145.

170 *Action Plan, supra* note 15, at 14.

171 The Internal Market Directorate General ("DG MARKT") published two consultation documents, in September 2004 and May 2005, on the minimum standards to facilitate the cross-border exercise of shareholders' rights in listed corporations. *See Fostering an Appropriate Regime for Shareholders' Rights: Consultation Document of the Services of the Internal Market Directorate General*, MARKT/16.09.2004 (2004), *available at* http://europa.eu.int/comm/internal_market/company/docs/shareholders/consultation_en.pdf [hereinafter 2004 DG MARKT Consultation]; Internal Market Directorate General, *Fostering an Appropriate Regime for Shareholders' Rights: Second Consultation by the Services of the Internal Market Directorate General*, MARKT/ 13.05.2005 (2005), *available at* http://europa.eu.int/comm/internal_market/company/docs/shareholders/consultation2_en.pdf [hereinafter 2005 DG MARKT Consultation].

172 *Shareholders' Rights Proposal, supra* note 15.

173 *See id.* art. 5 (requiring that the notice be issued not less than thirty calendar days before the meeting and contain information on the procedures that shareholders must comply with to participate and vote).

174 *See id.* art. 6 (requiring that rights must be guaranteed, at least, to holders of 5% of the share capital or shares having an aggregate nominal value of €10 million, whichever is lower).

ings, with a ban on share blocking systems[175] and the option for Member States to introduce record date systems[176] within a maximum period of 30 calendar days preceding the general meeting;[177] (iv) the right to participate in shareholders' meetings by electronic means;[178] (v) the right to ask questions;[179] (vi) measures on proxy voting;[180] (vii) the right to vote in absentia;[181] (viii) provisions with respect to the management of securities accounts and to voting by intermediaries upon instructions from accountholders;[182] and (ix) post-meeting information.[183]

According to the European Commission, EC action is needed because "EU-citizens holding shares in a listed company situated in another Member State often face severe problems when they wish to exercise the voting rights attaching to these shares and sometimes even encounter obstacles that make voting practically impossible."[184] This, in turn, poses "the threat of EU listed companies being owned by a passive shareholder base,"[185] which is at odds with the Commission's belief that "effective shareholder control is a prerequisite to sound corporate governance and should . . . be facilitated and encouraged."[186]

It is easy to see that the EC legislature is actually pursuing two distinct policy goals: the removal of national barriers and the en-

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[175] Under a share blocking system, shareholders must deposit their shares (either at the corporation's headquarters or at designated institutions) by a certain date prior to the meeting and cannot dispose their shares in between in order to be admitted. *Id.* art. 7.

[176] Under a record date system, only shareholders who are registered on the corporation's stock ledger as owners of the stock on the record date are entitled to participate in the meeting. *Id.*

[177] *See id.*; *see also infra* notes 199-203, 211-15 and accompanying text.

[178] The Shareholders' Rights Proposal prohibits Member States from establishing or maintaining "[r]equirements and constraints that act or would act as a barrier to the participation of shareholders in the general meeting by electronic means . . . except in so far as they are necessary to ensure the identification of shareholders and the security of the electronic communication and are proportionate to ensure the identification." *Shareholders' Rights Proposal*, *supra* note 15, art. 8, ¶2

[179] *Id.* art. 9.

[180] *Id.* arts. 10-11.

[181] *Id.* art. 12.

[182] *Id.* art. 13.

[183] *Shareholders' Rights Proposal*, *supra* note 15, art. 15.

[184] *Id.* art. 1.1

[185] *Id.*

[186] *Id.* pmbl., para. 3.

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hancement of shareholder protection. Note that in the view of the Commission, the former goal, which in our opinion is the European Community's only legitimate concern in the corporate law field, is merely instrumental in attaining the goal of improving shareholder protection. This explains why most of the measures in the Shareholders' Rights Proposal go well beyond what would be necessary to eliminate national barriers.

Actually, *none* of the measures are really addressed to eliminate the national barriers that hinder the rights of foreign investors. At best, the barriers to be repealed are national provisions or practices that supposedly harm both national and foreign investors in a given member state, with no real cross-border issue on the table; in fact, under no circumstances were the rights mentioned above thwarted because of shareholders' nationality.

The highly publicized issue of cross-border voting illustrates the point well. Inspired by the recommendations of the second Winter Report,[187] the DG MARKT emphasized that, in a system characterized by a chain of intermediaries between investors and issuers, foreign investors "should [be able to] assert their rights in relation to the votes attached to the shares to the exclusion of other holders in the chain of intermediaries,"[188] and proposed three sets of measures. First, they proposed a definition of the so-called ultimate investor—that is, the person entitled to "control the voting right."[189] Second, they proposed provisions to "ensure that the ultimate investor can actually exercise the entitlement to control voting rights;"[190] and third, a system of authentication and certifica-

[187] *See Report of the High Level Group of Company Law Experts on a Modern Regulatory Framework for Company Law in Europe, supra* note 98, at 53-56 (drawing on Jaap Winter, *Cross-Border Voting in Europe, supra* note 103 *passim*, and *Expert Group on Cross-Border Voting in Europe, supra* note 103).

[188] 2004 DG MARKT Consultation, *supra* note 171, at 10.

[189] *Id.* at 12 (defining such an interested investor as "the last natural or legal person holding a securities account in the 'chain' of intermediaries and who is not a securities intermediary within the European securities holding systems, nor a custodian").

[190] As noted in the 2004 DG MARKT Consultation:

> In order to respect the diversity of national company laws with respect to the formal voting right, the following options should be available . . . (1) The ultimate investor is acknowledged as shareholder entitled to vote. This would be suitable for systems based on bearer shares. (2) The ultimate investor is designated in the shareholders' register as entitled to vote, suitable for registered shares systems. (3) The ultimate investor is given a power of attorney by the intermediary formally entitled to vote. The intermediary has the formal voting right but gives a power of attor-

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tion to ensure that shares are not voted twice.[191] Although the Shareholders' Rights Proposal eventually dropped the idea of the ultimate investor[192] and a system of certification, it did endorse the second suggestion by proposing rules aimed at deregulating proxy voting and granting the possibility for accountholders to instruct their intermediaries on how to vote.[193]

Supporters of the EC measures have stressed that a single set of rules is needed because "rules and practices . . . developed to allow ultimate investors to exercise voting rights . . . do not particularly facilitate and often even hinder voting by shareholders in other jurisdictions."[194] Though exactly what they have in mind when referring to such difficulties and hindrances is quite obscure. Their concern is that non-residents holding shares through chains of intermediaries might find it hard to give proof of their entitlement to the exclusion of other holders in the chain because "[t]he position of the ultimate investor is formally not different from the securities intermediaries who are accountholders higher up in the chain."[195]

> ney to the ultimate investor. (4) The ultimate investor instructs the intermediary who is the formal shareholder to vote as instructed. . . . To complement this, the intermediary should not be allowed to exercise voting rights unless on the basis of clear instructions or of an agreement with the ultimate investor.

Id.

[191] *Id.* at 13. In the envisaged system, "[t]he authentication process should be launched at the request of the ultimate investor who would then notify his intermediary." As to the issue of which intermediary is responsible for the authentication, the DG MARKT describes two possible approaches: the authentication by the last intermediary in the chain only or by each intermediary throughout the chain.

[192] Several measures contained in the 2004 DG MARKT Consultation have been subsequently abandoned or watered down. The idea of introducing a definition of the "ultimate investor" was abandoned in light of the great uncertainties that such a definition would create. 2005 DG MARKT Consultation, *supra* note 171, at 6–7. As to the measures on stock lending and depositary receipts, see *infra* note 204.

[193] *See Shareholders' Rights Proposal, supra* note 15, arts. 10–11, 13 (setting forth the rules under which proxies may operate).

[194] *Expert Group on Cross-Border Voting in Europe, Final Report, supra* note 103, at 14.

[195] *Id.* at 15 ("[T]he ultimate investor in cross-border situations is usually not in the register and therefore not recognised as a shareholder with the power to exercise voting rights . . . in today's securities holding systems the ultimate investor is unable to produce a share certificate and can only prove his right to the shares by reference to his account with a securities intermediary."). *See also* 2004 DG MARKT Consultation, *supra* note 171, at 10 ("Whether foreign investors have acquired bearer or registered shares, they will often only be able to prove their

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The problem with cross-border voting is thus the potential confusion raised by possible duplications of claims to exercise shareholders rights.[196] Even assuming that this is the case, it is clear that an EC intervention would not be aimed at removing national barriers to cross-border activities but would be more simply oriented at solving a possible market failure along cross-border securities chains, namely that intermediaries may exercise ultimate investors' rights contrary to their principals' wills.[197] But even if this were ultimately true, plain vanilla fiduciary duties and rules on conflict of interest between intermediaries and investors would be better suited to preventing the expropriations feared.[198]

A similar argument can be made with respect to the ban on share blocking systems in Article 7. In fact, notwithstanding the Commission's contention that share blocking is the most important obstacle to cross-border voting,[199] a real cross-border issue seems to be missing here. In the Commission's view, share blocking "deters investors from voting because it prevents them from selling their shares for several days before any general meeting."[200] Even arrangements to allow disposal of shares during the blocking period are not considered satisfactory, as "the system is not understood by investors, who are often unaware of the possibility of disposing of their shares during the blocking period."[201] Yet, in no circumstance

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rights to the shares by reference to their accounts held with securities intermediaries.").

[196] Therefore, there is the need to define who the ultimate investor is and to grant her tools to effectively exercise her voting rights.

[197] Though possible, how probable is it? The burden of proof should be on advocates of the measures on cross-border voting who actually fail to provide any data relating to the existence and relevance of disputes among chain participants.

[198] A preliminary question is whether current rules governing intermediaries are unable to prevent shareholders' disenfranchisement. If this is the case, the next question would be whether such rules should be bolstered at the national level or should require EC intervention, that is, if the EC is better positioned to cure the underlying market failure. *See supra* Section 2.2. *Cf.* Ferran, *supra* note 97, at 447 ("If further legal underpinning of the system is desirable, a sensible way forward would be to reinforce the financial regulatory regime through the development of conduct of business rules that spell out in more explicit terms the obligations of regulated financial intermediaries . . . .").

[199] *See Shareholders' Rights Proposal*, *supra* note 15, at 3 (ranking share blocking first among the major impediments to cross-border voting).

[200] *Id.* at 5.

[201] *Id* at 5–6. *See* 2004 DG MARKT Consultation, *supra* note 171, at 17 ("Many investors, particularly those from foreign jurisdictions, find blocking requirements unduly restrictive and are therefore reluctant to vote their shares, if they lose their

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is share blocking discriminatory because of investors' nationalities.[202] The purported cross-border problem turns out to be, more simply, investors' confusion and dislike of the system.[203]

So with no real cross-border issue at stake, the drivers for measures to strengthen shareholders' rights clearly lie elsewhere, namely in the effort to create uniform practices (e.g. the systems for admission to the meeting, the right to ask questions, add proposals and table draft resolutions) or to correct purported market failures (e.g. the provisions to allow voting by the ultimate investor, as well as the measures envisaged by the DG MARKT on stock lending and depositary receipts,[204] which will apparently be included in a

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ability to respond to market developments as a result."); *see also infra* notes 211–13 and accompanying text.

[202] One could make the point that, albeit not expressly, share blocking discriminates *de facto* against investors based in jurisdictions endorsing the different record date system. This argument however proves too much, as it can theoretically be made with respect to each and any host state rule that differs from the investor's home state rule. In fact, following such logic, an investor based in a jurisdiction like Italy, which allows corporations to require a block for a maximum of two business days prior to the date of the meeting, could stress that Swedish law, which in turn allows corporations to fix a record date of five days prior to the meeting, *de facto* discriminates against their right to exercise the voting rights in relation to shares issued by a Swedish corporation that are purchased, for example, four days prior to the meeting. *See* 7 ch. 28 § Aktiebolagslag (SFS 2005: 551); *cf.* C.c. art. 2370, Gazz. Uff. (Nov. 31, 2006) (Italy). Note, incidentally, that art. 7, para. 3, of the Shareholders' Rights Proposal allows Member States to determine the record date within a maximum of thirty calendar days.

[203] Nevertheless, we do not necessarily consider share blocking an optimal system, as we reckon that it indeed imposes cumbersome formalities on investors and limits their liquidity. However, given that investors can easily price their dissatisfaction in relation to share blocking, it is difficult to see why the EC should step in with a mandatory prohibition. At best, the EC's intervention would be justified if it just required Member States to allow corporations to opt out of the share blocking system.

[204] The 2004 DG MARKT Consultation showed concern about the practice of stock lending. The DG MARKT is in fact concerned by the facts that "not all ultimate investors are informed that shares held by intermediaries on their behalf" may be lent and that such investors oftentimes are not "aware that when shares are lent the vote is transferred with the shares." 2004 DG MARKT Consultation, *supra* note 171, at 14. The DG MARKT thus wondered whether such an issue should be left to the freedom of contract of market participants or should be tackled at the EC level through disclosure of the consequences of stock lending or a prohibition to lend securities in the proximity of a shareholders' meeting. The 2004 Consultation also focused on the restrictions to the right to vote affecting the holders of depositary receipts. The DG MARKET asserts that in standard depositary agreements, holders of the receipts have the right to vote only if "the issuing company formally requests the depositary to ask the holders for their votes." *Id.* In all other cases, the voting rights remain with the intermediary. The DG MARKT questions "whether holders of depositary receipts should be allowed to

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separate Commission recommendation).[205] However, as noted above, none of these concerns deserve the enactment of substantive rules by the European Community.

We have already pointed out that uniformity and standardization are not sound rationales for EC legislation, its benefits being largely offset by the costs in terms of inflexibility[206] and obstacles to innovation, not to mention possible new complexities stemming from the harmonized regime.[207] Moreover, in certain circumstances, whenever the implementation of certain rules is likely to

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be recognised as holding the rights attached to the underlying shares" and thus if "any specific exclusion of depositary holders from the rights, including voting rights, associated with shareholdings [should] be removed." *Id.* Notwithstanding these concerns, none of these measures made it through the Shareholders' Rights Proposal. The reasons for the failure are not surprising. Prohibiting stock lending simply because some investors might not realize that the shares they are about to lend will be voted at a meeting by the borrower is pointless unless one comes to the conclusion that stock lending must per se be banned for other reasons. As regards depositary receipts, the choice whether or not to grant the right to vote to the holder of the receipts seems to be handled quite well by market participants and reflected in the price investors are willing to pay to purchase such securities. That is, absent any evidence of a market failure, there is no valid reason for a legislature (particularly the EC legislature) to adjudicate rights in contrast to the market. *Cf.* Siems, *supra* note 145, at 549.

[205] *See Shareholders' Rights Proposal, supra* note 15, at 3 ("Other topics covered in the public consultations, which are indirectly related to the exercise of voting rights, such as stock lending, depositary receipts or the rules governing languages, could form part of a Commission recommendation.").

[206] For instance, art. 5, para. 1, of the Shareholders' Rights Proposal, which requires that the notice to convene a general meeting be made at least thirty calendar days before the meeting, has raised severe criticism in the UK, where sec. 369, par. 1, of the 1985 Company Act provides for minimum periods of twenty-one and fourteen days, respectively, for the annual and the extraordinary meeting. *See* Companies Act, 1985, c. 6, § 369(1) (Eng.); *see also UK Law Society Takes Issue With New EU Proposals On Shareholder Rights* (Jan. 19, 2006), *available at* http://www.iofc.net/gowealthy/story.asp?storyname=22433 (explaining that while art. 5, para. 1 "may be suited to an AGM, it . . . fails to take account of business reality. EGMs are usually organised for a single issue and exceptional items of business . . . and requiring shorter notice periods").

[207] For a critical view on recent EC reform proposals in the field of clearing and settlement, on the argument that uniform mandatory rules would unduly dampen innovation by market players, see Ettore Scimemi, *Il Nuovo Diritto Europeo degli Strumenti Finanziari,* 2005 NUOVA GIURISPRUDENZA CIVILE COMMENTATA II/394, II/413-15 (arguing in general that uniformity should be imposed only when regulating a market, and not when regulating the products traded in the market). *Cf.* Ferran, *supra* note 98, at 443 ("[T]he existence of different national systems for the clearing and settlement of securities transactions, and the different levels of investor sophistication and market transparency . . . can be viewed as an important consideration militating against top down EC intervention . . . ."). *But cf. id.* at 451-52 (supporting an EC prohibition over share blocking systems).

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have a peculiar impact in some Member States, measures at the EC level might even involve additional costs in terms of national shocks and backlash.[208] The proposed top-down deregulation of the proxy rules may well be a case in point, as it would result, inter alia, in the ban of provisions imposing disclosure requirements for persons soliciting proxies above certain thresholds.[209]

If the main problem in connection with admission to meetings and the right to ask questions, add proposals, and table resolutions is the uncertainty of investors and current and future issuers, then disclosure, rather than a uniform substantive regime, would better serve the interests of all players.[210] Consider the criteria for admission to the meeting, in which respect the DG MARKT actually acknowledged that some Member States that formerly had a share blocking system opted for a framework under which the ownership of shares is verified during a few days before the General Meeting, but shareholders are now free to sell shares during that period.[211] If disposals occur, intermediaries must inform issuers, which in turn reconcile holdings and voting rights. So if experimentation has led to this solution, why bother imposing a record date system? According to the DG MARKT's view, eventually endorsed by the Commission,[212] it appears that few cross-border in-

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[208] The main example here is the debate surrounding the adoption of the board passivity rule in connection with takeover bids. One of the risks associated with a mandatory passivity rule was that, given the shock that the rule would have generated in certain Member States, it would have triggered backlash. For example, it would have stimulated incumbent shareholders and managers to lobby for certain regulatory obstacles against prospective bidders. *See* Gatti, *supra* note 99, at 566 n.35 (citing Christian Kirchner & Richard W. Painter, *Takeover Defenses Under Delaware Law, the Proposed Thirteenth EU Directive and the New German Takeover Law: Comparison and Recommendations for Reform*, 50 AM. J. COMP. L. 451, 459 (2002) for the proposition that antitrust is a regulatory barrier).

[209] E.g., in Italy, proxy rules requiring, among other things, filing of a prospectus with the Italian regulator are triggered if a person solicits more than 50, 100, or 200 shareholders, depending on the share capital of the given corporation. *See* C.C. art. 2372, para. 6, Gazz. Uff. (Mar. 31, 2006) (Italy) Legislative Decree No. 58 of Feb. 24, 1998, *supra* note 150, arts. 136–37; *Shareholders' Rights Proposal*, *supra* note 15, art. 10, para. 2 (according to which "[a] person acting as a proxy holder may hold a proxy from more than one shareholder without limitation as to the number of shareholders so represented," which would essentially prohibit the abovementioned rules).

[210] *See supra* Section 2.3.

[211] 2005 DG MARKT Consultation, *supra* note 171, at 17.

[212] *See Shareholders' Rights Proposal*, *supra* note 15, at 5–6 (acknowledging that investors "are often unaware of the possibility of disposing of their shares during the blocking period").

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vestors understand that these verification systems allow them to dispose of their shares during the verification period. As a result, they tend to continue to consider countries which have such systems as still imposing share blocking.[213]

The case for banning a share block system thus rests on the fact that "where issuers are free to decide to impose share blocking or a record date, financial intermediaries often tend to consider share blocking as the prevailing rule."[214] EC intervention is purportedly required by the need to prevent global financial institutions from being confused by different legal regimes. Frankly, we fail to see why this concern should be taken into account. Surely an intermediary lacking the elementary skills to distinguish between a share blocking system and a record date system deserves no attention from the EC policymaker.[215]

4.2.2. *Differential voting structures*

According to the Action Plan, "there is a strong medium to long term case for aiming to establish a real shareholder democracy in the EU,"[216] particularly with respect to the "one share, one vote" principle.[217] In October 2005, EC Internal Market Commissioner McCreevy advocated the introduction of the principle across the EU, while acknowledging that, rather than proposing binding legislation, the Commission is more likely to issue a recommendation.[218] A study on current restriction with respect to voting rights and on the consequences of the "one share, one vote" principle is expected to be commissioned at the beginning of 2006.[219] Mean-

[213] 2005 DG MARKT Consultation, *supra* note 171, at 17.

[214] *Id.*

[215] The same applies if they find it troublesome to figure out how to make questions, add proposals, or table resolutions.

[216] *Action Plan, supra* note 15, at 14. The Commission does concede that "any initiative in this direction . . . requires prior study" and has thus set up a study on the consequences of such a principle. *Id.*

[217] *Id.* For an analysis of the "one share, one vote" principle, and of the advantages and disadvantages of its possible adoption in Europe, see Guido Ferrarini, *One Share-One Vote: A European Rule?* (European Corporate Governance Inst., Law Working Paper No. 58/2006, 2006), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=875620.

[218] Charlie McCreevy, European Commissioner for Internal Market and Services, Company Law Action Plan: Setting Future Priorities 3 (Nov. 14, 2005), *available at* http://europa.eu/rapid/pressReleasesAction.do?reference=SPEECH/05/683&format=PDF&aged=1&language=EN&guiLanguage=en.

[219] *Action Plan, supra* note 15, Annex I, at 25.

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while, the main EC effort to fight differential voting structures had suffered a political defeat, as the so-called break-through rule, initially proposed in the first Winter Report[220] and subsequently endorsed in a much milder version in the 2002 proposal for a Takeover Directive,[221] was eventually made optional for Member States[222] due to wide political opposition and significant criticism from academics.[223]

Differential voting structures are criticized because they do not reflect a principle of proportionality between risk bearing and control, which is purportedly said to be optimal to allow shareholders "to determine the affairs of the company and the operation of its business."[224] Hence, using the taxonomy illustrated earlier, EC efforts in this field may well be characterized as aimed at correcting a market failure.[225]

As anticipated, correcting market failures at the EC level is justifiable only if three conditions are met: existence of a market failure; inability or unwillingness of Member States to correct it; and efficacy of the corrective measures. However, even if conceding, for the sake of argument, that differential voting structures trigger the first[226] and the second conditions, it is hard to see how EC ini-

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[220] The High Level Group of Company Law Experts, *Report of the High Level Group of Company Law Experts on Issues Related to Takeover Bids*, 29–36, (Jan. 10, 2002).

[221] *See Commission Proposal for a Directive of the European Parliament and of the Council on Takeover Bids*, at 4, COM (2002) 534 final (Feb. 25, 2003) (noting that the recommendations of the Winter Group found wide opposition "from virtually all Member States and interested parties," notably because of the legal problems to which they may give rise, including application threshold, concept of risk-bearing capital, compensation for rights forgone, etc.).

[222] *See id.* art. 12, at 10 (leaving the "content of [national] rules [applicable to the conduct of bids] to the discretion of the Member States"). As of the publication of this Article, no Member State seems to have the intention of adopting such a rule.

[223] *See infra* note 227; *see also* Ferrarini, *supra* note 217, at 5 (mentioning "the pressure exercised by powerful interest groups, including some prominent families of European capitalism").

[224] The High Level Group of Company Law Experts, *supra* note 220, at 21.

[225] *See id.* (discussing the importance of maintaining a proportionality between risk and control).

[226] As to the actual existence of an underlying market failure in any given firm adopting a dual-class structure, we agree with those commentators who stress that in certain cases differential voting structures do have efficient uses. *See, e.g.*, John C. Coates IV, *Ownership, Takeovers and EU Law: How Contestable Should EU Corporations Be?*, *in* REFORMING COMPANY AND TAKEOVER LAW IN EUROPE 677, 692–94 (Guido Ferrarini et al. eds., 2004); WILLIAM T. ALLEN & REINIER KRAAKMAN,

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tiatives may adequately solve the issue without triggering other costs.

Leaving aside the objections that such a ban would unduly limit freedom of contract, that one-size-fits-all approaches are over-inclusive, and that inefficient differential structures are already punished by the market in the form of higher cost of capital (with no need for paternalistic prohibitions from the legislature),[227] the problems with a mandatory "one share, one vote" principle are the undesirable side effects including the consequent substitutes for differential voting structures and the discouragement for firms to turn to capital markets.[228] Even embracing the underlying premise that such structures are almost always inefficient, a general ban may have social costs (for example, fewer firms going public), without even eliminating the inefficiencies it purports to overcome. Firms would most probably switch to functionally equivalent but arguably even less efficient devices such as pyramidal structures or cross-shareholding.[229]

COMMENTARIES AND CASES ON THE LAW OF BUSINESS ORGANIZATIONS 205-06 (2003); Daniel R. Fischel, *Organized Exchanges and the Regulation of Dual Class Common Stock*, 54 U. CHI. L. REV. 119, 121 (1987) (analyzing "whether exchange rules permitting the trading of dual class common stock are economically beneficial to investors and whether federal regulation is necessary to protect investors from such exchange rules"). Therefore, the relevant assumption might well prove not to hold in all the circumstances, and a one-size-fits-all approach would likely end up being over-inclusive. For an overview of the law and economics debate on the optimality of the "one share, one vote" principle, see Ferrarini, *supra* note 217, at 6–11 (noting that scholars agree on the fact that, at least at the IPO stage, deviations from the principle are not problematic but instead allow corporations to raise new capital without diluting the control of the dominant group).

[227] *See* ALLEN & KRAAKMAN, *supra* note 226, at 205 ("[I]f IPO entrepreneurs sell low-vote stock, public investors who discount accordingly will always get what they pay for.").

[228] *Cf.* Ferrarini, *supra* note 217, at 24–25 ("[I]f separating control rights from cash-flow rights were not possible, the initial owners could rather choose not to go public, possibly generating social costs higher than those caused by dual-class structures.").

[229] *See, e.g.*, Lucian Ayre Bebchuk & Oliver Hart, *A Threat to Dual-Class Shares*, FIN. TIMES (U.K.), May 31, 2002, at 13 (concluding that the breakthrough rule advocated by the high level group of company law experts, who were also cited in note 220, *supra*, "would have major consequences for ownership structures throughout Europe," with pyramids replacing dual-class structures in "companies going public in future"); Enriques, *supra* note 68, at 93–94 ("[S]eparating ownership control . . . can also be achieved by pyramids and cross-holdings, albeit in a more opaque and more costly way."); Guido Ferrarini, *Takeover Defences and the New Proposal for European Directive*, 5–6 (2002), *available at* http://www.cedif.org; Coates, *supra* note 226, at 684-90 (arguing that "switching to a pyramid or cross-holding structure," though more costly, would be "rela-

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4.2.3. *Pyramids*

If effective proportionality between risk-bearing capital and control cannot be achieved simply by banning dual-class share structures,[230] then EC officials would argue that there might be a case for regulating the substitute for such structures also —that is, pyramids.[231] Indeed, the Action Plan acknowledges that pyramids deserve further examination.[232]

Actually, pyramidal structures are more worrisome than dual-class structures in that they are a more opaque and costly way to separate control from cash flow rights.[233] The rationale for EC intervention is, similar to what we have seen with respect to dual-class shares, that of correcting a market failure. However, even in this case, it is doubtful that pyramids fulfill all three conditions needed to justify intervention. In fact, what makes legislative initiatives quite problematic in this field (irrespective of whether they are adopted at the national or at the EC level) is that pyramids are so complicated to regulate. It is likely that any response would

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tively more attractive" to many companies under the breakthrough rule). For a demonstration of the functional equivalence between dual-class share structures, pyramids and cross-shareholding, see Lucian Ayre Bebchuk, Reiner Kraakman & George G. Triantis, *Stock Pyramids, Cross-Ownership, and Dual Class Equity: The Mechanisms and Agency Costs of Separating Control from Cash-Flow Rights*, *in* CONCENTRATED CORPORATE OWNERSHIP 295 (Randall K. Morck ed., 2000). The similarity between differential voting structures and pyramids has been acknowledged also in the Winter Report. *See* The High Level Group of Company Law Experts, *supra* note 220, at 38 ("Pyramid structures in a different way achieve a similar disproportionality between ownership of risk bearing capital and control rights to that which is, for example, achieved by multiple voting rights.").

[230] *See* The High Level Group of Company Experts, *supra* note 220, at 33 (advocating the overriding of provisions limiting the rights ordinarily given to those owning risk bearing capital).

[231] *Cf. Consultation on Future Priorities for the Action Plan on Modernising Company Law and Enhancing Corporate Governance in the European Union*, *supra* note 155, at 6. At this stage of its implementation, the DG MARKT is submitting for consultation the measures listed in the Action Plan for adoption in the medium and long term to assess their continued relevance in the light of market developments and the current context for the Action Plan. *Id.*

[232] *Action Plan*, *supra* note 15, at 20; *see also Consultation on Future Priorities for the Action Plan on Modernising Company Law and Enhancing Corporate Governance in the European Union*, *supra* note 155, at 11 ("After one year of the application of the Regulation, the Directorate General for Internal Market would like to assess use made of the existing law and in particular, whether more flexibility is necessary for companies wishing to establish SE and operate on a European-wide basis.").

[233] *See* Coates, *supra* note 226, at 690 (noting that pyramids and cross-shareholdings make it more difficult for outside investors to understand, evaluate, and monitor existing controllers).

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end up being either both over-inclusive (as it can dampen efficient uses of group structures)[234] and ineffective (as market participants are likely to find loopholes that would allow them to devise some substitute), or merely just one or the other. This means that at least the third condition for intervention (effectiveness of an EC action) would be lacking. Moreover, the potential costs of EC intervention would be quite substantial. Just consider the petrifaction problems typically posed by EC law; once adopted, replacing ineffective or harmful regulation would be problematic.

From a more general perspective, rather than intervene based on the symptoms of supposed bad governance, in which pyramids and dual-class share structures are banned, policymakers should first focus on its causes. The trouble with these structures is that they allow controllers to extract value at the expense of other investors. This is of course easier when controllers, thanks to differential voting or pyramid structures, are comfortably entrenched with no danger of market reaction. Absent the threat of being ousted, incentives to misbehave are obviously greater. But investors do not necessarily dislike the structure itself and sometimes live with it quite happily. They just do not want to be cheated. Inefficient pyramids and dual-class share structures are indeed the by-product of the concurrent factors of ineffective policing of private benefits of control extraction and the small risk of being ousted. These can be seen as two aspects of the same problem: lack of accountability, whether due to poor legal enforcement or market constraints. Plausibly, as financial economists have pointed out, it is the lack of effective policing of conflicted transactions that actually makes these structures viable.[235]

Therefore, the real solution is not to ban structures that are the result of lax laws or enforcement, but rather to make laws against self-dealing more effective by actually enforcing them. In fact, effective checks on the extraction of private benefits of control would leave us with the far smaller problem of incumbent controllers who

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[234] *See* Guido Ferrarini, *European Corporate Governance Harmonisation Plans: A Critical Assessment*, *in* THE FUTURE OF CORPORATE GOVERNANCE 57, 68 (Mats Isaksson & Rolf Skog eds., 2004) (arguing that "it is often difficult to decide whether a pyramid is abusive or not").

[235] *Cf.* Simon Johnson et al., *Tunneling*, 90 AM. ECON. REV. 22, 26 (2000) (speculating that pyramidal group structures may be more rare in the United States and in the United Kingdom because "many transactions inside a group would be challenged on fairness grounds by minority shareholders of subsidiaries, who would get a receptive hearing in court").

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are unaccountable for poor performance due either to shirking, ineptitude, or both.

However, the EC legislature is not a viable candidate for this task for at least two reasons. First, as we have seen, EC legislation aimed to reduce private benefits of control would be either ineffective (if the EC decided to mandate certain *standards* that local judges may end up enforcing leniently) or inefficient (if it opted to impose *rules*, which by definition are inflexible and both over-inclusive and under-inclusive). Second, even leaving aside these lawmaking concerns and assuming an effective European legislative response, we should not forget that, as the literature recognizes, effective policing of self-dealing is the outcome not only of proper regulation, but of several other factors (e.g., business culture, economic and social norms, and efficiency of the judicial system), which are beyond the reach of the EC.[236] Mere legislative intervention to tighten fiduciary duties EU-wide, which is per se very unlikely to be adopted because of local resistance, would be insufficient at best.

4.2.4. *Cross-border mergers*

The EC has recently moved to facilitate cross-border mobility and restructuring. Both the Directive on Cross-Border Mergers ("DCBM")[237] and the announced proposal for a directive on the cross-border transfer of the registered office[238] tend to remove national barriers impeding EU corporations' freedom to migrate and, hence, to choose the corporate law by which they wish to be governed. As we have already pointed out,[239] the EC is best placed to eliminate such barriers, and initiatives in this field should be considered good policy, so long as the measures are not coupled with

[236] *See, e.g.*, Rock, *supra* note 48 (exploring the various factors and institutions that explain the efficient functioning of corporate law); Bernard S. Black, *The Legal and Institutional Preconditions for Strong Securities Markets*, 48 UCLA L. REV. 781, 806–14 (2001) (discussing the core institutions that control self-dealing, such as effective judicial structures, disclosure requirements, and business culture); Guido Ferrarini & Paolo Giudici, *Financial Scandals and the Role of Private Enforcement: The Parmalat Case*, (European Corporate Governance Inst., Working Paper No. 40/2005, 2005), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=730403 (stating that corporate scandals are often the products of poor enforcement rather than legislative gaps).

[237] Council Directive 2005/56, *supra* note 12.

[238] *Commission Proposal for a Directive on the Cross-Border Transfer of Companies' Registered Offices*, COM (2004) IP/04/270 (Feb. 26, 2004).

[239] *See supra* Section 2.3.1.

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onerous rules of positive or procedural harmonization. This caveat is of particular importance since the ECJ, just days after the enactment of the DCBM, clarified in the SEVIC case[240] that national provisions restricting the ability of corporations to enter into cross-border mergers violate Articles 43 and 48 of the EC Treaty. In fact, one can now legitimately wonder whether the DCBM may not ultimately be trivial, as it allows corporations to do something that, as a matter of EC law, has to be permissible in each Member State. Given that according to the Court, even before the DCBM corporations were able to enter into such cross-border transactions, the only problem for market players was legal uncertainty, it is important to assess whether the benefits of the Directive, in terms of legal certainty and protection of the relevant stakeholders, are not offset by the costs of all the positive, procedural measures.

Limiting our focus to the DCBM, the question is thus whether the EC legislature has imposed too cumbersome measures of positive or procedural harmonization. At first sight, one might be tempted to answer in the negative. Given the underlying principles that: (1) the decision-making process of the cross-border merger is regulated by the national authority that has jurisdiction over each of the merging corporations;[241] and (2) the completion of the merger and its effects are regulated by the laws of the corporation resulting from the merger,[242] one might conclude that a cross-border merger is essentially regulated by the same rules as a normal merger, except that, for the merging entities, the completion of the merger and its effects may be regulated by the law of a foreign jurisdiction—the jurisdiction of the surviving entity. On closer inspection, however, the DCMB has several provisions of positive and procedural harmonization, either in the Directive itself or substantially incorporated by "indirect" reference to the Third Directive on mergers,[243] with which national laws must still comply.

Consider the following four features: (1) the 10% limit for cash consideration;[244] (2) the bureaucratic system of pre-merger certificates to be issued by local authorities after scrutiny of the decision-making process of the cross-border merger by the relevant author-

[240] Case C-411/03, SEVIC Systems AG v. Amtsgericht Neuwied, 2005 ECJ CELEX LEXIS 768 (Dec. 13, 2005).

[241] Council Directive 2005/56, *supra* note 12, pmbl., para. 7.

[242] *Id.* art. 4, para. 1(b), arts. 10-12.

[243] Council Directive 78/855, 1978 O.J. (L 295) 36 (EEC).

[244] Council Directive 2005/56, *supra* note 12, art. 2.

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ity (court, public notary, or other authority) selected by each Member State;[245] (3) the complex procedure to guarantee safeguards for employee participation rights;[246] and (4) the requirement that the merger be approved by the supermajorities imposed by the Third Directive.[247]

At this stage it is hard to predict the extent to which such features will dampen reincorporations via cross-border mergers. But we can easily assert that the EC legislature has once again followed the familiar pattern of introducing measures of positive or procedural harmonization in exchange for corporations' wider freedom to move within the European borders.

5. CONCLUSION

This Article has shown that the case for corporate law harmonization is, to put it mildly, uneasy. We have identified a number of rationales for harmonization and argued that practically none of them justifies real-world harmonization—i.e., the harmonization that past experience has shown to be politically and technically feasible. This conclusion has been reached by demonstrating that these rationales do not stand scrutiny in light of the present status of EC corporate law, duly taking into account the dynamics of EC corporate lawmaking and the drawbacks of harmonization.

There are a few exceptions to this general conclusion. Harmonization of focal point rules can be justified, provided that they are narrowly defined and rigorously identified. Further, if negative harmonization were a real-world possibility, it would be desirable to enhance freedom of establishment (and thus free choice of corporate law). In the same vein, a twenty-sixth[248] regime that private parties, as opposed to Member States, may opt into[249] might also be considered worth introducing where national laws contain unjusti-

[245] *See id.*, arts. 10–11.

[246] *See id.*, art. 16.

[247] *See id.*, art. 9; Council Directive 78/855, *supra* note 243, art. 7.

[248] Or, better, a twenty-ninth, if we consider the whole EEA. *See supra* note 23 (discussing the already existing complexity of doing business under so many different business laws).

[249] *See* Gérard Hertig, *Revamping the EU Corporate and Takeover Law Agenda – and Making it a Model for the U.S.*, LAW AND ECONOMICS WORKSHOP (U. of Cal., Berkeley), Paper 20, 11–12 (2004), *available at* http://repositories.cdlib.org/berkeley_law_econ/spring2004/20 (discussing possible alternatives for regulatory approaches in the EU).

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fied mandatory rules, although this kind of top-down intervention would not be entirely problem-free.[250]

The fact is, however, that it is unrealistic to expect the Commission to issue purely freedom-enhancing harmonization proposals. Even less realistic is the prospect that the Parliament and the Council will adopt them. Rather, freedom-enhancing proposals face the serious risk of being "diluted" in the course of the law-making process—i.e., being converted into freedom-reducing measures. While the Commission can always withdraw its proposals, it may accept a freedom-reducing outcome for a variety of reasons, including lobbying by special interest groups or—as evidenced by the final outcome of the Takeover Directive's negotiations—its own inclination to accept whatever outcome the law-making process produces.

To conclude, as Gérard Hertig once noted at a conference in Brussels,[251] at present the Commission, first and foremost, should have the courage to do next to nothing.[252] Unfortunately, this is even less realistic than the expectation that purely negative harmonization measures can ever be adopted.

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[250] Even if sympathetic, at least under a general perspective, towards the view that corporate law should mainly consist of enabling provisions that private parties can contract around, we are well aware of the risks arising from a hypothetical (yet quite improbable) EC intervention aimed at enhancing private parties' contractual freedom. Any EC limit (including the introduction of a twenty-sixth regime, whether or not enabling) over a Member State's ability to impose mandatory provisions should be carefully evaluated, if only because of the probable collateral effects that an enabling regime can have in certain jurisdictions (abuses, social and cultural shocks, political backlash, judicial reaction, and so forth). Even if the issue is quite intricate and would require a separate analysis, the bottom-line question is whether providing corporations with the possibility to benefit from an enabling corporate law regime is a task for Member States or for the EC. For a different perspective, compare Stephen J. Choi & Andrew T. Guzman, *Choice and Federal Intervention in Corporate Law*, 87 VA. L. REV. 961, 976–79 (2001), which criticizes a proposal for an optional federal regime on takeovers on the grounds that the federal regulator may have a strong temptation to make the optional regime mandatory after introducing it. The regime would likely prove unattractive, and it may interact better with some states' corporate laws (those of the states dominating the market for incorporations for obvious reasons) than others, so as to distort regulatory competition in favor of the stronger competitors.

[251] Gérard Hertig, Professor of Law, Swiss Institute of Technology, Presentation at the Transatlantic Corporate Governance Dialogue Conference: Regulatory Competition and Subsidiarity in Corporate Governance in a Transatlantic Perspective (Jul. 12, 2004), *available at* http://ecgi.org/tcgd/launch/hertig_speech.php.

[252] Ideally, it should consider repealing most existing corporate law harmonization measures. But this program deserves nothing more than a footnote, as it is unimaginable that EC institutions would ever consider such an idea.