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TILEC Discussion Paper

Does the European Company Prevent the 'Delaware-effect'?

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

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Abstract

This is a time of spirited debate about company law reform in Europe. Discussions about the role of the European Union in the development of company law abound. Who is responsible for setting the agenda and controlling the legislative outcome? The further harmonization attempts and the introduction of the European Company Statute by the European Commission questions the necessity of EU intervention into the company laws regulated by the member states.

This article analyzes the history of EU company law and locates a stable "non-competitive equilibrium". This equilibrium follows from member states that founded the EU unwilling to give up their lawmaking authority regarding company law issues. From the outset, member states were determined to prevent the 'Delaware-effect'. 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 the recent enactment of the European Company has triggered discussion about competitive lawmaking in Europe.

1. INTRODUCTION

For well over four decades, the European Commission (EC) was locked in a battle with member states over the introduction of a new legal form, the European Company. Although the EC initially assumed that this business form would provide a complete set of uniform rules without reference to national law, over time the EC embraced a significantly more flexible approach in respect of national law in order to reach agreement on default provisions for employee involvement and the choice of board structure. Indeed, the European Council and Parliament approved in October 2001 a Regulation that has a limited number of provisions, which deal with the formation of a European Company, its governance structure, employee involvement and its real seat, and a Directive that regulates employee involvement. The initial skeptical reaction to the passage of the new legislation is entirely consistent with the repeated and troublesome attempts to secure an agreement on the new company form. The dominant view is that the absence of uniform

rules brings few benefits in comparison to national business forms and the cumbersome rules do not facilitate cross-border mergers.[1]

Many company law scholars, nevertheless, view the new Regulation with a mixture of hope and skepticism, arguing that, in the context of agreed employee involvement, the new company law form could stimulate regulatory competition.[2] An alternative view holds that the ultimate appeal of the new company law vehicle, compared to other national level company law vehicles, is due, if anything, to absence of legal rules on shares, financing and legal capital.[3] Proponents argue that the renvoi technique, used by the European Company Statute, creates the possibility for some firms to choose their place of central administration according to the law of the member state that offers the most attractive benefits.

In this article, we argue that the European Company Statute could very well rekindle the interest in and discussions on competitive lawmaking within the EU. The EU, through the Statute, creates for the first time the possibility for reincorporation without liquidation of the old firm and the formation of an entirely new company. The Statute's incompleteness and the significant differences in the national legislations may, we recognize, give rise to firms engaging in regulatory arbitrage.[4] The central question is whether the European Company Statute is a sufficiently attractive tool for larger firms to engage in forum shopping activities. There are a number of reasons, however, to believe that the legislation is unlikely pose a competitive threat to member states. First, as tax scholars have noted, the Statute does not contain tax provisions, leaving it up to national laws, international tax treaties and other European regulation to sort out the problem of taxation.[5] Second, the European Company will be taxed, in absence of a consolidated common tax based with the possibility of offsetting losses in different member states, in the member state where its head office is located on the basis of its world-wide taxation, leading in the cases of branches to double

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[1] See Lombardo and Pasotti (2004) (summarizing criticisms).
[2] See Rickford (2003: 140-141) (assessing the competitive effects of the European Company Statute).
[3] See Enriques (2004: 10-15).
[4] Regulatory arbitrage is the choice by firms to locate investment or other economic activity based on the regulatory environment of jurisdictions. See Woolcock (1996: 298); Enriques (2004).
[5] See Conci (2004).

taxation. Third, even if lawmakers eventually eliminate the tax obstacles to the use of the European Company Statute, it is unlikely, due to legal uncertainty, that firms will move from existing business statutes which continue to give them significant cost advantages. In additions to the arguments given above, we believe that the some member states, particularly Germany, have substantial incentives to discourage other governments from agreeing to EU-legal tax rules that would encourage cross-border reorganizations. In particular, our analysis may provide an explanation for the regulatory strategy of limiting the mobility of companies within the EU.

Accordingly, this article focuses on the evolution of company law at the EU and member state level and explores how the promulgation of the Regulation regarding the European Company affects this development.[6] 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. This article seeks to address the questions of which parties are responsible for setting the agenda for the reform of company law, and which considerations have been instrumental in constraining the emergence of a European Delaware.

It is particularly tempting to compare the lawmaking process in Europe with the development of company law statutes 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.[7] Second, because US firms of all sizes have long been operating throughout the nationwide market without severe constraints

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[6] Council Regulation 2157/2001/EC [2001] *OJ* L 294/1. See also, the Council Directive 2001/86/EC [2001] *OJ* L 294/22 (supplementing the statute for a European Company with regard to the involvement of employees).

[7] 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’).

regarding company law, the federal system has set a benchmark for the European Union.[8] 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 until recently 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 states' strategy to avoid taking steps to create a market for corporate charters which could ultimately displace the lawmaking autonomy of the member states.[9]

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 and other national law barriers, which have been reinforced by harmonizing company law rules by Directives. 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. But, as demonstrated in the US, the breakdown of a highly stable equilibrium could occur rapidly.[10] 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 protect

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[8] 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.').
[9] See McCahery and Vermeulen (2004).
[10] See Bratton and McCahery (2004) (explaining the factors that contributed to the introduction of the competition charters at the beginning of the 20th century).

their present legal system against possible competitive pressures from other member states. Indeed, a close examination of the European Company Statute confirms our view that the legislation is unlikely to facilitate firm mobility in the EU. Thus, we presume that the defects in the legislation simply reflect the core characteristics of the EU company law regime.

This article is divided into 5 sections. Section 2 turns to examine the US market-based system for corporate charters. A notable feature of the EU is that it tends to look to the operation of Delaware and the charter market with suspicion. In the US, a growing number of commentators have argued that the 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 and prevent the 'Delaware-effect'.[11]

Section 3 recounts the evolution of the EU company law harmonization program from 1957 through the recent enactment of the European Company Statute. This account shows that the aim of the EU was to limit the right of establishment of pseudo-foreign companies and create barriers to the introduction of charter competition.[12] 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. In this view, it is not surprising that an early strategy of the European Commission to introduce a truly EU-level company statute, to compete against the national level business forms, was systematically blocked by the member states who viewed an EU company form as a means to escape stricter national company law legislation. The compromise legislation, however, fails to offer a truly 'pan-European' business form, presenting an opportunity for firms to

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[11] In this paper, we assess the prospects for a single jurisdiction dictating the developments in the area of company law in the EU. As we discuss in the next section, Delaware plays this role in the context of the US state system of company lawmaking. We, however, do not consider whether Delaware has a suboptimal impact on the quality of legal rules.

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

reincorporate to a more beneficial legal system. Section 4 considers the evidence whether the status quo in EU company law is indirectly challenged by the recent enactment of the European Company. Section 5 offers a brief conclusion.

2. THE DELAWARE-EFFECT

The US legal system traditionally views company law in general as a local matter reserved to the states' governments.[13] Consequently, the 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,[14] 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.[15] Eventually, Delaware's statute made it the leading incorporation state in the United States since the 1920s,[16] 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.[17] 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

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[13] See Bebchuk (1992: 1438) (noting that even though federal law governs some important issues, including insider trading, disclosure and the making of tender offers, much of the law regulating a corporation's affairs stems from its state of incorporation). See also Leleux (1968) (comparing the European and the US situation).

[14] See Ribstein (2001: 825-827).

[15] 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.

[16] See, e.g., Bebchuk (1992: 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.').

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

being exhausted in a very short period of time.[18] 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 behavior,[19] and the superiority of Delaware's specialized chancery court, arguably preserve Delaware's leading position over time.[20]

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.[21] 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.[22] 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

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[18] 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).

[19] 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 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).

[20] See, e.g., Fisch (2000: 1063); Kahan and Kamar (2001: 1212-1214); Romano (1985); (1998: 365).

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

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

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.[23]

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-to-the-top with respect to some areas of corporate law,[24] 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.[25] 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.[26] 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.[27] 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.[28] 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.[29]

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[23] See Bebchuk (1992); Bebchuk and Ferrell (1999).
[24] See Bebchuk and Ferrell (1999: 1171).
[25] See Macey and Miller (1987: 491–498).
[26] See Bratton and McCahery (1995: 1887–1888); Kahan and Kamar (2001: 1217).
[27] See Kahan and Kamar (2001: 1252).
[28] See Bebchuk, Cohen and Ferrell (2002).
[29] See Bebchuk and Cohen (2001).

Thus, Delaware closely resembles a monopolistic 'seller' possessing market power and competitive advantages that other jurisdictions cannot replicate.[30] 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.[31] It follows from this discussion that regulatory competition may not automatically yield an efficient outcome. Its legal product, however, is arguably superior to what a centralized regime would produce.[32]

3. THE EUROPEAN "NON-COMPETITION" STRATEGY

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.[33] 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,[34] 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.[35] Recall that

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[30] See Bebchuk and Hamdani (2002).
[31] See Financial Times (2004).
[32] See Bratton and McCahery (2004).
[33] See Leleux (1968); Buxbaum and Hopt (1988) (explaining that the freedom of establishment guaranteed by the Treaty proscribes use of the real seat theory).
[34] The Treaty of Amsterdam renumbered the articles of the Treaty.
[35] 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 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.[36]

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.[37] The European Commission'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.[38] From this discussion, it should be clear

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> '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 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).

[36] See Charny (1991: 428).

[37] The European Commission 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).

[38] 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).

that the small number of member states could negotiate and enforce a political agreement that protected their domestic national stock, which produced 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,[39] 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.[40] This confirms the expectation that member states would also respect each other's lawmaking autonomy.

The first generation directives restated,[41] in effect, the content of the member states' national laws.[42] 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.[43] The array of mandatory legal

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[39] 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.

[40] See Charny (1991).

[41] 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).

[42] 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 issues like fiduciary duties, exit, expulsion and redemption, transfer of shares etc.').

[43] The first generation directives include the First and Second Company Law Directives. First Council Directive [1968] *OJ* Spec Ed (I) (disclosure of corporate data); Second Council Directive [1977] *OJ* 26/1 (protection of capital).

capital rules, however, seemed to benefit domestic interest groups.[44] 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 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.[45] 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.[46] 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,[47] shows the difficulty

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

[45] The second generation directives include the Third [1978] *OJ* L295/36 and Sixth Council Directives [1982] *OJ* L378/47 on Mergers and Split-Offs, Fourth [1978] *OJ* L222/11, Seventh [1983] *OJ* L193/1 and Eight Council Directives [1984] *OJ* L126/20 on Annual and Consolidated Accounts and the Qualification of Accountants.

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

[47] 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. See Fourth Council Directive [1978] *OJ* L222/11 (single accounts); Seventh Council Directive [1983] *OJ* L193/1 (consolidated accounts). 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

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.[48]

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).[49] 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.[50] 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.[51] In reality, the EEIG's restricted objectives and references to national law have resulted in a rather unpopular business form.[52]

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

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government changed the law according to the amending directive. See Edwards (1999: 124).

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

[49] 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).

[50] 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.

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

[52] 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).

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.[53]

Thus, the early phases of the harmonization process, with its root and branch approach, reached its inevitable terminus point with the failure of the Fifth, Ninth and Thirteenth Directives, and a new direction was required to achieve the aims of European economic integration.[54]

After the *Cassis de Dijon* judgment, 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.[55] Minimum harmonization and mutual recognition formed the so-called 'new approach' to harmonization.[56] 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.[57] With the second enlargement,[58] the EU adopted a new model of integration based on centralized federalism,[59] which gave the European Commission increased agenda-setting power. Between 1986 and 1992, the EU adopted the two, third generation directives, concerning the

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[53] At the outset of the EU, the member states understood that, given the 'Delaware effect' in the US, the consequences of competitive pressures would be detrimental to their own national lawmaking powers and immediately took steps to insulate the (horizontal) threat by establishing a federal type institution (European Commission) that undertook to harmonize areas of company law (without touching the core). While the original legislative strategy satisfied the objectives of the member states, the European Commission expanded their own lawmaking agenda by developing truly 'European' company forms. To the extent this (vertical) approach limited the lawmaking discretion of member states, their support for top down lawmaking was gradually eroded.

[54] High Level Group of Company Law Experts (2002). See also De Kluiver (1995: 300).

[55] See Case 120/78 *Rewe Zentral AG v Bundesmonopolverwaltung für Branntwein* ['*Cassis de Dijon*'] [1979] ECR 1979; European Commission (1985).

[56] 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.').

[57] 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).

[58] In 1986, Spain, Portugal and Greece entered the EU.

[59] See Inman and Rubinfeld (1998: 549); Pollack (2003)

disclosure of branches and formation of single member companies, which were marginal to domestic company law arrangements.[60]

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.[61] EU ordering continues to be subject to consensus, and to compromise lawmaking.[62] 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.[63]

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.[64] With regard to areas that are not of the exclusive competence of the European Union,[65] the subsidiarity principle embodied in Article 5 of the Treaty commands the decision to locate competence at EU level or at member

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[60] Eleventh Council Directive [1989] *OJ* L395/36; Twelfth Council Directive [1989] *OJ* L395/40.

[61] See Heritier et al. (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 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).

[62] See Scharpf (1999).

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

[64] 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).

[65] 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'.

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.[66] Recently, though, the Commission 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.[67]

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.[68] 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.[69]

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.[70] Very generally, the

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

[67] 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.').

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

[69] Cf. Forstinger (2002: 34); McCahery and Renneboog (2003: 46-51).

[70] 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).

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.

4. THE EUROPEAN COMPANY: CHALLENGING THE STRATEGY?

Recently, after more than thirty years of negotiation and bickering, the member states finally reached agreement on yet another truly genuine European business form: the European Company (*Societas Europea*, or SE). The SE statute, which entered into force in October 2004, gives firms operating in two or more member states the option to form a European company.[71] 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.

The EU initially pursued an exhaustive and comprehensive legislative measure for the creation of a European Company based on the German *Aktiengesellschaft*. The aim was to create uniform legislation for the internal governance without reference to national company laws. Although this approach should have been possible, it was ultimately shelved in the 1980s, when the European Community replaced the draft with framework legislation that referred extensively to national legislation. It took until the mid-1990s, when a group of experts, chaired by former Commission President Etienne Davignon, produced a report outlining a compromise solution regarding labor participation.[72] By December 2000, the political difficulties surrounding labor co-determination and board structure were resolved when the Council adopted the legislative measures governing the European Company.

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[71] Council Regulation 2157/2001/EC [2001] *OJ* L 294/1.
[72] See Keller (2002).

The Statute provides a number of means through which legal persons or corporate bodies may form a European Company.[73] Besides formation requirements, the Statute stipulates that the internal governance of the European Company will be regulated by national law of the place of its registration. In effect, the legislation allows firms to select either a one- or two-tier board.[74] Finally, there are a number of provisions, set forth in the Directive on Involvement of Employees, that detail the level of employee involvement in a company.[75] A special negotiation procedure for worker participation must be followed upon the creation of a European Company.[76] The Directive distinguishes between information and consultation, on the one hand, and participation, on the other hand. The employee representatives should be informed about material decisions and given the opportunity to influence the deliberation and decision-making process. In many cases, the employees' representatives are permitted to consent on the composition of the supervisory board (two-tier board) or board of management (one-tier board).

Despite the relative absence of mandatory rules, the Regulation, which should hold out some cost-saving benefits for some European firms, there are some other legal difficulties which should play an important role in determining whether companies are likely to adopt the form. First, many European lawyers have expressed skepticism about whether the new legislative measures will lead to significant changes in corporate practice.[77] For example, the proposed statute excludes a large number of areas relevant to businesses operating in two states, all of

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[73] Generally the European Company may be formed by consequence of: (1) a merger of two or more existing companies originating from at least two member states; (2) the formation of a holding company promoted by public or private limited companies; (3) the formation of jointly held subsidiary; and (4) the conversion of an existing public limited company. See article 2 and Title II of the Regulation.

[74] Article 38(b) of the Regulation.

[75] Provisions for participation of employees in the European Company, See Council Directive 2001/86/EC [2001] *OJ* L294/22.

[76] Section II of the Directive.

[77] 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).

which continue to be governed by national legislation.[78] Nevertheless, some argue that it is relatively easy to employ the European Company as a migration tool, especially when it is formed by merger.[79] However, the multiple layers of regulation, i.e., the statute itself, the laws implementing the European Company at a national level, national laws of the member states, and the European Company's constituent documents, which govern the European Company are likely to lead to uncertainty, thereby decreasing rather than increasing the European Company's attractiveness. Second, the failure of the European Statute to address the problem of taxation will clearly undermine the number of firms incorporating as European companies.[80] The argument for the attractiveness of the European Company is premised on the ability of a European Company to transfer its registered office to another member state. Although there is reason to expect that strong market pressures may lead some companies to reincorporate in jurisdictions with more hospitable company law regimes, we expect that the absence of a specific tax regime, particularly with regard to cross-border real seat transfers, will be a significant impediment to its use by a majority of firms.[81] Third, some companies may also be deterred by the complexity of the process of setting up a European Company. In particular, the need to enter into negotiations with employee representatives will likely be a bottleneck.[82] Many firms may be uncomfortable with the idea of worker involvement in the re-incorporation process. Accordingly, even if a class of firms would have sufficient incentives to convert to the European Company form, we are skeptical that there are sufficient cost benefits to encourage managers to adopt this legal business form.

To be sure, member states could take steps to make the European Company more attractive by adopting clear and effective provisions of laws that specifically implement EU measures relating to European

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[78] The Regulation addresses the Formation (Title II), the Structure of the SE (Title III), Annual Account and Consolidated Accounts (Title IV) and Winding Up, Liquidation, Insolvency and Cessation of Payments (Title V).
[79] Title II, section 2 of the Regulation. See also Enriques (2003); De Kluiver et al. (2004: 62-63).
[80] See Bolkestein (2003: 43-44). It is worth pointing out that, unlike earlier drafts, the Statute lacks any tax provisions at the EU level.
[81] See Thommes (2004: 23-25).
[82] See Davies (2003: 67; 81-82); Hopt (2003: 53-54).

Companies and, by doing so, engage in regulatory competition. However, although the first European Companies may already be formed, there are no signals that the member states have actually engaged in competition-based lawmaking in connection with the European Company or public corporations.[83]

In addition, we are skeptical whether the European Company will eventually become an attractive vehicle for company law shopping within the European Union.[84] The numerous corporate governance reforms (that started in 2001 in the wake of the Enron, Ahold and Parmalat scandals) which are high on the policy agenda leave the laws governing the European Company as more of a backwater.[85] That is not to say that policymakers should disregard the European Company. Rather, member states should arguably be on their guard against other jurisdictions trying to undermine their attractiveness by coming to the fore with a set of rules that are more ideally suited to public corporations. This issue becomes more pressing now that in the new era of corporate accountability regulatory groups and governing organizations have either adopted or modified existing corporate governance legislation and codes, which often establish mandatory goals and guidelines for the effective governance of publicly traded corporations.[86] Although the European Company compromise offers a rigid and unattractive system[87], the possibility of forum-shopping, through cross-border mergers, could in the long run provide incentives to modernize national company law legislation, thereby eroding cumbersome and intrusive national laws.[88] Recently, however, some

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[83] One may argue that French company law could obtain cost saving benefits as a result of the introduction of the European Company Statute since firms can easily opt into the flexible corporate business form, namely the Société par Actions Simplifiée (SAS) regulation. Financieele Dagblad (2004a).

[84] Cf. Garrido (2003).

[85] European Commission (2004); McCahery and Vermeulen (2005 forthcoming).

[86] See Hertig and McCahery (2004).

[87] See Kübler (2004).

[88] It follows, perhaps, that the ECJ's recent judgments in *Centros, Überseering* and *Inspire Art* – and their implications for the real seat theory – could, along with the pressure from the introduction of the European Company, induce the European Union to embark on a new, market-based approach to the process of business organization lawmaking. See McCahery and Vermeulen (2001); (2004). Now that the EU opened its door to new member states, national lawmakers must be on their guard against highly incentivized central and eastern European legislatures which may be considering modern and attractive company law legislation.

policymakers have suggested linking the European Company Statute to a European corporate governance code could provide a more efficient way to induce convergence of best practice norms within the EU.[89] If national lawmakers were to shift to this strategy, we expect two potential benefits would arise: (1) through linkage the member states' codes would be left untouched and thereby divergence would be respected;[90] and (2) the prospect of regulatory competition by means of the European Company would be substantially diminished. We conclude, then, that were the member states to embrace the linkage approach to the European Company Statute, this would serve to reinforce the non-competitive equilibrium within EU company law, a result that many lawmakers would appear to support.

4 CONCLUSION

This article has pointed out that the potential for the member states to engage in competitive lawmaking is limited. On this basis, we argued that member states, upon the entrance to the EU, entered into a long-term non-competition agreement regarding company lawmaking, thereby preventing the 'Delaware-effect'.

Section 2 explains the Delaware-effect. It clarifies that Delaware does currently not engage in regulatory competition with the other US states. Due to a series of historical coincidences, 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. We have argued that member states are unwilling, given their long tradition of independence, to relinquish their lawmaking autonomy in this area. All

[89] See High Level Group of Company Law Experts (2004: 67).
[90] See Financial Times (2004b).

steps taken by member states point in the same direction: to avoid a 'European Delaware'. 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. Our analysis questions whether the compromise legislation regarding the European Company could actually serve to cause irritation to the non-competitive equilibrium by opening the door to regulatory arbitrage and eventually competitive lawmaking. Even though many commentators cast doubt about the beneficial aspects of opting-into the European Company, we should, nevertheless, not rule out the possibility of firms making use of this structure to circumvent costly national company law rules.[91] For this to become viable, however, the European Union must first introduce an EU-wide tax regime for the European Company, and also bring about a common EU corporate tax base.[92] We suspect, however, that there are few political incentives for lawmakers to pass legislation that might serve to disrupt the EU's non-competitive equilibrium in company law.

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[91] The introduction of the European Company has stimulated discussion about the transformation of board-level labor representation regimes within the EU (Wall Street Journal Europe 2004). For instance, the possibility of circumventing the rigid labor representation laws through a merger with an English public company has given company law reformers more political leverage in their efforts to alter home country legislation (Financieele Dagblad 2004b).

[92] The recent meeting of the ECOFIN Council on 7 December 2004 expressed support for the European Commission's efforts to facilitate cross-border reorganizations by providing for tax deferral in the case of cross-border mergers.

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