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Martin Gelter

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The Structure of Regulatory Competition in European Corporate Law

MARTIN GELTER^{*}

In its opinions in the cases Centros, Überseering and Inspire Art, the ECJ has begun to open European corporate law for regulatory competition, as it has been discussed in the US for several decades. This article analyzes the structural conditions of competition, on the supply and demand sides of the market for corporate law, and the impact of supranational influence. In doing so, it identifies several factors that have received little attention in the incipient European debate. The supply-side analysis shows that a European Delaware is implausible because of the interdependence of competitive advantages and incentives to compete. On the demand side, an analysis of the effects of differences of financial structures indicates that a race to the bottom is more likely in Europe. The comparatively weak threat of supranational intervention in Europe makes actions and decisionmaking an unlikely factor to affect the decisions of national actors.

Keywords: regulatory competition, corporate law, European Union, Centros case, Überseering case, Inspire Art case

^{*} Universitätsassistent, Wirtschaftsuniversität Wien, Vienna, Austria. Olin Fellow in Law and Economics at Harvard Law School September 2003 to January 2005. Financial support from the Olin Center for Law, Economics and Business at Harvard Law School is gratefully acknowledged. I have published a more descriptive paper for a German-language audience (written mostly in 2003) in (2004) *Zeitschrift für Rechtsvergleichung* 170-186, from which this article has developed. Some arguments have been substantively revised and expanded since then. I would like to thank Thomas Bachner for encouraging me to publish my thoughts also in English, and John Armour, Thomas Haberer, Christian Nowotny, Mathias Siems and Tobias Tröger for comments or discussion in various stages of my work.

A. INTRODUCTION

1. The ECJ opens the door

As foreshadowed by *Centros*¹ in 1999, the ECJ has made it clear in the *Überseering*² decision of 2002 that the real seat theory is incompatible with the principle of freedom of establishment. That theory, which previously dominated the conflict of laws rules in many EU Member States³, was deemed impermissible by that opinion, at the very least in the strict form previously employed in Germany, where legal capacity was denied to foreign corporations that had moved their “real seat” there. Legal capacity thus needs to be assessed under the law of the state of incorporation;⁴ Member States are required to allow companies to “move in” while retaining their legal personality⁵ and, according to some authors, their limited liability.⁶ However, the existing case law, at least explicitly, does yet not prevent the state of incorporation from preventing companies from “moving out” of a particular jurisdiction.⁷

¹ *Centros Ltd v Erhvervs- og Selskabsstyrelsen (Case C-212/97)* [1999] ECR 1459.

² *Überseering BV v Nordic Construction Company Baumanagement GmbH (Case C-208/00)* [2002] ECR 9919.

³ The real seat theory is used in Austria, Belgium, France, Germany, Italy and Luxemburg, while various forms of the incorporation theory dominate in Anglo-Saxon jurisdictions, the Netherlands, Switzerland, Liechtenstein and Scandinavia. For comparative overviews see eg K Baelz and T Baldwin, “The End of the Real Seat Theory (Sitztheorie): the European Court of Justice Decision in Ueberseering of 5 November 2002 and its Impact on German and European Company Law”, (2002) *German Law Journal*, vol 3, no 12, para 9; PJ Omar, “Centros, Ueberseering and Beyond: A European Recipe for Corporate Migration, Part 1” [2004] 15 *ICCLR* 398-400. For a detailed discussion of Dutch, English, Swiss, German, French and Italian law see S Rammeloo, *Corporations in Private International Law* (Oxford, Oxford University Press, 2001) 95-236.

⁴ S Rammeloo, “The Long and Winding Road towards Freedom of Establishment for Legal Persons in Europe” (2003) 10 *Maastricht Journal of European and Comparative Law* 169, 184-6.

⁵ (German) Bundesgerichtshof March 13, 2003, VIII ZR 370/98, (2003) 56 *Der Betrieb* 986; WH Roth, “From Centros to Ueberseering, Free Movement of Companies, Private International Law and Community Law” (2003) 52 *ICLQ* 177, 196.

⁶ Eg Baelz and Baldwin, *supra* n 3, para 22; contra Eva Micheler, 52 *ICLQ* 521, 526 (2003) (pointing out that *Überseering* was not concerned with limited liability); also see T Bachner, “Freedom of Establishment for Companies: A Great Leap Forward” (2003) 62 *CLJ* 47, 49 (“this is the end of the theory of the real seat”).

⁷ Thus, *The Queen and HM Treasury and Commissioners of Inland Revenue ex parte Daily Mail and General Trust PLC (Case C-81/87)* [1989] ECR 5483, remains good law [see eg Bayerisches Obersters Landgericht, February 11, 2004, 3 Z 175/03, (2004) 95 *GmbH-Rundschau* 490; Roth, *supra* n 5, 184; F Woolridge, “Überseering: Freedom of Establishment of Companies Affirmed” (2003) 14 *European Business Law Review* 227, 23-2; Micheler, *supra* n 6, 524]. For a long time, *Daily Mail* had been used as a justification for the real seat theory [eg H Halbhuber, “National Doctrinal Structures and

In the *Inspire Art*⁸ opinion of 2003, the ECJ found a Dutch statute⁹ to be equally incompatible with primary EU law. Dutch law subjected “formally foreign companies”, whose activity was limited primarily to the Netherlands, to special disclosure provisions and a minimum actual capital requirement of €18,000. Violations were sanctioned with stiff personal liability of managers. While founding a corporation in another state to circumvent national requirements is thus considered legitimate by the ECJ, Member States are only entitled to take measures “to prevent individuals from improperly or fraudulently taking advantage of provisions of Community law. Under what exact circumstances that is permitted is not yet entirely clear;¹⁰ in any case, broad-sweeping measures depending solely on the fact that a company is incorporated in another Member State are impermissible.¹¹ Essentially, the ECJ has thus opened the door to regulatory competition in the corporate law of EU and EEA countries.

European Company Law” (2001) 38 *Common Market Law Review* 1385, 1391-5 (characterizing this as a misreading of the case); Micheler, *supra* n 6, 522 (pointing out dicta supporting that construction)].

⁸ *Kamer van Koophandel en Fabrieken voor Amsterdam v Inspire Art Ltd (Case C-167/01)* [2003] ECR 10155.

⁹ Wet op de Formeel Buitenlandse Vennootschappen, Staatsblad van het Koninkrijk der Nederlanden, 1997/697. See KE Sorensen and M Neville, “Corporate Migration in the European Union” (2000) 6 *Columbia Journal of European Law* 181, 187-8; Rammeloo, *supra* n 4, 194 (both suggesting that such laws might be a good solution).

¹⁰ Eg HJ de Kluiver, “Inspiring a New European Company Law” (2004) 1 *European Company and Financial Law Review* 121, 128-31; A Looijestijn-Clearie, “Have the dikes collapsed? Inspire Art a further breakthrough in the freedom of establishment of companies?” (2004) 5 *European Business Organization Law Review* 389, 409-14.

¹¹ Eg N Adensamer and C Bervoets, „Nationaler Gläubigerschutz auf dem Prüfstand“ (2003) 21 *Österreichisches Recht der Wirtschaft* 617, 618; de Kluiver, *supra* n 10, 127; Looijestijn-Clearie, *supra* n 10, 404. Interestingly, the US states of California and New York have statutes on “pseudo-foreign corporations” similar to the Dutch one. See eg WJ Carney, “The Political Economy of Competition for Corporate Charters” (1997) 16 *Journal of Legal Studies* 303, 314-5; S Grundmann, “Wettbewerb der Regelleiter im Europäischen Gesellschaftsrecht – jedes Marktsegment hat seine Struktur” (2001) 30 *Zeitschrift für Unternehmens- und Gesellschaftsrecht* 783, 803; EM Kieninger, *Wettbewerb der Privatordnungen im europäischen Binnenmarkt* (Tübingen, Mohr Siebeck, 2002), 109-12; C Kersting, “Corporate Choice of Law – A Comparison of the United States and European Systems and a Proposal for a European Directive” (2002) 28 *Brooklyn Journal of International Law* 1, 16-37; Drury, *supra* n 25, 16-21.

2. The US model of regulatory competition

Regulatory competition has been discussed in the US for several decades. The cornerstones of this debate are well-known: Some argue that regulatory competition has led to a race to the top (i.e. to optimal or near-optimal law), while others submit that a race to the bottom has been going on. While the first school of thought asserts that corporations need to cater to shareholder interest to attract investment and thus incorporate in a jurisdiction with good law,¹² the second cites failures and inefficiencies of capital markets as reasons for the exploitation of jurisdictional competition in favor of managers.¹³ The empirical evidence is inconclusive: A 2001 study by Robert Daines found that Delaware corporations had a higher shareholder value (measured by Tobin's Q¹⁴) than others.¹⁵ However, a 2004 paper by Guhan Subramanian shows that this effect disappears from 1996 onwards.¹⁶ This probably can be explained by the market for corporate control to a significant degree, which is often considered the single most important issue affecting shareholder value, as it supposedly curbs managerial self-serving behavior. Benefits to shareholders reaped at that front ap-

¹² RK Winter, "State Law, Shareholder Protection, and the Theory of the Corporation" (1977) 6 *Journal of Legal Studies* 251 ; RK Winter, "The 'Race to the Top' Revisited" (1989) 89 *Columbia Law Review* 1526; FH Easterbrook and DR Fischel, *The Economic Structure of Corporate Law* (Cambridge MA, Harvard University Press, 1991) 212-27; R Romano, *The Genius of American Corporate Law* (Washington, AEI Press, 1993). Romano also argues that regulatory competition in Securities Regulation would be equally beneficial. R Romano, "Empowering Investors: A Market Approach to Securities Regulation" (1998) 107 *Yale Law Journal* 2359; R Romano, "The Need for Competition in International Securities Regulation" (2001) 2 *Theoretical Inquiries Into Law* 387; R Romano, *The Advantage of Competitive Federalism for Securities Regulation* (Washington, AEI Press, 2002).

¹³ This view traces its roots back to Justice Brandeis' dissent in *Louis K. Liggett Co. v Lee*, 288 US 517, 559 (1933) and was famously brought forward by WL Cary, "Federalism and Corporate Law: Reflections Upon Delaware" (1974), 83 *Yale Law Journal* 663. It has been reaffirmed with the tools of law and economics by LA Bebchuk, "Federalism and the Corporation: The Desirable Limits on State Competition in Corporate Law" (1992) 105 *Harvard Law Review* 1442.

¹⁴ Tobin's Q is calculated by dividing market value by the replacement value of assets.

¹⁵ R Daines, "Does Delaware law improve firm value?" (2001) 62 *Journal of Financial Economics* 525 (finding an advantage of 2-3% in value). Some argue that this effect might be due to reverse causality, because that better managed corporations are more likely to incorporate in Delaware. LA Bebchuk and A Ferrell, "A New Approach to Takeover Law and Regulatory Competition" (2001) 87 *Virginia Law Review* 111, 137-8; LA Bebchuk, A Cohen and A Ferrell, "Does the Evidence Favor State Competition in Corporate Law" (2002) 90 *California Law Review* 1775, 1786-7 (criticizing Daines' study on grounds of the fluctuations in firm value he finds).

¹⁶ G Subramanian, "The Disappearing Delaware Effect" (2004) 20 *Journal of Law, Economics and Organization* 32.

pear to have been largely eliminated by more recent Delaware case law,¹⁷ which effectively gives the board a “just say no defense” against takeovers and thus replicates¹⁸ the effects of the more effective antitakeover statutes in other US states.¹⁹

The core result of regulatory competition in the US is the supply-side dominance of the state of Delaware, where almost 60% of public corporations are registered.²⁰ Beside that, incorporation patterns show a home-state bias, especially among smaller firms.²¹ This has led some scholars to doubt whether any other state is seriously

¹⁷ After the Delaware Supreme court had permitted the poison pill in *Moran v Household International Inc.*, 500 A 2d 1346 (Del 1985), the crucial issue was when the board has to “pull” the pill or lower other takeover defenses. Originally, the courts employed an arguably rather strict test, resting on the decision whether a defense was reasonable to the threat posed by the takeover [*Unocal Corp v Mesa Petroleum Co.*, 493 A 2d 946 (Del. 1985)]; See LA Bebchuk and A Ferrell, “Federalism and Corporate Law: The Race to Protect Managers from Takeovers” (1999) 99 *Columbia Law Review* 1168, 1185; *City Capital Associates v Interco Inc.*, 551 A 2d 787 (Del. Ch. 1988), rejected by *Paramount Communications, Inc v Time, Inc.*, 571 A 2d 1140 (Del. 1990)]. This test was narrowed down in *Unitrin Inc v American General Corp.*, 651 A 2d 1361 (Del. 1995) to prohibit only “draconian”, i.e. “coercive” and “preclusive” defenses. See eg RJ Gilson, “Unocal Fifteen Years Later” (2000) 26 *Delaware Journal of Corporate Law* 491, 500-1; Subramanian, *supra* n 16, 53.

¹⁸ Delaware’s own antitakeover statute (DGCL § 203) has a reputation of being relatively permissive towards hostile takeovers. See eg M Kahan and EB Rock, “How I learned to stop worrying and love the pill: Adaptive Responses to Takeover Law” (2002) 69 *University of Chicago Law Review* 871, 894; WT Allen, JB Jacobs and LE Strine, “The Great Takeover Debate: A Mediation on Bridging the Conceptual Divide” (2002) 69 *University of Chicago Law Review* 1067, 1068 n.2; see LA Bebchuk, JC Coates and G Subramanian, “The Powerful Antitakeover Force of Staggered Boards: Further Findings and a Reply to Symposium Participants” (2003) 55 *Stanford Law Review* 855, 911-2 (stating that legislation intended to leave the further development to case law). But see G Subramanian, “The Influence of Antitakeover Statutes on Incorporation Choice: Evidence on the „Race” Debate and Antitakeover Overreaching” (2002) 150 *University of Pennsylvania Law Review* 1795 (finding a trend towards incorporations in states with strict takeover statutes, i.e. those beneficial to managerial entrenchment, which stop short only of the most extreme statutes); Bebchuk et al, *supra* n 15, 1818 (arguing that control-share-acquisition statutes and poison-pill-endorsement statutes attract most out-of-state incorporations).

¹⁹ Subramanian, *supra* n 16, 52-5; Bebchuk et al, *supra* n 15, 1803. For overviews on antitakeover statutes see eg WT Allen and R Kraakman, *Commentaries and Cases on the Law of Business Organizations* (New York, Aspen, 2003) 548-57; RC Clark, *Corporate Law* (New York, Aspen, 1986) 568-71; Bebchuk and Ferrell, *supra* n 17; also see R Romano, “Law as a Product: Some Pieces of the Incorporation Puzzle” (1985) 1 *Journal of Law, Economics and Organization* 225, 265 (finding that a significant proportion of reincorporations results from the defense against hostile takeovers).

²⁰ LA Bebchuk and A Hamdani, “Vigorous Race or Leisurely Walk: Reconsidering the Competition over Corporate Charters” (2002) 112 *Yale Law Journal* 553, 568 (finding that in 1999 57.75% were incorporated in Delaware, 59% of the Fortune 500, and 68% corporations which had recently gone public). See Subramanian, *supra* n 18, 1795 (estimating a Herfindahl-Hirschman Index (HHI) of 2662, which corresponds to a market concentration that would usually cause concern to antitrust authorities).

²¹ Bebchuk and Hamdani, *supra* n 20; R Daines, “The Incorporation Choices of IPO Firms” (2002) 77 *New York University Law Review* 1559; See Romano, *supra* n 19, 278 (considering the identification of company and state as an immaterial asset which would be lost in case of a reincorporation in Delaware).

committed to the market for corporate law.²² In any case, there seems to be some agreement that Delaware is able to extract monopoly rents from its “customers” on the demand side of the market.²³

3. Is Europe different?

The European debate, fueled by *Centros* and its progeny, stands only at the beginning. This article, while largely trying to avoid the pitfalls of specific predictions on substantive outcomes in the law, investigates the institutional framework within which competition will operate. I argue that there are significant deviations from the US model which should lead us to expect a different outcome. On the supply side, I ask whether any state will be able to establish itself as a monopolist comparable to Delaware (section B). Even though the answer is a clear no, this does not entirely rule out regulatory competition. The discussion of the demand side in section C is concerned mostly with deviating share ownership and financial patterns, which are likely to require a substantively different corporate law and steer competition into a different direction.²⁴ Section D investigates the influence of actual and potential federalization or supranationalization on the development of competition.

B. SUPPLY SIDE: PERSPECTIVES FOR A EUROPEAN DELAWARE

1. Delaware’s past and Europe’s future

The historical background how Delaware obtained its monopoly position is well known. New Jersey first offered the developing large trusts (such as Standard Oil of Ohio) advantages they could not get in other states, most of all the power to hold

²² M Kahan and E Kamar, “The Myth of State Competition in Corporate Law” (2002) 55 *Stanford Law Review* 679; Bebchuk and Hamdani, *supra* n 20.

²³ Bebchuk and Hamdani, *supra* n 20, 582-3.

²⁴ Needless to say, there are also some obvious factors potentially affecting markets, eg cultural preferences. I address those briefly in section C.1 and take them as an exogenous influence that will most likely reduce the demand for out-of-state incorporations.

shares in other corporations.²⁵ It also invented the franchise tax.²⁶ When Governor Woodrow Wilson sought to become president, he could not uphold this policy against public opinion,²⁷ and New Jersey's Seven Sisters Act of 1913 reversing that policy drove the trusts to Delaware,²⁸ which had previously copied New Jersey corporate law.²⁹ Its neighbor's blunder made Delaware the home of most large American corporations overnight, and it has managed to hold on to that position since then.³⁰

For the European debate, it suffices to point out that Delaware's position was the result of historical accident, which only could happen because of a rapid concentration process in the industrializing late 19th-century US, which brought an important share of the economy first to New Jersey and then to Delaware. New Jersey's and later Delaware's unusual position is crucial for regulatory competition in the US. At present, there is no reason to believe that anything on a comparable scale should happen in Europe, which could grant anyone in the EU or EEA a huge first-mover advantage through a massive migratory wave among large firms; no single issue that is only addressed by the law of one state is likely to become that important.³¹ We shall see that, without the peculiar incentive structure put into place by that great migration, many of the properties of regulatory competition are fundamentally changed,

²⁵ See MJ Roe, "Delaware's Competition" (2003) 117 *Harvard Law Review* 588, 608-10; (discussing Standard Oil of Ohio, which obtained monopolistic power under the control of John D. Rockefeller); R Drury, "A European Look at the American Experience of the Delaware Syndrome", (2005) 5 *JCLS* 1, 3-7.

²⁶ See C Grandy, "New Jersey Chartermongering, 1875-1929" (1989) 49 *Journal of Economic History* 677; K Heine and W Kerber, "European Corporate Laws, Regulatory Competition and Path Dependence" (2002) 13 *European Journal of Law and Economics* 47, 54-5 (viewing the franchise tax as consideration for the permission of trusts).

²⁷ Kahan and Kamar, *supra* n 22, 731; Roe, *supra* n 25, 609-10.

²⁸ Grandy, *supra* n 26, 689; Kahan and Kamar, *supra* n 22; Roe, *supra* n 25, 610.

²⁹ Eg Cary, *supra* n 13, 664; Drury, *supra* n 25, 7-8.

³⁰ Delaware's market share even increased from 35% in 1965 to 40% in 1973 and reached about 50% in 2000. See Subramanian, *supra* n 18, 1804.

³¹ Cf L Enriques, "EC Company Law and the Fears of a European Delaware" (2004) 15 *European Business Law Review* 1259, 1269 (arguing that few "product innovations" in corporate law are available today); TH Tröger, "Choice of Jurisdiction in European Corporate Law: Perspectives on European Corporate Governance" (2005) 6 *European Business Organization Law Review* 3, 43 (speaking of a "historical singularity").

particularly with respect to the issue which states are well-positioned to offer law favored by the competitive process (section 2), which, other than in the US, does not appear to coincide with the question which states have incentives that will require them to do so (section 3).

2. Network externalities and (purportedly) good Delaware law

(a) Delaware

Delaware's competitive advantages are said to result from network externalities, stemming from the use of the Delaware product by a large number of purchasers.³²

The Delaware Chancery Court and Supreme Court largely specialize in corporate law³³ and are noted for the absence of a jury trial³⁴ and their speedy judicial process.³⁵

Specialization – which requires a critical mass of registered corporations – allows for the purported good substantive quality of Delaware law. Whether one considers Delaware's law beneficial to shareholders or not, regulatory competition has led US corporate law away from a regulatory approach.³⁶ Delaware may not usually have been the leading innovator, but it always was a quick adopter of innovations.³⁷ This goes with another network externality, the sheer mass of its case law. One of the arguments for Delaware's lead, besides the judges' good understanding of the needs

³² Cf M Klausner, "Corporations, Corporate Law and Networks of Contracts" (1995) 81 *Virginia Law Review* 757, 772; Bebchuk and Hamdani, *supra* n 20, 586-8.

³³ Romano, *supra* n 12, 39-40; BS Black, "Is Corporate Law Trivial?: A Political and Economic Analysis" (1990) 84 *Northwestern University Law Review* 542, 589-91; Kahan and Kamar, *supra* n 22, 708.

³⁴ Kahan and Kamar, *supra* n 22, 708; Roe, *supra* n 25, 594.

³⁵ Eg Black, *supra* n 33, 590. Sometimes it takes only weeks or months to get the preliminary injunction decided on, which can be crucial in a takeover battle.

³⁶ Winter, *supra* n 12, 254-5; JR Macey and GP Miller, "Toward an Interest-Group Theory of Delaware Corporate Law" (1987) 65 *Texas Law Review* 469, 484-6.

³⁷ Romano, *supra* n 12, 9; cf Cary, *supra* n 13, 668; Romano, *supra* n 19, 240.

of business practice, is predictability, resulting from many decisions having been made in the past.³⁸

(b) The large Member States' edge in substantive law

For an EU or EEA Member State to become a European Delaware, it would have to offer similar advantages. Originally, only a few, but important issues *in legislation* may have given Delaware the decisive edge over New Jersey, but today the case law, which has had time to mature both quantitatively and qualitatively, is its advantage, for which the large number of Delaware corporations provided a sufficient number of disputes. Other states, with a smaller number of corporations, would be virtually unable to catch up, as the number of legal disputes is certain to be much smaller.³⁹ Thus, the development of attractive substantive law usually requires a long-term evolutionary process, which leaves some leeway for trial and error over time.

As a general matter, a developed corporate law should be a competitive advantage. Admittedly, statutory law which is perceived to be attractive could be copied with relative ease, translation problems aside. However, both in common law and civilian jurisdictions, the crucial issue is how that law is put into effect in practice. One should not rashly conclude that common law jurisdictions have an inherent advantage in providing a better developed body of law.⁴⁰ Even without a formal doctrine of *stare decisis*, civilian courts cannot merely apply legal codes without learning from experience and displaying certain patterns of consistency in their interpretation of the law.

³⁸ Romano, *supra* n 12, 39; Romano, *supra* n 19, 250; but see Black, *supra* n 33, 589 (arguing that large states have an equally developed case law or would be able to develop it quickly); E Kamar, "A Regulatory Competition Theory of Indeterminacy in Corporate Law" (1998) 98 *Columbia Law Review* 1908, 1913-23, 1939-40; Bebchuk and Ferrell, *supra* n 17, 1190-1; Bebchuk and Hamdani, *supra* n 20, 601-4 (all arguing that the indeterminacy of Delaware law creates income for the bar).

³⁹ Kahan and Kamar, *supra* n 22, 725-6.

⁴⁰ Cf J Armour, "Who Should Make Corporate Law? EU Legislation versus Regulatory Competition" (Working Paper, May 25, 2005), section 3.b, 21 (arguing that UK judges' deference to precedent may become an advantage for the UK).

In general,⁴¹ and particularly in corporate law⁴², precedent and judge-made law are of considerable practical importance also in continental jurisdictions. A related factor in many civil law jurisdictions is doctrinal work by legal academics, which influences courts to some degree.⁴³

Again, the development of case law and experience with applying statutory rules is a matter of trial, error and evolution. What degree of development and experience can be reached will depend on characteristics of the particular state, the sophistication of its courts and legal academics. Most of all, legal systems that have to deal with a larger number of cases are better positioned to reach a higher level of development more quickly.

Other than just copying a statute, the development of a corporate law system in that sense cannot easily be transplanted. Consider, for example, Austrian jurists working in corporate and commercial law, and Austrian courts deciding in that field, who, as a matter of practice, regularly absorb German case law and scholarship, as the corporate and commercial laws of the two countries are very similar. Issues are often raised much earlier in a larger legal system, whereas certain fact patterns and disputes have not come to pass yet in a smaller one, while remaining important when they finally do. In that, the Austrian corporate lawyer's perspective on German corporate case law and academic writing resembles the approach of the courts of other US states to the ones in Delaware, whose decisions often provide persuasive authority.

⁴¹ On the role of precedent in civil law jurisdictions see eg R David, "Sources of Law", in R David, *International Encyclopedia of Comparative Law, Vol II: The Legal Systems of the World and their Comparison and Unification* (Tübingen, Mohr, 1984), 116-119; M Lasser, "Judicial (Self-)Portraits: Judicial Discourse in the French Legal System, (1995) 104 *Yale Law Journal* 1325-1410; C Baudenbacher, "Some Remarks on the Method of Civil Law", (1999) 34 *Texas International Law Journal* 333, 349-356.

⁴² An example that has gained some international attention is the German *Holz Müller* doctrine. See eg M Löbbe, "Corporate Groups: Competences of the Shareholders' Meeting and Minority Protection – the German Federal Court of Justice's recent *Gelatine* and *Macrotron* Cases Redefine the *Holz Müller* Doctrine", (2004) 5 *German Law Journal* 1057-79.

⁴³ See generally David, *supra* n 41, 143-4.

However, even though transplantation of German doctrines to Austria takes place, Austrian corporate law usually lags behind.

In view of the firmly entrenched and well-developed corporate law traditions in EU Member States, no single among them should be able to provide a better developed case law as a competitive advantage to start with. In particular, the states with the smallest population and total economic output, which should in theory have the best financial incentives to enter into a maximization of revenue from incorporations (as we shall see in section 3), are in the worst starting position to develop a competitive advantage in case law, while larger Member states such as the UK, Germany, or France should be ready to leap ahead. Without catching up at the same time also in the number of firms, a smaller state should normally not be able to capture a market niche by providing highly developed case law.

Conceivably, the overall assessment of the persons deciding about the state of incorporation of the particular case law may also be negative, in which case a judicial clean slate would actually be an advantage. An example could be the German doctrine of equity substitution (*Eigenkapitalersatz*), which provides for the subordination of loans given by shareholder to companies in times of crisis in order to protect creditors. It was originally developed by the courts, but is today often criticized as over-regulation.⁴⁴ When New Jersey and Delaware fought for predominance in US corporate law in the early 20th century, the case laws of US states were not quite as devel-

⁴⁴ W Meilicke, "Die Niederlassungsfreiheit nach 'Überseering'" (2003) 94 *GmbH-Rundschau* 793, 808-9 (using *Überseering* as reason to argue for the abolition of the doctrine). By contrast, both Austria [Bundesgesetz über Eigenkapital ersetzende Gesellschafterleistungen (Eigenkapitalersatz-Gesetz – EKEG), art I Gesellschafts- und Insolvenzrechtsänderungsgesetz 2003 – GIRÄG 2003, BGBl I 2003/92] and Italy (Codice Civile, art 2467, 2497quinquies, introduced by the law of January 17, 2003, Gazzetta Ufficiale no 17, Supplemento Ordinario) have recently enacted statutes on this issue. For a formal economic analysis of subordination and a brief comparative overview see M Gelter, "The Subordination of Shareholder Loans in Bankruptcy", Harvard John M. Olin Center for Law, Economics, and Business Fellows' Discussion Paper Series 4/2005, <http://www.law.harvard.edu/programs/olin_center/fellows_papers/4_Gelter.php>.

oped yet, and closer to being a clean slate than today's European legal traditions and corporate governance structures. However, after the mass migration of firms from New Jersey, Delaware had the critical amount of large firms which allowed it to develop the case law and experience in dealing with issues of corporate law, which is today seen as one of its core advantages. By contrast, none of Europe's diverse corporate governance traditions appears to be endowed with both a similar number of firms and a relatively clean slate allowing it to begin developing a system of corporate law favored by the market. It is more likely that a large country (which starts out with a lot of firms) could have some success if the law it already has is considered favorable by those decide on where to incorporate.

(c) Will legal procedure become an important factor in competition?

A similar point can also be made with respect to legal procedure. Within Europe, there are certainly considerable differences between the different national court systems, regarding both expertise and speed in decisionmaking. Appeals and preliminary rulings of the ECJ may delay procedures for many years. However, the presence of juries as a factor of uncertainty in corporate law, as it may sometimes be present in the US outside Delaware, is unimportant in Europe. It also seems unlikely that the specialization of judges will give any state a competitive edge. Here too, the advantages should normally be on the side of larger Member States, where a larger number of cases will facilitate specialization.

Both advantages in substantive law and in the efficiency of the judicial process can only fully come to bear when there is little doubt in which court a corporate dispute will be litigated. Even in the US, derivative suits are not always brought in the state of

incorporation.⁴⁵ Most of all, diversity jurisdiction allows disputes between citizens of different states to be brought in the federal courts,⁴⁶ which will then adjudicate on the basis of the state law applicable in the particular case.⁴⁷ Still, where the case for venue in another state could be made, suits are typically brought in Delaware itself.⁴⁸ The reasons usually given for this are the known advantages of the Delaware courts, but also the expectation of attorneys to receive contingency fees.⁴⁹ Furthermore, according to an explicit provision of Delaware law, every nonresident person accepting a director's position in a Delaware corporation is deemed to have consented to the Delaware courts' jurisdiction.⁵⁰

Jurisdiction might have a different impact in Europe. Under art. 60 of the "Brussels-I Regulation" on jurisdiction⁵¹, a legal person is domiciled and hence may be sued (art. 2) in the Member State where it has (a) its statutory seat, (b) its central administration or (c) its principal place of business. Thus, corporations may, in extreme cases, be

⁴⁵ Macey and Miller, *supra* n 36, 494-5.

⁴⁶ US Constitution art III, § 2; see eg AT von Mehren, *Law in the US: A general and comparative view* (Deventer, Kluwer, 1988) 41-50; S Grissom, "Diversity Jurisdiction: An Open Dialogue in Dual Sovereignty" (2001) 24 *Hamline Law Review* 372; DL Bassett, "The Hidden Bias in Diversity Jurisdiction" (2003) 81 *Washington University Law Quarterly* 119.

⁴⁷ *Erie RR v Tompkins*, 304 US 64 (1938) (finding that state law applies). According to the internal affairs doctrine, the law of the state of incorporation applies to disputes within the company (including those between shareholders and directors). Eg Restatement (Second) of Conflict of Laws, § 302; *First National City Bank v Banco Para el Comercio Exterior de Cuba*, 462 US 611, 621 (1983); cf *Kamen v Kemper Financial Services, Inc.*, 500 US 90, 106 (1991); see Macey and Miller, *supra* n 36, 495; Carney, *supra* n 11, 313; Kersting, *supra* n 11, 2-11; Kieninger, *supra* n 11, 107; S Lombardo, "Conflict of Law Rules in Company Law after Überseering: An Economic and Comparative Analysis of the Allocation of Policy Competence in the European Union (2003) 4 *European Business Organization Law Review* 301, 312-3.

⁴⁸ Macey and Miller, *supra* n 36, 496; cf Romano, *supra* n 12, 41.

⁴⁹ Macey and Miller, *supra* n 36, 497.

⁵⁰ 10 Delaware Code, § 3114.

⁵¹ Regulation 44/2001 EC [2001] OJ L 12/1. Generally, the regulation applies only to "civil or commercial matters" (art 1(1)). Thus, it may not apply to disputes for company registers. In a different context, that ECJ found that German and Austrian courts were acting in a non-judicial function when acting in their function as registers. *HSB Wohnbau (Case C-86/00)* [2001] ECR 5353; *Lutz GmbH and Others (Case C-182/00)* [2002] ECR 00547 (ECJ dismissing requests for preliminary opinions). Cf G Eckert, "Internationale Zuständigkeit nach der EuGVVO bei Kapitalgesellschaften" (2003) 14 *ecolex* 76, 78; R Hübstege, "Art 60 EuGVVO", in H Thomas and H Putzo (eds), *Zivilprozessordnung mit Gerichtsverfassungsgesetz, den Einführungsgesetzen und europarechtlichen Vorschriften (EuGVVO, EheVO, ZustellungsVO, ZustDG, AVAG)* (München, Beck, 25th ed. 2003), para 11.

sued in either of three states.⁵² However, art. 22(2) provides an exception to this rule, according to which

“in proceedings which have as their object the validity of the constitution, the nullity or the dissolution of companies or other legal persons or associations of natural or legal persons, or of the validity of the decisions of their organs, the courts of the Member State in which the company, legal person or association has its seat“

have exclusive jurisdiction. “In order to determine the seat”, the regulation points to the respective rules of private international law. Since the regulation does not purport to harmonize that field,⁵³ it is by no means clear that this will always be the state of incorporation. Art. 22 also applies to lawsuits challenging the legality of shareholder decisions,⁵⁴ which includes, for example, the German *Anfechtungsklage* (suit challenging shareholder decisions for their validity),⁵⁵ which is frequently sought as a battleground for corporate law disputes by minority shareholders. In the case of out-of-state companies, such proceedings may not necessarily be held in the state of incorporation. By contrast, jurisdiction over suits against directors or shareholders is determined by those persons’ own domicile (arts. 2),⁵⁶ which will often not be the state of incorporation. As a result, it seems likely that courts beside the ones of the state of

⁵² Kersting, *supra* n 11, 47.

⁵³ Cf Roth, *supra* n 5, 191 (criticizing that this reference to private international law foils the purpose of harmonization); Rammeloo, *supra* n 3, 39 (“the everlasting trench war between the ‘incorporation’ theory and the ‘real seat’ theory reappears at the level of international competence”). The ECJ in *Überseering* does not explicitly require EU Member States to have specific conflict of laws rules, but only to recognize legal capacity. Even UK private international law does not exclusively rely on incorporation: According to (2001) SI 2001/3929, schedule 1, para 10, a company has its seat in the UK if “it was incorporated or formed under the law of a part of the United Kingdom“, or if “its central management and control is exercised in the United Kingdom“. See L Collins, A Briggs, J Hill, JD McLean and CG Morse, *Dicey and Morris on the Conflict of Laws* (London, Sweet & Maxwell, 13th ed. 4th Supp. 2004), §§ 11-060, S11-346.

⁵⁴ J Kropholler, *Europäisches Zivilprozeßrecht* (Heidelberg, Verlag Recht und Wirtschaft, 7th ed., 2002), art 22, para 39; Hüßtege, *supra* n 51, para 11.

⁵⁵ German Aktiengesetz §§ 243-55

⁵⁶ Kropholler, *supra* n 54, art 22, para 40; Eckert, *supra* n 51, 80.

incorporation will have to decide on the interpretation of corporate law in more cases than in the US.

At present, the courts of no particular Member State seem to have a clear competitive advantage.⁵⁷ The interests of the parties involved can vary considerably; for example, small shareholders might be interested in bringing suit in their own home state, if the company is also active there, instead of relying on the courts of the state of incorporation; lawsuits out of state may result in considerable costs.⁵⁸ Moreover, one could imagine that (in particular large) corporations will attempt to avoid uncertainty with respect to jurisdiction by including arbitration clauses in the corporate charter,⁵⁹ as far as permitted by the applicable national law.⁶⁰

Still, it is theoretically conceivable for a Member State to combine the supply of a favorable corporate law with the advantage of a speedy trial. Again, the better starting position should lie with larger Member States, which should be able to provide network externalities for their already large number of corporations. For other states, any attempts to invest in the creation of network externalities may be deterred by their costs and risks, as it is by no means certain that a high market share will be achieved.⁶¹ If uncertainties in jurisdiction persist, and even more so if a widespread practice of arbitration develops, advantages in legal procedure are unlikely to be-

⁵⁷ Enriques, *supra* n 31, 1271 (stating that not even the UK has judges „even faintly as specialized and reliable“); but see Armour, *supra* n 40, section 3.b., 21 (arguing that the UK is the only EU Member State with a specialist corporate law court).

⁵⁸ S Maul and C Schmidt, "Inspire Art – Quo vadis Sitztheorie?" (2003) 58 *Betriebs-Berater* 2297, 2299; Tröger, *supra* n 31, 24. By contrast, the state of incorporation will normally be able to provide a faster decision, as its own courts will be more familiar with its law.

⁵⁹ See C Kirchner, RW Painter and WA Kaal, "Regulatory Competition in EU Corporate Law After Inspire Art: Unbundling Delaware's Product for Europe", U. Illinois Law and Economics Research Paper No LE04-001 (December 2004) <<http://ssrn.com/abstract=617681>>, 40-9 (arguing that it would be beneficial to "unbundle" procedural law from corporate law).

⁶⁰ For example, arbitration is considered problematic for lawsuits challenging the validity of shareholder decisions in German law. See (German) Bundesgerichtshof March 29, 1996, II ZR 124/95, (1997) 132 *Entscheidungen des Bundesgerichtshofes in Zivilsachen (BGHZ)* 278-290.

⁶¹ Cf Bebchuk and Hamdani, *supra* n 20, 588; Kirchner et al, *supra* n 59, 21-22 (discussing recoupment of investments in attractive corporate law).

come significant factors in regulatory competition that would necessarily be “bundled” with attractive substantive law.

3. Supply-side economic incentives

(a) *Motivation for competition*

In the US debate, the motivation why decisionmakers should be interested in a large number of incorporations, instead of promoting their own economic policy, is quite clear. American literature usually states two factors which make a large number of incorporations seem desirable for a state, those being fees, most of all *franchise tax*, and business opportunities for the local bar. The incentives created by these are a prerequisite of regulatory competition and thus of a race in any direction.

(b) *Hypothetical European franchise taxes*

Delaware’s franchise tax⁶² makes up, in conjunction with incorporation fees, between 15% and 20% of the state budget.⁶³ It is usually considered the main economic incentive, making the state almost totally dependent on the incorporation business and thus on the advantages it offers. At the same time, Delaware is the only state imposing a franchise tax of more than a nominal amount and receiving significant total revenue from it,⁶⁴ both of which is the result of its de-facto monopoly.⁶⁵ The reason

⁶² The tax is collected annually, with the amount depending on the number of authorized shares, corporate assets and authorized capital. On the calculation of the tax base see 8 Delaware Code § 503.

⁶³ Roe, *supra* n 25, 594; Drury, *supra* n 25, 9. For a detailed overview on the amount of tax revenue collected since 1960, see Romano, *supra* n 12, 7-8.

⁶⁴ The annual amount ranges from \$ 35 to \$ 165.000.

⁶⁵ In the rest of the US, 45 states only have either a low fee, which is independent from the company’s size, a tax depending on the amount of the firm’s business activity in the state or both, including those states which are by some considered Delaware’s main competitors. Kahan and Kamar, *supra* n 22, 687-93; cf Bechuk and Hamdani, *supra* n 20, 576-7. Usually, an incorporation in Delaware is thus considerably more expensive than in the home state (Romano, *supra* n 19, 257).

why Delaware's incentive structure works is its small size and insignificant economic power.⁶⁶ Naturally, this gives corporate lobbyists an edge over other interest groups. By contrast, in Europe a franchise tax would run afoul of the Directive on Indirect Taxes on the Raising of Capital.⁶⁷ It allows the Member State to impose a tax on the raising of capital of companies whose effective centre of management is located on its territory (art 2). Art 10(c) prohibits taxes and charges "in respect of registration or any other formality required before the commencement of business to which a company, firm, association or legal person operating for profit may be subject by reason of its legal form." According to the ECJ, this prohibition also covers fees which are imposed on an annual basis.⁶⁸ Income from corporate tax cannot provide an equivalent incentive either, as tax treaties normally provide for taxation of business profits in the state where the enterprise has a permanent establishment.⁶⁹ Furthermore, residence within the meaning of tax treaties is normally determined by the place of effective management.⁷⁰

One should not rush into the conclusion that a legislative removal of the franchise tax by European law would create a strong incentive for EU Member States to compete

⁶⁶ Cf Romano, *supra* n 19, 239 (finding a correlation between the speed of adopting new corporate law innovations and franchise tax as a percentage of the state's total tax revenue). *But see* Kahan and Kamar, *supra* n 22, 700 n 64.

⁶⁷ Directive 69/335 EEC [1969] OJ L249/25; cf H Merkt, "Das Europäische Gesellschaftsrecht und die Idee des „Wettbewerbs der Gesetzgeber“ (1995) 59 *Rebels Zeitschrift für ausländisches und internationales Privatrecht* 545, 565 (pointing out that neither Germany, the UK nor the Netherlands impose such taxes).

⁶⁸ *Ponente Carni SpA and Cispadana Costruzioni SpA v Amministrazione delle Finanze dello Stato* (Cases C-71/91 and C-179/91) [1993] ECR 1915; *Fantask A/S ea v Industriministeriet (Erhvervministeriet)* (Case C-188/95) [1997] ECR 6783. Art 12 of the directive lists permissible exceptions.

⁶⁹ Cf OECD Model Convention with Respect to Taxes on Income and on Capital, art 7; cf BR Cheffins, *Company Law: Theory, Structure and Operation* (Oxford, Oxford University Press 1997), 435-6. (1997) (arguing that tax revenue would not create a significant incentive in the UK unless companies also physically relocate there); Tröger, *supra* n 31, 16 (speaking of an "unwarranted concern" that incorporation choices could be affected by corporate tax).

⁷⁰ OECD Model Convention with Respect to Taxes on Income and on Capital, art 4(3); cf Kieninger, *supra* n 11, 185; JC Dammann, "A New Approach to Corporate Choice of Law" (2005) 38 *Vanderbilt Journal of Transnational Law* 51, 71-2.

for charters.⁷¹ Delaware only receives more than nominal revenues from franchise tax because of its preexisting monopoly position and advantages. Any other state would risk a loss of many firms by imposing a large fee.⁷² By contrast, no single EU Member State has a remotely comparable monopolistic position or competitive advantage. Logically, such a position is necessary to create a sufficient incentive to create a corporate law suited to the needs of the target group in the first place, most of all to overcome political resistance.⁷³ Without the incentive, there is no monopoly rent; without the monopoly, there is little incentive, and the chances of overcoming by a large one-time investment are small and remote. Hence, if no historic accident – as it came to pass in Delaware – brings a European state into a similar position, budgetary incentives for the creation of a European Delaware are absent. If any state should try to create them by imposing similarly high franchise taxes, this would be very detrimental to attracting incorporations and would thus destroy any competitive advantage. Even if the Directive on Taxes on the Raising of Capital were repealed, a similar incentive effect would remain highly unlikely.

(c) *Advisory business*

The incorporation of a large number of firms also creates a lot of income potential for Delaware's small, but influential bar.⁷⁴ Advisory activity related to incorporations reportedly accounts for about \$167 million of additional income.⁷⁵ The close personal association between members of the legislature, the judiciary and the bar is said to

⁷¹ Contra JC Dammann, "Freedom of Choice in European Corporate Law" (2004) 29 *Yale Journal of International Law* 477, 521, 524-33.

⁷² Cf Tröger, *supra* n 31, 19.

⁷³ Cf Kahan and Kamar, *supra* n 22, 728-35. (discussing political resistance in the American context); but see Grundmann, *supra* n 11, 795-6. (discussing Europe and expecting incentives already because of minimal tax effects and other factors such as prestige; however, one could counter this argument by pointing out that in any European country, political resistance is likely to be much greater than in Delaware).

⁷⁴ Cf Macey and Miller, *supra* n 36, 486-7.

⁷⁵ Kahan and Kamar, *supra* n 22, 697.

create a strong alignment of interests among decisionmakers within the state;⁷⁶ other than larger states with significant industry, Delaware lacks local interest groups such as unions or companies which are important employers,⁷⁷ which could push policy-making into another direction. On top of this, Delaware is not home to many shareholders, for which reason some scholars argue that voter preferences do not force legislators to implement a shareholder-friendly corporate law.⁷⁸ The maintenance of its current line of policy thus seems assured. Even if legislators and judges do not reap the full benefits accruing to the state and its bar,⁷⁹ legislators are subject to pressures from lobbies, and judges may (at least to some degree) be kept in line by the threat of statutory regulation limiting their freedom of choice in adjudication.⁸⁰

It has been suggested that professional organizations of lawyers and accountants (the latter in view of the requirement of UK companies to conform to UK GAAP in their financial statements)⁸¹ or lawyers also in other European countries⁸² might lobby for making the respective company law attractive to foreign incorporators. This kind of economic incentive seems more plausible than a hypothetical franchise tax. However, the relative economic importance of the Delaware corporate law is disproportionately large. Still, it is rather small if put into a broader perspective: the total amount of additional revenue for lawyers in that state does not even reach the gross revenue of a single large New York law firm.⁸³ Admittedly, Delaware firms face com-

⁷⁶ This was noted already by Cary, *supra* n 13, 690-2; *but see* Macey and Miller, *supra* n 36, 492-4. (pointing out revenue by investment bankers and non-Delaware lawyers).

⁷⁷ Roe, *supra* n 25, 594.

⁷⁸ Bebchuk, *supra* n 13, 1452.

⁷⁹ Easterbrook and Fischel, *supra* n 12, 217.

⁸⁰ Black, *supra* n 33, 584. The case of *Smith v van Gorkom*, 488 A 2d 858 (Del 1985) is particularly notable, as – which is an unusual outcome in Delaware – directors were ordered to pay damages in spite of the business judgment rule (Allen and Kraakman, *supra* n 19, 254). A legislative change followed promptly, allowing companies to opt out of a judicial review of duty of care [DGCL § 102(b)(7)].

⁸¹ Cheffins, *supra* n 69, 437-8; Armour, *supra* n 40, section 3.c, 30.

⁸² Dammann, *supra* n 71, 522-3.

⁸³ Kahan and Kamar, *supra* n 22, 697-8.

petition from national law firms,⁸⁴ while legal education and languages still provide for a strong separation of European legal markets,⁸⁵ which may make a large number of incorporations attractive to the respective bar associations. However, as with respect to franchise taxes, for such incentives to make a really large impact that is sure to surpass the interests of other groups in most European states, especially larger ones, a Delaware-style monopoly position will probably be necessary.⁸⁶ For a business location such as the UK, even this is not plausible. Although the possibility that it will become UK policy to encourage incorporations of foreign businesses cannot be ruled out,⁸⁷ the UK will thus lack the economic incentives to be as responsive to the interests of the groups deciding on incorporations as Delaware is.⁸⁸

4. Small states and microstates vs the UK

Which state could become Europe's preferred site for incorporations in the long run? In spite of all these considerations, at the moment one might actually think that English Private Limited Companies were often preferred to companies in other states, such as the German *Gesellschaft mit beschränkter Haftung* (GmbH). In addition to the fact that the ECJ's opinions in *Centros* and *Inspire Art* arose from disputes over companies incorporated in England and Wales, there are reports about sharp increases in the numbers of English companies being set up with the purpose of doing

⁸⁴ Daines, *supra* n 21, 1584-6; Enriques, *supra* n 31, 1264.

⁸⁵ But see Easterbrook and Fischel, *supra* n 12, 217 n.8 (pointing out that out-of-state lawyers are permitted to represent Delaware corporations and to take residence and practice there). In Europe, it seems equally likely that the economic incentive to create a source of income for the local bar will decrease with an increasing transnational integration of law firms.

⁸⁶ Cf Kahan and Kamar, *supra* n 22, 698 (estimating additional revenue to lawyers from incorporations in US states other than Delaware).

⁸⁷ S Deakin, "Regulatory Competition versus Harmonization in European Company Law", in DC Esty and D Geradin, *Regulatory competition and economic integration: comparative perspectives* (Oxford, Oxford University Press, 2001), 190, 205.

⁸⁸ Cf Armour, *supra* n 40, section 3.c, 30 (suggesting that London law firms may become an influential interest group in the development of UK corporate law).

business in Germany.⁸⁹ Also, companies formed in the UK have been known to gain popularity in the Netherlands.⁹⁰

One reason which is often cited for the attractiveness of the UK is the lack of a minimum legal capital requirement for private limited companies,⁹¹ since the Second EU Directive⁹² does not apply to this type of corporation.⁹³ The British approach can be described as „lax” or „liberal” (depending on the perspective)⁹⁴, and UK courts enjoy a high reputation.⁹⁵ However, with minimum capital requirements and formalities being subject to a discussion on the European level and are undergoing reform in various Member States,⁹⁶ those factors alone probably will not create permanent competitive advantages for the UK.⁹⁷

One of the cornerstones of the American debate is the small size and economic power of Delaware – and the lack of opposed interest groups resulting from this, which are seen an essential requirement for the strength of economic incentives to provide corporate law tailored to the ”needs of the market”.⁹⁸ It seems reasonable to

⁸⁹ See H Hirte, „Wettbewerb der Rechtsordnungen nach „Inspire Art“: Auch das Beurkundungserfordernis für GmbH-Anteilsübertragungen steht zur Disposition“ (2003) 94 *GmbH-Rundschau* R 421; J Kleinert and P Probst, "Endgültiges Aus für Sonderanknüpfungen bei (Schein-)Auslandsgesellschaften“ (2003) 56 *Der Betrieb* 2217, 2218 n.10; cf Kieninger, *supra* n 11, 172; Halbhuber, *supra* n 14, 1403 (considering England a “candidate for a European Delaware”).

⁹⁰ Looijestijn-Clearie, *supra* n 10, 397; De Kluiver, *supra* n 10, 122-124 (discussing Dutch companies moving into UK law).

⁹¹ See eg P Kindler, "Auf dem Weg zur Europäischen Briefkastengesellschaft?“ (2003) 56 *Neue Juristische Wochenschrift* 1073, 1078 (2003).

⁹² Second Company Law Directive 77/91 EEC [1977] OJ L26/1.

⁹³ Second Directive, art 1.

⁹⁴ Cf Cheffins, *supra* n 69, 440-3; Micheler, *supra* n 6, 529; Armour, *supra* n 40, section 3.b, 19.

⁹⁵ JA McCahery and EP Vermeulen, “Limited Partnership Reform in the United Kingdom: A Competitive Venture Capital Oriented Business Form” TILEC Discussion Paper DP 2004-024 (2004), 20.

⁹⁶ For example, France recently reduced minimum capital to 1 € in the *Société à Responsabilité Limitée (SARL)* and has considerably deregulated the process of setting up a company. See Loi n° 2003-721 du 1. 8. 2003 pour l’initiative économique, Journal officiel n° 179 du 5. 8. 2003, 13449, art 1. Similar legislation has been introduced in Spain. See EM Kieninger, “The Legal Framework of Regulatory Competition Based on Company Mobility: EU and US Compared” [2004] 6 *German Law Journal* 741, 768. The German Ministry of Justice has recently released a proposal to reduce minimum capital for German GmbHs from € 25,000 to € 10,000. *Entwurf eines Gesetzes zur Neuregelung des Mindestkapitals der GmbH (MindestkapG)*, at <<http://www.bmj.de/media/archive/908.pdf>>, accessed May 28, 2005.

⁹⁷ Armour, *supra* n 40, section 3.c, 29.

⁹⁸ See eg Bebchuk, *supra* n 13, 1452.

assume that lawmakers generally have an incentive to increase franchise tax revenues if it helps to secure their political success,⁹⁹ which will be diminished if it is fairly unimportant relative to the revenue of other taxes and to the influence of other groups with a stake in corporate law. In a country such as UK, which is itself an important business location, it is safe to assume that the impact of franchise tax revenues on reelection prospects would be minute.¹⁰⁰

However, other states could step in. Just comparing population size,¹⁰¹ Delaware is larger than the founding EU Member State of Luxembourg and the new members Malta and Cyprus. A larger number of small EU states compares in terms of GDP. Moreover, as the Freedom of Establishment also applies within the European Economic Area (EEA),¹⁰² the smaller nations of Iceland and Liechtenstein enter the scene. In principle, it is thus easy to find eligible candidates.¹⁰³

One important objection is that sovereign states in Europe retain broader authority over taxes than US states. The total tax revenue of a sovereign European nation is larger than in a US state of comparable population. Even for Luxembourg to obtain the same proportion of tax revenue from incorporation business (which it cannot because of the prohibition), it would have to exceed Delaware's revenue by a factor of three in absolute numbers.¹⁰⁴ The same marginal tax revenue should thus be of much smaller overall importance when it is weighed against other policy concerns.

⁹⁹ But see G Hadfield and E Talley, "On Public versus Private Provision of Corporate Law", USC CLEO Research Paper No. C04-13 (2004), <http://ssrn.com/abstract=570641>, 11-15 (assuming that legislators' private benefits decrease after a certain point).

¹⁰⁰ Also see D Charny, "Competition among Jurisdictions in Formulating Corporate Law Rules: An American Perspective on the „Race to the Bottom” in the European Communities" (1991) 32 *Harvard Journal of International Law* 423, 447 (not seeing a danger of a race to the bottom in larger EU member states); Kieninger, *supra* n 96, 758-9.

¹⁰¹ According to the census of 2000, Delaware has a population of 783,600; see US Census Bureau, http://factfinder.census.gov/bf/?lang=en_vt_name=DEC_2000_PL_U_QTPL_geo_id=04000US10.html (visited Mai 9, 2003).

¹⁰² EEA Treaty, artt 31 and 34.

¹⁰³ Also see McCahery and Vermeulen, *supra* n 95, 22.

¹⁰⁴ Kieninger, *supra* n 3, 191.

Eva-Maria Kieninger has pointed out that e.g. Liechtenstein, as an EEA member, is not subject to the Directive on Indirect Taxes on the Raising of Capital¹⁰⁵, and that it in fact imposes a special tax of 0.1% of net assets (or a minimum of 1,000 Swiss Franks) on legal entities registered in the principality.¹⁰⁶ Between 1995 and 1998, revenues from that tax amounted to 15-20% of total tax revenue.¹⁰⁷ Thus, if Liechtenstein actively promotes its qualities as a possible site of incorporation for public companies, it might in theory become the state closest to the competitive structure of Delaware.¹⁰⁸ However, Liechtenstein's current advantage seems to be largely based on its character as a tax haven, while no particular advantages in corporate law are visible.¹⁰⁹ Furthermore, the proportion of total tax revenue has decreased significantly since 1985.¹¹⁰ The prospects of a "Liechtenstein effect" are thus still uncertain.

5. Conclusion

The analysis of the supply side in the European market should lead us to the conclusion that the likelihood of a European Delaware is very small. Even assuming away the EU law prohibition of a franchise tax, significant incentives for any state to cater to the market are unlikely to develop, as possible advantages remain small relative to total tax revenue and thus too small to overcome countervailing political interests. Moreover, in order to benefit from incorporations, a state would have to establish a quasi monopolistic position in the market. The reason why Delaware could obtain such a position is found in the economic history of the US, which is unlikely to repeat in Europe.

¹⁰⁵ EEA Treaty, art 40, annex XII; cf Kieninger, *supra* n 11, 188; Kieninger, *supra* n 96, 754-5.

¹⁰⁶ Gesetz über die Landes- und Gemeindesteuern (Steuergesetz) vom 30.1.1961, LGBl 1961/7, art 84.

¹⁰⁷ Kieninger, *supra* n 11, 187.

¹⁰⁸ But see Tröger, *supra* n 31, 21 n.63.

¹⁰⁹ *Ibid* at 69.

¹¹⁰ Kieninger, *supra* n 11, 187 (showing a decrease from 26.6% in 1985 to 15.4% in 1998).

C. THE DEMAND SIDE: THE DEVELOPING PRODUCT AND ITS PURCHASERS

1. Impediments to market development

Not only supply, but also the demand side of the market for corporate law in Europe differs markedly from the one in the US. The most obvious differences are language barriers and a lack of familiarity of members of the legal profession with the law of other Member States;¹¹¹ another one is the requirement to comply with accounting standards of the state of incorporation. English-speaking jurisdictions may have an edge because their language is widely understood, making their law more easily accessible;¹¹² however, one could also imagine¹¹³ the development of various submarkets of states sharing the same language and related legal traditions, such as German-speaking or French-speaking countries. Still, both the cost of decisionmakers to inform themselves about foreign law will often exceed the expected value of the advantages of an out-of-state incorporation; decisionmakers might decide to remain „rationally ignorant“.¹¹³ Competition might also be impeded by a widespread sentiment of suspicion about „pseudo-foreign“ corporations, which could result in additional risk penalties when taking out debt.

Another factor could be differences in legal traditions. One might expect an aspiring European Delaware to adopt the *Delaware General Corporation Law* (DGCL), which could be seen as the best available law (at least in terms of guaranteeing incorporations), having successfully undergone the test of regulatory competition. In theory, it could be enacted by European states as far as allowed by European directives.

¹¹¹ Heine and Kerber, *supra* n 26, 62 (speaking of sunk costs of human capital eg of lawyers who invested in expertise in their own law); Kirchner et al, *supra* n 59, 13 (discussing costs of handling foreign law); Enriques, *supra* n 31, 1264. On cultural and language barriers see Kieninger, *supra* n 11, 171-2; M Siems, „Convergence, competition, Centros and conflicts of law: European company law in the 21st century“ (2002), 27 *European Law Review* 47, 54; Dammann, *supra* n 71, 492-3; also see Bachner, *supra* n 6, 49; Maul and Schmidt, *supra* n 58, 2298-9.

¹¹² Kirchner et al, *supra* n 59, 23; McCahery and Vermeulen, *supra* n 95, 20.

¹¹³ See generally GJ Stigler, „The Economics of Information“ (1961) 69 *Journal of Political Economy* 213.

However, the DGCL, as a common law statute, is not designed as a comprehensive code, but leaves core issues such as fiduciary duties largely to the courts. Certain mechanisms of shareholder protection may therefore be hard to transplant. This supply-side problem aside, even the DGCL may be less well-adapted to the demand it would meet in Europe, given that economic, legal and cultural circumstances differ from the ones in the US. The most efficient law for Europe or for individual countries may require different answers.

Exogenous cultural and linguistic influences, which do not apply in the US regulatory debate, are likely to reduce demand for out-of-state corporate law in Europe. In the rest of section C, I will look at two crucial differences which have received little attention, but may imply markedly different results of competition in Europe than in the US. First, the European discussion centers on different types of companies. Second, different groups of persons are likely to appear as decisionmakers on the demand side of the market. As shall be seen, we should expect a smaller demand for out-of-state charters, a more fragmented market, and probably a higher likelihood of a race (or “leisurely walk”) to the bottom.

2. Competition for incorporations of different types of firms

(a) Regulatory competition and newly founded private corporations

While the US discussion is focused on large public corporations, in Europe, the market for corporate law has almost exclusively been a concern of privately held, newly founded corporations (if one considers the reports on increasing numbers of incorporations in the UK with the purpose of doing business elsewhere¹¹⁴ and the reported

¹¹⁴ Hirte, *supra* n 89, R 421.

cases of the ECJ and national courts¹¹⁵ to be representative). So far, mainly the founders of new firms have been interested in making use of the law of other EU Member States.¹¹⁶

(b) High, but decreasing costs of corporate law arbitrage for large firms

Even though the ECJ has already eliminated major impediments to regulatory competition, and even though a shift in actual business activity may often be effectuated by creating a branch office,¹¹⁷ reincorporation into another law is still wrought with difficulties. While US corporate laws typically include statutes on reincorporations¹¹⁸ and cross-border mergers,¹¹⁹ the corporate laws of countries traditionally following the real seat theory usually do not have such provisions and sometimes even interpret such decisions by shareholders as resolutions to liquidate.¹²⁰ The European commission tried to remedy this with its 1997 proposal for a Directive on the Transfer of a Company's Seat¹²¹, which, however, presumed an identity of statutory and real seat and has now been made redundant by the ECJ's decisions.¹²²

Still, lawyers often manage to devise complex and costly transactions to circumvent legal barriers.¹²³ In practice, cross-border mergers seem to have become a practical

¹¹⁵ Besides the ECJ cases cited in section A.1, see eg Oberster Gerichtshof (Austrian Supreme Court), July 15, 1999, 6 Ob 123/99b and 6 Ob 124/99z, (1999) 17 *Österreichisches Recht der Wirtschaft* 719 (1999); Oberlandesgericht Zweibrücken, March 26, 2003, 3 W 21/03 (2003) 58 *Betriebs-Berater* 864.

¹¹⁶ Cf Kirchner et al, *supra* n 59, 22-23.

¹¹⁷ M Straube, "Was bleibt von der '14. Gesellschaftsrechtlichen Richtlinie'?" in S Kalss, C Nowotny and M Schauer (eds), *Festschrift Peter Doralt zum 65. Geburtstag* (Vienna, Manz, 2004) 637, 644.

¹¹⁸ Eg DGCL § 390.

¹¹⁹ DGCL §§ 252, 256, 258.

¹²⁰ For a European overview, see MM Siems, "The European Directive on Cross-Border Mergers: An International Model?" (2005) *Columbia Journal of European Law* (Forthcoming), section II; also see Sorensen and Neville, *supra* n 9, 191-2; Kieninger, *supra* n 11, 148-9; Dammann, *supra* n 71, 488-489; Dammann, *supra* n 70, 78; Enriques, *supra* n 31, 1261; cf Deakin, *supra* n 87, 203.

¹²¹ Proposal for a Directive of the European Parliament and of the Council on the cross-border transfer of companies' registered offices, COM (1997) 6002.

¹²² Straube, *supra* n 117, at, 643, 649.

¹²³ Consider eg the Daimler-Chrysler merger, Cf T Baums, "Corporate contracting around defective regulations: The Daimler-Chrysler case", (1999) 115 *Journal of Institutional and Theoretical Economics* 119.

vehicle for a transfer of seat on the continent. For example, the Austrian Supreme Court recently permitted a particular type of merger where an Austrian company was amalgamated into its sole shareholder, a German company.¹²⁴ Also, there have been reports of mergers of Italian and French companies into a German GmbH¹²⁵, and of a German GmbH onto its Austrian parent.¹²⁶ A German court has asked the ECJ to issue a preliminary ruling on whether the legal restrictions on statutory mergers to German corporations are compatible with the freedom of establishment.¹²⁷ Even though ECJ case law still seems to allow Member States to prohibit the „emigration” of companies,¹²⁸ it is probably unavoidable that the court will soon put an end to this. In any case, the EU Council has already approved the Commission’s proposed Directive¹²⁹ on Cross-Border Mergers,¹³⁰ which will – after approval by the European Parliament – provide for a more straightforward way of transfer of registered office. Member states will be unable to maintain impediments in tax law. The Directive on the Taxation of Mergers prohibits the taxation of hidden reserves in cross-border mergers.¹³¹ In the recent *Lasteyrie du Saillant* case, the ECJ found that the taxation of unrealized gains, where a natural person moved to another Member State, was

¹²⁴ Oberster Gerichtshof 20.3.2003, 6 Ob 283/02i, (2003) 24 *Zeitschrift für Wirtschaftsrecht* 1085. Also in the US, cross-border merger are frequently used to engineer a reincorporation in another state. See eg Subramanian, *supra* n 18, 1795, 1803.

¹²⁵ R Dorr and G Stukenborg, "Going to the Chapel": Grenzüberschreitende Ehen im Gesellschaftsrecht – Die ersten transnationalen Verschmelzungen nach dem UmwG (1994)", (2003) 56 *Der Betrieb* 647.

¹²⁶ G Wenglorz, "Die grenzüberschreitende „Heraus“-Verschmelzung einer deutschen Kapitalgesellschaft: Und es geht doch!" (2004) 59 *Betriebs-Berater* 1061.

¹²⁷ Landgericht Koblenz, September 16, 2003, 4 HK.T 1/03, (2003) 94 *GmbH-Rundschau* 1213.

¹²⁸ Under the predominant interpretation, Daily Mail permits such restraints, *supra* section A.1.

¹²⁹ Proposal for a Directive of the European Parliament and of the Council on cross-border mergers of companies with share capital, presented by the Commission, November 18, 2003, COM(2003) 703 final; for an overview see Siems, *supra* n 120.

¹³⁰ Eg "Cross-border deals in the European Union: Merger muddle", *Economist*, 4 December 2004, 35.

¹³¹ Directive 90/434 EEC [1990] OJ L225/1, 20, art 4(1); see Dammann, *supra* n 71, 491. In the US, reincorporation into another state is normally considered a „reorganization" (IRC § 368(a) (2004)) not giving rise to taxation. Cf Subramanian, *supra* n 18, 1802. On tax impediments in Europe see Meilicke, *supra* n 44, 804; HF Hügel, „Steuerliche Hindernisse bei der internationalen Sitzverlegung" (1999) 28 *Zeitschrift für Unternehmens- und Gesellschaftsrecht* 71.

not permissible under the freedom of establishment.¹³² There can be little doubt that this also applies where a company reincorporates or moves to another Member State.¹³³

(c) Consequences

Given all that, we can safely say that company law arbitrage is already becoming easier and less costly.¹³⁴ What will it mean for the market for corporate law? Potential consequences offered by for close corporations in the US discussion are diverse. Some scholars have suggested that states may be specializing in different products. The needs of Berle-Means firms may be relatively homogenous, other than those of privately held firms.¹³⁵ Some scholars suggested that there may be product specialization,¹³⁶ for example for firms with large shareholders, who may be interested in retaining more control over management (which is why more legal control may be beneficial in the absence of pressure from capital markets).¹³⁷ Roberta Romano argued that for public corporations, a legislative standard template may be optimal, while the optimal arrangement for close corporations could be assessments by

¹³² *Hughes de Lasteyrie du Saillant v Ministère de l'Economie (Case C-09/02)* (not yet reported).

¹³³ Eg J Kleinert and P Probst, "Endgültiges Aus für steuerliche Wegzugsbeschränkungen bei natürlichen und juristischen Personen", (2004) 47 *Der Betrieb* 673, 674; Tröger, *supra* n 31, 17; but see G Parleani, "Relocation and Taxation: the European Court of Justice Disallows the French Rule of Direct Taxation of Unrealised Gains" (2004) 1 *European Company and Financial Law Review* 379, 381 (waiting for a legislative solution).

¹³⁴ The recently adopted European Company Statute [Regulation 2157/2001 EC [2001] OJ L294/1] only allows reincorporation company law arbitrage between states if a corporation is willing to relocate its central administration (art. 7). See L Enriques, "Silence is Golden: The European Company as a Catalyst for Company Law Arbitrage" (2004) 4 *JCLS* 77, 80-81.

¹³⁵ Cf R Romano, "State Competition for Close Corporation Charters: A Comment" (1992) 70 *Washington University Law Quarterly* 409, 413; Romano, *supra* n 12, 26.

¹³⁶ RA Posner and KE Scott, *Economics of Corporate Law and Securities Regulation* (Boston and Toronto, Little Brown and Company, 1980) 111.

¹³⁷ BD Baysinger and HN Butler, "Race for the Bottom v. Climb to the Top: The ALI Project and Uniformity in Corporate Law" (1985) 10 *Journal of Corporation Law* 431, 459-60. This conjecture is supported by evidence that corporations frequently reincorporate in Delaware in the course of an IPO or another major transaction. Romano, *supra* n 19, 250; Easterbrook and Fischel, *supra* n 12, 216; contra Romano *supra* n 19, 266-73; cf Macey and Miller, *supra* n 36, 478.

judges in individual cases.¹³⁸ Ian Ayres suggested that the high costs of an out-of-state incorporation are to blame for the lack of competition for the charters of closed corporations,¹³⁹ which includes tax issues and the risk of having to litigate in another state and to comply with Federal Securities Law.¹⁴⁰ Franchise tax revenues from small companies may be too insignificant for any state to develop incentives to seriously compete for charters, allowing courts more latitude to implement their own ideas in corporate law cases.¹⁴¹

Assuming for the moment that European competition remains restricted to new corporations, we would expect – independently of whether the „race” is going to the top or the bottom – a development of law deviating from the US, as conflicts of interest of decisionmakers are quite different in newly founded corporations. First, one should expect a much more fragmented market. If conflicts of interest between companies with various capital and ownership structures are actually more diverse than in a market of Berle-Means firms, one would expect suppliers of corporate law to cater to those needs. Heterogeneity of legal and business cultures is likely to bolster this effect.¹⁴²

Furthermore, even in the US, no state has achieved a near-monopoly situation for closed corporations, as Delaware has for publicly held ones;¹⁴³ in Europe, the costs of out-of-state incorporation are likely to be even higher, resulting from the need to inform oneself about foreign law, potentially having to litigate in another legal culture and having to comply with foreign accounting standards. With relatively small stakes

¹³⁸ Romano, *supra* n 12, 26-8.

¹³⁹ I Ayres, “Judging Close Corporations in the Age of Statutes” (1992) 70 *Washington University Law Quarterly* 365, 374-8.

¹⁴⁰ Most importantly to the Securities Act of 1933 (15 USC §§ 77a-77z-3) and the Securities Exchange Act von 1934 (15 USC §§ 78a-78mm).

¹⁴¹ Ayres, *supra* n 139, 378.

¹⁴² Armour, *supra* n 40, section 2.a, 5.

¹⁴³ Cf Kahan and Kamar, “Price Discrimination in the Market for Corporate Law” (2001) 86 *Cornell Law Review* 1205, 1227 (reporting that only 6% of nonpublic corporations are incorporated in Delaware).

in newly founded firms, administrative costs will often outweigh the benefits of out-of-state incorporation (at least when the objective of the firm is to run a serious business), and incentives to lobby for an improved law will be much smaller as well.

Hence, high costs of out-of-state incorporation should deter a large number of “purchasers” from the market for out-of-state corporation law, resulting in an exacerbated home-state bias, and thus a relatively low demand (corresponding to the comparatively small supply identified in section B). As a result, the rewards any state can reap from tailoring its corporate law to the market will be reduced even more, which will further decelerate the race.

3. Controlling interest groups and ownership structures

(a) The predominance of large shareholders

Independent of whether we are discussing small or large, established firms, the direction of regulatory competition in corporate law is ultimately determined by which persons and interest groups are in the position to create demand within the market, i.e. who decides whether and where to reincorporate, and what interests determine the decisions. In the US, reincorporations (to Delaware) are normally enacted before an IPO;¹⁴⁴ at that point in time, the decision is, on one side, arguably driven by the controllers’ need to commit to a corporate law regime which is sufficiently attractive to investors,¹⁴⁵ but, on the other side, potentially influenced by their interest in gaining private benefits of control.¹⁴⁶

In the close corporation setting discussed in the previous section, differences to the US should not be all that great. In many cases, there will be a small circle of foun-

¹⁴⁴ Cf Romano, *supra* n 19, 250; Easterbrook and Fischel, *supra* n 12, 216.

¹⁴⁵ Winter, *supra* n 12, 254-8.

¹⁴⁶ Cf Bebchuk and Ferrell, *supra* n 17, 131-40 (arguing that states have incentive to cater to managerial interest by allowing excessive takeover defenses).

ders, who take the company's shares and often also manage the firm. Admittedly, the possible conflicts of interests in various firms are quite diverse, but in many cases, the line-up will be one of arm's length bargaining between several partners setting up a business as a common endeavor. At least initially, there will be few control problems and information asymmetries. One should therefore think that the law only needs to provide a transaction-cost reducing template of default rules which are useful in practice and reduce the costs of contracting.¹⁴⁷ However, if only one of the founders manages the firm, while the others merely provide financing, there could be considerable information asymmetries. Both in Europe and in the US, it seems unlikely that those are resolved by regulatory competition. If the lawyer drafting the agreement and advising where to incorporate represents the majority, which is quite probable,¹⁴⁸ a corporate law favoring insiders has a competitive advantage if future conflicts are not anticipated by the minority when the firm is initially created. A specific country's law could thus be attractive for new incorporations by favoring the majority as long as this does not give it an excessively bad reputation.

By contrast, there may be considerable differences between the US and Europe concerning large, publicly traded corporations, where problems of asymmetric information are exacerbated. For reasons hotly debated in the comparative corporate governance literature,¹⁴⁹ US and (continental) European share ownership patterns are very different. In the US, an IPO usually leads to the development of a Berle-Means structure in the long run, where a multitude of small shareholders is juxtaposed to a

¹⁴⁷ Easterbrook and Fischel, *supra* n 12, 34-35; RA Posner, *Economic Analysis of Law* (New York, Aspen, 5th ed. 1998), 431-5; *contra* LA Bebchuk, "Limiting Contractual Freedom in Corporate Law: The Desirable Limits of Charter Amendments" (1989) 102 *Harvard Law Review* 1820; LA Bebchuk, "The Debate on Contractual Freedom in Corporate Law" (1989) 89 *Columbia Law Review* 1395.

¹⁴⁸ Cf Romano, *supra* n 135, 415.

¹⁴⁹ The main contenders are the „legal origins“ theory [see R La Porta, F Lopez-de-Silanes, A Shleifer and RW Vishny, "Law and Finance" (1998) 106 *Journal of Political Economy* 1113], and the political theory [MJ Roe, *Political Determinants of Corporate Governance* (Oxford, Oxford University Press, 2003)].

strong board of directors. Similarly, large British firms mostly have dispersed ownership. Share ownership structures on the continent deviate from the Anglo-Saxon model in the persistence of blockholdings, and the importance of debt finance is often thought to be greater.¹⁵⁰ Continental systems are usually considered to be characterized by “control-oriented finance”, as opposed to Anglo-Saxon “arm’s-length finance”:¹⁵¹ The latter emphasize mechanisms of markets instead of control by core shareholders. Different decisionmaking structures resulting from this are likely to yield different outcomes of competition. While the US debate on regulatory competition is mostly concerned with conflicts of interest between dispersed shareholders and managers, regulatory competition may affect the agency conflict between controlling shareholders and minority investors in large publicly traded companies usually.

(b) Reincorporation – who decides?

Under US corporate law, a reincorporation in another state normally requires both a proposal by the board of directors and a shareholder vote;¹⁵² the latter alone is not enough. The requirement of a proposal by the board implies, as Lucian Bebchuk pointed out, that there will hardly ever be an initiative to reincorporate (and the board could block one by activist shareholders) if there were not some advantages also for

¹⁵⁰ See eg R La Porta, F Lopez-de-Silanes and A Shleifer, “Corporate Ownership around the World” (1999) 44 *Journal of Finance* 471; R La Porta, F Lopez-de-Silanes, A Shleifer and RW Vishny, “Legal Determinants of External Finance” (1997) 52 *Journal of Finance* 1131; M Becht and A Röell, “Blockholdings in Europe: An international Comparison” (1999) 43 *European Economic Review* 1049; Roe, *supra* n 149, 49-56; but see RG Rajan and L Zingales, “What Do We Know about Capital Structure? Some Evidence from International Data” (1995) 50 *Journal of Finance* 1421 (finding that it turns out that the debt ratios of German companies on debt are overstated when differences in accounting standards are taken into account, but also finding that the debt ratio of French companies was considerably higher than both that of British and German ones); A Antoniou, Y Guney and K Paudyal, “Determinants of Corporate Capital Structures: Evidence from European Countries”, EFMA 2002 London Meetings (March 2002) <http://ssrn.com/abstract_id=302833>, 6 (stating that leverage is only slightly higher in German companies than in British ones, but considerably higher in French ones).

¹⁵¹ See eg E Berglöf, “A Note on the Typology of Financial Systems” in K Hopt and E Wymeersch (eds), *Comparative Corporate Governance* (Berlin/New York, Walter de Gruyter, 1997), 151, 159-64.

¹⁵² Bebchuk, *supra* n 13, 1458; cf Clark, *supra* n 19, 416-7 (discussing mergers, which are often used to arrange a reincorporation).

management itself.¹⁵³ If pressures from the market for takeovers or the managerial labor market are too weak to force them to, a slant towards managerial interest is therefore likely.¹⁵⁴ The necessity of a shareholder vote remedies this problem only to a limited degree, as shareholders are unable to effectively pursue their interests because of collective action problems and information asymmetries.¹⁵⁵ Dispersed ownership structures and additional mechanisms of entrenchment make it hard for shareholders to replace an unwilling board.

Similar reasoning can be applied to UK companies with dispersed ownership: reincorporations clearly favoring managers to the detriment of shareholders may be even less likely than in the US:¹⁵⁶ First, institutional investors in the UK are known to own a larger total proportion of public firms than their American counterparts, and take a more “activist” stance vis-à-vis directors.¹⁵⁷ Second, a reincorporation to anywhere on the European continent would probably alarm British shareholders more than a move within the US would alarm their American counterparts. One should thus not necessarily expect UK firms to make much use of the potential offered by regulatory competition.

Concentrated ownership structures are likely to have different effects on regulatory competition for continental European firms. Of course, a reincorporation is also unlikely to be effected on the continent without the assent of management; but with the presence of controlling shareholders or even mere blockholders, an unwilling management is at much greater risk of being replaced. In practice, with no effective separation of ownership and control in place, majority shareholders or cooperating

¹⁵³ Bebchuk, *supra* n 13, 1460-1.

¹⁵⁴ *Ibid*, 1461-7 (describing how particular types of market failure make a race to the bottom likely).

¹⁵⁵ *Ibid*, 1470-5.

¹⁵⁶ Deakin, *supra* n 87, 206-7.

¹⁵⁷ See, eg J Armour, BR Cheffins and DA Skeel, “Corporate Ownership Structure and the Evolution of Bankruptcy Law: Lessons from the United Kingdom” (2002) 55 *Vanderbilt Law Review* 1699, 1750-2.

blockholders alone will be able to decide to reincorporate: In the US and the UK, at least the two sides of the conflict of interest (managers and dispersed shareholders) have to strike a bargain. On the continent, large shareholders will often be able to decide unilaterally. With legal impediments to cross-border reincorporations being removed, they will often be able to decide on moves into other jurisdictions single-handedly, without needing the votes of dispersed shareholders, as rational apathy will frequently give them the majority they need, even if it is a supermajority. Investors may not always realize this problem, resulting in a disappointment in their economic expectations because of information asymmetries or boundedly rational behavior. Thus, one should be at least cautious with respect to the argument that minority shareholders need not be protected when buying shares of a foreign company.¹⁵⁸

(c) What incentives determine reincorporation decisions under concentrated ownership?

If large shareholders are not required to strike bargains with other interest groups, the first thing one might expect is reincorporation to a Member State where corporate law is more favorable to large shareholders by taking, for example, a more permissive stance on private benefits of control. The resulting slant in favor of large shareholders would be even bigger than the one arguably favoring management in the US, who may need to make some concessions to shareholders. There is little reason to believe that they will have an incentive to subject themselves to a corporate law favoring the minority.¹⁵⁹ Pressures from managerial labor markets and the threat of a

¹⁵⁸ Inspire Art, *supra* n 8, para 135. If that statement could be generalized, any mandatory minority protection would be superfluous. However, all major corporate law systems provide at least for some mandatory minority protection, which prima facie indicates that it is not superfluous. For a functional comparison, see H Hansmann and R Kraakman, "The Basic Governance Structure", in R Kraakman (ed), *The Anatomy of Corporate Law* (Oxford, Oxford University Press, 2004) 33, 54-61.

¹⁵⁹ See eg Bebchuk, *supra* n 13, 1478 (finding that market mechanisms do little to oppose transfers of value to a controlling shareholder); Tröger, *supra* n 31, 28 (hypothesizing that "dominant stockholders

hostile takeover, which are often brought forward as a constraint of managers in the US, do not apply to them. Once shares have been issued, minority shareholders, as a group, cannot withdraw their contribution to the firm, and thus lack leverage vis-à-vis the majority.

Yet, there is also a second way of how a controlling shareholder could benefit from reincorporation, namely by increasing her own wealth by maximizing the total value of the firm, which might in some cases be done by reincorporating in a Member State with “particularly good law” suitable to the needs of firms with a dispersed ownership structure. This would be desirable also from the point of view of minority shareholders and may even allow large continental shareholders to let go of their blocks by reincorporating in a Member State the law of which is rewarded with a premium by capital markets, by virtue of being good at keeping managers in check.¹⁶⁰

If both the “private benefits” reincorporation and the “firm value maximization” options are available to a controlling shareholder, she will only take the “firm value maximization” option if the total wealth she can accumulate by letting go of her control block is greater than the private benefits of control another Member State might offer. In some cases, a move to a state offering larger private benefits might even be beneficial if it also increases the total value of the firm. However, inefficient moves will very often prevail over efficient ones, since blockholders do not internalize gains accruing to other shareholders.

may consider reincorporating for purposes of extracting higher private benefits”); Armour, *supra* n 40, section 3.b, 24.

¹⁶⁰ Armour, *supra* n 40, section 3.b, 25 (arguing that continental European controlling shareholders might be able to “unwind” and diversify their holdings by reincorporating in the UK). There is some evidence that blockholdings may be unwinding (or have been unwinding) even without regulatory competition. See eg D Wójcik, “Change in the German model of corporate governance: evidence from blockholdings 1997 – 2001” (2003) 35 *Environment and Planning A* 1431-58.

(d) Possible consequences

We have seen that countries seeking to offer attractive corporate law could employ two alternative strategies, one that seems desirable (“firm value maximization”) and one that seems undesirable (“maximization of private benefits”), as private benefits will almost certainly decrease firm value beyond a certain level. Conceivably, we might see states pursuing either strategy. However, if there were actually fierce competition between Member States, a movement “to the bottom” could happen if it is easier to leave private benefits of control unchecked than to develop “good law” maximizing firm value for competing states. Instead of using political clout within a particular county to maintain private benefits, large blockholders might capture the regulatory competition process.¹⁶¹ Thus, if in a control-oriented system of corporate governance, pressures from capital market and even the need to resort to them are smaller, one should, at the very least, expect a greater danger of a movement to the bottom than in a corporate governance system characterized of public corporations with dispersed ownership such as the one of the US.

Admittedly, one factor that could mitigate possible negative effects of regulatory competition would be product markets. A firm with excessive private benefits will most likely be at a competitive disadvantage in the long run.

Still, if one follows the theory that developed legal minority protection is correlated to or even a prerequisite for the development of dispersed ownership and capital mar-

¹⁶¹ Cf A Ferrell, “The Case for Mandatory Disclosure in Securities Regulation Around the World”, Harvard Olin Discussion Paper No 492 (September 2004), <<http://ssrn.com/abstract=631221>>, 12 (“As is widely recognized, controlling shareholders – once minority shareholders are in the picture – will tend to ignore the harm caused to minority shareholders’ interests in the course of deciding which actions the firm should undertake”); LA Bebchuk and MJ Roe, “A Theory of Path Dependence in Corporate Ownership and Governance” (1999) 52 *Stanford Law Review* 127, 143-9 (arguing that, once a concentrated ownership structure is in place, private benefits of control will assure that controllers have no incentive to move towards a dispersed ownership structure).

kets,¹⁶² one might even predict a weakening of minority protection in some countries and, as a consequence, of stock markets as a result of regulatory competition (in the absence of significant countervailing factors). The US is not a good model with which to oppose this argument: First, dispersed ownership was firmly in place as early as 1932, allowing Berle and Means to write their pathbreaking study on the separation of ownership and control.¹⁶³ More importantly, other mechanisms were in place that prevented the rise of controlling shareholders.¹⁶⁴

Race-to-top advocates might conclude that European laws will remain more strongly committed to a regulatory approach in corporate law: Where the forces of capital markets are weaker in disciplining managers and controlling shareholders an approach favoring mandatory law may be economically superior.¹⁶⁵ Given that controlling shareholders will usually be able also to initiate a reincorporation, they might want to find a way of committing to a regime friendly to the minority, for example by enhanced supermajority requirements in the company's charter. However, such a commitment to a specific mandatory corporate law regime would be difficult and probably come with costs of reduced flexibility. It seems much more likely that companies would rather subject themselves to a strong regime of securities regulation,¹⁶⁶ which would not necessarily affect the development of corporate law.

Following the hypothesis that Delaware law is tailored to the needs of typical American publicly traded firms,¹⁶⁷ one would expect the European market to exhibit more

¹⁶² Cf La Porta et al, *supra* n 149, 1145-51.

¹⁶³ AA Berle and G Means, *The Modern Corporation and Private Property* (New York, Macmillan, 1932).

¹⁶⁴ MJ Roe, *Strong Managers – Weak Owners. The Political Roots of American Corporate Finance* (Princeton, Princeton University Press, 1995) 51-145.

¹⁶⁵ Cf Baysinger and Butler, *supra* n 137, 456-61.

¹⁶⁶ Cf E Rock, "Securities Regulation as Lobster Trap: A Credible Commitment Theory of Mandatory Disclosure" (2002) 23 *Cardozo Law Review* 675; LE Ribstein, "Cross-Listing and Regulatory Competition" [2005] 1 *Review of Law and Economics* 97.

¹⁶⁷ Posner and Scott, *supra* n 121, 111; Easterbrook and Fischel, *supra* n 12, 215-6.

fragmentation and less uniformity also because of ownership patterns, even once it extends also to large corporations. As long as many large public companies continue to deviate from what has been called the “standard model” of corporate law¹⁶⁸, the market should be expected to demand a high degree of diversity to accommodate a great variety of idiosyncratic structures and problems, which precludes the existence of a one-size-fits-all solution.

4. Stakeholder protection, creditor power, and codetermination

The US discussion only barely touches upon the effects of corporate law on other stakeholders beside shareholders,¹⁶⁹ such as creditors and employees, who cannot directly influence the choice of law decision.¹⁷⁰ However, regulatory competition in Europe cannot eschew this issue, as most of all the interests of employees and creditors are much more an issue of corporate law than they are in the US.

Were stakeholders able to protect their interests by complete contingent contracts or by insurance, they could penalize a detrimental corporate law regime by a premium, e.g. higher interest rates in the case of creditors. In that case, there would be an incentive for shareholders to take those interests into account when deciding on incorporation.¹⁷¹ However, when market failures or information asymmetries rule out complete contracting, there is little incentive to take nonshareholder constituencies’ interests into account in ex post reincorporation decisions.¹⁷² Furthermore, while some authors suggest that US corporate law ties shareholders’ hands to prevent the ex-

¹⁶⁸ H Hansmann and R Kraakman, “The End of History for Corporate Law” (2001) 89 *Georgetown Law Journal* 439, 440.

¹⁶⁹ Cf Bebchuk, *supra* n 13, 1455 (stating that scholars of both directions of the race see shareholder value maximization as the objective of corporate law policy).

¹⁷⁰ Cf *ibid*, 1492 (arguing that state law will be unable to provide the efficient rule as nonshareholder constituencies do not participate in the incorporation decision).

¹⁷¹ Cf Lombardo, *supra* n 47, 322-30.

¹⁷² Cf Bebchuk, *supra* n 13, 1485.

propriation of other constituencies' quasi-rents,¹⁷³ this is not feasible in the presence of large shareholders with control over management. Thus, a race to the bottom with respect to nonshareholder constituencies seems quite likely, e.g. with respect to tort creditors,¹⁷⁴ whose interests are normally not aligned with any other constituency, not even contractual creditors with whom they compete on insolvency quotas.

This may be different with respect to at least some contractual creditors in view of financial structures on the European continent. According to the conventional wisdom, institutional creditors such as banks are more concentrated in Europe (even in the UK) than in the US.¹⁷⁵ First, the position as a firm's main bank may give it particularly strong bargaining position and even some decisionmaking power within the firm, which may make regulation unnecessary. Second, it may give them the power to favor corporations which are incorporated in a creditor-friendly Member State. This may mean that competition will result in a law that is hospitable to large institutional creditors. Where the interests of this group and trade creditors are aligned, the latter will also benefit from the large creditors' powerful position. However, where their interests differ, trade creditors may suffer if they are not powerful or not sophisticated enough

¹⁷³ MM Blair and LA Stout, "A Team Production Theory of Corporate Law" (1999) 85 *Virginia Law Review* 247; also see A Shleifer and LH Summers, "Breach of Trust in Hostile Takeovers", in AJ Auerbach (ed), *Corporate Takeovers: Causes and Consequences* (Chicago, University of Chicago Press, 1988), 33.

¹⁷⁴ Cf Bebchuk, *supra* n 13, 1489; also see Eidenmüller, *supra* n 4, 2236). I am not trying to argue that tort creditors are particularly well protected by minimum capital and capital maintenance rules as required for public corporations by the Second Directive (*supra* n 92). For critical views see J Armour, "Share Capital and Creditor Protection: Efficient Rules for Modern Company Law" (2000) 63 *MLR* 355, 371-2; L Enriques and JR Macey, "Creditors versus Capital Formation: The Case against the European Legal Capital Rules" (2001) 86 *Cornell Law Review* 1165-1204; PO Mülbart and M Birke, "Legal Capital – Is There a Case against the European Legal Capital Rules?" (2002) 3 *European Business Organization Law Review* 695-732.

¹⁷⁵ Cf MJ Roe, "Some Differences in Corporate Structure in Germany, Japan and the United States" (1993) 102 *Yale Law Journal* 1927, 1943 (comparing the US, where regulation has kept financial institutions fragmented, to Germany and Japan); BR Cheffins, "Putting Britain on the Roe Map: The Emergence of the Berle-Means Corporation in the United Kingdom", in JA McCahery, P Moerland, T Raaijmakers and L Renneboog (eds), *Corporate Governance Regimes* (Oxford, Oxford University Press, 2002), 148, 159 (finding that British banks were more concentrated than their continental counterparts as early as 1920); T Beck, A Demirgüç-Kunt and R Levine, "Bank Concentration and Crises", World Bank Policy Research Paper No 3041 (2003), <http://ssrn.com/abstract_id=432081> (data on concentration in the banking industry).

to protect themselves by risk premia, insurance and the services of credit rating agencies. To some degree, even tort creditors may benefit from the power of institutional creditors: However, it seems unavoidable that they suffer on issues where their interests are opposed to the ones of financial institutions (e.g. concerning securitization of debt). However, this will also depend to what exact legal mechanisms regulatory competition will extend (see section D.3).

With respect to employees, it is obvious that a lot of legislation intended to safeguard their interests (such as protection against dismissals) lies outside the scope of corporate law and are only subject to regulatory competition if firms are able to relocate plants at low cost (or indirectly through product market competition). However, employees are affected only when legal mechanisms attach to the corporate form, such as the codetermination systems in place in several Member States.¹⁷⁶

Irrespective of whether codetermination is economically beneficial or detrimental, up to now, firms have been committed to the current regime by impediments and costs of reincorporation. If codetermination actually induces beneficial firm-specific human capital investments by employees, the possibility or the threat to reincorporate allows shareholders to expropriate employees' quasi-rents, without being able to commit to a specific national law. If such investments are beneficial, this may make a good case for European harmonization. However, this approach is obviously problematic for firms or industries where specific investments by employees are not present.

¹⁷⁶ Deakin, *supra* n 87, 207.

D. FEDERAL AND SUPRANATIONAL INFLUENCE

1. Europe and Roe's thesis of vertical competition

While EU company law measures of harmonization were designed to create uniformity among Member States, the effect of the federal law on the regulatory competition process in the US has long received little attention in the academic debate.

Of course, the new European Company Statute¹⁷⁷ is of some importance, as it offers, at least with respect to those issues not left to national law, a federal type of company that could, in theory, compete with national forms. However, for various reasons, the European Union itself is unlikely to actively engage the market for corporate law,¹⁷⁸ and the national varieties of the European Company can only compete with each other for firms that are willing to actually transfer their "real seat" to the state of incorporation.¹⁷⁹

The more interesting question is how actual and potential federalization affects the development on the national level. In a recent article, Mark Roe has suggested that Delaware's actual competitors are not the other US states, but actors on the federal level. The incentive shaping Delaware corporate law is thus not potential reincorporation to other states, but the permanent threat of federalization of the law of publicly traded corporations, for which Roe cites some actual historic examples, such as the 1933 and 1934 Acts and the recent Sarbanes-Oxley Act of 2002.¹⁸⁰ Beside congress,

¹⁷⁷ Regulation 2157/2001 EC [2001] OJ L294/1.

¹⁷⁸ On the parallel case of Canada, where federal incorporation has been permitted as an alternative to incorporation in one of the provinces, see Romano, *supra* n 12, 118-28. (generally arguing that the federal government, other than a small state, does not have incentives to create good corporate law).

¹⁷⁹ See *supra* n 7.

¹⁸⁰ Roe, *supra* n 25, 588; cf Kahan and Kamar, *supra* n 22, 679, 741 (arguing that there was no actual state competition, but that it was possible in theory); Bebchuk and Hamdani, *supra* n 20, 580-3; also see Bebchuk, *supra* n 13, 1454 (arguing that the threat of federal legislative intervention might prevent decisionmakers in Delaware from introducing value-decreasing statutes); MJ Roe, "Delaware's Politics" (April 15, 2005), <<http://ssrn.com/abstract=601962>> (analyzing the interplay of Delaware and federal law from a public choice perspective). On the Sarbanes-Oxley provisions on audit committee see eg LE Mitchell, "The Sarbanes-Oxley Act and the Reinvention of Corporate Governance" (2003) 48 *Villanova Law Review* 1189, 1198 (speaking of a "federalization of corporate governance").

the SEC, the Second Circuit Court of Appeals¹⁸¹ (when interpreting securities laws), and the New York Stock Exchange are the most important actors.¹⁸² If Delaware oversteps its permissible bounds, federal decisionmakers will intervene or threaten to do so. In some cases such intervention was averted only by policy changes in Delaware.¹⁸³ Actual intervention is thus not required to influence state corporate law, but its permanent threat may push Delaware into the desired direction. Thus, in Roe's theory, whether Delaware corporate law is good or bad is ultimately not a matter of a race to the top or bottom between states, but into what direction state law is pushed by federal actors.

2. Consequences for Europe

The obvious question for Europe, raised by Mark Roe himself, is what influence European law will in the future have on state competition, and whether actual or the threat of Europeanization of corporate and securities law will pull the Member States' company into one direction or the other.¹⁸⁴

However, there are some fundamental differences: First, under the EU political system, the Council, Commission and Parliament act considerably more slowly as legislators than that of US congress; concerning issues of corporate law. In the US, federal legislation in corporate law has usually been the result of issues discussed on the federal level; for example, the 1933 and 1934 Acts resulted from the depression and perceived problems of capital markets that had contributed to it; the Williams Act of 1968 was the answer to an increase in dubious takeover attempts during the

¹⁸¹ The Second Circuit includes the states of New York, Connecticut und Vermont (28 USC § 41) and thus adjudicates in many cases involving securities law.

¹⁸² Roe, *supra* n 25, 592.

¹⁸³ In the course of the 20th century, the issue of federalization of corporate law was discussed several times. See *ibid*, 602-7. One important example is the Delaware case law on hostile takeovers.

¹⁸⁴ *Ibid*, 643-4.

1960s¹⁸⁵; most recently, the Sarbanes-Oxley Act was the result of Enron and other corporate governance scandals. Admittedly, the EU commission has become much more active than it had previously been in company and securities law,¹⁸⁶ and the EU may be attempting to streamline its legislative and regulative processes,¹⁸⁷ but in comparison to the maybe sometimes hasty US legislation, it is still rather a cumbersome giant, under whose auspices projects that were discussed for many years, such as the Takeover Directive,¹⁸⁸ can sometimes be delayed by particular, sometimes unrelated national interests.¹⁸⁹ So far, spectacular insolvencies in Europe had immediate effects only on the level of the respective Member State, in which most of the media attention to corporate governance scandals occurs. As a consequence, reforms are usually called for on the Member State level. Just two of many examples are the German KonTraG of 1998¹⁹⁰ or accounting reforms in Austria in 2001 – which ultimately were the result of two bank insolvencies.¹⁹¹ If a similar pattern prevailed in the US, Enron would have resulted in a reform of the corporate law of the state of Oregon;¹⁹² however, there was a rather speedy reaction in the form of a federal law. A major factor shaping the decisions of legislators and others is the public discussion

¹⁸⁵ See eg Clark, *supra* n 19, 546-8.

¹⁸⁶ Cf *Modernising Company Law and Enhancing Corporate Governance in the European Union - A Plan to Move Forward* (COM [2003] 284 final), <http://europa.eu.int/eur-lex/en/com/cnc/2003/com2003_0284en01.pdf> (last visited May 1, 2005).

¹⁸⁷ Cf E Ferran, *Building an EU Securities Market* (Cambridge, Cambridge University Press, 2004), 61-126 (discussing the Lamfalussy process).

¹⁸⁸ Directive 2004/25 EC [2004] OJ L142/12.

¹⁸⁹ See eg Ferran, *supra* n 187, 116-117 (discussing the impact of the dispute about the status of Gibraltar on the takeover directive).

¹⁹⁰ KonTraG – Gesetz zur Kontrolle und Transparenz im Unternehmensbereich (law on control and transparency in business), April 27, 1998, (German) BGBl 1998 I, 786; see eg D Dörner, "Ändert das KonTraG die Anforderungen an den Abschlußprüfer?" (1998) 42 *Der Betrieb* 1, 1 (stating that the legislation was the result of corporate governance scandals).

¹⁹¹ The FMAG of 2001 (Bundesgesetz über die Errichtung und Organisation der Finanzmarktaufsichtsbehörde, BGBl I 2001/97) resulted in an increase and differentiation of the auditor's liability cap and an introduction of mandatory auditor rotation. See C Nowotny and M Gelter, "Die Prüferrotation nach dem FMAG" (2001) 11 *Österreichische Zeitschrift für Recht und Rechnungswesen* 325; W Dehn, "Die Haftung des Abschlussprüfers nach § 275 HGB (nF)" (2002) 50 *Bank-Archiv* 377.

¹⁹² Enron was incorporated in Oregon. See eg M Cole, "Delaware is not a state': Are We Witnessing Jurisdictional Competition in Bankruptcy?" (2002) 55 *Vanderbilt Law Review* 1845, 1874.

in the media, in which, in Europe, political discussions are waged rather on the national than the European level. As long as there is no European public sphere, one can safely expect that in Europe, a crisis will normally result in national rather than supranational intervention. European regulation tends to deal with more fundamental issues and is sometimes discussed for decades before enactment.

Differences in the court system are probably even more significant: the ECJ, as far as it is asked to deal with issues of company and securities law at all, can hardly be compared to the Federal Appellate Court for the 2nd Circuit and the US Supreme Court, whose adjudicative activity regularly goes back to claims to damages resulting from the violation of protective norms of securities law.¹⁹³ In Europe, these issues are normally dealt with by national courts, and the rare cases in which the ECJ has been asked for a preliminary opinion (on the interpretation of EU directives) have led to few meaningful substantive solutions.

But most importantly, Europe lacks a capital markets regulator comparable to the SEC, which is specialized in its field and can relatively quickly issue regulations binding on public corporations; thus, the SEC frequently interferes with companies' corporate governance structures. Good examples are proxy rules¹⁹⁴, which affect the stockholders' ability to vote and thus a core field of the inner affairs of the corporation,¹⁹⁵ or the SEC's recent proposal aiming at giving minority shareholders the opportunity to propose a competing short slate of candidates for the board of direc-

¹⁹³ A good example are suits for damages due to insider trading. See Allen and Kraakman, *supra* n 19, 590-1. The prohibition of insider trading largely developed from Securities Exchange Act § 10(b) and the SEC rule 10b-5, which were originally directed at fraudulent practices in sales of securities. See *Kardon v National Gypsum Co*, 69 F Supp 512 (ED Pa 1946); *SEC v Texas Gulf Sulphur Co*, 401 F 2d 833 (2d Cir 1968), cert denied 394 US 976 (1969); *Chiarella v United States*, 445 US 222 (1980); *Dirks v SEC*, 463 US 646 (1983); see Clark, *supra* n 19, 309-56.

¹⁹⁴ Securities Exchange Act § 14, 15 USC § 78n; SEC Regulation 14A, 17 CFR § 240.14A.

¹⁹⁵ Also see Roe, *supra* n 25, 612-4.

tors.¹⁹⁶ Europe also lacks a pan-European stock exchange comparable to the NYSE, whose listing requirements (under sometimes considerable influence of the SEC¹⁹⁷) also affects corporate governance. But even if a European SEC or NYSE existed, as long as European competition focuses on closely-held corporations, the influence of capital market institutions is irrelevant anyway.

All this leads to the conclusion – in spite of EU attempts at harmonization in corporate and securities law – that the gravitational pull of the EU level is likely to be significantly weaker than the one of the US federal level. No potential supplier in the market for European corporate law would have much to fear the threat of the EU taking away its powers (as US federal law does). The latitude of discretion assigned to competitors will thus remain considerably larger than in the US, even though the difference is one in degree and not an absolute one.

Furthermore, the pressure of economic incentives by which potential Europeanization would force EU Member States to pursue a „supranational” course in its policy measures, will be reduced. For Delaware, federalization is a considerable threat: the more its own discretion is reduced by federal authorities, the more it loses of its special competitive advantage and its exceptional position among US states, which yields a considerable proportion of state income. Delaware will avoid putting that at risk. However, as long as no state is in a similar position – i.e. near complete dependency on corporate law – in Europe, the threat of supranationalization is much less drastic for any participant in the market. The weak incentives to compete for Member States are counterbalanced by a weak supranational gravitational pull.

¹⁹⁶ SEC Proposal No 34-48626 of October 14, 2003, 68 FR 60784.

¹⁹⁷ Roe, *supra* n 25, 599-600.

3. Approaches similar to harmonization in creditor protection

It is sometimes speculated that whether the German GmbH and other continental types of corporations will be the “victims” of regulatory competition, which the UK Private Limited Company seems to be winning. This has already encouraged some countries to eliminate or reduce minimum capital requirements.¹⁹⁸ Conspicuously, capital adequacy and maintenance requirements are virtually non-existent in the US. Usually other measures are considered to be important for creditor protection, which are regulated either by federal law or by uniform laws.¹⁹⁹ The *Uniform Fraudulent Transfer Act* and the older *Uniform Fraudulent Conveyance Act* have been – in some form – implemented in all US states.²⁰⁰ Those laws do not only address transfers with the actual intention to defraud creditors. A transaction will be considered a fraudulent transfer in two cases: In the first case, the debtor either “was engaged or was about to engage in a business or a transaction for which the remaining assets of the debtor were unreasonably small in relation to the business or transaction”;²⁰¹ in the second case, he or she must have (2) “intended to incur, or believed or reasonably should have believed that he [or she] would incur, debts beyond his [or her] ability to pay as they became due.”²⁰² The provision²⁰³ also covers dividend payments,²⁰³ one of the main targets of the Second EU Directive.²⁰⁴ Foreseeability by the beneficiary is not necessary for the application of the statute.

¹⁹⁸ See *supra* n 96.

¹⁹⁹ Also see Tröger, *supra* n 31, 54 n 225.

²⁰⁰ Ultimately, those statutes go back to an English statute of 1571. See Allen and Kraakman, *supra* n 19, 140; *Twyne’s Case*, [1601] 3 Coke 80b, 76 Eng Rep 809 (Star Chamber 1601); also see Clark, *supra* n 19, 44-5 n11.

²⁰¹ Uniform Fraudulent Transfer Act § 4(a)(2)(i).

²⁰² Uniform Fraudulent Transfer Act § 4(a)(2)(ii).

²⁰³ On the discussion see Clark, *supra* n 19, 88-90; eg *Wells Fargo Bank v Desert View Building Supplies*, 475 F Supp 693 (D Nev 1978); *In re Jenkins Landscaping and Excavating, Inc*, 93 BR 84 (WD Va 1988); *In Re Dondi Financial Corp*, 119 BR 106 (Bkrtcy, ND Tex 1990); but see RO Kummert, “State Statutory Restrictions on Financial Distributions by Corporations to Shareholders: Part II” (1984) 59 *Washington Law Review* 185.

²⁰⁴ Second Directive, *supra* n 92, art 15.

In the US, insolvency law (referred to as bankruptcy law) is federal law²⁰⁵, and it also includes a provision mirroring fraudulent conveyances.²⁰⁶ Federal courts developed the doctrine of equitable subordination,²⁰⁷ which allows for a subordination of certain types of problematic claims to the benefit of other debtors. Thus, the only important doctrine aimed at creditor protection under state law is veil piercing.²⁰⁸

This adds up to the picture that creditor protection mostly remains outside the scope of regulatory competition in the US. Admittedly, there is an incipient discussion on regulatory competition in bankruptcy law, as debtors appear to have considerable discretion as to where to file for bankruptcy protection.²⁰⁹ However, this is limited by the fact that all bankruptcy courts are bound by the Bankruptcy Code and decisions of higher courts and ultimately the US Supreme Court.

By contrast, issues of creditor protection are in part an issue of company law in Europe (and also an important aim of the EC Company Law Directives). With the ECJ apparently setting tight limits to the application of mechanisms of corporate law to foreign companies in *Inspire Art*, effects of competition on creditor interests are likely to depend on the applicability of instruments of insolvency law to companies incorporated in other EU and EEA Member States, and on the courts of which state will be in charge of insolvency proceedings.

According to art. 3(1) of the Council Regulation on Insolvency Proceedings²¹⁰, „[t]he courts of the Member State within the territory of which the centre of a debtor's main interests is situated shall have jurisdiction to open insolvency proceedings.“ Art. 3(2)

²⁰⁵ US Constitution, Art 1 § 8.

²⁰⁶ 11 USC § 548.

²⁰⁷ See Clark, *supra* n 19, 52-71; Allen and Kraakman, *supra* n 19, 141-56.

²⁰⁸ There may be some regulatory competition on veil piercing. For example, Nevada has promoted its corporate law with the argument that veil piercing is more difficult than in all other states. Cf Kahan and Kamar, *supra* n 22, 717.

²⁰⁹ See eg Cole, *supra* n 192, 1845.

²¹⁰ Regulation 1346/2000 EC [2000] OJ L160/1.

sets out a presumption that the main interests are at the place of the registered office, and other states may only open proceedings if there is an establishment in the particular state, and the proceedings have to be restricted to the assets there in that case. However, the presumption can be rebutted, and some national courts have vigorously asserted their jurisdiction. For example, a German court, the *Amtsgericht Hamburg*, found that it could open proceedings over an English letterbox company, and it even stated that its shareholders could not rely on limited liability, as it was grossly undercapitalized.²¹¹ Likewise, the English High Court found that insolvency proceedings could be opened in England over a German holding company, which, in the eyes of the court, had the center of its business activities in Bradford.²¹² In the *Eurofoods* case, an Irish subsidiary of Parmalat over which both Italian and Irish courts had claimed jurisdiction, the Supreme Court of the Republic Ireland has referred a number of questions concerning the interpretation of the regulation to the ECJ.²¹³

Effects of regulatory competition on creditor interests will partly depend on how national courts, and possibly the ECJ, will deal with the regulation. If insolvency proceedings will usually be initiated in the state of incorporation, the effects described in section C.4 are likely to pertain also to insolvency law. Furthermore, even when the issue of jurisdiction is clear, national courts have to grapple with the question whether the application of national doctrines of insolvency law (as well as corporate law) is

²¹¹ *Amtsgericht Hamburg*, May 14, 2003, 67g IN 358/02, [2003] 6 *Neue Zeitschrift für Gesellschaftsrecht* 732; also see *Amtsgericht Mönchengladbach*, April 27, 2004, 19 IN 54/04, [2004] 26 *Zeitschrift für Wirtschaftsrecht* 1064 (German court asserting jurisdiction for primary insolvency proceedings over objection of the company).

²¹² *In Re Daisytek-ISA Ltd and others*, [2004] BPIR 30. A German court, the *Amtsgericht Düsseldorf*, initially considered English insolvency proceedings void in its decision of June 6, 2003, 502 IN 126/03, [2003] 25 *Zeitschrift für Wirtschaftsrecht* 1363, but finally had to amend this decision after the case was remanded by a higher court. See *AG Düsseldorf*, March 12, 2004, 502 IN 126/03, [2004] 26 *Zeitschrift für Wirtschaftsrecht* 623.

²¹³ *In Re Eurofoods IFSC Ltd*. [2004] IESC 45 (27 July 2004).

compatible with the freedom of establishment under the criteria set out by the ECJ.²¹⁴ If the bounds set by the ECJ are narrow, the effects of regulatory competition will be stronger.

E. SUMMARY

The analysis in this article has shown that the structural conditions of European market for corporate law differ from the US in several respects.

On the supply side, a European Delaware is virtually impossible. Delaware owes its unique position to unusual historical circumstances, which cannot be expected to be reproduced in 21st century Europe. Even without the current prohibition of franchise tax, small European states are badly positioned to offer advantages which could allow them to become quasi-monopolists, which is, in turn, a precondition for a credible commitment to the kind of corporate law favored by the market.

On the demand side, legal, administrative and cultural factors are likely to reduce market demand as such, and thus slow down the race either to the top or bottom. The focus of regulatory competition on newly founded corporations, and even European financial structures among publicly traded firms are likely to reinforce fragmentation in the market. With less developed capital markets on the continent, and continental large shareholders being able to control reincorporation without having to bargain with the minority, a movement “to the bottom” cannot be ruled out. Large institutional creditors may also be able to influence the development in their favor, which may be detrimental to other groups of nonshareholder constituencies and even shareholders.

²¹⁴ In *Inspire Art*, *supra* n 8, para 133, the ECJ refers to the criteria set out in *Reinhard Gebhard v Consiglio dell'Ordine degli Avvocati e Procuratori di Milano* (Case C-55/94) [1995] ECR 4165. National measures hindering or making less attractive the exercise of the freedoms “must be applied in a non-discriminatory manner; they must be justified by imperative requirements in the public 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.”,

The European level of legislation and regulation is less likely to influence the conduct of national actors in the market than the federal level in the US, because Europe lacks an influential common public sphere, the legislative process is slow, and there is no court system or European securities authority with substantive influence on corporate law in place.

However, while the danger of a race to the bottom as such seems to be larger in Europe than in the US, and while federal influence (in whatever direction) seems weaker, both the reduced incentives for states on the supply side and certain impediments on the demand side are likely to slow down the competitive development of corporate law considerably, in whatever direction it may be going.