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# The changing landscape of EU company law

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# TILEC Discussion Paper

# The Changing Landscape of EU Company Law

**Joseph A. McCahery[*] and Erik P.M. Vermeulen[**]**

**1. Introduction ........ 2**

**2. The Changing Pattern of EU Lawmaking ........ 7**

**2.1 The Pre-EU Era ........ 7**

**2.2 The EU Era: Decentralized Federalism ........ 9**

**2.3 The EU-Era: Centralized Federalism ........ 14**

**2.4 The EU-Era: Democratic Federalism ........ 15**

**3. Competitive Lawmaking in the EU ........ 18**

**3.1 US Experience ........ 19**

**3.2 The Entrance of a New EU Era? ........ 23**

**3.3 Barriers to Regulatory Competition in Europe ........ 32**

**4 Conclusion ........ 36**

**References ........ 39**

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## Abstract

*This is a time of spirited debate about regulatory competition in Europe. Discussions about competitive lawmaking abound. At the same time, the introduction of the European Company and the further harmonization attempts by the European Commission puts questions about the necessity of EU intervention into the company laws regulated by the member states. We, however, see no cause for excitement on either front.*

*This article explains why not, drawing on analytical tools from law and economics. Analyzing the history of EU company law, we locate a stable non-competitive equilibrium, which prevails in the EU. This equilibrium follows from member states that founded the EU unwilling to give up their lawmaking authority regarding company law issues. Since then, stability has ruled. The agenda-setting in EU company law changed little during the existence of the EU. Operative incentives, market structure, and regulatory results have been more constant than dynamic, even as recent case law of the European Court of Justice triggered a loud discussion about competitive lawmaking in the EU.*



**Keywords:** Company Law, Legal Evolution, Regulatory Competition.

**JFL:** K22, F15, G38


## 1. INTRODUCTION

The purpose of this article is to analyze the evolution of company law at the EU and member state level. Its emphasis is on elucidating lawmaking processes, and not on comparing legal rules and doctrines. The aim therefore is to explain and assess the process by which company law evolves, rather than to evaluate the content of the law in several jurisdictions.[1] This article seeks to address the questions of which parties

[1] In order to explain and evaluate the law, it is necessary to understand the process by which the law emerges, changes or persists. Cf. Ribstein (2001: 854) ('[p]olicy reform should focus on the mechanisms of legal evolutions and markets rather than on the substantive provisions of business law.'); Van Alstine (2002) (arguing that, because of their potentially significant impact, the presence and extent of legal transaction costs

are responsible for setting the agenda for the reform of company law, and which considerations have been instrumental in stimulating the recent law reform strategies.

It is particularly tempting to compare the lawmaking process in Europe with the fundamental changes in company law that have occurred in the United States. There are two reasons that make the European Union and the United States suitable candidates for a comparative study. First, like the United States, the European Union can be viewed as a federation in which the individual countries retain considerable sovereignty, while at the same time allocating important prerogatives to a supranational government.[2] Second, because US firms of all sizes have long been operating throughout the nationwide market without severe constraints regarding company law, the federal system has set a benchmark for the European Union.[3] Viewed in this context, the emulation of the US approach regarding the evolution of company law seems logical. The development of legal rules in the United States as a result of competition between jurisdictions does appear to have essential lessons for Europe as it embarks on the modernization of company law in general. In the evolving pattern of EU company law, the European Commission and the European Court of Justice (ECJ) have consistently avoided intervention into the national legislation of member states that has limited cross-border mobility of firms. The decision not to intervene has reinforced the member state strategy to avoid taking steps to create a market for corporate charters which could displace the autonomy of the member states.

Even though the threat of competition continues to be a defining feature of the market for closely held firms and holding companies, the possibility of free choice for publicly listed firms is thwarted due to tax

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should be viewed as material inputs in decisions over the merit, form and structure of proposed changes in the law).

[2] In contrast to the United States, the European Union is not a superstate. However, it is more than just a free-trade area. It is an arrangement of countries, of which the shape and purpose have been adapted to changing circumstances with remarkable ingenuity. Cf. Micklitz and Weatherill (1997: 1-3) (arguing that unlike the US, the EU is not a federation of states, but a 'market without a State').

[3] Cf. Moussis (1992) ('[t]he new enterprise policy of the Community has three broad objectives: to create a legal framework which lends itself to the setting up and development of enterprises in the Community; to create an economic environment which will help enterprises reach their full development in the internal market; and to promote cooperation between enterprises situated in different regions of the Community.').

and other national law barriers, which have been reinforced by ECJ case law and harmonized rules. The combination of the real seat doctrine along with exit taxes proved capable of creating a stable, long-run non-competitive equilibrium. With the core company law agenda defined by member states, the role of Brussels was merely to protect the cooperative agreement between member states—by limiting incentives for the emergence of a European Delaware—and to protect the public interest. Since its inception, the cooperative equilibrium has remained stable and largely intact, due to learning and adaptive changes made by the member states and the European Commission.

Despite the success of this enduring strategy, it is argued that political and legal transformations currently taking place in the EU, could disrupt these stable arrangements leading to the outbreak of free choice for companies. In this Article, we challenge recent claims that the ECJ has created, through *Centros* and its progeny of cases, the conditions for the transition to a fully-fledged competitive lawmaking regime. To date, the recent efforts of the ECJ to introduce free choice have so far done little to alter the stable equilibrium. To be sure, should the ECJ explicitly decide that the real seat is inconsistent with EU law, we cannot immediately expect an outbreak of competition-induced lawmaking, because mobility itself is only a necessary but not sufficient condition for the emergence of regulatory competition.[4]

We show that besides the existing institutional barriers at the EU level, the potential for regulatory competition is constrained by other factors. First, the reincorporation costs in Europe make firms immobile. A recent judgment by the European Court of Justice, for instance, reinforces the *Daily Mail*[5] judgment on hidden reserves, which will do little to stimulate demand for reincorporation.[6] Second, we argue that national company law regulation and equity capitalization do not open up market opportunities for revenue seeking jurisdictions. The evidence shows that member states are responsive to managers and controlling shareholder on many company law issues that affect their private interests. Third, Europe's linguistic and normative landscape is complex. These barriers cast doubt on the establishment of specialized court, like the Delaware Chancery Court, that could offer adjudication to managers

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[4] Cf. Bratton and McCahery (1997: 233-234)

[5] Case 81/87 *The Queen v. H.M. Treasury & Commissioners of Inland Revenue, ex p. Daily Mail and General Trust Plc* [1988] ECR 5483.

[6] Case C-208/00 *Überseering* [2002].

and shareholders in other member states. Fourth, recent evidence suggests that a number of core members states which are highly vulnerable to the pressures of market competition, such as Germany and France, have taken steps to speed up the EU harmonization program, in order to stem the flow of out-migrating firms. Moreover, to the extent that the European Union continues to restrict member states from imposing franchise taxes, they will have few incentives to innovate.

But, as we have also seen in the US, the break-down of a highly stable equilibrium could occur rapidly.[7] While it is difficult to foresee with certitude the conditions that could lead to the breakdown of an equilibrium strategy in the EU, it is argued, nevertheless, that the stability of the equilibrium depends crucially on the continued ability of member states to impose exist taxes on reincorporating firms. In light of the *Centros* progeny of cases, this strategy could be viewed as a violation of EU law, to the extent that it prohibits a firm from choosing a jurisdiction that reflects its preferences. Moreover, if one perceives member states as players of an indefinitely repeated game, it could be argued that domestic lawmakers will be induced to adjust their regulatory and fiscal strategies in order to avoid losing domestic firms to other member states.

This Article is divided into five sections. Section 2 recounts the evolution of the EU company law harmonization program from 1957 through the modernization period of the High Level Group of Company Law Experts. This account shows that the objective of the EU was to limit the right of establishment of pseudo-foreign companies and create barriers to the introduction of charter competition.[8] This discussion goes on to describe the emergence of a non-intervention approach of EU lawmaking, excluding federal level regulators from disrupting state level accords between interested parties that are reflected in company law legislation. Finally, section 2 shows that the an early strategy of the EC to introduction of a truly EU-level company statute, to compete against the national level business forms, was blocked by the member states who viewed a EU company form as means to escape stricter national company law legislation.

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[7] Bratton and McCahery (2004) (explaining the factors that contributed to the introduction of the competition for charters at the beginning of the 20th century).

[8] Pseudo-foreign corporations are firms that are incorporated in one state but conduct a significant amount of their business in another state.

Section 3 turns to examine the US market-based system for corporate charters. A notable feature of the EU is that it has always looked to the operation of Delaware and the charter market, initially with suspicion and more recently as an example of more efficient lawmaking. In the US, a growing number of commentators have argued that charter market is sub-optimal because Delaware faces little competition from the other states. The absence of competition in the charter market calls into question the description of Delaware, as emblematic of a particular form of market-based lawmaking, used by EU regulators to justify policies to reinforce the cooperative arrangement between member states. Ironically imperfections in the US charter market provide less than a firm basis for emulation by the EU lawmakers to reform the petrified company law rules, on the one hand, and the use of single instance of active competition between New Jersey and Delaware almost a century ago used to erect barriers to counter the so-called Delaware effect, on the other hand, suggest that the long term motivations of EU lawmakers have been guided by their own political preferences rather than an accurate account of the charter market and its impact on legal rules.

Meanwhile, the shape of EU law has been indirectly challenged by the ECJ's line of cases starting with *Centros*, which sets in train the basis for the cross-border movement of administrative headquarters and the migration of new firms to more favorable jurisdictions. While we anticipate that this mobility trend will continue, we are skeptical that the structural conditions supporting the emergence of a EU Delaware can arise. Indeed, unlike New Jersey in 1888, the absence of a large interest group or a large source of rents that could stimulate a stable market for charters in the EU is evident. Moreover, it is unlikely that EU member states will, upon embarking on a non-cooperative path, backtrack, as did New Jersey when it enacted a series of anti-trust amendments in 1913. Thus, even if the circumstances change so that free mobility is an option, we are unlikely to witness a change in lawmaking preferences of the EU member states and the corresponding quality of legal rules.

Section 4 offers a brief conclusion.

## 2. THE CHANGING PATTERN OF EU LAWMAKING

### 2.1 *The Pre-EU Era*

Prior to the establishment of the European Union, Europe was characterized as a group of island jurisdictions, in which domestic lawmakers, acting in there own sphere, increase social welfare. Indeed, in line with traditional theories of law and society, lawmakers are supposedly public regarding actors who identify which rules are efficient across different firms, time and place, and replace inefficient rules accordingly. Yet in reality, legal rules and institutions have emerged and persisted for other reasons than welfare maximization. The application of the idea of path dependence to law shows that legal rules evolve along a historical path and can therefore become locked-in and resistant to change.[9]

It is submitted that in an island jurisdiction, legislators, judges, practitioners, regulatory agencies, professional groups and legal scholars constitute an elite lawmaking group that is responsible for interpreting, preserving and developing the law.[10] As a result, the law is inherently conservative. First, the lawmaking elite treats the law as existing in its own right. In this view, the law is largely autonomous and operates in its own sphere.[11] As one commentator puts it: 'the means of creating law, the sources of law, come to be regarded as a given, almost as something sacrosanct, and change in these even when they are obviously deeply flawed is extremely difficult to achieve'.[12] Second, the law is justified in its own terms. Lawmakers, i.e., persons trained in law and nothing else, search for the legitimacy of legal change, which makes the law typically backward-looking. To a large extent, this insulates legal evolution from social and economic change and it therefore displays a serious degree of path dependence.[13] Thus seen, lawmakers in an island jurisdiction who

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[9] See Bebchuk and Roe (1999).
[10] See Ewald (1995: 499-500); Monateri (1998: 841).
[11] See Kelsen (1967) (arguing that law is autonomous and justified exclusively by its own foundations). Cf. Bourdieu (1987: 806); Posner (1987: 762).
[12] See Watson (1985: 119).
[13] See Watson (1978: 331) ('[t]he undoubted respect which exists for law because it is law favours the status quo; it is what it is, that is regarded with something approaching reverence at times, not what it could be made to be.').

view law as an autonomous discipline are an important source of defending the *status quo*.

Even if the lawmaking process does not display a tendency to introduce legal change, in their imperfect attempts to imitate other jurisdictions, reform minded lawmakers 'unconsciously innovate by unwittingly acquiring some unexpected or unsought unique attributes'.[14] Indeed, one could roughly distinguish between conservative and innovative lawmakers. Conservative lawmakers, supported by the concentrated interest groups, deploy the existing legal doctrines, principles, culture and increasing returns benefits to protect the *status quo* and thwart legal change. Reform-minded lawmakers, on the other hand, traditionally use the examination of foreign legal rules and institutions to propose legal change and to induce the controlling elite of the receiving system to believe that the offered model meets their expectations. As a consequence, the development of the law takes place mainly by transplantation of legal rules.[15] However, when legal parochialism is strong and jurisdictions are largely resistant to transplants (which is often the case in the western world, where jurisdictions are convinced of the efficiency of their own legal system),[16] transplanting elites usually deny the fact that a model is borrowed, and use local authority to bolster their opinion.[17] Hence, legal change in the western world could be explained largely by 'hidden' transplants, which are a mixture of foreign and indigenous doctrines and principles.[18]

The upshot is that even if changes in the underlying social and economic conditions dictate an overhaul of the law, the reform process is subject to sources of path dependence that inhibit the emergence of modern and innovative legal rules and institutions. Moreover, domestic lawmakers cannot be expected to respond adequately to possible changes in the legal system of surrounding islands. However, this approach may well turn if an island jurisdiction legislature, facing global competition, rapid changes in technology and evolving market conditions, is

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[14] See Alchian (1950: 218-219).
[15] See La Porta *et al.* (1998: 1115).
[16] In transition economies, the influence of legal transplants may bring about broad statutory convergence across jurisdictions. Cf. Pistor (2000: 93) ('[t]he high level of statutory legal convergence is largely the result of an external supply of legal solutions.').
[17] Cf. Mattei (1994: 16) (noting that legal transplants can be very hidden phenomena).
[18] Cf. Hay *et al.* (1996: 566) (arguing that borrowing would be inefficient if foreign legal rules and institutions interfere with the existing business practice).

motivated to promote the competitiveness of indigenous industries by adopting favourable company law rules that reflect social and economic changes. Clearly, this could entail a more vibrant and competitive economy. The presence of market-driven pressures could force monopolistic legislatures to alter their company law regimes. Yet in the absence of an open market for trade in goods and services and free movement of the factors of production, it cannot be assumed that political actors and lawmakers generate a new lawmaking approach. But, if the island jurisdiction becomes part of a common market, like the United States or the European Union, and the national barriers to trade gradually dissipate, incentives to engage in competitive lawmaking could very well come to the surface. In the next section, the question is posed if, as the European Union becomes a more integrated economy, the jurisdictions will eventually change their lawmaking approach.

## 2.2 *The EU Era: Decentralized Federalism*

The Treaty of Rome (1957) between France, West Germany, Italy, Belgium, the Netherlands and Luxembourg established the European common market. The Treaty provided for the right of establishment for foreign corporations to establish branches in another member state, without being subject to more restrictive company law provisions of the host state.[19] At the time, the real seat theory, which provides that the laws of the host state are applied if the actual centre of the corporation's activities has moved to the host state, was still dominant although many feared it was losing ground since the Netherlands had recently abandoned the doctrine. Furthermore, provision 293 (ex 220) of the Treaty,[20] which invited the member states, for instance, to enter into negotiations regarding the 1968 Brussels Convention on the Mutual Recognition of Companies and Legal Entities, would have abandoned the real seat theory in favor of the incorporation doctrine.[21] Recall that

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[19] See Leleux (1968); Buxbaum and Hopt (1988) (explaining that the freedom of establishment guaranteed by the Treaty proscribes use of the real seat theory).
[20] The Treaty of Amsterdam renumbered the articles of the Treaty.
[21] Article 293 (ex 220) of the Treaty provides that 'Member States shall, so far as necessary, enter into negotiations with each other with a view to securing for the benefits of their nationals:

> …
> 'the mutual recognition of companies or firms within the meaning of the second paragraph of Article 48 (ex 58), the retention of legal personality in the event of

the real seat doctrine was developed in opposition to the opportunistic conduct of island jurisdictions attempting to lure foot-loose firms at the expense of higher cost jurisdictions. Drawing on the concepts of evolutionary game theory, we see that, prior to the 20th century, Belgium played a non-cooperative game *vis a vis* France, which enabled French managers to change their state of incorporation. The threat of losing firms to foreign jurisdictions provided the impetus for the introduction of the real seat doctrine in Europe.[22]

In these circumstances, the Treaty would have arguably enhanced the introduction of a market for corporate charters for companies. The reaction to this was split. The founding member states, such as France and West Germany who feared the consequences of an outbreak of a so-called 'race-to-the-bottom' reacted in the 1960s by binding existing members and new entrants to accept the harmonization of their company laws. More specifically, France was concerned that the Netherlands, which had a flexible company law code, would be able to attract a large number of pseudo-corporations.[23] The EC's preferred solution to this problem was the top-down harmonization of national company laws. Under this strategy, the member states entered into a cooperative game in which the parties agreed, in exchange for political benefits or rents, to desist from opportunism in exchange for membership in the Community.[24] From this discussion, it should be clear that the small number of member states could negotiate and enforce a political agreement that protected their domestic national stock, which produced

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> their seat from one country to another, and the possibility of mergers between companies or firms governed by the laws of different countries.'

So far, there has been one attempt to meet the obligation of Article 293: the 1968 Brussels Convention on the Mutual Recognition of Companies and Legal Entities. As early as 1956, the Hague Conference on Private International Law drafted a treaty on the mutual recognition of the legal personality of companies. Both attempts failed. See Rammeloo (2001: 24-37)

[22] See Charny (1991: 428).

[23] The EC established, in 1960s, the first expert committee to analyze the effects of different capital income taxation policies of the member states. The Netherlands and Luxembourg, which had an interest in developing their thriving capital markets, successfully impeded the harmonization of capital taxation to protect their successful policy of opening their borders. Cf. Holzinger (2003).

[24] See Timmermans (2003: 628). Political rather than economics rents were considered more valuable to member states given their concern for political stability and economic integration, Cf. Inman and Rubinfeld (1998: 548).

both fiscal and political benefits for these governments. It should be clear that the combined effect of these benefits outweighed the value of the payoffs of competitive lawmaking.

During the 1970s a number of countries also entered the EU for similar reasons of political stability and economic integration. Even though the new entrants, Denmark, Ireland and the United Kingdom, endorsed the incorporation regime,[25] which could easily have reinforced the possibility of the out-migration of domestic companies, the cooperative equilibrium was sufficiently stable to neutralize this tendency. The cooperative agreement also included another element. The member states would only agree to the harmonization of their national laws if this could be achieved without the alteration of the core components of company law.[26] This confirms the expectation that member states would also respect each others lawmaking autonomy.

The first generation directives restated,[27] in effect, the content of the member states' national laws.[28] Rigid and complete 'top-down' harmonization was high on the agenda. The mandatory rules, such as minimum capital requirements and disclosure rules, constituted part of the initial wave of harmonized rules.[29] The array of mandatory legal capital rules, however, seemed to benefit domestic interest groups.[30] Incumbent management may have influenced the EU legislature to supply provisions that limit dividend payments and share repurchases so as to obtain more leeway to reinvest firm's profits. Accountants, who

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[25] Under the incorporation regime, the company is not governed by the laws of the state of state where the actual center of the companies are, but by the laws of the state incorporation.

[26] See Charny (1991).

[27] See Villiers (1998: 28-51) (distinguish four generations of directives: the first generation emphasized uniformity and prescription; the second generation supplied a set of options which essentially represent the predominant approach in the member states; the third generation explicitly left issues to the member states; and the fourth generation took the process even further by adopting only a framework model).

[28] See Carney (1997: 318) (arguing that the first generation directives are likely to be representative of the dominant legal practices in the member states because their adoption required unanimous consent of the member states; Cheffins (1997: 448) ('the EU has typically done little more than superimpose a series of measures on domestic regulations already in place'); Halbhuber (2001: 1406) ('[t]he directives do not purport to deal with crucial issiues like fiduciary duties, exit, expulsion and redemption, transfer of shares etc.').

[29] The first generation directives include the First and Second Directive.

[30] See Carney (1997: 324); Enriques and Macey (2001: 1202-1203).

play a pivotal role in the required valuation, also had a substantial interest in exerting influence on the legislative outcome.

With the introduction of England and other member states, the second wave of directives was arguably more flexible, granting states options to comply with the terms of the directives.[31] Given the diversity of legal regimes, the optional approach ensured that the directives did not interfere with the core elements of member states national company law rules and hence respected the cooperative agreement.

The rigid approach of the first and second generation directives quickly showed its limitations. The harmonization of core areas of company law, like the structure and responsibility of the board of directors, cross-border mergers, representation of employees, and bankruptcy procedures, proved to be predictably slow and ineffective.[32] The fundamental disagreements among member states with regard to important issues, such as employee participation and the reluctance of member states to implement the harmonized rules,[33] shows the difficulty with touching the autonomy of member state law. For instance, member states regularly vetoed directive proposals under Article 100 of the EC Treaty (now Article 94), unless a politically acceptable consensus would be achieved.[34]

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[31] The second generation directives include the Third and Sixth Directive on Mergers and Split-Offs, Fourth, Seventh and Eight Directives on Annual and Consolidated Accounts and the Qualification of Accountants.

[32] See Woolcock (1996: 292). In the words of the Commission (1985: 18): 'relying on a strategy based totally on harmonization would be overregulatory, would take a long time to implement, would be inflexible and could stifle innovation.'

[33] See Wouters (2000: 275). Germany's reluctance to implement Council Directive (EEC) 90/605 of 8 November 1990, extending the Fourth and Seventh Directive to partnerships and limited partnerships with corporate general partners, perfectly exemplifies this trend. These hybrid business forms were not within the original scope of the Fourth and Seventh Directive. While some jurisdictions applied these Directives voluntarily to hybrid 'limited liability vehicles', like the Netherlands, the Commission took the view that it would run counter to the spirit and aims of the Fourth and Seventh Directive to allow these vehicles not to be subject to Community rules. The limited partnership with a corporate general partner (*GmbH & Co KG*) is particularly popular in Germany. Although the German government agreed on further extension of the directives after the European lawmakers announced further exemptions available to SMEs, it deferred implementing the amendment. Only after the ECJ's judgment in Case C-272/97 *Commission v Germany* the German government changed the law according to the amending directive. See Edwards (1999: 124).

[34] See Inman and Rubinfeld (1998: 548) (describing the initial steps toward the economic union as *decentralized federalism*).

It was clear early, given the legislative setbacks involving the first and second generation directives, that the European Commission would be unable to remove the most intractable barriers to economic integration. While the EU continued to pursue its harmonization strategy, policymakers within the Commission set out to design a more independent agenda on the basis of Article 308 (ex 235).[35] To this end, the EC introduced the Regulation of the European Economic Interest Grouping (EEIG), which made it possible for firms from different member states to develop certain joint activities without having to merge or to set up a jointly owned subsidiary.[36] The first genuine European business form came into existence because it was not detrimental to national doctrines and usages and hardly competed against national business forms.[37] In reality, the EEIG's restricted objectives and references to national law have resulted in a rather unpopular business form.[38]

In 1970 the Commission also proposed the introduction of the European Company. This legal business form was designed to allow firms, operating in two or more member states, the option to employ a genuine European business form, meaning that they will be able to move registered offices from one country to another without needing to dissolve the company in the first member state and to formally establish it in the second one. The strong resistance of member states to adopt the legislation, until recently, reflected their continued preference to retain legislative autonomy and control over core areas of company law.

Thus, the early phases of the harmonization process, with its root and branch approach, reached its inevitable terminus point with the failure of

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[35] Article 308 (ex 235) specifies two preconditions for unification: (1) action by the Community should prove necessary to attain; (2) the powers provided in the Treaty are insufficient. See Buxbaum and Hopt (1988: 210-212).

[36] The EEIG is adopted in 1985 (Council Reg (EEC) 2137/85 on the European Economic Interest Grouping (EEIG) [1985] OJ L199/1). The EEIG creates a European legislative framework that provides existing firms with an easy and accessible vehicle for restructuring across frontiers.

[37] Cf. Grundmann (1999: 645 fn. 36).

[38] The EEIG is a mirror image of the French *Groupement d'Interêt Economique*, which has proved to be a popular business in the French business community. However, the *Groupement d'Interêt Economique* appears to owe its existence to limitation of the French partnership form. See Lutter (1996: 67) (arguing that from a German perspective, the promulgation of the EEIG is a mistake). See also Wouters (2000: 261).

the Fifth, Ninth and Thirteenth Directives, and a new direction was required to achieve the aims of European economic integration.[39]

## 2.3 *The EU-Era: Centralized Federalism*

After the 'Cassis de Dijon' case, and with the Commission's 1985 White Paper as accepted in a Council Resolution of the same year, the EU tried to respond to calls for greater flexibility.[40] Minimum harmonization and mutual recognition formed the so-called 'new approach' to harmonization.[41] The following year, the Single European Act (SEA) attempted to resolve possible veto blockages at Council level by providing for a consultation procedure and qualified majority voting.[42] With the second enlargement,[43] the EU adopted a new model of integration based on centralized federalism,[44] which gave the European Commission increased agenda-setting power. Between 1986 and 1992, the EU adopted the two, third generation directives, concerning the disclosure of branches and formation of single member companies, which were marginal to domestic company law arrangements.

Despite greater flexibility under the 'new approach', standards imposed remain fairly high. Market regulation proves inadequate to market evolutions. Lacking solid foundations for legitimacy, the European Union remains a forum for member states eager to impose or defend their own legislative products, and hence their own regulatory policies and legal doctrines.[45] EU ordering continues to be subject to

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[39] De Kluiver (1995: 300).
[40] See Case 120/78 *Rewe Zentral AG v Bundesmonopolverwaltung für Branntwein* [*'Cassis de Dijon*'] [1979] ECR 1979; European Commission (1985).
[41] See Majone (1993a: 1-3) ('[t]he immediate reason for introducing this new strategy was to reduce the burden on the Commission in harmonizing national rules.').
[42] See Inman and Rubinfeld (1998: 549) ('[b]orn in part from the frustration over the slow pace of integration of the advantages such reforms might have in combating Europe's declining economic fortunes (known as 'Eurosclerosis'), the ten members of the Community put aside the Luxembourg Compromise and decentralized federalism and adopted in 1986 the Single European Act (SEA) and a new institutional structure closely approximating that of *centralized federalism*.'). Cf. Streit and Mussler (1998: 104-105).
[43] In 1986, Spain, Portugal and Greece entered the EU.
[44] See Inman and Rubinfeld (1998: 549).
[45] See Heritier (1996: 149). Cf. Caruso (1997) (arguing that entrenched in legal formalism, obstinate in the defence of the doctrinal coherence of their codes and unwilling to discuss the political merits of their consolidated policies, European legal actors manage to slow down, and even at times to halt, the process of private law

consensus, and to compromise lawmaking.[46] Fragmentation and the lack of a general concept on the part of Brussels may be suggested as a best case scenario. The harmonization process cannot be explained on efficiency grounds only, but should be viewed as a response to pressures from several interest groups wanting to protect the existing legal framework and frustrate competitive lawmaking.[47]

## 2.4 *The EU-Era: Democratic Federalism*

A new stage in the evolution of federalism was characterized by the development of the subsidiarity principle, which member states embraced in the 1992 Maastricht Treaty on the European Union.[48] With regard to areas that are not of the exclusive competence of the European Union,[49] the subsidiarity principle embodied in Article 5 of the Treaty commands the decision to locate competence at EU level or at member state level. Rather than listing the competencies of the Union and member states, the subsidiarity principle provides for an efficiency test to determine competencies and, more crucially, to constrain the Commission's executive power.[50] Recently, though, the Commission

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integration); Halbhuber (2001: 1409-1411) (arguing that domestic doctrinal structures appear to play an important role in shaping the German understanding of European company law materials).

[46] See Scharpf (1999).

[47] See Carney (1997: 317 and 329).

[48] Besides constraining the Commission's role through the subsidiarity principle, the Maastricht Treaty also introduced the co-decision procedure. As a consequence, the European Union's decision-making structure closely resembles the constitutional form of *democratic federalism* in which central government policies are agreed to by a simple majority of elected representatives from lower-tier governments. See Inman and Rubinfeld (1997: 50-53); (1998: 550).

[49] Areas within the exclusive competence of the Union are subject to the proportionality test. Article 5 §3 of the Treaty provides that 'any action by the Community shall not go beyond what is necessary to achieve objectives of the Treaty'.

[50] First of all, it has to be determined whether there is a power under the Treaty to take action. The subsidiarity principle then determines whether and how the Community may act. It must be shown that the objectives of the proposed action cannot be sufficiently achieved by the member states. The finding must then justify the further conclusion that in view of the measure the objective can be better achieved at Community level. Eventually, the proportionality test as defined in §3 of Article 5 has to be satisfied. See Micklitz and Weatherill (1997: 16). See also Bermann (1994: 334) ('[t]he drafters' apparent purpose was to reassure Member State populations, and subcommunities within those populations, the Community's seemingly inexorable march toward greater legal

responded by proposing a new approach in governance and regulation at EU level that would reinforce the principle of subsidiarity, but at the same time strengthen the role of the European Commission as a political driving force.[51]

The European Commission, building on the principle of subsidiarity and proportionality, has introduced a new type of directive, based on general principles. Despite the further flexibilization of directives (moving from the provision of certain minimum standards to a framework model for directives), promulgating directives remained much like running the gauntlet.[52] For instance, the collapse in 2001 of the Thirteenth Directive, on takeovers, exemplifies the deeply rooted conflict between some member states over the direction and pace of the directives.[53]

At the national level, there are noticeably few incentives for lawmakers to modify regulatory design or reform inefficient rules because of legislative inertia and special interest.[54] Very generally, the differences in the normative arrangements between the continental and common law systems partly explain the deeply rooted conflict between the member states over the direction and pace of the harmonization program. These insights provide key clues as to why only a relatively small number of EU-level initiatives have been heralded as major breakthroughs in the field of company.

Recently, after more than thirty years of negotiation and bickering, the member states reached agreement on yet another truly genuine European business form: the European Company (*Societas Europea*, or SE). The SE statute, which is due to enter into force in October 2004, gives firms operating in two or more member states the option to form a

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and political integration would not needlessly trample their legitimate claims to democratic self-governance and cultural diversity.').

[51] See European Commission (2001b). See Cygan (2002: 240) ('[t]he main criticism against the contents of the White Paper is that it promotes the institutional self-interest of the Commission, at the expense of substantive concerns of many EU citizens.').

[52] See Deakin (2001: 192-195).

[53] Cf. Forstinger (2002: 34).

[54] Powerful insiders that derive private benefits from blockholding arrangements and non-stakeholder interests have few incentives to optimize national corporate governance regimes for the benefit of shareholders. See, e.g., Roe (2001) (noting that as nations with norms and corporate rules that harm shareholders become more competitive through customs unions and single-currency areas, pressure on these norms, these corporate law and labour law rules, and old politics rises, as it has been doing).

European company. According to this view, a menu of European business forms could create a legal framework that helps firms to set up and develop at a European level, to create an economic environment through which firms can reach their full development in the internal market, and, more crucially, to promote cooperation between firms located in different regions of the European Union.[55]

Nevertheless, most European lawyers have expressed skepticism about whether the new law will lead to significant changes in corporate practice. For example, the proposed statute excludes a large number of areas relevant to businesses operating in two states, all of which continue to be governed by national legislation.[56] Moreover, the failure of the European Statute to address the problem of taxation will clearly undermine the number of firms incorporating as European companies. Indeed, the compromise agreed by ministers after more than 30 years received the unenthusiastic endorsement of the European Parliament, although its disapproval would not have made any difference – but importantly it neutralized the threat of federal intervention in national company law, thereby reinforcing the cooperative arrangements between member states.

The latest efforts of the EC to create a modern regulatory framework for corporate law are largely inspired by recommendations made by a group of experts commissioned by the EU. The reform measures are designed to simplify existing rules and improve freedom of choice between alternative forms of organization. The reform efforts will be carried forward at four levels. First, it proposes to modernize company law by further attempting to harmonize corporate disclosure, board structure and director liability requirements, and by amending capital rules.[57] Second, it plans to adopt rules facilitating corporate restructuring

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[55] In the words of Frits Bolkestein, Commissioner for EU internal market affairs, the SE will boost Europe's competitiveness. See European Commission (2001).

[56] See Springael (2002) (arguing that the European Company is not a uniform company type, as originally intended, but instead a 'national European Company'); Hampton (2002: 1) (arguing that without an EU-wide regime for tax, freedom of movement between countries and a single corporate form, it offers little that cannot be achieved already).

[57] The simplification of the Second (and First) Company Law Directive is part of the fourth phase of the Simpler Legislation for the Single Market (SLIM) initiative. In this respect, the Company Law SLIM Working Group has reconsidered contribution in kind, nominal value, withdrawal of shares, acquisition of own shares, financial assistance and pre-emptive rights. However, the SLIM Working Group did not enter into the theoretical

and mobility. Third, the Commission proposes the establishment of a permanent coordination structure, the European Corporate Governance Forum, and of (Member State) agencies to sanction unfit directors. Fourth, it proposes to strengthen the supervision of auditors and to adopt comprehensive rules on the conduct of audits. It should be easy to see that the new direction largely retraces the earlier terrain covered by previous attempts of the EC to harmonize company law rules and therefore we should not be too optimistic about its prospects for success.

The next section analyzes the stable character of the US system of charter competition, and then moves on to discuss the various institutional structures in Europe that could give rise to competitive lawmaking in the field of company law. We discuss the recent decisions of the European Court of Justice in *Centros, Überseering* and *Inspire Art*,[58] which could eventually trigger the development of competitive lawmaking and thereby threaten the stable equilibrium in EU company law.

## 3. COMPETITIVE LAWMAKING IN THE EU

Even though the dynamics of European company law have not changed fundamentally in more than thirty years, recent developments in EU case law could eventually undermine the stable equilibrium and set the stage for member states engaging in competitive lawmaking by offering modernized company law. The case for a more explicit consideration of competitive lawmaking is further reinforced by the introduction of the subsidiarity principle, which has strengthened the conviction that national lawmakers are better suited to develop legal rules and

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discussion about whether the legal capital requirement should be maintained. See Wymeersch (2000b). The High Level Group of Company Law Experts has added two more approaches to the reform of legal capital in Europe: the US approach and a new European approach, which is based on the capital maintenance rules of several jurisdictions. Both new systems entail elimination of legal capital. See High Level Group of Company Law Experts (2002b: 24-25). In its final report (High Level Group of Company Law Experts (2002c: 78-93)), the High Level Group stated that the capital maintenance regime laid down in the second company law directive should be simplified along the lines proposed by the SLIM working group. Moreover, it suggested that the European Commission should review the feasibility of an alternative to the capital formation and maintenance rules on the basis of solvency tests.

[58] Case C-212/97 *Centros Ltd v Erhvervs- og Selskabsstryelsen* [1999] ECR I-1459; Case C-208/00 *Überseering BV v Nordic Construction Co Baumanagement GmbH*; Case C-167/01 *Kamer van Koophandel en Fabrieken voor Amsterdam v Inspire Art Ltd.*

institutions.[59] In this respect, European policymakers may be forced to use regulatory competition as a strategy to create an environment that helps SMEs to reach their full development in the European market. In addition, the introduction of a single currency in Europe and the development of Europe's high-growth stock markets may act as a catalyst for competitive lawmaking. Of course, these developments will not change the equilibrium overnight, but they may well cause a shift in the balance of political power away from those who favour lawmaking autonomy towards those who look at the US experience and wish to stimulate regulatory competition.

It should be noted that, as Europe enters the competitive lawmaking environment, lawmakers will mainly focus on the needs of business firms that are most likely to engage in forum shopping. Since the Directives regarding publicly held corporations have reduced the feasibility of competition in the context of large corporations, European lawmakers will begin to turn their attention to holding companies and closely held firms, such as joint ventures. This section discusses the potential effect of the competition among national rules on the evolution of company law rules in Europe. We consider moreover the incentives of states to respond quickly to the competition by adopting efficient legislation that meets business needs and assess whether a 'European Delaware' is likely to play a leading role in stimulating regulatory competition and experimentation in business statutes.

## 3.1 *US Experience*

In the context of company law, regulatory competition has been well publicized in the US.[60] Since this discussion is likely to become increasingly relevant to the EU, it is worth providing a brief summary of the literature here.

The US legal system traditionally views company law in general as a local matter reserved to the states' governments.[61] Consequently, the

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[59] Cf. Charny (1991: 440-441) (arguing that decentralization facilitates adaptation to local conditions).

[60] Corporate law has served as an adequate test field of the models developed by public sector economists. See, e.g., Bebchuk (1995); Bebchuk and Ferrell (1999); Cary (1974); Easterbrook and Fischel (1991); Fischel (1982); Romano (1985); Romano (1993); Winter (1977).

[61] See Bebchuk (1995: 1438) (noting that even though federal law governs some important issues, including insider trading, disclosure and the making of tender offers,

corporation statutes of some states may differ appreciably from those of most other states on many critical matters. Once US business owners decide to incorporate, they must select an attractive state of incorporation. Under traditional conflict-of-law rules,[62] courts will respect this choice even if the corporation in question has no other contact with the chosen state. The corporate laws of the incorporating state govern the basic rights and duties of a corporation and its participants.

At the end of the 19th century, New Jersey and Delaware, concerned about incorporation decisions, adopted modernized general incorporation statutes.[63] Eventually, Delaware's statute made it the leading incorporation state in the United States since the 1920s,[64] presently serving as the state of incorporation for nearly half of the corporations listed on the New York Stock Exchange and more than half of all Fortune 500 firms.[65] In addition, Delaware is also the leading destination for firms that opt to reincorporate. Clearly, Delaware's value to incorporating firms is more than an up-to-date statute. The possibility of other states rapidly free-riding on the efforts and resources of the Delaware legislature by copying its statute would entail Delaware's lead being exhausted in a very short period of time.[66] For instance, the less easily replicated judicial expertise and other enduring advantages, such as a well-developed corporate case law, learning and network benefits, herd behaviour,[67] and the superiority of Delaware's specialized chancery court, arguably preserve Delaware's leading position over time.[68]

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much of the law regulating a corporation's affairs stems from its state of incorporation). See Leleux (1968) (comparing the European and the US situation).

[62] See *supra* footnotes [2].

[63] With its 1888 corporation statute and the 1896 revision, New Jersey was the first state to enter the competition. Delaware joined New Jersey in 1899.

[64] See, e.g., Bebchuk (1995: 1443) ('[a]fter restrictive amendments to its corporation law were made in 1913, New Jersey lost the leading role to Delaware, whose corporation law was at the time a close copy of New Jersey's original statute.').

[65] See Romano (1993: 6-12). See also Fisch (2000: 1061) ('incorporations bring Delaware approximately $440 million per year in franchise taxes and related fees.').

[66] One should distinguish this process from legal transplantation, emulation or imitation. The latter occurs when laws are changed in the absence of pressures on the legislature in economic and political markets. See Sun and Pelkmans (1995); Woolcock (1996: 297-298).

[67] See Coffee (1999: 703) (arguing that corporations may prefer to locate in a popular jurisdiction of incorporation for reasons that are simply based on its popularity, not the inherent superiority of its law). 'Herd behavior loosely refers to a situation in which

Delaware's corporate law plays a key role in the evolution of companies in the United States, because Delaware law provides an alternative set of rules which serve firms and their legal advisers across the country. Consequently, many commentators have dealt with the vexed question of whether the choice of Delaware's corporate law eventually leads to value maximization. In other words, is regulatory competition better described as a 'race to the bottom' or as a 'race to the top'?

Some commentators continue to point to possible shortcomings of the competitive process that ensue from the divergence between the interests of managers and public shareholders.[69] In their view, the development of state anti-takeover legislation perfectly exemplifies the shortcomings of regulatory competition. Because of the ability of firms' management to capture state legislation, states (including Delaware) have developed anti-takeover statutes and judicial decisions permitting the use of defensive tactics that are overly protective of incumbent managers at the expense of shareholders.[70] If the possibility of shareholder exit by tender to a hostile offeror is severely threatened, market mechanisms cannot adequately align the interests of managers and shareholders. By providing a constant and credible risk of hostile acquisitions, the takeover market creates a powerful incentive for managers to restrain from managerial self-dealing. Assuming that the 'market-for-corporate-control' is economically efficient in that it increases firm value, regulatory competition has serious implications for the race-to-the-top thesis. Consequently, according to this argument, mandatory federal rules should at least ensure that the market for corporate control remains active, robust, and competitive.[71]

It is doubtful, however, that US company laws will be placed under federal jurisdiction in the near future. Although it is conventional wisdom among US scholars that regulatory competition produces a race-

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people imitate the actions of others and in so doing ignore, to some extent, their own information and judgments regarding the merits of their decisions.' See Kahan and Klausner 1996: 355).

[68] See, e.g., Easterbrook and Fischel (1991: 212-213); Fisch (2000: 1063); Kahan and Kamar (2001: 1212-1214); Romano (1985); Romano (1998: 365).

[69] See Bebchuk (1992); Bebchuk et al. (2002).

[70] See Bratton and McCahery (1995: 1887–1889).

[71] See Bebchuk (1992); Bebchuk and Ferrell (1999).

to-the-top with respect to some areas of corporate law,[72] it certainly has its flaws. First, states do not pursue regulatory competition solely by offering rules that meet their clients' needs. High-powered interest groups within a particular state induce the competitive process because of considerable tangible benefits. It has been argued that Delaware's corporation law is devised to maximize the amount of work performed by lawyers who are members of the Delaware Bar.[73] By providing standards and ambiguous default rules rather than rules that are clear in application, Delaware law enhances the amount of litigation in the state.[74] Delaware lawmakers thereby respond to the lobbying efforts of in-state lawyers who are able to capture a considerable share of the incorporating revenues, due to litigation-increasing standards.

Furthermore, since Delaware can rely on its dominant position in the market for incorporations, it could allow itself to prevent the emergence of optimal legal rules that would prevail in a perfectly competitive market.[75] Finally, recent empirical research indicates that regulatory competition in the context of corporate law is imperfect as not only the product quality, but also the location of the 'seller' plays a pivotal role. It appears that since firms display a marked home preference with respect to company law rules, states are more successful in retaining in-state firms than attracting out-of-state business formations.[76]

Thus, Delaware closely resembles a monopolistic 'seller' possessing market power and competitive advantages that other jurisdictions cannot replicate.[77] The increasing return mechanisms act as substantial barriers to other states wishing to enter the market for out-of-state business formations. Since the radical change in company lawmaking in the late 19th century, the Delaware-equilibrium has ruled. Delaware has played and still plays a pivotal role as the national lawmaker in the US, protecting itself from other states and federal interference by responding to interest group pressures. It follows from this discussion that regulatory competition may not automatically yield an efficient outcome. Its legal

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[72] See Bebchuk and Ferrell (1999: 1171).
[73] See Macey and Miller (1987: 491–498).
[74] See Bratton and McCahery (1995: 1887–1888); Kahan and Kamar (2001: 1217).
[75] See Kahan and Kamar (2001: 1252).
[76] See Bebchuk and Cohen (2001).
[77] See Bebchuk and Hamdani (2002).

product, however, is arguably superior to what a centralized regime would produce.[78]

### 3.2 *The Entrance of a New EU Era?*

From the 1999 onwards, a number of law and economics scholars have interpreted the ECJ's rulings involving the freedom of establishment of foreign corporations and the mutual recognition of companies by the member states as providing the demise of the real seat doctrine. This approach suggests that the improvement of corporate mobility, achieved by the ECJ in case law in *Centros* and its progeny of cases, provides the basis for the development of a market for incorporations in the EU.

In an important sense, a competitive environment for legal rules has yet to fully develop due to the real seat doctrine that governs in most member states. In recent years, however, the combination of new decisions by the European Court of Justice (ECJ) and the legislative blockage in the company law harmonization program has stimulated considerable interest in the competition between jurisdictions. While the real seat doctrine continues to restrict firm mobility, the ECJ's recent judgments in *Centros*, *Überseeing* and *Inspire Art* may, in the near term, encourage the introduction of competitive lawmaking within the European Union. Member states may gain by competing to supply flexible company forms for closely held businesses.

In fact, some of this sort of competition is stimulated by cross-border tax competition.[79] Consequently, there are adequate incentives for governments to create better company law vehicles. Thus, a crucial debate in Europe is whether a market for corporate legal rules will ultimately emerge within the European Union, and if so, whether it will be based on a Delaware-like model in which firms can freely select their country of incorporation.[80] In the face of mounting economic pressure to reduce existing levels of regulation, the virtual absence of any lawmaking behaviour that arguably resembles the charter competition in

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[78] See Bratton and McCahery (2004).

[79] See Carney (1997: 327); Code of Conduct Group, *Report form the Code of Conduct Group on Business Taxation to Ecofin Council*, 29 November 1999.

[80] See, e.g., Ebke (2000: 625-628) (explaining that competitive lawmaking has become a dominant theme in European company law); Cheffins (1997: 421-451) (explaining the potential role of the market for incorporations in deepening European economic integration).

the United States suggests that there are substantive legal and procedural barriers to the establishment of jurisdictional competition in the European Union.[81] Moreover, critics suggest that competition based on considerations of company law rules will only play a marginal role in Europe. Firms (and their participants) that stand to decide where to organize their business would set a higher value on the tax rates they have to pay on capital income than on available legal rules.[82] From the perspective of the jurisdictional competition paradigm, it is therefore more likely that innovative jurisdictions attempt to attract firms and capital by lowering their tax rates. Ireland and the Netherlands present famous cases of successfully capitalizing on the tax preferences of European and non-European business firms.[83]

Under the influence of competitive market pressures, a number of member states could be driven to institute reforms to their tax regimes and company law legislation not only to stem the flow of firms migrating to other countries, but also to gain a reputation for being a competitive jurisdiction which satisfies the needs of a range of firms. In fact, the incentive effect of regulatory arbitrage is also present without firm mobility when firms can observe government performance across jurisdictions and can sanction political actors whose performance is inferior to that of other jurisdictions.[84]

Although jurisdictional competition in Europe is still a remote possibility, the empirical evidence lends support to the view that an outbreak in competition for incorporations is not probable unless large incentives for lawmakers materialize. However, it might be argued that we can already foresee a pattern of regulatory competition in the context

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[81] See Scharpf (1999: 101-103).

[82] See Wymeersch (2000) (arguing that competition is taking place on the basis of differences in tax laws, labour laws and environmental laws in Europe; business forms are not an essential component of regulatory competition). Cf. Ferran (2001) (noting that limited evidence considered in the context of the UK's company law review supports the view that fiscal, operational and macro-economic considerations rather than company law are the major considerations in the decision whether or not to locate a business in a given country).

[83] See Bratton and McCahery (2001: 701).

[84] Cf. Breton and Ursprung (2002: 4). Thus seen, large firms that made irreversible investments and therefore cannot threaten to move their seat to another jurisdiction could conceivably join other interests in a lobbying process. See also Bratton and McCahery (1997: 256-259) (discussing 'yardstick competition models' that attempt to ameliorate the Tiebout model's shortcomings by substituting the vote for mobility as the competitive mechanism).

of closely held and holding companies. But this market, for the most part, is an effect of tax-induced regulations rather than company law. Against this background, this section will assess the implications of these cases to determine whether the ECJ's decisions point toward the eventual introduction of a new era in lawmaking.

In the context of company law, the ECJ's ruling provides two important elements of regulatory competition: mutual recognition and minimum standards.[85] Certainly, the ECJ did not explicitly rule the real seat doctrine contrary to community law.[86] The ECJ focused solely on the (secondary) establishment of a branch by an English private company in Denmark,[87] thereby explicitly refraining from contradicting the *Daily Mail* case and the 1997 proposal for a Fourteenth Directive dealing with the transfer of a firm's registered office or de facto head office.[88] In the *Daily Mail* case, the ECJ ruled that the right to transfer a firm's real seat to a member state other than where it incorporated is not protected by Article 43 (ex 52) of the Treaty.[89] It restricted firms' rights of primary establishment, on the grounds that no agreement on the mutual recognition of companies or firms within the meaning of Article 293 (ex 220) had been reached, and hence denied the opportunity for firms to choose a favoured company law regime.[90]

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[85] Thus seen, the *Centros* case is a further variation on the theme of the *Cassis de Dijon* case. See Bratton *et al.* (1996: 31-32); Streit and Mussler (1998: 102-103); Woolcock (1996: 294). *Centros* goes beyond *Cassis de Dijon* by applying a test of market access, according to which all goods and persons should have substantive access to other member states' markets irrespective of any form of discrimination. See Barnard and Deakin (2001: 18).

[86] See Ribstein (2001: 820) (arguing that *Centros* invites erosion of the *real seat* doctrine). However, many commentators have a different view, in 'their desire to advance the law and giving expression to deeply felt convictions as to what the freedom of establishment under Articles 43 and 48 of the EC Treaty should entail'. See Ebke (2000: 629); Xanthaki (2000: 2).

[87] The secondary establishment alludes to the setting up of agencies, branches or subsidiaries. If *Centros* had dealt directly with the primary establishment – a firm's right to establish itself in a member state by transferring its real seat – the Danish Trade and Companies Board would have questioned the existence or the legal status of *Centros Ltd.* As Denmark follows the theory of incorporation, the legal status was naturally beyond dispute in Danish courts. Cf. Ebke (2000: 631 and 636); Rammeloo (2001: 65-85).

[88] Case 81/87 *The Queen v HM Treasury and Commissioners of Inland Revenue, ex p. Daily Mail and General Trust plc* [1988] ECR 5483. See Edwards (1999: 376-383).

[89] In *Daily Mail*, the ECJ held that member states may impose 'exit' taxes on firms that wish to reincorporate, that is they may treat reincorporation as a 'liquidation'.

[90] See *Daily Mail* (§21-25).

The proposal of the Fourteenth Directive intends to reconcile the real seat and incorporation doctrines by providing that member states shall take all measures necessary to allow firms to transfer their registered office or de facto head office, together or separately, to another member state.[91] According to Article 3 of the proposal, such a transfer involves a change in the law applicable to the firm.[92] The draft proposal understandably refrains from eliminating the real seat doctrine. The majority of member states use this doctrine to protect existing regulatory regimes, which in various instances represent a capital asset of that state or regulate a controversial issue.[93] Germany's system of labour representation (*unternehmerische Mitbestimmung* or co-determination) on the supervisory board of large corporations is a marvellous example of such a capital investment in regulation. If the European Union chooses to federalize choice-of-law legislation, it may very well lose more political support than it would gain from interfering. Moreover, drafting a proposal that lacks the member states' support is clearly quite futile.

By expanding the scope of the term 'branch', however, the ECJ has reduced the difference between primary and secondary establishment to a minimum, thereby accepting the principle of mutual recognition in the context of company law.[94] In fact, the English corporation transferred its

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[91] For instance, a firm that initially incorporated in a *real seat* jurisdiction has to move both its registered and central administration. See Drury (1999: 362-371).

[92] The High Level Group of Company Law Experts (2002b: 33-34) argues that the change of the governing law is in many cases unnecessary and produces anomalies.

[93] Macey (1990) identifies 'three situations in which federal lawmakers will maximize political support for themselves by relegating authority to state officials. The first is where existing state law has created expropriable quasi-rents through the development of asset-specific investment whose continued value depends on the perpetuation of such laws. The second is when a single national rule, permitting new entry, would deprive local interest groups of the advantage of an existing spatial monopoly. Finally, we have seen that federal lawmakers, who often must act under conditions of uncertainty, sometimes will wish to avoid the political fallout that accompanies particularly controversial decisions.'

[94] See Ebke (2000: 633-637, 660) (noting that in the *Centros* case, the ECJ may have expanded the scope of the term 'branch' within the meaning of Article 43(1) of the Treaty). The ECJ held that:

> 'It is contrary to Articles 52 and 58 of the EC Treaty for a Member State to refuse to register a branch of a company formed in accordance with the law of another Member State in which it has its registered office but in which it conducts no business where the branch is intended to enable the company in question to carry on its entire business in the State in which the branch is to be created, while avoiding the need to form a company

seat to Denmark.[95] The ECJ recognized the right of a Danish firm to incorporate in the United Kingdom without the intention of conducting business operations in the state of incorporation. In this way, *Centros* renewed the discussion about regulatory arbitrage in Europe.[96] Thus seen, the case is a forerunner of a new approach to the evolution of company law and will predictably yield some tangible results in this field.[97] It already shows that firms can migrate to countries that offer internal processes and legal regimes that lower their costs regardless of where the firm's assets, employees and investors are located.[98]

*Centros* also dealt with a necessary precondition for mutual recognition, which at the same time is viewed by European commentators as the second key element of regulatory competition, i.e., minimum essential requirements.[99] Experience within the European Union suggests that due to a lack of mutual trust, the principle of mutual recognition may only work if there is agreement on minimum standards to protect the general interest of the stakeholders.[100] In this respect, it is submitted that the ECJ is an active participant in European regulatory

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there, thus evading application of the rules governing the formalities of companies which, in that State, are more restrictive as regards the paying up of a minimum share capital.'

[95] See Wymeersch (2000a) (suggesting that if a member state cannot deny access to a corporation formed in accordance with the law of another member state, it is difficult to explain why a member state could prevent such an incorporated firm from establishing itself in the other member state); Xanthaki (2000: 7) (arguing that in the light of the *Centros* intention to circumvent Danish corporation law, the ECJ's decision is unfair, albeit basically legal).

[96] Regulatory arbitrage 'is the action taken by market operators in selecting the best location for investment or economic activity depending on the local regulatory environment'. See Woolcock (1996: 298).

[97] Cf. Gilson (2001: 353) (arguing that from the perspective of an American, a narrow interpretation of *Centros* seems like wishful thinking).

[98] For instance, in *Centros* the ECJ permitted a Danish firm to incorporate in the United Kingdom so as to circumvent cumbersome Danish corporation law rules, especially those on minimum capital. This trend is far from new. In Segers (case 79/85 *Segers v Bedrijfsvereniging voor Bank- en Verzekeringswezen, Groothandel en Vrije Beroepen* [1986] ECR 2375), the court already decided that under Article 43 (ex 52) a Dutch sole proprietor could incorporate in England, because setting up a Dutch close corporation took considerably longer – even if he intended to continue to operate wholly in the Netherlands.

[99] See Majone (1993); Sun and Pelkmans (1994); Woolcock (1996: 305).

[100] See *infra* footnotes 84-107 and accompanying text. Cf. Gatsios and Holmes (1998: 273) (noting that repeated attempts to introduce mutual recognition of the registration of new drugs failed because there is a lack of mutual trust regarding such procedures).

policy in the sense that it can determine that the minimum standards in one member state are equivalent to those of another.[101] If a member state maintains higher standards, these measures must be proportional and non-discriminatory.[102] In *Centros*, the ECJ decided that it is contrary to the Treaty for Denmark to refuse to register a branch of a firm organized as a close corporation in the United Kingdom solely to evade the application of the minimum capital requirements. Apparently, minimum capital requirements are not essential requirements to protect the interests of creditors of closely held firms.[103] The court found that such creditors are protected by the disclosure requirements applicable to close corporations on the ground of the Fourth and Eleventh Directives on annual and consolidated accounts.[104] The ECJ argued furthermore that that it is possible to adopt measures that are less restrictive and interfere less in fundamental freedoms. In addition, the ECJ noted that the Danish authorities were not precluded from entering into an agreement with the British authorities to overcome potential efficiencies from a British firm doing business in Denmark only.

Even though regulatory competition may not be the aim of the ECJ's intervention, the above analysis shows that *Centros* could very well usher in a new era of competitive lawmaking with regard to company law in Europe. Of course, commentators may take refuge behind a phalanx of obscure and convoluted statements in the ECJ's decision in

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[101] See Woolcock (1996: 294).
[102] See *Centros* §§31-38.
[103] Most European member states view minimum capital as essential to obtaining limited liability protection. However, these minimum capital requirements do not pass the four-factor test. See *Centros* §34: 'it should be borne in mind that, according to the Court's case law, national measures liable to hinder or make less attractive the exercise of fundamental freedoms guaranteed by the Treaty must fulfil four conditions: they must be applied in a non-discriminatory manner; they must be justified by imperative requirements in the general interest; they must be suitable for securing the attainment of the objective which they pursue; and they must not go beyond what is necessary in order to attain it.'
[104] The ECJ seems to follow the Second Directive on the formation of publicly held corporations and the maintenance and alteration of their capital. See *Centros* §36. For a short comment on the efficiency of capital maintenance rules. But see Rammeloo (2001: 78-79) ('[t]he precondition that "national measures must be justified by imperative requirements in the general interest" was not followed by any overall conclusion that capital requirements *as such* are not suited to protect company creditors.').

order to defend the real seat doctrine.[105] That said, the conclusion that *Centros* stimulates regulatory competition, in the case of secondary establishments and new companies, is in line with the policy laid down by the European Commission in the 1985 White Paper on Completing the Internal Market. This new approach to lawmaking aims to limit harmonization efforts to the essential minimum, and provides for mutual recognition of national regulations.[106]

It is only to be expected that the ECJ will continue along the path it set about developing in *Centros*. The *Centros* decision constitutes an initial step in the evolution of the ECJ's jurisprudence on freedom of establishment and mutual recognition of companies in Europe.[107] Indeed the *Überseering* judgment should be considered an extension of *Centros*, as this ruling represents the view of the ECJ that companies enjoy freedom of establishment and mutual recognition based on Articles 43 and 48 of the Treaty. In *Überseering*, the ECJ rejected the German principles of case law, under which the Dutch corporation was denied legal entity status and the corresponding right to file an action, against a company for breach of contract, in a German court.[108] The Court's decision in *Überseering* has been extensively studied by other scholars and will require only brief summary here.[109] The ECJ held that where a firm incorporated in accordance with the law of a member state (A) in which it has its registered office, is deemed, under the law of another member state (B), to have moved its actual centre of administration to member state B, Articles 43 EC and 48 EC preclude member state B from denying the legal capacity and, consequently, the capacity to bring

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[105] See Halbhuber (2001: 1409) ('German authors exhibited a certain bias in reading judgments of the ECJ. They failed to see the contradiction between the Court's reasoning in *Segers* and German *Sitztheorie* practice, and misread a confirmation of *Sitztheorie* into *Daily Mail*, which dealt only with restrictions imposed by the member state of incorporation.').

[106] See Gatsion and Holmes (1998: 272); Woolcock (1996: 289-290).

[107] See Hathaway (2001: 645-650) (referring to the phenomenon of 'sequencing path dependence' in judicial lawmaking); Stone Sweet and McCown (2001: 7) ('[i]n any specific legal domain, judicial rulings on cases that come first will exert influence on subsequent litigation and judicial decisionmaking.').

[108] It is argued that the action was unnecessary because, under German law, the Dutch *BV* should have been treated as a German commercial partnership, which can bring an action in a German court. See Ebke (2000: 653-654).

[109] See, e.g., Roth (2003); Heine (2003); and (Lombardo (2003).

legal proceedings before its national courts for the purpose of enforcing rights under a contract with a firm established in member state B.

The ECJ initially distinguished its *Daily Mail* judgment and *Überseering*, differentiating between the freedom of movement concerning immigration of companies, in which case member states cannot impose any additional requirements, and emigration where the national legislator has wide discretion. According to the *Überseering* Court, companies are best understood as 'creatures of national legal orders'.[110] Thus, if a company is validly formed under the national laws of one member state, another member state must accept this. The ECJ thereby effectively rejected the application of the real seat doctrine when it ruled that *Überseering* had the legal capacity in Germany despite being incorporated in the Netherlands, and its shareholders living in Germany.

The ECJ's recent judgment in *Inspire Art* constitutes yet another landmark ruling in the field of the freedom of establishment. This case involved a private limited company established under English law with its statutory seat in Folkestone. Its sole shareholder and director, however, had his domicile in the Netherlands and no business was conducted in the UK. Apparently the company was established under English law in order to avoid the stringent rules of Dutch company law. A branch of the company was registered in the *Handelregister* of the Chamber of Commerce in Amsterdam. But, *Inspire Art* refused to register as a pseudo-foreign company and therefore did not comply with one of the obligations under Dutch law imposed on foreign companies. The Chamber of Commerce brought this as a test case before the *Kantonrechter* in Amsterdam, claiming *Inspire Art* had violated Dutch law. It petitioned the *Kantonrechter* to order *Inspire Art* to complete its registration to the effect that *Inspire Art* is a pseudo-foreign company and therefore required to comply with the minimum capital requirements. The *Kantongerecht* submitted two questions to the ECJ: (1) whether Articles 43 and 48 are to be seen as precluding The Netherlands from setting additional demands such as those found in Articles 2-5 of the *Wet op de formeel buitenlandse vennootschappen* (*WFBV*-Dutch law on pseudo-foreign companies); (2) if the provisions in the *WFBV* are found to be incompatible with European law, must Article 46 be interpreted in such a way that Articles 43 and 48 do not preclude

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[110] Paragraph 40 of the *Überseering* decision.

The Netherlands from applying rules such as those setforth in the WFBV, on grounds of creditor protection?

The ECJ held that Article 1 of the *WFBV*, which required *Inspire Art* to register under as a pseudo-foreign company, was contrary to Article 2 of the Eleventh Council Directive because it does not allow any disclosure requirement not provided for by the directive. In terms of the second issue before the ECJ, the Court referred to its earlier judgment and ruled that it was immaterial for the applicability of the freedom of establishment that a company, established in a certain member state, carries out its operations in another member state. Moreover, the ECJ held that the minimum capital requirements for pseudo-foreign companies mandated by the *WFBV* were in violation of the freedom of establishment, as they were not justified by the exception of Article 46 or any other requirement in the general interest.

In the ECJ's judgment in *Inspire Art* the ECJ has extended the earlier case law by applying the *Überseering* rule to the entire legal system of the member states. Unlike *Centros* and *Überseering*, however, *Inspire Art* involved questions of substantive company law. Indeed, after the *Überseering* judgment, the issue often raised involved the extent national law may be applied to so-called pseudo foreign companies in the areas other than legal personality or right of standing in court. Having ruled that the disclosure requirement in Article 1 of the WFBV is in violation of the Eleventh Directive and the minimum capital requirements are in violation of the freedom of establishment, the major implication of *Inspire Art* is that the WFBV cannot be maintained in its present form and other member states must follow suit in altering their laws that conflict with this judgment. We should note that *Inspire Art* holds out few implications for cases involving domestic companies wishing to leave its state of incorporation.

This section critically examined the ECJ's recent case law on the freedom of establishment and its implications for the free movement of companies and the real seat doctrine. We have seen that while *Centros* did not involve a strict real seat context, the Courts ruling can easily be interpreted to imply that the validity of the view that an incorporation in one member state cannot be called into question in another simply because its central administration is not located in its state of incorporation. Even though the *Centros* case does not touch directly on the real seat doctrine, the broad contours of the ECJ's developing jurisprudence in this area is arguably clear. *Überseering* continues to

develop this line of reasoning and *Inspire Art* extends this view, moreover, to substantive law.

We have argued that the real seat doctrine poses serious barriers to the freedom of establishment. However, the recent ECJ decisions have considerably reduced the scope of the real seat doctrine. To be sure, the mutual recognition of companies alone is insufficient to support the emergence of a market for incorporations in the EU. Serious obstacles, which has until now been left unaddressed by the ECJ, such as the absence of a reincorporation procedure and the issue of exit taxes continue to serve as serious barriers to the freedom of establishment and restrict the cross-border mobility of companies. Inevitably the ECJ will confront these issues, but we suspect that the Court will take few steps, as signaled in *Überseering* judgment, to restrict member state discretion in these areas.

### 3.3 *Barriers to Regulatory Competition in Europe*

The question, then, is whether regulatory competition is a superior alternative that can supersede top-down harmonization. To rephrase this, could competitive lawmaking lead to a welfare optimum in Europe? The answer to this question is arguably reflected in the development of the lawmaking process within the European Union.

If free choice and mutual recognition were viewed as the only precondition for regulatory competition, a potential 'lemons' problem could exist in the European market-for-business-forms.[111] To illustrate this point, let us suppose that jurisdictions cannot reject firms organized under foreign company laws to avoid more restrictive formation and operation requirements. In that event, the lack of transparency in the European market could lead to a competition to laxity, to the extent that firms have no preferences with respect to the jurisdiction from which they buy their 'products'. When it is difficult for the participants and creditors of a firm to obtain and compare information about the differences in quality between company forms from different member states and higher qualities imply higher costs, it is submitted that only

[111] The 'market for lemons' hypothesis is developed by Akerlof (1970), who illustrated how asymmetric information, which makes it different to distinguish good quality from bad, can lead to a situation where only poor quality products ('lemons') become available in a product market.

the lowest possible quality will survive the competitive process.[112] The fact that the European Union has opened the door to new members reinforces the problem of firm participants' ability to distinguish the quality of the different member states' products. In order to give firms organizing under their company laws a competitive advantage, member states have a tendency to undercut their rivals' formation and operation requirements. This is especially true of small member states, which are better able to externalize the costs of inefficient company law, as the firm participants mainly operate outside their jurisdiction. Consequently, the argument goes, the European Union would be expected to settle at a sub-optimal equilibrium if market failures were not solved by centralized intervention.[113]

It is widely argued that jurisdictional competition suffers from several shortcomings which prevent the evolution of first-best law, as we have seen in section 3.1.[114] How then will a race-to-the-bottom be prevented? In the case of the European Union, one could point to the 'minimum requirements' principle as applied by the ECJ. This principle allows member states to restrain foreign companies that do not conform to national rules from doing business in its jurisdiction.[115] In addition, a member state could choose to apply its own corporation law to 'pseudo-foreign corporations'.[116] The Dutch Pro-Forma Foreign Companies Act of 1998 was one example of a statute that subjects these corporations to local creditor protection rules.[117] However, the ECJ case law has

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[112] See Scharpf (1999: 92) (noting that asymmetric information among buyers and sellers and the buyers' distrust of the information provided by the better-informed sellers could lead to a market for lemons).

[113] See Sinn (1997: 264-265 and 268-270) (arguing that if centralized lawmakers aim at correcting market failures, it would not be efficient to subject laws to a market decision, which, in turn, is likely to suffer from a market failure itself).

[114] The Tiebout model of regulatory competition, which predicts that competitive markets will settle at an efficient equilibrium, does not hold in the real world. Several shortcomings, like asymmetric information or observability, denude the Tiebout model of predictive capacity. See Bratton and McCahery (1997); Inman and Rubinfeld (2000: 669).

[115] See Scharpf (1999: 96).

[116] Pseudo-foreign corporations are firms that are incorporated in one state but conduct a significant amount of their business in another state.

[117] See Rammeloo (2001: 76-79). In the United States, California and New York apply some provisions, including shareholder protection rules in particular, to pseudo-foreign corporations. See Johnson (1997: 272-275); O'Hara and Ribstein (2000: 1206) ('[n]ot

mitigated the effect of this principle by expanding the proportionality test, which limits the autonomy of member states to impose minimum requirements, even if they serve social purposes.[118]

To be sure, the court-led deregulation approach requires the removal of national measures that impede market access, free choice, and hence, regulatory competition. However, even if some competitive pressures are present, inertia to innovate keeps playing a major role in the evolution of company and partnership law. In fact, we argue that the current law reform projects are a result of interest group pressures and responsive lawmaking, rather than a product of fully-fledged regulatory competition.[119] It appears that innovative lawmaking is unlikely to occur if the obstacles to firm mobility and free choice are not overcome.

It should also be stressed that besides the standardization and *status quo* preference, the development of company law has been constrained by several other factors. First, formation costs in Europe make firms immobile. As discussed, reorganizing under a foreign company law statute often triggers taxes on hidden reserves, effectively restricting the demand for firms to opt into different national governance systems.[120]

Second, direct and indirect taxes are perhaps the most obvious barrier to cross-border mobility. Exit taxes in particular are the most politically charged issues, especially for large member states, such as France and Germany. Interestingly, the ECJ has recently revisited the issue of exit taxes in the context of their permissibility upon transfer of residence by an individual, self-employed person. In *Lasteyrie du Saillant*,[121]the ECJ held that discriminatory taxation of a taxpayer leaving the jurisdiction is proscribed. In that case, Mr de Lasteyrie left France in 1998 to settle in Belgium, transferring both his professional practice and tax residence. At that time, he held securities that exceeded 25% of the profits of a

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surprisingly. Pseudo-foreign restrictions are limited to California and New York, which have enough market power to avoid being punished by exit of the affected firms.').

[118] See Barnard and Deakin (2001: 36-38); Deakin (2001: 203 and 216-217).

[119] Gilson (2001: 354 fn 87) perfectly illustrates this point. He uses the Embarcadero Freeway, which separated downtown San Francisco from the waterfront, as an example. While many San Francisco residents wanted the freeway to be torn down, they were only able to break the opponents' block after the 1989 earthquake inflicted sufficient damage on the freeway.

[120] Cf. Gilson (2001: 356) (noting that in Germany, a significant tax barrier would remain despite *Centros*).

[121] Hughes de Lasteyrie du Saillant v. Ministerie de l'Economie, des Finances et de l'Industrie, Case C-9/02, [2004] ECR 00000, Judgment of 11 March 2004.

company subject to corporation tax in France, and their market value was above their acquisition price. The Code General de Impots (CGI) included a provision that prescribes a levy of income taxes on such differences in value of securities when a French resident leaves the country. The plaintiff challenged this provision and the case was referred to the ECJ, which held that the legislation in question impeded the exercise of free establishment. The Court in *Lasteyrie du Saillant* reasoned that the rule was discriminatory because taxpayers who transfer their residence abroad are taxed on latent increases in value, while taxpayers remaining in France are taxed only on increase in value after they have actually realized such gains. It is crucial to observe, however, that the ECJ distinguished between natural persons and corporate residents, which is common practice in tax judgments, and therefore does not touch upon the Court's judgment in *Daily Mail*. Thus, *Lasteyrie du Saillant* provides that exit taxes cannot hinder the exercise of the free establishment exercised by a natural person and must comply with the criteria established in *Centros*. Clearly this case is important because it challenges the discretion of member states to use of exit taxes on the basis of freedom of establishment, if only in relation to individual taxpayers. It is difficult to assess whether the ECJ will extend its freedom of establishment jurisprudence to legislation hindering corporate emigration, such as seat transfers and mergers. Recall that exit taxes are a central defense in restricting firm mobility and free choice and we suspect that the ECJ issue a decision, in the near term, that substantially alters the pre-existing corporate contracts negotiated at the member state level, unless the contracts have already been altered.

Third, the absence of a common history, culture, language and economic system obviously limits the ability of firms to choose a foreign legal business form.[122] The fact that the difference between legal regimes limits the extent to which lawyers can practice outside their home jurisdictions reinforces the firms' preference for their home countries.[123] Fourth, European patterns of corporate regulation and equity capitalization do not open up market opportunities for revenue-seeking jurisdictions. National governance systems do not allow for much shareholder litigation, and some systems restrict shareholder voting

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[122] See, e.g., Charny (1991: 456); Ribstein (2001: 853). Transparency regarding the nature and effects of the legislation is one of the preconditions for regulatory competition. See Woolcock (1996: 302-303).
[123] See Ribstein (2002a: 63-64).

rights.[124] Fifth, Europe's normative landscape is complex. Crucially, labour co-determination in Germany and employee participation structures elsewhere create a barrier to a regulatory system directed to the preferences of managers and shareholders.[125] This dampens the demand for responsive lawmaking in the European Union in general. It is not surprising, therefore, that national lawmakers and incumbent interest groups are happy with the current institutional arrangement that impedes legal reforms aiming to improve the welfare of firms.

Other harmonization costs reflect the institutional and legal problems that characterize jurisdictions with monopolistic lawmakers. European company law is immune from the evolutionary pressures of competitive lawmaking, largely due to the implementation of the directives, which have given the substantive corporate law of the member states a mandatory and petrified quality.[126] The involvement of the European Union in developing a harmonization program has tended to restrict innovations in company law in general. The harmonization process applies mainly to public corporations,[127] but both national and European lawmakers have extended the directives' reach to other limited liability vehicles when introducing policy reforms.[128] Quite apart from the normative concerns of employing a harmonization process to develop a system of uniform rules, the imposition of mandatory rules – without the opportunity of opting out – has had the effect of increasing the incidence of standardization, and created a number of legal and institutional barriers to free choice.[129] Consequently, given the 'petrification externality', the prospects for changing the main elements of company law in Europe are rather slim even in light of the modernization reforms recently proposed by the European Commission.

## 4 CONCLUSION

This article has provided an overview of the changing landscape of EU company law. We pointed out at the beginning of this article that the potential for the member states to engage in competitive lawmaking is

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[124] See Centre for Law and Business (1998: 2-9).
[125] See Wymeersch (1998: 1045).
[126] See Buxbaum and Hopt (1988: 232-243); Coffee (1999: 651); Wouters (2000:267).
[127] See, e.g., Bisacre (1999: 89-90); Halbhuber (2001: 1406).
[128] See also Wouters (2000: 265-266).
[129] See, e.g., Wouters (2000: 264-267).

limited. On this basis, we argued that member states, upon the entrance to the EU, enter into a long-term non-competition agreement regarding company law. There is no evidence that the emergence of new judgments from the ECJ, which allegedly reflect changes within the EU about lawmaking strategies, tip the equilibrium towards regulatory competition.

In section two, we described that in an island's lawmaking process, the production of legal rules may fall short of the optimal required level due to role played by lawmakers, intermediaries and organized groups. To the extent that law reform efforts are undertaken by government committees and private lawmaking bodies, foreign legal rules will be borrowed and adapted to a jurisdiction's doctrines and principles. The divergence in legal rules and institutions among jurisdictions reflects not so much the differential needs of businesses as the institutional and legal traditions. Even if exogenous events should occur, a jurisdiction's lawmaking process is unlike to react positively to these new pressures. In addition, the standardization process, which creates both positive and negative externalities, accounts for lawmakers' preference for the dominant legal rule.

Based on our review of the changing pattern in EU lawmaking we have argued that, even when these island jurisdictions become part of a common market, they are unwilling, given their long tradition of independence, to relinquish their lawmaking autonomy. The commitment of member states to respect the cooperative lawmaking equilibrium is reflected in the following observations: (1) the first and second generation company law directives restated the dominant legal practices in the member states; (2) the third and fourth generation directives became less detailed and precise leaving the important issues to the member state's discretion; (3) federal intervention through supranational provisions for truly European company forms faced severe objections and are, until now, not very successful; (4) all the steps taken by the member states point in the same direction: to avoid a "European Delaware".

Section 3 clarifies that Europe's fear of creating a EU-Delaware is misguided. Delaware does currently not engage in regulatory competition with the other US states. Due to a series of historical coincidences, As we have seen, Delaware can rely on its dominant position in the market for companies. Delaware closely resembles a monopolistic lawmaker possessing market power and 'competitive'

advantages that other states cannot replicate, which act as substantial barriers to other states wishing to enter the market for out-of-state companies.

In the EU, the harmonization program for publicly held companies set in place mechanisms that protected the lawmaking autonomy of member states. Since these firms were most likely to engage in cross-border activities, re-incorporation strategies could put pressure on domestic lawmakers to conform to their peer jurisdictions. With the European market becoming reality, however, small and medium-sized firms are increasingly reviewing their strategies so as to reach their full potential, thereby choosing the jurisdiction of incorporation. To be sure, the real seat doctrine, that is still dominant in the EU, initially prevented start-up firms to choose their company law. However, recent ECJ's case law provides for mutual recognition: jurisdictions cannot reject firms that, in order to avoid more restrictive formation and operation requirements, organized under foreign company laws. This could potentially cause irritation to the non-competitive equilibrium, but we suspect that these out-of-equilibrium challenges will not touch the core of the legal rules and institutions supporting the stability.

We argued furthermore that the effect of the ECJ's judgments is rather slim. Indeed, it might be argued that, as the ECJ allowed firms to opt for a foreign company structure solely to evade the application of the minimum capital requirements, it distorted the no-competition equilibrium and encouraged the member state lawmakers to respond. Nevertheless, apart from measures designed to implement the European developments, the domestic lawmakers are apparently more engaged in window-dressing activities without touching their core legal principles, thereby pretending that they are business-friendly and at the same time restoring the equilibrium.

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