Choice of Jurisdiction in European Corporate Law: Perspectives of European Corporate Governance

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I. The Fortified Right of Establishment in the European Union

In a line of three landmark decisions the Court of Justice of the European Communities (ECJ) univocally enforced the right of incorporators to freely choose the corporate law system of any Member State of the European Union to govern their company's internal affairs regardless of where the arising entity will establish its actual center of administration or plans to do business.[1] Taken together, the holdings of the judgments made clear that the only way to determine a corporation's legal personality, its status, and most of its governance issues consistent with fundamental Community freedoms,[2] is to apply a conflict of laws rule which points to the jurisdiction of formation.[3] The judgments set a tone distinctly different from an older decision that rested on the assumption that the EC TREATY had taken account of the differences in national rules on the conflict of cor-

1 Case C-212/97, Centros Ltd. v. Erhvervs- og Selskabsstyrelsen, 1999 E.C.R. I-1459; Case C-208/00, Überseering BV v. Nordic Construction Company Baumanagement GmbH, 2002 E.C.R. I-9919; Case C-167/01, Kamer van Koophandel en Fabrieken voor Amsterdam v. Inspire Art Ltd., 2003 WL 102001, Celex No. 601J0167 *available at* http://europa.eu.int/eur-lex/.

2 In particular the grant of freedom of establishment, TREATY ESTABLISHING THE EUROPEAN UNION, CONSOLIDATED VERSION, Dec. 24, 2002, artt. 43, 48, O.J. (C 325) 33, 53, 54 (2002) [hereinafter EC TREATY].

3 It has been pointed out by commentators that the ECJ's elaborations cannot be grasped by simply subsuming them under national conflict of corporate laws rules but call for an unpreceded European legal model. For a detailed analysis *cf.* Eddy Wymeersch, The Transfer of the Company's Seat in European Company Law 23-29 (Eur. Corporate Governance Inst., Working Paper No. 08/2003, Mar. 2003) *available at* http://ssrn.com/abstract=384802 coining the term "Community formation theory"; Horst Eidenmüller & Gebhard Rehm, *Niederlassungsfreiheit versus Schutz des inländischen Rechtsverkehrs: Konturen des Eurpäischen Internationalen Gesellschaftsrechts [Freedom of Establishment versus Protection of Domestic Legal Relations: Outline of a European Conflict of Corporate Laws*], 33 ZEITSCHRIFT FÜR UNTERNEHMENS- UND GESELLSCHAFTSRECHT (ZGR) 159, 164-66 (2004) (same).

porate laws and had referred resolution of the problems associated therewith to harmonizing legislation for which the freedom of establishment could not serve as a substitute.[4] They meant nothing but a revolution[5] for those European jurisdictions that until then followed the "real seat" doctrine (*Sitztheorie*, *théorie du siège reel*), i.e. a conflict of laws rule compelling to address the above mentioned internal governance issues by looking at

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[4] Case 81/87, The Queen v. Treasury and Commissioners of Inland Revenue, ex parte Daily Mail and General Trust, 1988 E.C.R. 5483. But see already Case 79/85, D.H.M. Segers v. Bestuur van de Bedrijfsvereniging voor Bank- en Verzekeringswezen, Groothandel en Vrije Beroepen, 1986 E.C.R. 2375. (interpreting artt. 52 and 58 EC TREATY (as in effect 1986, now EC TREATY artt. 43, 48) as prohibiting the authorities of a Member State from excluding the company's director from a national sickness insurance benefit scheme solely on the ground that the company was formed in accordance with the law of another Member State, where it also had its registered office but did not conduct any business. It was already at this time that some commentators concluded the incompatibility of the real seat theory with the freedom of establishment *e.g.* Inne G.F. Cath, *Freedom of Establishment: A New Step towards Completion of the Internal Market*, 6 Y.B. EUR. L. 246, 259-61 (1986)).
Some commentators have pointed to the fact that the ECJ in *Überseering* only distinguished *Daily Mail* and consequentially left room for member states to impose restrictions on the emigration of companies which, until then, were subject to their jurisdiction. *E.g.* Wymeersch, *supra* note 3, at 17-18; Stefan Leible, *Niederlassungsfreiheit und Sitzverlegungsrichtlinie [Freedom of Establishment and Directive on the Transfer of Seat]*, 33 ZGR 531, 536 (2004).
However, the spirit of the three decisions and the underlying strong emphasis on the goal of mutual recognition suggests that the Court would not be – and should not be (Daniel Zimmer, *Wie es euch gefällt? Offene Fragen nach dem Überseering-Urteil des EuGH [As you please? Open questions after the Überseering-Judgment of the ECJ]*, 58 BETRIEBS-BERATER (BB) 1 (2003)) – more generous with regard to regulations hindering the free migration of corporate entities, if these impediments emanated from the previously applicable corporate law system.

[5] A foreseeable one, though. Some national courts had years before anticipated the essence of the ECJ's holdings, *e.g.* Bayerisches Oberstes Landesgericht [Bavarian Supreme Court], 36 Entscheidungen des Bayerischen Obersten Landesgerichts in Zivilsachen [BayObLGZ] 61 (1986) (holding that artt. 52 and 58 EC TREATY as in effect 1986 (now artt. 43 and 48 EC TREATY) mandated the recognition of an English limited company as a general partner of a limited partnership formed under German law). For a thoughtful commentary on the judgment *see* Werner F. Ebke, *The Limited Partnership and Transnational Combinations of Business Forms: "Delaware Syndrome" Versus European Community Law*, 22 INT'L LAW. 191 (1988).

the corporate law of the jurisdiction in which the company has established its administrative headquarter.[6] The exact scope of the newly interpreted freedom of establishment and the consequences it entails in detail may not be yet clear and some of the ECJ's doctrinal arguments are assailable.[7] Nonetheless, the fundamental precept is straightforward. Any national regulation making the recognition of a foreign business entity's legal personality contingent on broad compliance with domestic standards conflicts with EC TREATY artt. 43, 48.[8] Moreover, it has become clear, that the Court pushes for a far reaching mutual recognition of corporate entities among Member States and prohibits the general recourse to regulations reshaping a foreign corporation's legal personality as awarded by the

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[6] In particular, with considerable variations in doctrinal details: Austria, Belgium, France, Germany, Greece, Luxembourg, Portugal, Spain. For references *see* Helen Xanthaki, Centros*: is this really the end for the theory of the* siège réel?, 22 COMPANY LAW., 1, 2 (2001). For an overview of the pertinent European conflict of laws rules *see* Wymeersch, *supra* note 3, at 7-15; STEPHAN RAMMELOO, CORPORATIONS IN PRIVATE INTERNATIONAL LAW 20-41 (2001); Jan Wouters, *Private International Law and Companies' Freedom of Establishment*, 2 EUR. BUS. ORG. L. REV. 101, 103-10 (2001).

[7] For further discussion of *Centros cf.* Werner F. Ebke, Centros – *Some Realities and Some Mysteries*, 48 AM. J. COMP. L. 623 (2000); Eva Micheler, *The Impact of the Centros Case on Europe's Company Laws*, 21 COMPANY LAW. 179 (2000); Helen Xanthaki, *Secondary Establishment of Companies within the EU: A Real Challenge or Another Missed Opportunity?*, 10 EUR. BUS. L. REV. 120 (1999).
For commentaries on *Überseering cf.* Mads Andenas, *Free Movement of Companies*, 119 LAW Q. REV. 221 (2003); Thomas Bachner, *Freedom of Establishment for Companies: a Great Leap Forward*, 62 CAMBRIDGE L.J. 47; Eva Micheler, *Recognition of Companies Incorporated in Other EU Member States*, 52 INT'L. & COMP. L.Q. 521, 524-29 (2003); Wulf-Henning Roth, *From Centros to Ueberseering: Free Movement of Companies, Private International Law, and Community Law*, 52 INT'L. & COMP. L.Q. 177 (2003); Frank Wooldridge, *Überseering: Freedom of Establishment of Companies Affirmed*, 14 EUR. BUS. L. REV. 221 (2003).

[8] The converse position still represented after *Centros* (for an overview *cf.* CHRISTIN M. FORSTINGER, TAKEOVER LAW IN THE EU AND THE USA 34-48 (2002); Christian Kersting, *Corporate Choice of Law – A Comparison of The United States And European Systems And A Proposal for a European Directive*, 28 BROOK. J. INT'L. L. 1, 39-40 note 206 & 207 (2002)) is no longer sustainable.

member state of formation. As a consequence Europe has now uniformly reached a state, where incorporators can select a statutory domicile for their business entity independent of the location of the firm's physical assets and its place of business.[9] In fact, the judicially enforced[10] European state of formation rule creates a situation similar to the scenario under the United States' mutual recognition rule and the internal affairs doctrine which together grant true choice of law in the corporate domain.[11]

In light of the reinforced right of establishment and the accomplished freedom to incorporate at will, the critical question whether incorporators' ability to select a corporate law regime, generally or under certain conditions, constitutes a desirable prospect for Europe cannot be muted anymore by reference to the alleged lack of an enabling legal

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9 *See also* Council Regulation 2157/2001 on the Statute for a European company (SE), art. 8, 2001 O.J. (L 294) 1, 4-6 [hereinafter SE-Regulation] providing in detail for the transfer of the SE's administrative seat or registered office without affecting the continuity of its legal personality. Yet, the SE-Regulation allows Member States to require both registered office and administrative seat be located in the same place (art. 7) and to sanction any non-concurrence with the ordered liquidation of the SE (art. 64(2)). A similarly regulation can be found already in Council Regulation 2137/85 of July 1985 on the European Economic Interest Grouping (EEIG), artt. 2(1), 5(b), 6, 12, 1985 O.J. (L. 199) 1-4. Some analysts have pointed to the conflict of this real seat theory oriented rule with the ECJ's holdings in *Centros* and *Überseering*, *e.g.* Wymeersch, *supra* note 3, at 33.

10 The Convention of 29 February 1968 on the Mutual Recognition of Companies and Bodies Corporate never entered into force due to lack of ratification by the Netherlands. On the various attempts to accomplish mutual recognition of corporations *see* Wymeersch, *supra* note 3, at 5-6.

11 *Cf.* RESTATEMENT (SECOND) OF CONFLICT OF LAWS §§ 297, 302 (1971); REVISED MODEL BUS. CORP. ACT § 15.05 (2002). CTS Corp. v. Dynamics Corp. of America, 481 U.S. 69, 90 (1987) (emphasizing the necessity that a corporation – save in the rarest situations – is organized under and governed by the laws of a single jurisdiction). McDermott Inc. v. Lewis, 531 A.2d 206, 214-19 (Del. 1987) (purporting the Constitution required the application of the internal affairs doctrine). On the origins of the internal affairs doctrine *see* Richard M. Buxbaum, *The Origins of the American "Internal Affairs" Rule in Conflict of Laws*, *in* FESTSCHRIFT FÜR GERHARD KEGEL ZUM 75. GEBURTSTAG (Hans-Joachim Musielak & Klaus Schurig eds., 1987).

framework.[12] Even if Europe will not witness an immediate avalanche of cross-border re-incorporations, the topic is on the agenda and the European legal systems, national and supranational, have to face up to the challenge. Rational decisions where to incorporate can more than ever be based on suitability considerations with regard to the corporate law environment a jurisdiction has to offer. Corporate law arbitrage has become possible.

This article addresses the question what will be the impact of the permitted choice of corporate law in Europe and how regulators can and should react. Drawing upon the empirical evidence and theoretical insights produced in the abundant debate in the United States (II), I will argue that the European scenario differs significantly from the American. After outlining the most relevant varieties which will influence European cross-border incorporation choices and constitute European idiosyncrasies (III), I will discuss incentives conceivably accounting for cross border incorporations within the European Union (IV). The analyses will allow the conclusion, that at the outset no Member State neither provides at present, nor has proper incentives and political maneuvering space to assume a similarly preponderant position like the winner in the historical American competition for corporate charters. The key to success in the franchise fee-driven American

[12] For earlier viewpoints in the then largely academic debate *cf.* Clive M. Schmitthoff, *The Future of the European Company Law Scene*, in: THE HARMONIZATION OF EUROPEAN COMPANY LAW 3, 9 (Clive M. Schmitthoff ed. 1973) (arguing for complete harmonization to prevent race to the bottom); Walter Kolvenbach, *EEC Company Law Harmonization and Worker Participation*, 11 U. PA. J. INT'L. ECON. L. 709, 711-12 (1990) (same); Bernhard Großfeld, *The Internal Dynamics of the European Community Law*, 26 INT'L LAW. 125, 138-39 (1992) (same). Thomas E. Abeltshauser, *Towards A European Constitution of the Firm: Problems and Perspectives*, 11 MICH. J. INT'L L. 1235, 1264-68 (1990) (suggesting harmonization only with respect to areas of corporate law where the recognition of national rules as functionally equivalent is not possible). Generally *see* Norbert Reich, *Competition Between Legal Orders: A New Paradigm of EC Law?*, 29 COMMON MKT. L. REV. 861 (1992); Roger van den Bergh, *The Subsidiary Principle in European Community Law: Some Insights from Law and Economics*, 1 MAASTRICHT J. EUR. & COMP. L. 337 (1994).

race lay in the easily cognizable edge successful States' corporate law had from an incorporator's perspective and these States' ability to commit themselves credibly to maintaining their advantage. At the crack of dawn of a potential European race, no Member State provides a clearly superior corporate law. Franchise fees as a motivation to excel are banned by European law and could, if at all, only induce the smallest Member States to shape their corporate law with regard to incorporator's needs. However, even this faint prospect is further attenuated. Without a wave of re-incorporations, comparable to the rush from New Jersey to Delaware in early 20th century, the timeframe during which the relatively high entering cost to the market for corporate charter would finally amortize probably exceeds the maximum period the Union's tiny States are willing and able to wait (V). Hence, although individual preferences of decision-makers may motivate some cross-border (re-)incorporations, no dominant state of incorporation will emerge in the European Union in medium-term. Synthesized with the possible restraints Member States can put on corporate law arbitrage (VI), the important conclusion to be drawn is that in the European context some forces arguably accountable for a socially undesirable pro-managerial tilt in the American market for corporate charter are not present. Thus, the case for remedying centralized legislation is harder to make in the EU. Some of the prospective and existing harmonization, even if only providing minimum standards, should be reassessed under this perspective (VII).

II. Regulatory Competition in the United States – The Unresolved Mystery

It has been a long unchallenged paradigm of U.S. corporate law scholarship that States are competing for corporate charter and have during the course of more than a century amended and rewritten their corporate statutes to satisfy the needs of incorporators.[13]

The vigorous debate in the literature focuses on the evaluation of the States' generosity towards their clientele in the incorporation business.[14] In an attempt to set the stage, this paragraph tries to outline the most important arguments advanced in the opulent American academic discussion in order to assess the European situation against this background of theoretical explanations and empirical evidence.

A. Race to the top

1. Competition as a Discovery Process

Ralph K. Winter's modern articulation of the race to the top theory represents a variation of the broader posit that attributes superior ability to spur innovation to federal legislative systems.[15] The concept dwells on the well established idea of competition as a discovery process[16] and attributes to decentralized lawmaking a faster rate of legal innovation and a greater adaptability to all kinds of exogenous shocks whereas in centralized

[14] The contending views were early outlined long before the modern debate refined and ramified the arguments, *cf.* RUSSEL CARPENTER LARCOM, THE DELAWARE CORPORATION v-vi (1937).

[15] Ralph K. Winter, Jr., *State Law, Shareholder Protection, and the Theory of the Corporation*, 6 J. LEGAL STUD. 251 (1977). See also Peter Dodd & Richard Leftwich, *The Market for Corporate Charters: "Unhealthy Competitions" Versus Federal Regulation*, 53 J. BUS. 259, 260-61; Daniel R. Fischel, *The "Race to the Bottom" Revisited: Reflections upon Recent Developments in Delaware's Corporation Law*, 76 NW. U.L. REV. 913 (1982); Frank H. Easterbrook, *Managers' Discretion and Investors' Welfare: Theories and Evidence*, 9 DEL. J. CORP. L. 540, 549-50 (1984); FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 212-217 (1991); Roberta Romano, *Law as A Product: Some Pieces of the Incorporation Puzzle*, 1 J. L. ECON. & ORG. 225 (1985); Roberta Romano, *The State Competition Debate in Corporate Law*, 8 CARDOZO L. REV. 709 (1987); ROBERTA ROMANO, THE GENIUS OF AMERICAN CORPORATE LAW (1993).
The idea has – through the pen of Judge Easterbrook – also entered into judicial opinions, *cf.* Amanda Acquisition Corp. v. Universal Foods Corp., 877 F.2d 496, 507 (7th Cir. 1989).

[16] FRIEDRICH AUGUST VON HAYEK, NEW STUDIES IN PHILOSOPHY, POLITICS, ECONOMICS AND THE HISTORY OF IDEAS 179-190 (1978).

legal systems only sequential experimentation and learning is deemed possible. An underlying assumption in the corporate context is that where franchise fees are the driving force behind legislative initiatives, lawmakers' incentives are exclusively focused on incorporators' desire to have the firm's internal affairs governed by investor-friendly corporate law that induces equity investment and is largely undistorted by special interest of other constituencies.

2. Large Firms

It has been pointed out in the American debate that there is no competition among jurisdictions for the incorporation of close corporations.[17] Commonly this is explained with the structure of franchise fees which render the additional benefit attainable from attracting close corporations relatively small and make the venture not worth embarking on.[18] Moreover, Delaware's extensive body of precedents together with its experienced bar, judiciary, and its efficient administration are especially helpful for corporations of a certain magnitude that typically engage or are exposed to mergers and acquisition, public offerings and takeovers.[19] The latter observation, however, only indicates that some features of Delaware's substantive and procedural package are value maximizing but leaves

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[17] Ian Ayres, *Judging Close Corporations in the Age of Statutes*, 70 WASH. U. L.Q. 365 (1992); ROMANO, *supra* note 15, at 24-28.

[18] Alternative views *e.g.* Barry D. Baysinger & Henry N. Butler, *Race for the Bottom v. Climb to the Top: The ALI Project and Uniformity in Corporate Law,* 10 J. CORP. L. 431 (1985) (assuming that investors in smaller firms, unable to rely on efficient capital markets, prefer stricter statutory constraints and consequentially favor jurisdictions with less enabling corporate law) only tackle the question why Delaware does not attract closed corporations but leave unexplained why not another state is comparably predominant like Delaware with regard to small firms' incorporations.

[19] Romano, *supra* note 15, at 225; Romano, *supra* note 15, at 709.

room for the concession that other aspects may well deviate from the welfare maximization objective.

3. Corporate Takeovers

Since the beginning of the 1990s when in many jurisdictions, including Delaware,[20] the market for corporate control involving hostile takeovers had been seriously inhibited, one focal point of the debate became the question, whether the incorporation in takeover-hostile jurisdictions indicated that managers maximized their discretion at investors' expense.[21] Attempts of race to the top proponents to reconcile the appearance of anti-takeover regulation and adjudication which ostensibly served to the detriment of shareholders[22] included some backing up, when these investor-hostile activities were

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[20] Delaware's legislative reaction to the takeover frenzy of the late 1980s was relatively moderate as a comparison of its business combination statute DEL. CODE ANN. tit. 8, § 203 (2003) with the far more severe anti-takeover legislation enacted elsewhere, *e.g.* WIS. STAT. § 180.726 (1987), readily illustrates. However, taking into account that Delaware courts approved strong takeover devices like the poison pill, Moran v. Household Intern., Inc., 500 A.2d 1346 (Del. 1985), and honored management's wide discretion in determining the corporations' stance with regard to an unsolicited bid, Paramount Communications, Inc. v. Time Inc., 571 A.2d 1140 (Del. 1989), the overall picture changes dramatically. It was only recently that the pendulum rebounded somewhat with the revived emphasis on safeguarding shareholders' franchise in takeover contests, *e.g.* MM Companies, Inc. v. Liquid Audio, Inc., 813 A.2d 1118 (Del. 2003).

[21] For recent comments in the debate *cf.* Lucian A. Bebchuk & Allen Ferrell, *Federalism and Corporate Law: The Race to Protect Managers from Takeovers*, 99 COLUM. L. REV. 1168 (1999) (arguing that competition works to produce takeover law that excessively protects managers); Lucian A. Bebchuk, Alma Cohen & Allen Ferrell, *Does The Evidence Favor State Competition in Corporate Law?*, 90 CAL. L. REV. 1775 (2002) (producing evidence for the pro-managerial tilt); Lucian A. Bebchuk & Alma Cohen, *Firms Decision where to Incorporate*, 46 J. L. & ECON. 383 (2003) (same); Jonathan R. Macey, *Displacing Delaware, Can the Feds to a better job regulating takeovers*, 57 BUS. LAW. 1025, 1032-1040 (2002) (arguing that Delaware takeover law does in truth not cater to managers).

[22] It is not without relevance to the debate, that the controversy about the merits of anti-takeover devices is far from settled. For the classic positions *cf.* Martin Lipton, *Take-*

viewed as a product of counteracting forces which only partly hinder the overall tendency of state competition to benefit shareholders.[23]

B. Race to the bottom

The modern race-to-the-bottom-view was articulated by former SEC chairman William Cary who attributed Delaware's success to its loose corporation law and reluctant judiciary permitting managers, who in fact dominated incorporation decisions, to maneuver with only minimal constraints when attempting to siphon capital from investors.[24] In Cary's view the appetite for franchise revenues incrementally lead to the erosion of corporate standards in both statutory and case law. The general theme of Cary's argument persists today,[25] triggering the follow-up query what kind of institutional arrange-

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over Bids in the Target's Boardroom, 35 BUS. LAW. 101 (1979) (advocating to endow the board with veto power); Ronald J. Gilson, *The Case Against Shark Repellent Amendments: Structural Limitations on the Enabling Concept*, 34 STAN. L. REV. 775 (1982) (recommending shareholder choice). For a recent, positive view of takeover protection *see* Marcel Kahan & Edward B. Rock, *Corporate Constitutionalism: Antitakeover Charter Provisions as Pre-Commitment*, 152 U. PA. L. REV. 473 (2003) (arguing that shareholders may rationally entrench boards in order to pursue value increasing selling strategies); for the converse position cf. Lucian A. Bebchuk, *The Case Against Board Veto in Corporate Takeovers*, 69 U. CH. L. REV. 973 (2002) (arguing that boards role should be confined to facilitating an informed shareholder decision).

[23] EASTERBROOK & FISCHEL, *supra* note 15, at 222-223; Ralph K. Winter, Jr., *The 'Race for the Top' Revisited*, 89 COLUM. L. REV. 1526, 1529 (1989); William J. Carney, *The Political Economy of Competition for Corporate Charters*, 26 J. LEGAL STUD. 303, 329 (1997)

[24] William L. Cary, *Federalism and Corporate Law: Reflections upon Delaware*, 83 YALE L.J. 663 (1974); *see already* Louis K. Ligget Co. v. Lee, 288 U.S. 517, 558 n.34 (1934) (Brandeis, J., dissenting). A lack of investor protection in Delaware's corporation law was alleged too by the drafters of the Model Business Corporation Act, *cf.* John C. Campbell, *The Model Business Corporation Act*, 11 BUS. LAW. 98, 100-101 (1956).

[25] Variations include Melvin A. Eisenberg, *The Modernization of Corporate Law: An Essay for Bill Cary*, 37 U. MIAMI L. REV. 187, 188-91, 196-98, 202-09 (1983);

ments are necessary, to either steer against the detrimental forces of a continuous downward drag or to bolster up the hampered benevolent market mechanisms.

C. The Slackening of the Race

Recent research has emphasized that while historically a fierce competition for corporate charter may have ensued among states, the struggle has effectively ceased today with states other than Delaware making no or only negligible efforts to attract incorporations.[26] The gist of this scholarship is that Delaware has effectively established a quasi-monopoly in the chartering market dulling competitive mechanisms that would lead to the corporate law tinkering race to the top advocates envision. Without legal intervention, the situation characterized by prohibitive market entrance cost for any challenger could only change if the monopolist commits an extreme frailty.[27]

Melvin A. Eisenberg, *The Structure of Corporation Law*, 89 COLUM. L. REV. 1461 (1989); Lucian A. Bebchuk, *Federalism and the Corporation: The Desirable Limits on State Competition in Corporate Law*, 105 HARV. L. REV. 1435 (1992).

[26] Marcel Kahan & Ehud Kamar, *The Myth of State Competition in Corporate Law*, 55 STAN. L. REV. 679 (2002) (arguing that political and economic barriers prevent other states to truly compete with Delaware); Lucian A. Bebchuk & Assaf Hamdani, *Vigorous Race or Leisurely Walk: Reconsidering the Competition over Corporate Charters*, 112 YALE L.J. 553 (2002) (holding that Delaware faces only a minor threat from potential challengers who cannot easily make good its competitive edge); Robert Daines, *The Incorporation Choices of IPO Firms*, 77 N.Y.U. L. REV. 1559 (2002) (presenting evidence for the lack of a national market for corporate charter); Bebchuk & Cohen, *supra* note 21, at 383 (same).
The idea was already articulated by Winter, *supra* note 23, at1528-29, when he coined the description of the chartering competition as a "leisurely walk" that could be accelerated by a "second Delaware" with insatiable appetite for franchise taxes.

[27] Martin Lipton's famous memo proposing reincorporation out of Delaware in reaction to *City Capital Assoc. v. Interco Inc.*, 551 A.2d 787 (Del. Ch. 1988) gives eloquent testimony that the business community and its counsel actually think along these lines. Martin Lipton, To Our Clients: The Interco Case (Nov. 3, 1988) (quoted in Jeffrey N. Gordon, *Corporations, Markets and Courts*, 91 COLUM. L. REV. 1931, 1959 note 95 (1995)).

D. The Role of Federal Legislation and Rule Making

1. The Descriptive Analysis: The Role in the Past

Exposing a remarkable conception of legislative division of labor, state legislators sometimes attributed federal authorities a central role in securing investor protection which state law exposed to standard-softening competition according to their understanding could not provide.[28] However, recent research indicates that the federal role was much more complex.[29] Federal influence existed not only where federal rules were actually promulgated to supplement or override state law. In fact, it constituted an all-embracing force shaping corporate law, because the ever-present threat of federal regulation induced state activity and confined state discretion to the band considered tolerable in Washington. In this view much of the content of U.S. corporate law can be explained by this particular vertical institutional framework under which corporate law is made.[30] Delaware's legislature concerned with franchise tax revenues and subject to pressure only from a limited number of special interest groups[31] caters by and large to the interests of

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[28] *E.g.* Report of the Corporation Law Revision Commission of New Jersey, N.J. STAT. ANN. § 14A, at x-xi (1969).

[29] Mark J. Roe, *Delaware's Competition*, 117 HARV. L. REV. 588 (2003). See already John C. Coffee, Jr., *The Future of Corporate Federalism: State Competition and the New Trend Toward De Facto Federal Minimum Standards*, 8 CARDOZO L. REV. 759, 766 (1987) (explaining the volatility of Delaware's case law with the ebb and flow of the federal threat to Delaware's hegemony).

[30] Mark J. Roe, Delaware's Politics (Oct. 2003) (unpublished manuscript on file with the author). For an interest group model of corporate law making *see* William J. Carney, *supra* note 24, at 307-09.

[31] Commentators have identified the legal profession's self-interest as a factor shaping the (procedural) aspects of Delaware corporate law. Coffee, *supra* note 29, at 763-64; Jonathan R. Macey & Geoffrey P. Miller, *Toward an Interest Group Theory of Delaware Corporation Law*, 65 TEX. L. REV. 469 (1987).

those responsible for reincorporation decisions[32] whereas public and private federal rule-makers (Congress, SEC, NYSE etc.) are exposed to the desires of a much broader array of constituents.

2. The Normative Angle: The Case for Federal Legislation

Early in the academic discussion commentators advocated federal standards to remedy the perceived flaws of state corporate law.[33] Yet, conceding that federal players historically were more apt to bear the investor interest in mind renders the common counterargument that comprehensive federalization would do more harm than good because the decentralized system may be imperfect, but is still the best available real-world alternative,[34] even more persuasive: Understanding the vertical process of corporate law making outlined in the preceding paragraph as a beneficial separation of proposal and ratification entails that federal action would preempt future state proposals in the then centrally regulated field and thereby would shut down this quality-enhancing two-step procedure that is independent of the existence of interstate competition.[35] Consequen-

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[32] In most jurisdictions reincorporation decisions, which are executed by merging the reincorporating entity into a shell corporation established under the corporate statute of the receiving jurisdiction, require board initiation and shareholder consent. *E.g.* DEL. CODE ANN. tit. 8, §§ 252, 251 (2003); CAL. CORP. CODE §§ 1101, 1201, 181 (2004); N.Y. BUS. CORP. LAW §§ 901-903 (2004); REVISED MODEL BUS. CORP. ACT §§ 11.04, 11.02 (2002). This distribution of power induces suppliers of corporate charter to reasonably accommodate both interest groups, however, without excluding a bias in favor of the choice-dominating faction.

[33] Cary, *supra* note 24, at 692-96, 700-01; Bebchuk, *supra* note 25, at 1499-1507.

[34] For the race to the top advocates' rebuttal of federalization proposals *cf.* ROMANO, *supra* note 15, at 148 (pointing to self-correcting mechanisms in a decentralized system); Macey, *supra* note 21, at 1028 (pointing to interest group pressure and empire building tendencies of legislators and bureaucrats that would worsen current corporate law's deficiencies).

[35] *Cf.* Roe, *supra* note 29, at 635-36.

tially, the goal of recent proposals is to create the requisites for a reopening of once-existing regulatory competition by reinvigorating the competitive forces inherent in the existing decentralized regime and aligning the process of competition more closely with shareholder interest.[36] The advocated optional federal alternative meets concerns resulting from Delaware's dominant position and acknowledges that in a viably competitive market for corporate charter welfare may be created if management is unable to opportunistically distort incorporation choices.

E. Observations from a European Perspective

The driving force during the first wave of reincorporations in Delaware was the fierce antitrust regulation in New Jersey, the relevant provisions known as the "Seven Sisters", promulgated under then governor Woodrow Wilson.[37] Equally relevant, New Jersey's crack down on the "trusts" triggered the reincorporation-avalanche because most of the monopoly firms where located in the then reneging State that had attracted them beforehand by promulgating favorable regulations enabling monopoly-friendly corporate

[36] Lucian A. Bebchuk & Allen Ferrell, *A New Approach to Takeover Law and Regulatory Competition*, 87 VA. L. REV. 111 (2001) (arguing that the federal government should offer a fifty-first takeover regime, asserting that federal rules may provide a more shareholder-oriented alternative, and proposing a procedural rule by which a majority of shareholders, acting independently of the board of directors, may unilaterally opt into the federal takeover regime.); Stephen J. Choi & Andrew T. Guzman, *Choice and Federal Intervention in Corporate Law*, 87 VA. L. REV. 961 (2001) (contending that the federal alternative does not provide sufficient choice and incorporators' options should include private lawmakers' offerings). *See already* Coffee, *supra* note 29, at 773-77 (proposing a federal minimum standard enabling shareholders to choose the corporate law regime independent of board initiation).

[37] Christopher Grandy, *New Jersey Corporate Chartermongering*, 49 J. ECON. HIST. 677 (1989); Andrew G. T. Moore II, *A Brief History of the General Corporation Law of the State of Delaware and the Amendatory Process*, in: THE DELAWARE LAW OF CORPORATIONS AND BUSINESS ORGANIZATIONS H-1, H-8 (R. Franklin Balotti & Jesse A. Finkelstein eds., 3d ed. 1998).

structures.[38] This suggests that historically reincorporation for large firms came on the agenda on a grand scale when threats for the existence of the corporate entity arose or a jurisdiction facilitated business combinations, yielding significant added profits which could not be accomplished under the laws of the current state of incorporation. The mere duplication of a successful corporate law system alone did not suffice to attract incorporators.[39] Assuming that rational decision makers opt for reincorporation if the prospective benefits outweigh the cost associated with the change in jurisdiction, the obvious conclusion is that a Member State in order to attract existing corporations has to do substantially and cognizably better than the present state of incorporation.

The American debate also sheds light on the relevant determinants that may distort outcomes in a market dominated by a monopolist. Many factors accounting for Delaware's dominance do not warrant the conclusion that there is a race either to the top or to the bottom with regard to substantive corporate law. The positive network externalities (i.e. Delaware's extensive body of case law, its experienced judiciary and administration) simply explain the state's preponderance,[40] even under the assumption that its corporate law is suboptimal, because they are largely independent of the substantive rules

[38] Henry N. Butler, *Nineteenth Century Jurisdictional Competition in the Granting of Corporate Privileges*, 14 J. LEGAL STUD. 129, 161-63 (1985); LAWRENCE M. FRIEDMAN, A HISTORY OF AMERICAN LAW 524-25 (2d ed. 1985).

[39] Delaware that had in large portions copied New Jersey's corporate statutes and in *Wilmington City Ry. Co. v. People's Ry. Co.*, 47 A. 245 (Del. Ch. 1900) adopted New Jersey's precedents could not immediately attract large numbers of incorporations, although it offered lower taxes than its competitor, *cf.* Butler, *supra* note 38, at 162; LARCOM, *supra* note 14, at 155. It was the change in New Jersey's economic and political structure that opened the window of opportunity for Delaware, Grandy, *supra* note 37, at 685-91.

[40] *Cf.* Michael Klausner, *Corporations, Corporate Law, and Networks of Contracts*, 81 VA. L. REV 757, 842-847 (1995).

and standards applying under Delaware's corporate statute. Their absence in Europe does not necessarily indicate that there can be no positive effect of corporate law arbitrage. On the contrary, the lack of similar head start for a Member State should lead to more pristine incorporation decisions, mainly based on the pertinent corporate law's merits.

From a European perspective it is important to realize that some of the alleged negative effects of Delaware's dominance may remain irrelevant in the European scenario, if there is only a small likelihood that a comparable haven of incorporations with an insatiable appetite for franchise fees will lord over the other jurisdictions.

III. The European Scenery – Some Differences

The preceding paragraph set the stage for the discussion of the European situation. That this is not a purely academic playground is amply illustrated by empirical evidence generated in the American debate: Research suggests that corporate law matters considerably with regard to firm value in the United States.[41] The data and its interpretation

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[41] Robert Daines, *Does Delaware Law Improve Firm Value?*, 62 J. FIN. ECON. 525 (2001) (finding a 5% positive Delaware-effect using Tobin's Q analysis).
For earlier event studies trying to determine the reincorporation effect on stock prize *cf.* Dodd & Leftwich, *supra* note 15 (positive abnormal returns for twenty-four-month period preceding reincorporation); Allen Hyman, *The Delaware Controversy – The Legal Debate*, 4 J. CORP. L. 368, 385-87 (1979) (positive abnormal returns in the days and weeks surrounding the announcement of the move to Delaware); Romano, *supra* note 15, at 271-72 (significantly positive abnormal returns in a ten-day period surrounding the reincorporation amplified by concomitant announcement of acquisition plans); Michael Bradley & Cindy A. Schipani, *The Relevance of the Duty of Care Standard in Corporate Governance*, 75 IOWA L. REV. 1 (1989) (6.2% cumulative positive abnormal return in the period of 30 to 10 days prior to distribution of proxy-materials describing the reincorporation); Jeffry M. Netter & Annette Poulsen, *State Corporation Laws and Shareholders: The Recent Experience*, 18 FIN. MGMT. 29 (1989) (positive abnormal returns). Randall A. Heron & Wilbur G. Lewellen, *An Empirical Analysis of the Reincorporation Decision*, 33 J. FIN. & QUANTITATIVE ANALYSIS 549 (1998) (positive abnormal returns if reincorporation limits director liability and negative abnormal returns if it establishes takeover defenses); Pamela P. Peterson, *Reincorporation: Motives and Shareholder Wealth*, 23 FIN. REV. 151, 159

tion may be contestable[42] but the underlying idea of law as a value influencing determinant is obviously persuasive. Taking the relative uniformity of U.S. corporate law into account,[43] it becomes apparent that the margins in a more diverse legal environment, like the European, are potentially even more substantial. Before outlining possible developments in the European Union this paragraph tries to highlight important differences distinguishing the European corporate law scenery from the one in the United States.

A. Reincorporation Mechanism

Due to the trans-jurisdictional nature of the process, national corporate statutes do typically not provide a direct mechanism for reincorporation understood as the mere change of law applicable to the unaltered legal entity. In the United States reincorporation

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(1988) (generally positive abnormal returns except where reincorporation leads to stronger takeover defenses).

[42] Oren Bar-Gill, Michal Barzuza & Lucian A. Bebchuk, The Market for Corporate Law (John M. Olin Center for Law, Economics, and Business, Discussion Paper No. 377, 2002) *available at* http://www.law.harvard.edu/programs/olin_center/papers/pdf/377.pdf (arguing that Delaware firms' higher Tobin's Q may be attributed not only to its corporate law but also to network externalities and the legal infrastructure offered and that Delaware has incentives to underprice this package in the incorporation market to chill competitors). See also Guhan Subramanian, *The Disappearing Delaware Effect*, 20 J.L. ECON. & ORG. 32 (2004) (presenting evidence that Delaware firms' higher Tobin's Q disappeared over the course of the 1990s).

[43] The posit is evidenced by the SEC's persistent denial that a reincorporation within the United States alters shareholder rights significantly enough to require registration under the Securities Act of 1933, 15 U.S.C.A. § 77a et seq. (2004). *See e.g.* Worldwide Energy Co., Ltd., SEC No-Action Letter [1971-1972 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶78,648 (Jan. 24, 1972). Since the adoption of Rule 145 (General Rules and Regulations, Securities Exchange Act 1933, 17 C.F.R. § 230.145 (2004)) the problem is addressed in context with the question if the transaction falls within Rule 145(a)(2), *cf.* Cygnus Therapeutic Systems, 1994 SEC No-Act. LEXIS 482 (May 6, 1994).

of an existing company is accomplished by virtue of a cross-border merger.[44] However, most European jurisdictions do lack institutions that allow cross-border mergers.[45] Clearly, without the alleviation of universal succession provided by merger statutes reincorporation becomes cumbersome, because it demands for a transaction cost boosting individual transfer of the companies' assets or circumventing convoluted structures.[46] A transfer of all the corporation's shares to a foreign holding company is not a fully-fledged alternative. Even if a good share of the company's corporate governance can be subjected to the law applicable to the holding corporation, the implementation of management decisions reached on the higher level have to be implemented in accordance with the corporate law pertaining to the then-subsidiary's internal affairs.

This finding is rather surprising. It indicates that in fact the state of formation rule without supplementing regulations permitting cross border mergers locks up existing corporations more thoroughly than the real seat theory. Switching jurisdictions through a transfer of the company's administrative seat may not always be such a burdensome undertaking, depending on the size of the business and the complexity of administrative tasks.[47]

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44 *Cf. supra* note 32.

45 On the current state of national laws *cf.* Jens Christian Dammann, The U.S. Concept of Granting Corporations Free Choice among State Corporate Law Regimes as a Model for the European Community, 21-22 (SSRN Electronic Paper Collection, Aug. 4, 2003) (available at http:// ssrn.com/abstract=418660). But *see also infra* note 157. On the possibility to merge into the supra-national *Societas Europaea cf. infra* VII.A.

46 For a description of the structure of the Daimler-Benz/Chrysler combination *cf.* Theodor Baums, *Corporate Contracting Around Defective Regulations: The Daimler-Chrysler Case*, 155 J. INSTITUTIONAL & THEORETICAL ECON. 119, 122 (1999).

47 In *Überseering* the cross-border relocation of the administrative seat was a consequence the parties involved ostensibly did not even notice. *Daily Mail* also consti-

A forceful, albeit not too advanced effort to facilitate cross-border re-incorporations lies in the announced Fourteenth Company Law Directive on the cross-border transfer of the registered office of limited companies.[48] This envisioned European regulation tackles the issue at hand directly by allowing an existing business organization to travel from one jurisdiction to another without having to be wound-up in the home Member State.[49] Yet, the Commission seems to endorse an approach that would tie the transfer of the statutory seat which triggers the change in applicable corporate law to the transfer of the company's headquarters, a solution that would hamper corporate law arbitrage considerably.[50] Such a requirement of transferring registered office and administrative seat concurrently is consistent with the ECJ's deliberations in *Daily Mail*,[51] although

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tuted a dispute arising out of a corporation's transfer of its administrative seat for tax purposes.

48 Currently only few Member States corporate laws permit the transfer of the registered office without relocating the company's administrative seat, *cf*. Dammann, *supra* note 46, at 19-20.

49 Commission of the European Communities, Communication from the Commission to the Council and the European Parliament, Modernising Company Law and Enhancing Corporate Governance in the European Union – A Plan to Move Forward, COM(03)284 final at 20. The public consultation on the planned proposal was closed April 15th 2004.

50 The Commission describes the favored content of the Directive in pertinent part as follows:

> Depending on the law of the host Member State, a substantive requirement for obtaining legal personality and for registering could be that the company's registered office and de facto head office be one and the same. In that event, the decision to transfer the registered office should also cover the transfer of the de facto head office.

Cf. The European Commission, *supra* note 49.

51 Case 81/87, The Queen v. Treasury and Commissioners of Inland Revenue, ex parte Daily Mail and General Trust, 1988 E.C.R. 5483, § 23 (holding that whether the reg-

there is some speculation that the Court will seize the next arising opportunity to overrule its older judgment.[52]

Presumably, the adoption of the detailed proposal for a directive on cross-border mergers will facilitate re-incorporations more effectively.[53] It will require Member States to provide a framework for transnational business combinations via mergers and consolidations. Comparable to the regulatory framework in the United States, the Cross Border Merger Directive tries to approximate the procedure applicable to a transaction involving foreign corporations with the familiar procedures provided by Member States for domestic mergers.

With regard to a reincorporation that is exclusively fueled by the desire to subject the company's internal affairs to another legal regime, the envisioned facilitations constitute a critical determinant, at least for larger entities. Where the reincorporation requires complicated legal structures, the undertaking will simply be too costly, unless the current corporate regime is egregiously detrimental which does not seem apparent for any of the European legal systems.

B. Tax Distortions

1. Taxation of Annual Profits

If the mere fact of taking a registered office would lead to the accrual of corporate income taxes in the pertaining Member State, the European competition for corporate

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istered office of a company may be transferred from one Member State to another is not resolved by the rules concerning the freedom of establishment).

[52] *Cf. supra* note 4.

[53] Proposal for a Directive of the European Parliament and of the Council on cross-border mergers of companies with share capital, COM(03)703 final [hereinafter Cross Border Merger Directive].

charter would presumably be exclusively driven by respective tax considerations. Although some corporate income tax statutes read literally might justify the conclusion Member States could benefit substantially from incorporations,[54] agreements to avoid double taxation provide otherwise. All bilateral agreements between Members of the European Union follow the Organisation for Economic Co-operation and Development's (OECD) Model Convention, which provides that taxes are only incurred in the state where the company established its administrative seat.[55] If the state of formation rule developed by the ECJ determines the applicable corporate law, the choice of jurisdiction for corporate law purposes does not entail tax consequences, while on the other hand the tax relevant establishment of the administrative seat does not have an impact on the applicable corporate law either. With respect to the topic of this paper it can be concluded, that the observed difference in the relevant criteria for the conflict of corporate laws rules and the double taxation agreement, secures a choice of corporate law undistorted by tax considerations.

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54 *E.g.* The German Corporate Income Tax Code subjects corporate revenues to German taxation if the company has either its registered office (*Sitz*) or its administrative headquarter (*Geschäftsleitung*) in Germany, *cf.* Körperschaftssteuergesetz [KStG] v. 15.10.2002, § 1 (BGBl. I S. 4144, 4146).

55 Organisation for Economic Co-operation and Development (OECD), Model Convention with Respect to Taxes on Income and on Capital, Jan. 28, 2003, art. 7(1) provides in pertinent part that

> [t]he profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein.

Art. 3(1)(d) defines the term "enterprise of a Contracting State" as an enterprise carried on by a "resident" of said state. In the corporate context a legal entity, according to art. 4(3) is "deemed to be a resident only of the State in which its place of effective management is situated."

2. Reincorporation as Foundation and Liquidation

Besides the unwarranted concern that incorporation choices could be distorted by considerations pertaining to regular corporate income taxes, another tax related problem arises from the fiscal treatment of the act of incorporation itself. Evidently, high tax burdens in the event or reincorporation could discourage such activities.

a. Formation in the New Host State

Under a strict application of the real seat doctrine the state of reincorporation grants the company immigrating into its corporate law realm legal personality i.e. reincorporation constitutes the formation of a company incurring all applicable taxes.[56] It seems pretty straightforward that such taxation creates a barrier to cross border migration incommensurate with the freedom of establishment as interpreted by the ECJ. Formally, the doctrinal edifice crumbles where the national grant of legal personality is replaced by mutual recognition of foreign companies. Treating the immigration as a formation is exactly the opposite of the recognition of the legal personality as it was granted by the Member State of original formation. From a policy perspective, the taxation of the immigrating company is nothing but a highly questionable extra income for the host state's treasury.

b. Liquidation in the State of Origin

Traditionally emigration of an existing corporation to a foreign jurisdiction entailed significant tax consequences regardless of whether the conflict of corporate laws

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[56] For the (former) position of the French tax authorities *cf.* PIERRE MAYER & VINCENT HEUZÉ, DROIT INTERNATIONAL PRIVÉ 685-86 at no. 1066 (7th ed. 2001). However, today quiet many Member States do no longer treat the formation of a corporation as a taxable event, *cf.* JULIAN MAITLAND-WALKER, GUIDE TO EUROPEAN COMPANY LAWS 165, 210, 328, 452, 571 (2d ed. 1997).

rules adhered to the state of incorporation or real seat doctrine ("settling all tax accounts at the border").[57] A strict example of this rule can be found in German tax law that considers the transfer of the administrative seat as liquidation of the company which leads, among other, to a taxable disclosure of the firm's hidden reserves.[58] National courts tried to limit the impact of the ECJ's reinforced interpretation of the freedom of establishment to prohibiting only a state of reincorporation from imposing taxes on the corporation moving into its jurisdictions but leaving member states' ability to treat moving away from their jurisdiction as a taxable liquidation intact.[59]

It seems that the ECJ will not go along with these interpretations. In a recent judgment the Court made clear that taxing the unrealized increase in value of a natural person's assets in the event of relocating her tax residence, and even the mere demand for guarantees, violates EC TREATY art. 43.[60] From this, it could be extrapolated in the cor-

[57] Case 81/87, The Queen v. Treasury and Commissioners of Inland Revenue, ex parte Daily Mail and General Trust, 1988 E.C.R. 5483 pertained to a British regulation under the Income and Corporation Tax Act, 1970, § 482(1)(a), prohibiting a corporation resident for tax purposes in the United Kingdom from ceasing to be so resident without consent of the Treasury.

[58] § 12 KSTG. On the purpose of the rule *see* Bundesfinanzhof [Supreme Tax Court] BStBl. II 1974, 255 (taxation of hidden reserves at a time when it is still operable). On the impact of the rule on companies' willingness to reincorporate *cf.* Brigitte Knobbe-Keuk, *Niederlassungsfreiheit: Diskriminierungs- oder Beschränkungsverbot? [Freedom of Establishment: Prohibition against Discrimination or Prohibition against Limitation?]*, 51/52 DER BETRIEB [DB] 2573, 2578 (1990) (claming that taxation of unrealized gains will prevent most corporations from reincorporating). With regard to tax consequences France followed a similar model, MAURICE COZIAN & ALAIN VIANDIER, DROIT DES SOCIÉTÉS 109 n.295 bis (10th ed. 1997).

[59] *E.g.* Bundesfinanzhof [Supreme Tax Court], 53 GMBH-RUNDSCHAU (GMBHR) 722, 724-25 (2003).

[60] Case C-9/02, Hughes de Lasteyrie du Saillant v. Ministère de l'Économie, des Finances et de l'Industrie (available at http://europa.eu.int/eur-lex/).

porate context that EC TREATY artt. 43, 48 enjoin Member States from taxing the appreciation of assets of corporations moving out of their jurisdiction.[61] Commentators have beforehand expressed their substantial uneasiness if the ECJ compelled Member States to let taxable substance slip away without being able to subject it to taxation.[62] Yet, the Court's *coup de main* has made clear that where no actual fraudulent intention is present (i.e. in cases of temporary artificial transfers of tax residence), the goal to prevent erosion of the tax base in general does not constitute an imperative reason in the public interest sufficient to justify the compromise of the freedom of establishment.[63]

The judgment may mark a cataclysm in European tax law. Yet, its impact with regard to choice of corporate law seems limited. It has to be recalled that the transfer of a company's tax residence in international tax law requires the relocation of its administra-

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[61] This consequence is drawn for example by a German Supreme Tax Court Judge, *cf.* Franz Wassermeyer, *Steuerliche Konsequenzen aus dem EuGH-Urteil „Hughes de Lasteyrie du Saillant" [Tax Law Consequences of the ECJ-Judgment „Hughes de Lasteyrie du Saillant"]*, 54 GMBH-RUNDSCHAU (GMBHR) 613, 615-16 (2004). For an earlier discussion of the problem *see* Jan Wouters, *The Principle of Non-discrimination in European Community Law*, 8 EC TAX REV. 98 (1999).

[62] Wymeersch, *supra* note 3, at 19. The ECJ in a line of cases has expressed the view, that although direct taxation does not fall within the scope of the Community's legislative authority, Member States must exercise their retained powers in compliance with Community law, thus, subjecting national tax regulations to judicial review by the ECJ, *cf.* Case C-297/93, Finanzamt Köln-Altstadt v. Roland Schumacker, 1995 E.C.R. I-225 § 21; Case C-264/96, Imperial Chemical Industries plc. (ICI) v. Kenneth Hall Colmer (Her Majesty's Inspector of Taxes), 1998 E.C.R. I-4695 § 19; Case C-436/00, X and Y v Riksskatteverket, 2002 E.C.R. I-10829, § 32.

[63] Case C-264/96, Imperial Chemical Industries plc. (ICI) v. Kenneth Hall Colmer (Her Majesty's Inspector of Taxes), 1998 E.C.R. I-4695, § 28; Joined Cases C-397/98 and C-410/98, Metallgesellschaft Ltd and Others, Hoechst AG and Hoechst (UK) Ltd v Commissioners of Inland Revenue and HM Attorney General, 2001 E.C.R. I-1727, § 59.

tive seat,[64] whereas under the state of formation rule the switch of corporate law jurisdiction does not involve similar activities. To wit, a natural person's tax relevant resettlement naturally involves physical relocation (but no transfer of title) while reincorporation requires no movement of any tangibles (but necessitates the assignment of the company's property to the foreign shell if executed by cross border merger). As a consequence, the diverging criteria in international tax law and conflict of corporate laws disentangle the choice of corporate law from the election of the company's tax residence. Moreover, if after implementing the pertinent directive re-incorporations can be executed throughout Europe by cross-border merger existing European law will prohibit the taxation of capital appreciations explicitly.[65]

C. Ban on Franchise Fees

1. The Union

The historical evidence clearly indicates that at the beginning of the last century, the appetite for franchise fees was the motivating force behind the competition ensuing between corporate law jurisdictions in the United States.[66] Even from today's perspective where the existence of a competition for incorporation tax revenues between States is de-

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[64] *See supra* III.B.1.

[65] Council Directive 90/434 of 23 July 1990 on the common system of taxation applicable to mergers, divisions, transfers of assets and exchanges of shares concerning companies of different Member States, art. 4(1), 1990 O.J. (L 255) 1, 2 provides:

> A merger or division shall not give rise to any taxation of capital gains calculated by reference to the difference between the real values of the assets and liabilities transferred and their values for tax purposes.

[66] For a comprehensive analysis *cf.* Grandy, *supra* note 37.

batable,[67] the dominant supplier of corporate law is unquestionably caring for franchise revenues.[68] The doubts expressed by declared advocates of the race to the top view concerning the extent to which franchise fees can motivate legislators to produce (efficient) corporate law because the revenues are a public good,[69] can be muted in the special case of Delaware where the tightly knit circle of corporate rulemakers, legislators and judges evidentially considers the attainment of franchise revenues as an objective of the polity.[70] However, this may well be a unique situation, not easily duplicable in Europe.

So far franchise fees do not play a major role in the European context and are illegal under European law if not collected by the Member State in which the administrative headquarter is located, i.e. the registered office in the Member State of incorporation currently is not an admissible criterion to tie up to for franchise tax purposes.[71] Repealing the

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[67] *See supra* II.C.

[68] The fact of Delaware's budgetary dependence on franchise fees is (with contending evaluations) acknowledged by race to the top and race to the bottom advocates alike, *see* Cary, *supra* note 24, at 668-70 (underscoring his point that the dependence compels Delaware to cater to management); ROMANO, *supra* note 15, at 38 (praising Delaware's dependence as reason for its beneficial responsiveness to corporate concerns).

[69] EASTERBROOK & FISCHEL, *supra* note 15, at 216-217 (1991). Still, the observation seems even more relevant with regard to judges.

[70] Cary, *supra* note 24, at 668-70, 679, 690-92. For examples of Delaware judges' self-understanding *see* Roe, *supra* note 29, at 604-607, 636-37.

[71] Council Directive 69/335 of 17 July 1969 concerning indirect taxes on the raising of capital, art. 2(1), 1969 O.J. (L 249), 25 provides that

> [t]ransactions subject to capital duty shall only be taxable in the Member State in whose territory the effective centre of management of a capital company is situated at the time when such transactions take place.

Art. 4(3)(b), prohibits to consider

opposed European directive with respect to franchise fees might open possibilities to create tax incentives for European legislatures.[72] Even if the amounts collectible may be relatively small in relation to large Member States' budgets, they may not be completely negligible in times of strained national finances. In addition, some poorer accession states might see a chance to develop a source of revenues and richer states might welcome the opportunity to subsidize the economic development of these members without direct transfers.

Yet, with corporate taxes allegedly already approaching the upper limits, doubts might be raised about Member States' ability to impose franchise fees without holding a monopoly position comparable to Delaware. However, where the gains associated with reincorporation outweigh the disadvantage of incurring franchise fees, their imposition should not deter corporate migration. Admittedly, either the quality gains have to be substantial or the franchise fees have to be kept marginal. A conceivable solution could be a fee uniformly imposed throughout Europe, by definition excluding evasion opportunities within the Community. In order to incentivize national legislatures the yields of such a

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> the transfer from a Member State to another Member State of the effective centre of management or of the registered office of a company, firm, association or legal person which is considered in both Member States, for the purposes of charging capital duty, as a capital company

as a formation subject to capital duty. Finally, art. 10(a) provides that

> [a]part from capital duty, Member States shall not charge, with regard to companies, firms, associations or legal persons operating for profit, any taxes whatsoever … in respect of the transactions referred to in Article 4,

thereby ruling out U.S.-style franchise fees.

[72] Dammann, *supra* note 46, at 82.

harmonized fee should remain in the Member States where they were generated, to wit the state of incorporation. With franchise fees being indirect taxes, EC-TREATY art. 93 could provide the legislative competence for the envisioned European harmonization if "such harmonisation is necessary to ensure the establishment and the functioning of the internal market". Besides the question whether a franchise fee driven market for corporate charter is a necessary component of the internal market, the prime barrier seems to be the unanimity requirement for the Council's action under EC-TREATY art. 93.[73]

The above shows that a franchise free driven competition in Europe faces serious obstacles. Presupposing the (highly unlikely) political will, these obstacles might in part be overcome, providing at least for smaller states an incentive to solicit reincorporations.

2. Liechtenstein

It has to be mentioned that there is a notable exception from the aforesaid. Tiny Liechtenstein, currently not a member of the European Union but a member of the European Economic Area in which the freedom of establishment also applies,[74] is deriving a substantial part of its budget from franchise taxes imposed on corporations with a registered office in the principality.[75] When joining the European Economic Area Liechten-

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73 The required consensus seems politically hard to achieve, especially because commentators recommend the capital duty taxation of corporations in the EU be abolished altogether, e.g. BEN TERRA & PETER WATTÈL, EUROPEAN TAX LAW, 333 (3d ed. 2001).

74 TREATY ESTABLISHING THE EUROPEAN ECONOMIC AREA, artt. 31 and 34.

75 Between 1985-1998 the numbers ranged from 15.4% to 26.6% of the state budget, *cf.* EVA-MARIA KIENINGER, WETTBEWERB DER PRIVATRECHTSORDNUNGEN IM EUROPÄISCHEN BINNENMARKT [COMPETITION OF PRIVATE LAW SYSTEMS IN THE SINGLE EUROPEAN MARKET] 187 (2002).

stein was able to successfully shield its franchise tax system from restricting European regulations like the above mentioned directive.[76]

D. The Lack of a Shared Legal Basis

Scholars have pointed to the fact that the United States, apart from Louisiana, shares the legal basis of common law facilitating out of state incorporations whereas European corporate law is not situated on similarly common ground.[77] The argument seems striking at first glance, but is not altogether convincing if the relative autonomy of corporate law is taken into account. The European families of law (Common Law, Civil Law and therein Roman, Germanic and Scandinavian traditions) date back to ancient times whereas the law of the modern business organization is a relatively recent product, reflecting the organizational imperatives in times of division of labor and industrialization.[78] Within corporate law, the different historical affiliations rather translate into idiosyncratic styles of regulation than into fundamentally diverging substantive rules and standards. The most prominent differences in the legal environment very often result from relatively modern political movements (e.g. codetermination).[79] More importantly,

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[76] Vgl. CYRILL SELE, STANDORTKONKURRENZ ZWISCHEN FINANZPLÄTZEN UNTER BESONDERER BERÜCKSICHTIGUNG DES OFF-SHORE GESCHÄFTS – DER FALL LIECHTENSTEIN [COMPETITION BETWEEN FINANCIAL CENTERS WITH SPECIAL REGARD TO OFF-SHORE BUSINESS – LIECHTENSTEIN'S CASE] 250 (1995). However, it may well be that the provided tax benefits (*supra* VI. 1. a) aa) (b)) constitute a prohibited state subsidy which would destroy the basis for the collection of franchise taxes, *cf. id.* at 251 et seq.

[77] FORSTINGER, *supra* note 8, at 31; Klaus Heine & Wolfgang Kerber, *European Corporate Law, Regulatory Competition*, 13 EUR. J. L. & ECON. 47, 60-61 (2002).

[78] For the classic story *cf.* ADOLF A. BERLE & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (1932).

[79] Attempts to link German codetermination to Germanic cooperative principles simply distort the historical developments which do not warrant the assumption of continuity.

corporate law does not seem to be substantially interlocked with other parts of Member States' legal systems as to make the exchange of the regime governing a firm's internal affairs impossible or prohibitively costly in this respect. That is not to say, that it goes without friction in border areas[80] – mostly to the detriment of third parties – but the point here is, that exchange of corporate law regimes between jurisdictions without common tradition is feasible.

E. The Information Problem

Another point seems straightforward. While the market for corporate charter in the United States is highly transparent,[81] European incorporators allegedly face a severe lack of accessible information about the choices at hand.[82] The language barrier further puts some jurisdictions at a considerable disadvantage. Engaging in a thorough comparative analysis of the quality of corporate law in fifteen/twenty-five member states – if undertaken on an ad-hoc basis – initially appears prohibitively costly. On the other hand, the

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To be sure, there were influential scholars of the Historic School that draw on cooperative theory, most importantly the seminal work of OTTO FRIEDRICH VON GIERKE, DAS DEUTSCHE GENOSSENSCHAFTSRECHT [German Cooperative Law] (1863-1913). However, this school of thought did rather influence German labor law with its prominent collective bargaining elements, than shape entrepreneurial codetermination law. The history of ideas underlying codetermination blends late 19th and 20th century Christian social ethics with socialist and German variations of liberal thought, i.e. has distinctly modern roots. *Cf.* THOMAS RAISER, MITBESTIMMUNGSGESETZ [CO-DETERMINATION ACT] Einl Rdnr. 6-8 (4th ed. 2002).

[80] For an interesting case study describing the difficulties of an insolvency proceeding involving an English limited under German bankruptcy law *see* Susanne Riedemann, *Das Auseinanderfallen von Gesellschafts- und Insolvenzstatut [Divergence of Corporate and Insolvency Statute]*, 54 GMBH-RUNDSCHAU (GMBHR) 345 (2004).

[81] American secondary sources include detailed and comprehensive checklists and surveys concerning the incorporation choice, *e.g.* 18A AM. JUR. 2D *Corporations* § 158.

[82] KIENINGER, *supra* note 75, at 170-72.

pessimistic view seems exaggerated. The consolidated and scholarly scrutinized corporate laws in the Union's large economies principally allow a profound assessment of each jurisdictions strengths and weaknesses. Corporate counsel will shortly become able to advise their individual clients on the choices at hand. Where the language barrier does not impose limits the task is structurally identical with the advice rendered to facilitate the choice among domestic forms of organization, though more complex, of course. The possibility of a comparative evaluation on a relatively coarse level,[83] should not be disregarded as insufficient for purposes of incorporation commitments altogether. It is an illusion to believe that in today's legal practice the choice of organizational form is always based on a profound analysis that incorporates highly sophisticated cutting-edge research. Realistically, simplifications and generalizations make every day practice workable. Moreover, it seems possible that European corporate law scholars and economists pick up the topic with the same intensity shown by their American colleagues, collecting over time empirical data on the impact of corporate law on the value of firms.[84] The merits of event studies may be questionable,[85] and even with a more refined analytical setup the relevance of the overall value effect of a corporate law system may be limited with regard to the individual incorporation decision, but the data may still provide useful guidance.

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[83] For an example of this kind of simplifying assessments take the anti-director index developed by Rafael La Porta, Florencio Lopez-De-Silanes, & Andrei Shleifer, *Corporate Ownership Around the World*, 54 J. FIN. 471, 478 (1999).

[84] For the United States *cf. supra* note 41.

[85] The explanatory power of these studies depends in significant part on the informational efficiency of capital markets which is questionable with regard to complex information such as corporate law quality, *cf.* Lynn A. Stout, Stock Prices and Social Wealth 5-14 (John M. Olin Center for Law, Economics, and Business, Discussion Paper No. 301, 2000) *available at* http://www.law.harvard.edu/programs/olin_center/papers/pdf/301.pdf.

Still, the complexity of the considerations in which to engage when judging a foreign corporate law system's merits and the insecurities associated with such an extensive analysis entail that a responsible reincorporation decision can only be advocated if the competitive edge of the targeted jurisdiction is quite evident. Not surprisingly, clear-cut advantages of the winning jurisdictions accounted for the incorporation waves, observable in the United States during the early race.[86] Furthermore, Delaware's network externalities and its reputation as a hospitable incorporation haven are easily identifiable factors accounting for the tiny State's persistent success in the incorporation market.[87] Finally, statistical evidence shows that Delaware performed especially successful in the incorporation market when high profile events strikingly displayed its corporate law's favorable character from the perspective of incorporators/directors.[88]

The quintessence of the aforesaid seems to be that only some jurisdictions will play a role in the chartering decisions of incorporators. The merits of their corporate law have to be accessible, either because the particular Member State is due to its economic weight and size in the center of interest anyway or because it makes a considerable effort to draw attention to its corporate law. Moreover, incorporators seem to react to palpable advantages i.e. only where a corporate law can credibly display its virtues will it lure corporations. The attractiveness of the English limited for small business incorporators from

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[86] *Cf. supra* II.E.

[87] The importance of Delaware's reputation is widely acknowledged, *e.g.* ROMANO, *supra* note 15, at 38; Kahan & Kamar, *supra* note 26, at 726.

[88] Gordon Moodie, Forty Years of Charter Competition: A Race to Protect Directors from Liability?, 16-29, 36-54 (Apr. 2004) (unpublished manuscript, on file with the author) (presenting data that Delaware surged ahead in the incorporation market when it liberalized its director liability statute in 1967 and 1986).

minimum capital jurisdictions[89] reinforces this conclusion, because incorporators do not have to engage in complex considerations to determine the (alleged) advantage gained by ridding themselves of the obligation to pay-up and maintain minimum capital.[90]

F. Consequences of Jurisdiction

Occasionally corporate law analysts have pointed to consequences cross-border incorporation entails with regard to litigation and have argued that within the European scenery these consequences pose more significant obstacles to incorporator's undistorted choice of corporate law than in the United States.[91] The argument centers around the correct observation that U.S. incorporators can typically by means of "outbound" forum selection clauses avoid having to litigate their internal affairs in the state of incorporation while their European counterparts are partly denied this possibility.[92] For smaller businesses the prospect of having actually to litigate abroad may constitute a significant cost

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89 *Cf.* Stephan Rammeloo, *Recognition of Foreign Companies in "Incorporation" Countries: A Dutch Perspective*, *in* CURRENT ISSUES OF CROSS-BORDER ESTABLISHMENT OF COMPANIES IN THE EUROPEAN UNION 47, 58-61 (Jan Wouters & Hildegard Schneider eds. 1995); for Germany *see infra* note 5.

90 But *see also infra* IV.A.

91 Dammann, *supra* note 46, at 25-34.

92 Council Regulation 44/2001 of 22 December 2000 on jurisdiction and the recognition and enforcement of judgments in civil and commercial matters, artt. 22(2), 23(5), 2001 O.J. (L 12),1, 8 [hereinafter: Recognition and Enforcement Regulation] (establishing imperatively exclusive jurisdiction of the courts in the Member State of incorporation – assuming that all member States are now compelled to follow the state of formation rule in conflict of laws – 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).

factor, raising the threshold for an efficiency enhancing reincorporation.[93] However, the possibility to mitigate the problem with arbitral clauses has to be considered.[94] On the other hand, the aspect becomes even more prominent if it is taken into account, that the foreign establishment also affords the possibility to third parties to sue the corporation in the Member State of its incorporation unless forum selection clauses govern the parties' relationship.[95]

The aforementioned mandatory jurisdiction of the courts of the Member State of incorporation for critical corporate lawsuits also assumes relevance under a different angle. With the choice of corporate law, the incorporators automatically import the quality of the pertinent jurisdiction's system of adjudication, i.e. the speed with which judgments are rendered, the expertise of judges and the bar etc.[96] This aspect is well familiar from the United States, where a good share of Delaware's preeminent position is attributable to its superior judiciary, administration and corporate bar. Moreover, in Europe, the mandatory provisions of the Recognition and Enforcement Regulation render the unbundling of the corporate law package virtually impossible, accentuating even more the necessity to consider both, corporate law quality and the efficiency of its administration.[97]

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[93] U.S. scholars consider the cost of litigation in the state of incorporation as a factor chilling close corporations' migration, *cf.* Ayres, *supra* note 17, at 374-75; F. HODGE O'NEAL & ROBERT B. THOMPSON, O'NEAL'S CLOSE CORPORATIONS §2.13 (3d ed. 1986).

[94] *Cf. infra* note 207.

[95] Recognition and Enforcement Regulation, artt. 2(1), 60(1)(a).

[96] Dammann, *supra* note 46, at 35-39 (illustrating the point with a comparison of Germany and Italy).

[97] It is the gist of a recent proposal to bolster up the competitive forces in the European market for corporate charter by disentangling choice of substantive corporate law and

In sum, foreign incorporation in Europe incurs potentially higher cost due to jurisdictional consequences which have to be compensated for by an adequately more efficient corporate law package.

G. The Significance of Close Corporations in Europe

It is a European particularity that reincorporation considerably affects the relation between shareholders and creditors/debtholders.[98] Two of the leading cases brought before the ECJ concerned attempts to explicitly opt-out of creditor protective minimum capital requirements. These requirements have proven to be specifically burdensome for smaller businesses i.e. closed corporations, because the cost of compliance, especially at the stage of formation, and the risk of personal liability in case of non-compliance tend to be relatively high. To illustrate the point, one of the strictest systems in this respect, the German, deserves portrayal.[99] Here, it is not the founders' obligation to pay-up the sum

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jurisdiction, *cf*. Christian Kirchner, Richard W. Painter & Wulf Kaal, Legislatory Competition in EU Corporate Law after Inspire Art: Unbundling Delaware's Product for Europe (SSRN Working Paper Series, Jan. 2004) (available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=496395).

[98] In sharp contrast it has been contended that regulatory competition in the U.S. concerns "how corporate disputes between directors and shareholders are resolved – and nothing else." Kahan & Kamar, *supra* note 26, at 681.

[99] Other Member States familiar with minimum capital requirements for their private limited liability companies include Belgium (*Besloten Vennootschap met Beperkte Aansprakelijkheid/Société Privée à Responsibilité Limitée*), Denmark (*anpartsselskap*), Finnland (*Osakeyhtiö*), France (*Société à Responsabilité Limitée*), Greece (*Eteria Periorismenis Eythinis*), Italy (*Societa a responsabilita limitata*), Luxemburg (*Société à Responsabilité Limitée*), Netherlands (*Besloten Vennootschap*), Portugal (*Sociedad por quotas*), Spain (*Sociedad de Responsabilitdad Limitada*), Sweden (*privat aktiebolag*), Austria (*Gesellschaft mit beschränkter Haftung*). *Cf.* COMPANY LAW IN EUROPE A[202]; B[24]; C[54]; D[34]; F[24]; H[10-20]; I[10]; J[24]; L[2]; M[25]; N[4]; P[72] (Richard Thompson ed. 1992-).

of € 25.000,[100] but the surrounding statutory and doctrinal safeguards that create the hardship mentioned above. Where the capital contribution is not paid in cash (*Bareinlage*), the contribution in kind (*Sacheinlage*) is subject to a value inspection by the registry court (*Registergericht*) based on documentation the founders have to provide. Where the court determines that the contribution in kind was overvalued it will reject the registration of the company.[101] The founders are obliged to pay up the difference in cash,[102] and are liable for damages if they negligently made wrong statements vis-à-vis the registry court.[103] If the founders start the business before the court actually registers the company it may happen that the duly paid in capital contribution is already consumed by debt when the company is finally registered. In this scenario the founders are held personally liable for the adverse balance (*Unterbilanzhaftung*) i.e. they de facto assume the company's debt (and, in addition have to pay-up once again the capital contribution).[104] If the asset selected as capital contribution cannot be left idle, e.g. if it is an enterprise, founders are compelled to conduct business before registration thereby assuming the risk of liability. Further down the road, the shareholders face the risk of being held liable for pay

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[100] Gesetz betreffend die Gesellschaften mit beschränkter Haftung [GmbHG], v. 20.4.1892, § 5(1) (RGBl. S. 477) in der Fassung der Bekanntmachung v. 20.5.1898 (RGBl. S. 369, 846) zuletzt geändert durch Art. 3 des Gesetzes v. 19.7.2002 (BGBl. I S. 2681) (Limited Liability Company Act).

[101] §§ 9c(1), 8(1) No. 5 GmbHG.

[102] § 9 GmbHG.

[103] § 9a GmbHG.

[104] Entscheidungen des Bundesgerichtshofs in Zivilsachen (BGHZ) [Decisions of the Supreme Civil Court] 80, 129, 140.

backs of the company's capital.[105] The risk here again lies in the doctrinal ramifications of the general principle, which subject many transactions between the company and its shareholders to the prohibition of paybacks.[106] It is a particularly nasty aspect of the principle of maintenance of capital that its full scope frequently occurs in bankruptcy proceedings when the trustee collects from shareholders on behalf of the insolvent company. The shareholders who wanted to shield themselves from liability in case of the venture's failure are held liable for part of the company's debt.

While in the United States closely held corporations mainly stay in the state where they do business,[107] minimum capital requirements seem to produce sufficient pressure to migrate, making closed corporations relevant participants in the European cross-border incorporation setting.

H. Imperative Character of Large Fractions of Corporate Law in Continental Europe

It is one of the distinct features of American corporate law that its general character is enabling with only a small number of cogent provisions.[108] On the other hand,

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[105] §§ 30, 31 GmbHG.

[106] The doctrines of hidden distribution of profits (*verdeckte Gewinnausschüttungen*) and equity substituting shareholder loans (*eigenkapitalersetzende Gesellschafterdarlehen*) with all their implications are notorious and have produced a coppice of case law, in which often bona fide shareholders get entrapped. For details *see e.g.* HARTWIN VON GERKAN & PETER HOMMELHOFF (EDS.), HANDBUCH DES KAPITALERSATZRECHTS [COMPENDIUM OF THE LAW OF EQUITY SUBSTITUTION] (2d ed. 2002); HERRMANN-JOSEF TRIES, VERDECKTE GEWINNAUSSCHÜTTUNG IM GMBH-RECHT [HIDDEN DISTRIBUTION OF PROFITS IN LIMITED LIABILITY COMPANY LAW] (1991).

[107] *Cf.supra* II.A.2.

[108] The Cary – Winter debate circled around the evaluation of this feature. The enabling character of Delaware's corporate law was common ground. However, it has to be emphasized that U.S. securities laws (Securites Exchange Act of 1934, 15 U.S.C.A.

European corporate law is in many jurisdictions more restrictive,[109] in part because European corporate statutes contain provisions protecting corporate constituencies which by nature cannot be put up for bargain among the corporation's founders or shareholders and management. Yet, corporate law arbitrage becomes attractive mainly where individual adaptation of the corporate form through the charter or the bylaws is impossible.[110] Hence, the determinants in incorporation decision are – disregarding for this purpose potential network externalities etc. – the mandatory provisions of corporate law.[111] With regard to cross-border incorporations, it can be ascertained that the less leeway for individual adjustments national corporate law provides the more attractive the opt-out option

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§ 78a et seq. (2004); Securities Act of 1933, 15 U.S.C.A. § 77a et seq. (2004)) which encompass a good share of crucial aspects of corporate governance (*e.g.* proxy-voting of shares) are binding. The description as "minimum disclosure requirements" (ROMANO, *supra* note 15, at 4) is euphemistical in light of the extensive and comprehensive style of regulation.

[109] Again Germany can serve as a striking example, declaring *in grosso modo* the entire stock corporation act binding law subject only to minor supplements, *cf.* Aktiengesetz [AktG], v. 6.9.1965, § 23(5), (BGBl. I 1089) zuletzt geändert durch Art. 73 Abs. 5 des Gesetzes vom 25.11.2003 (BGBl. I 2304) (Stock Corporation Act).

[110] Clark D. Stith, *Federalism and Company Law: A "Race to the Bottom" in the European Community*, 79 Geo. L.J. 1581, 1587 (1991) (purporting high vulnerability of constituency protective regulations to a downward drag). But *see also* Hanno Merkt, *Das Europäische Gesellschaftsrecht und die Idee des "Wettbewerbs der Gesetzgeber" [European Corporate Law and the Idea of „Regulatory Competition"]*, 59 RABELS ZEITSCHRIFT FÜR AUSLÄNDISCHES UND INTERNATIONALES PRIVATRECHT [RABELSZ] 545, 558 (1995) (arguing that in light of the traditional European constituency approach any opt-out would be hard to put through against labor's resistance).

[111] Consistent with this view seems to be the case of California which has done poor in the U.S. incorporation market during the last decade. The results can arguably be attributed to its (cogent) shareholder protective takeover regulation, inducing firms to move out of its jurisdiction, *cf.* Guhan Subramanian, *The Influence of Antitakeover Statutes on Incorporation Choice: Evidence in the Race Debate and Antitakeover Overreaching*, 150 U. PA. L. REV. 1795 (2002).

becomes, especially where the mandatory provisions allegedly represent the results of successful efforts of interest groups to capture lawmakers and extract rents.[112]

For some European corporate lawyers the long awaited bust up of incrusted doctrinal structures and institutional compromises warrants the conclusion that competition for corporate charter can indeed be regarded as the favorable discovery process described by race to the top advocates. However, it is unclear if the difference in ownership structures[113] warrants or even mandates to a certain extent a less enabling approach. Where the critical agency conflict is not between management and dispersed shareholders, but between large blockholders and small investors, the protective devices might well have to be provided by strict rules.[114] Fiduciary duties cannot be subjected to contrary agreement in the United States either, and some statutory provisions in European corporate law may simply serve as substitute for less developed fiduciary duty doctrines.[115] Generally, where majority vote does not warrant a fair decision, because it is in fact a self-empowerment of

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[112] *Cf.* Carney, *supra* note 24, at 315-27 (illustrating how the real seat theory functioned to insulate labor and creditor friendly provisions of European corporate laws).

[113] *Cf. infra* III.I.

[114] Generally on the importance of taming large shareholders for the development of capital markets, Lucian A. Bebchuk, A Rent Protection Theory of Corporate Ownership and Control (Nat'l Bureau of Econ. Research Working Paper 7203, July 1999) (presenting a theoretical model why dispersed ownership without efficient minority protection is unstable). Rafael La Porta et al., *Legal Determinants of External Finance*, 52 J. FIN. 1131 (1997) (presenting empirical evidence that deep and liquid capital markets develop where minority protection is strong); Rafael La Porta et. al., *Law and Finance*, 106 J. POL. ECON. 1113 (1998) (same); La Porta, Lopez de Silianes & Shleifer, *supra* note 83, at 471 (1999) (same).

[115] *E.g.* the German statute on groups of companies (§§ 291-339 AKTG) in large parts was promulgated because legislators did not perceive fiduciary duties as a viable alternative to handle the blockholder-minority conflict, *cf.* TOBIAS TRÖGER, TREUPFLICHT IM KONZERNRECHT [FIDUCIARY DUTIES IN THE LAW OF GROUPS OF COMPANIES] 210-13 (2000).

the majority-shareholder, additional safety devices have to be provided. Consequentially, opting out of the strict structures by means of reincorporation potentially runs the risk of decreasing minority protections.

I. Ownership Structure, Employee Participation, and Dept Financing

The existence of dominant stockholders and strong financial intermediaries in public companies as well as the participation of employee representatives in board-decisions constitute strong institutional counterweights to management's opportunism.[116] On the other hand this continental European distribution of power in corporate governance allows other corporate players to pursue their individual or group interest. Where powerful constituencies are unable to initiate the reincorporation decision their anticipated objections may at least distort the deliberations of decision-makers.

The notion that dominant stockholders may consider reincorporating for purposes of extracting higher private benefits is at least plausible. In a system where reincorporation requires coaction of the board and shareholders[117] a dominant stockholder could, absent particular protective institutions, relatively easily realize her will. The prevalence of equity financing, indicated by market capitalization and the relative magnitude of equity

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[116] For overviews of ownership structures *see* Marco Becht & Alisa Röell, *Blockholding in Europe: An International Comparison*, 43 EUR. ECON. REV. 1049 (1999); Julian Franks & Colin Mayer, *Corporate Ownership and Control in the U.K., Germany and France*, *in* STUDIES IN INTERNATIONAL CORPORATE FINANCE AND GOVERNANCE SYSTEMS 281 (Donald H. Chew ed. 1997).

[117] *See infra* IV.B.1.

funds raised,[118] makes the idea of counterbalancing forces from a corporate finance perspective comprehensible for the United States (and the United Kingdom) but far less for continental Europe. Certainly, even where equity financing does not play a major role in corporate finance, firms cannot do without it. Assuming at least some market efficiency the penalizing reaction of investors should be similar to the one purported for United States' security markets. But, the frequency with which companies have to revisit equity markets is critical when determining the efficiency of competitive constraints.[119] However, assuming that in the normal course of business creditor and minority shareholder interests are aligned against blockholder opportunism, small investors will benefit as free-riders from debt financiers' increased influence. Where debt financing is more important the clout of creditors to punish incorporation decisions disregarding debtholder (and reflexively shareholder) interests seems even stronger.[120]

In sum, due to the factors mentioned, management opportunism will not play the central role it assumes in the American discussion. However, the vertical agency conflict is only substituted for the well known horizontal clash. Mechanisms limiting egregious

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[118] For a comparative survey *see* Raghuram G. Rajan & Luigi Zingales, *The great reversals: the politics of financial developments of the twentieth century*, 69 J. FIN. ECON. 5, 15-16 (2003) (presenting – among other – numbers for 1999).

[119] There is another angle to this issue: If only weakly competitive product markets allow generating funds internally in form of quasi monopoly rents, the need to address capital markets for funding becomes even less urgent, *cf.* MARK J. ROE, POLITICAL DETERMINANTS OF CORPORATE GOVERNANCE 130 (2003).

[120] Sometimes amplified through the central role of depository banks in the proxy voting system. For a (maybe too) bright picture of German universal banks influence on firm performance, Gary Gorton & Frank A. Schmidt, *Universal Banking and the Performance of German Firms*, 58 J. FIN. ECON. 29 (2000).

behavior of dominant blockholders exist. Not surprisingly, however, in a certain band the acquainted agency problem expands into the domain of incorporation.

J. Absence of Serious Takeover Threats in Continental Europe

Related to the above mentioned continental European particularities is the low frequency with which contested control transactions occur.[121] The relative safety of continental European corporations from control contests decreases management's incentives to reincorporate in a takeover hostile jurisdiction. On the other hand, research suggests that there are control transactions involving a good share of hostility that do not fall within the ambit of the common definition of an unsolicited tender offer.[122] However, the structure of the transactions, mostly sales of control blocks, limits the impact a switch of jurisdiction could afford with regard to management's safety. And, more importantly, the self-insulating incentives management might have cannot be acted out against the will of a dominant stockholder, who, on the other hand, simply has no incentive to barricade the company.

Conversely reincorporation in a takeover friendly jurisdiction in order to attract investors is unlikely to be a relevant motive for most companies. The structural grounds

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[121] *E.g.* Erik Berglöf & Mike Burkhard, *European takeover regulation*, 18 ECON. POL'Y 171, 176-77 (2003) (hostile takeovers in all of continental Europe in 1999 equaled the number in the United Kingdom).

[122] Tim Jenkinson & Alexander Ljungqvist, *The role of hostile stakes in German corporate governance*, 7 J. CORP. FIN. 397, 432-445 (2001) (presenting 17 case studies of German control transactions which did not involve a tender offer without board approval but nevertheless were unfriendly at the outset); Jens Köke, Control transfers in corporate Germany: Their frequency, causes, and consequences, 9-12 (Centre for European Economic Research (ZEW), discussion paper no. 00-67, 8/2001) *available at* ftp://ftp.zew.de/pub/zew-docs/dp/dp0067.pdf (examining a sample of 1000 large, medium-sized, and small firms between 1987-1994 and concluding that there is significant trading in control blocks leading to management turnover).

for the relevant impediments, i.e. large blockholdings, influence of financial intermediaries etc., simply persist, regardless of the corporate law regime governing the firm's internal affairs. The case is slightly more complicated with regard to employee participation – assuming for that purpose that it is a significant takeover impediment[123] – because the opt out could indeed solve the problem. Yet, it is not a viable option for other reasons.[124]

K. Temporary Character of Certain Conditions

Some of the parameters mentioned above may deteriorate over time. Most significantly, legislative efforts to deepen capital markets and the dependence of continental European firms on new sources of finance to accomplish growth up to a competitive size in globalized markets could not only influence corporate finance but also result in more dispersed ownership structures making takeovers a more viable option for control seekers. Similarly, cross border business combinations may lead to a dilution of blockholders' power. These developments could also trigger a more investor oriented "shareholder culture" with shareholder interest as the focal point, reinforced by providing protective legal institutions.[125] However, these are visions of a rather remote future and therefore cannot serve as the basis for the analysis undertaken here.[126]

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[123] Commentators sometimes mention German corporate law with mandatory codetermination as "the biggest poison pill of all", Hwa-Jin Kim, *Markets, Financial Institutions, and Corporate Governance: Perspectives from Germany*, 26 LAW & POL'Y INT'L BUS. 371, 384 (1995); Mark G. Ribilotti, *Recent Development: Codetermination, Stakeholder Rights, and Hostile Takeovers: A Reevaluation of the Evidence from Abroad*, 38 HARV. INT'L L.J. 536, 552 (1997).

[124] *Cf. supra* IV.B.2.iv and VI.B.1.

[125] The French consensus that corporations should be managed in the social interest (*intérêt social*) has been challenged to propel a more shareholder oriented approach, PHILIPPE MARINI, LA MODERNISATION DU DROIT DES SOCIÉTÉS: RAPPORT AU PREMIER MINISTRE 12 (1996). On the "conversion" of German top-managers with regard to

L. Reincorporation in the Age of Global Convergence

It may be a significant difference that the European market for corporate charter has been (re-)opened only at the beginning of the 21st Century. The alleged global trend to convergence in corporate governance structures[127] might take away the attractiveness or reincorporation if the advantages attainable would be relatively minor. Although the claim of global convergence in corporate law was made primarily with regard to public companies it may well also be justified for other organizational forms if fierce cross-border competition takes out the fetch in their markets that so far allowed the adoption of governance models less strictly oriented towards shareholder value maximization.[128] If the thesis that corporate law should strive for the long-term increase in shareholder value is propelled by the forces of transnational capital and product markets, the consequential convergence in governance structures reaches as far as the cross-border market-integration. Neither the merits of the essay proclaiming the end of history in corporate

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shareholder value as opposed to a constituency approach of corporate governance *see* FORSTINGER, *supra* note 8, at 55-56. *See also* Jeffrey N. Gordon, An International Relations Perspective on the Convergence of Corporate Governance: German Shareholder Capitalism and the European Union, 1990-2000 (Eur. Corporate Governance Inst., Working Paper No. 06/2003, 2003) (arguing with regard to the German example that the development of shareholder capitalism depends crucially on a group of countries' commitment to a project of transnational economic and political integration).

[126] It is a consequence of the still prevailing functionalist approach towards integration in the European Communities that economic unity comes first, leading, with regard to the Single European Market, to a more vigorous competition and the implications it entails for bulky corporate governance institutions. However, the sequence of events does not necessarily rule out that in a second step constituency politics are reinstated on a European level. *Cf.* ROE, *supra* note 119, at 141.

[127] Henry Hansmann & Reinier Kraakman, *The End of History for Corporate Law*, 89 GEO. L.J. 439 (2001).

[128] A closed corporation that faces a contestant in a viably competitive market who is not compelled to take care of stakeholder interests will also have a competitive disadvantage.

law, nor the strength of countervailing forces need to be assessed for purposes of this research.[129] Suffice it to say that at least today European corporate law is substantially divergent in order to make legal arbitrage possible and worthwhile reflecting on.

IV. Incentives for Foreign Incorporations in the European Setting (Demand Side)

Before outlining the expectable developments in the opened market for corporate charter it seems necessary to analyze the determinants that motivate incorporators' choice of jurisdiction. Knowledge about these motivations allows both, to determine if there are jurisdictions better able to accommodate incorporators' demands as well as to explore how hospitable corporate law systems in general will be towards these needs. With regard to the economic and legal differences it is advisable to distinguish for purposes of analysis between first time incorporations of typically smaller businesses and re-incorporations of existing, generally lager enterprises.

A. Incorporation of New Businesses

The legal framework for first time foreign incorporations is as simple as it can be. The European state of formation rule in conflict of corporate laws allows for a practically unrestricted choice of corporate law governing the organization's internal affairs. To do business through a branch in a Member State different from the incorporation state, foun-

[129] On path dependence in corporate law *cf.* Lucian A. Bebchuk & Mark J. Roe, *A Theory of Path Dependence in Corporate Ownership and Governance*, 52 STAN. L. REV. 127 (1999) (arguing that initial ownership structures account for persistence of governance structures); Klaus J. Hopt, *Gemeinsame Grundsätze der Corporate Governance in Europa [Common Principles of Corporate Governance in Europe?]*, 29 ZEITSCHRIFT FÜR UNTERNEHMENS- UND GESELLSCHAFTSRECHT (ZGS) 779, 798-809 (2000) (comparing fundamental, path dependency creating differences between Great Britain and Germany); Heine & Kerber, *supra* note 77, at 57-64 (identifying stabilizing factors in European corporate law).

ders simply have to register the branch which – as European case law has amply illustrated – in fact can be the only business establishment of the company.[130] The burdens national law can impose conforming to European law are trivial.[131]

As outlined,[132] opting out of minimum capital requirements seems to be an important determinant in incorporation decisions of small businesses. However, the focus on the seemingly clear advantages achievable at the stage of formation by getting rid of the strict requirements regarding the rendering of capital contributions constitutes too narrow a view. A short comparison between the German limited liability company (*Gesellschaft mit beschränkter Haftung*) and the company limited by shares under the laws of England and Wales will illustrate the point.

With regard to the company formation the advantages of the English form are striking: Where German law requires a capital contribution of at least € 25.000 enforced by the doctrinal instruments of torture outlined above[133] and mandates costly notarization of the company's charter,[134] the British law knows no such requirements.[135] Yet, the pic-

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[130] Case 79/85, D.H.M. Segers v. Bestuur van de Bedrijfsvereniging voor Bank- en Verzekeringswezen, Groothandel en Vrije Beroepen, 1986 E.C.R. 2375 at § 16; Case C-212/97, Centros Ltd. v. Erhvervs- og Selskabsstyrelsen, 1999 E.C.R. I-1459 at § 29; Case C-167/01, Kamer van Koophandel en Fabrieken voor Amsterdam v. Inspire Art Ltd., at § 139 (available at http://europa.eu.int/eur-lex/).

[131] *Cf.* Eleventh Council Directive 89/666 of 21 December 1989 concerning disclosure requirements of branches opened in a Member State by certain types of company governed by the law of another State, art. 2, 1989 O.J. (L 395) 36 (mainly proscribing disclosure of easily available information about the company).

[132] *Supra* III.G.

[133] *Supra* III.G.

[134] § 2(1)(1) GmbHG. It seems worth noticing that the services of German notary publics are expensive, because they are obliged to counsel their clients on the substantive matters underlying the notarized document and assume liability in case of failure.

ture changes later down the road. Members of a German *GmbH* can pay out capital surpluses at will as long as the firm's capital does not dip beneath the nominal minimum capital.[136] On the other hand, an English limited company can only distribute net profits after they have been charged against losses carried forward.[137] Outside of liquidation this may lead to a much stricter capital lockup and an increase in entrepreneurial risk for the shareholders of the English company.

Moreover, the especially complicated German principle of capital maintenance in times of crisis, in particular the doctrine of equity substituting shareholder loans (*eigenkapitalersetzende Gesellschafterdarlehen*)[138] which is often thought of as creating a liability risk that is hard to manage, may prove less burdensome at second glance. Under English law the functional equivalent to protect creditors is the liability for wrongful trading.[139] Doubts regarding the applicability of the doctrine to pseudo-foreign companies

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[135] COMPANIES ACT, 1985, §§ 7, 10 (Eng.) require the submission of memorandum of association and printed articles of association. § 2 provides that the memorandum must state the amount of share capital and its division into shares, however, these figures are purely nominal. *Cf.* GEOFFREY MORSE (ED.), PALMER'S COMPANY LAW, 2.802 (1992-) GEOFFREY MORSE ET AL., CHARLESWORTH & MORSE COMPANY LAW 56-57 (1999).

[136] § 30(1) GmbHG.

[137] COMPANIES ACT § 263(3) contains the formula that a company's profits available for distribution are its accumulated realized profits less its accumulated realized losses.

[138] The new Italian Limited Liability Company act contains a provision explicitly dealing with equity substituting shareholder loans in a manner quite similar to German doctrine. *Cf.* CODICE CIVILE, art. 2467 (Civil Code).

[139] In a recent Action Plan, the European Commission followed the recommendation of an expert group and announced its long-term intention to provide a harmonized system of creditor protection based largely on the English doctrine of wrongful trading (and the French/Belgium *action en comblement du passif*). This system should not replace existing capital formation and maintenance rules but should serve as an eligible alternative for Member States. *Cf.* Commission of the European Communities, *supra*

incorporated in England that pursue their business exclusively in another Member State aside,[140] the pertinent rules designate that if the liquidator of a company can show that the director, prior to the liquidation, knew or ought to have concluded that there was no reasonable prospect that the company could avoid going into insolvent liquidation, and that he took insufficient steps in the circumstances to minimize the potential loss to the company's creditors, the court can require the director to make a contribution to the company's assets compensating for the amount by which the assets were depleted by the director's conduct.[141] It seems that the quite indeterminate general principle does not provide a basis for a bright line separation of permissible director's conduct from liability triggering misbehavior.[142] Moreover, where German shareholders can be sure that their liability is limited to the amounts received from the corporate treasury or to the funds they actually provided as equity substitute, the English doctrine creates a potentially

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note 49, at 18 referring to the final report of the High Level Group of Company Law Experts, A Modern Regulatory Framework for Company Law in Europe (Nov. 4, 2002), 86-89 available at http://europa.eu.int/comm/internal_market/en/company/company/modern/consult/report_en.pdf.

[140] Formally, the liability for wrongful trading is part of English insolvency law which is inapplicable if the bankrupt company has its centre of main interest (i.e. its administrative headquarters) abroad, Council Regulation 1346/2000 on Insolvency Proceedings, artt. 3(1), 4(1), 2000 O.J. (L 160) 1, 5-6 (*cf. also* infra note 263 and accompanying text). Yet, the codification of the common law doctrine in the Insolvency Act should not distract from its corporate law nature. Consequentially, for conflict of laws purposes it should be qualified as a corporate law doctrine, remaining applicable to a company incorporated in England regardless of where it locates its administrative seat.

[141] INSOLVENCY ACT, 1986, §§ 214 (Eng.).

[142] For the judicial construction of the doctrine *cf. in Re* Produce Marketing Consortium Ltd. (No. 2), 1989 B.C.L.C. 520.

higher liability compelling the director's to assume the full entrepreneurial risk in the moment of crisis.[143]

Another aspect that might be critical from a founder's perspective is the rather rigorous authority afforded to courts under English law with regard to the disqualification of director's that does not have a parallel under German law.[144] Under English law the court has to issue a disqualification order under the circumstances of an unfit director.[145] It can make such order under various circumstances with regard to indictable offences in connection with the promotion, formation, management or liquidation of a company,[146]

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[143] However, it is unclear, whether in most cases the German liability for delaying insolvency proceedings (*Insolvenzverschleppungshaftung*), § 64(1) GMBHG, which also leads to unlimited personal liability, would largely level the differences. *Cf.* Mathias Habersack & Dirk A. Verse, *Wrongful Trading – Grundlagen einer europäischen Insolvenzverschleppungshaftung? [Wrongful Trading – Groundwork for a European Liability for Delaying Insolvency Proceedings]*, 168 ZEITSCHRIFT FÜR DAS GESAMTE HANDELS- UND WIRTSCHAFTSRECHT (ZHR) 174, 187-88 (2004) (showing that director liability under the wrongful trading rule doctrinally can kick in earlier than the German doctrine, albeit in the judicial practice rarely does).

[144] A German closed limited liability company director (*GmbH Geschäftsführer*) can only be recalled by a majority-vote of the shareholder assembly, §§ 38(1), 46 Nr. 5 GmbHG. The charter may alter this competence (*e.g.* empower an individual shareholder) and the majority requirement. Codetermination laws confer the authority to the supervisory-board, Gesetz über die Mitbestimmung der Arbeitnehmer (MitbestG), v. 4.5.1976, BGBl. I S.1153, § 31 (Codetermination Act); Gesetz über die Mitbestimmung der Arbeitnehmer in den Aufsichtsräten und Vorständen der Unternehmen des Bergbaus und der Eisen und Stahl erzeugenden Industrie (MontanMitbestG) v. 21.5.1951, BGBl. I S.347, § 12 (Mining and Steel Codetermination Act); Gesetz zur Ergänzung des Gesetzes über die Mitbestimmung der Arbeitnehmer in den Aufsichtsräten und Vorständen der Unternehmen des Bergbaus und der Eisen und Stahl erzeugenden Industrie (MontanMitbestErgG), v. 7.8.1956, BGBl. I S.707, § 13 (Mining and Steel Codetermination Supplement Act)). Court interference, however, is not designated.

[145] Company Directors Disqualification Act 1986, 1986, § 6, (Eng.).

[146] § 2(1).

fraudulent and wrongful trading,[147] persistent default in complying with the provision of the companies legislation which require returns, accounts or documents to be filed with the registrar or notice to be given to him [148] and conviction of summary offenses consisting in a failure to comply with the provision of the companies legislation which require a return, etc., to be filed with the registrar or notice to be given to him.[149] Moreover the Secretary of State under certain preconditions may initiate the proceedings leading up to a disqualification order of the High Court or the Court of Session if she deems the disqualification to be in the public interest.[150]

Finally, incorporating a German business as an English limited liability company can cause significant extra cost with regard to accounting and auditing. The prevailing opinion infers from the Eleventh Directive that a foreign corporation has to draw up, must have audited and is compelled to submit to the company register accounting documents in accordance with the law of its Member State of incorporation.[151] Regardless of existing harmonization, Member States' accounting rules still differ significantly in critical parts, which might require the company to retain foreign accounting and, where required, auditing firms. With regard to small businesses, the extra-expenses associated therewith can easily foil the cost-reduction attained during the founding process. Fur-

[147] § 10.

[148] § 3(1).

[149] § 5.

[150] § 8.

[151] *Cf*. Eleventh Council Directive 89/666 of 21 December 1989 concerning disclosure requirements in respect of branches opened in a Member State by certain types of company governed by the law of another State, art. 3, 1989 O.J. (L 395) 36, 38.

thermore, foreign incorporation generally adds to the accounting effort. The English limited company with its administrative headquarters in Germany is subject to German corporate income tax[152] and consequentially has to draw up financial statements complying with German accounting rules for tax purposes.[153]

The point here is that there is no straightforward, compelling reason for incorporators to opt out of forms of organization only with regard to minimum capital requirements. Clearly, the evidence presented is not comprehensive and a thorough analysis would have to take other jurisdictions into account.[154] But, to dare a guess, probably the picture would look similarly with no existing corporate statute providing a doubtlessly superior set of rules. Even where the case seemed crystal clear, the picture became blurry when scrutinized more thoroughly! The more general conclusion to be drawn is that in an environment with a multitude of significant differences in pertaining corporate statutes and case law, it will rarely be one aspect of corporate law which warrants a company's migration from the perspective of diligent incorporators apt to comply with the full set of regulations pertaining to the corporate form chosen.[155] Only in a more uniform setting, specific determinants of incorporation decisions may be easier to

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[152] *Cf. supra* III.B.2.b.

[153] For a practitioner's perspective on the substantial cost incurred by proper accounting of pseudo-foreign companies *cf.* Bodo Riegger, *Centros – Überseering – Inspire Art: Folgen für die Praxis [Centros – Überseering – Inspire Art: Consequences in Practice]*, 33 ZGR 510, 517 (2004).

[154] However, among the fifteen old Member States, Ireland is the only jurisdiction unfamiliar with minimum capital requirements besides the United Kingdom. *Cf. supra* note 99.

[155] The picture changes, of course, for incorporators who do not intend to subordinate completely to the provisions of the foreign corporate statute. Ostensibly, in Austria a good share of pseudo-foreign limited liability companies does not comply with the double accounting requirement outlined above, but simply draws up its financial

specific determinants of incorporation decisions may be easier to identify – e.g. takeover regulation in the United States.

B. Reincorporation of Existing Businesses

1. The Legal Framework

It was already stated above that the legal framework in the view of the prevailing opinion currently does not allow for reincorporations executed by cross-border merger or direct transfer of the registered office.[156] If EC TREATY artt. 43, 48 were to compel an interpretation of national merger statutes to allow foreign corporations to participate in business combinations under Member States corporate law,[157] the legal framework would strongly resemble the situation in the United States. The template for Member States' merger statutes is the Third Council Directive, although it only covers public companies. The administrative or managing bodies of the involved corporate entities have to draw up the terms of the merger and have to seek shareholder approval after extensive disclosure.[158] It is exactly this pattern of management preparation of the merger plan and informed shareholder approval that reoccurs in the proposed Cross Border Merger Direc-

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statements according to the law of its administrative seat. I owe this information to Martin Gelter.

[156] *Supra* III.A.

[157] For this opinion *see e.g.* Harald Kallmeyer, *§ 1 Rdnr. 12, 13*, *in* UMWANDLUNGSGESETZ [MERGER ACT] (Harald Kallmeyer ed., 2. ed. 2001); Volker Triebel & Karl von Hase, *Wegzug und grenzüberschreitende Umwandlungen deutscher Gesellschaften nach „Überseering" und „Inspire Art" [Relocation and cross border mergers of German Corporations after "Überseering" and "Inspire Art"]*, 58 BETRIEBS-BERATER (BB) 2409, 2416 (2003).

[158] *Cf.* Third Council Directive 78/855 of 9 October 1978 based on Article 54 (3) (g) of the Treaty concerning mergers of public limited liability companies, artt. 5(1), 7(1), 23(1) 1978 O.J. (L 295) 36 [hereinafter: Merger Directive].

tive.[159] Similarly, the few general deliberations made in connection with the announcement of a Fourteenth Company Law Directive on the cross-border transfer of the registered office of limited companies refer to the "formalities and procedures for altering of the memorandum and articles and association" i.e. will require a joint effort of management and shareholder meeting.[160]

Hence, in Europe like in the United States the legal framework will provide that management and shareholder interests enter into reincorporation decision, with all potential for distortion on the side of (dispersed) shareholders.[161] However, the peril of distorted shareholder choice might at least in part be mitigated by supermajority requirements, further restricting management's latitude to pursue opportunistic incorporation choices.[162]

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[159] *Cf.* Cross Border Merger Directive, art.3-6.

[160] The European Commission, Public Consultation related to the outline of the planned proposal for a 14th Company Law Directive on the cross-border transfer of the registered office of limited companies, *available at* http://europa.eu.int/comm/internal_market/company/seat-transfer/2004-consult_en.htm.

[161] Bebchuk, *supra* note 25, at 1470-76.

[162] Cross Border Merger Directive, art. 2 provides that the covered business combinations shall be governed, as far as merger formalities are concerned, by provisions of national law including those concerning the decision making process. The harmonized national provisions in question have to provide that that the shareholder meeting's decision requires a majority of not less than two thirds of the votes attaching either to the shares or to the subscribed capital represented. The laws of a Member State may, however, provide that a simple majority of the votes shall be sufficient when at least half of the subscribed capital is represented. Merger Directive, art. 7(1). For an overview of the implementation of the Merger Directive in various Member States see Dammann, *supra* note 46, at 60-61.

2. Incentives to Reincorporate

Major events identified in the American debate that motivate existing businesses to reincorporate are: a prospective public offering (typically an IPO), the intended implementation of a mergers and acquisitions program, and the deployment of anti-takeover devices. Under a transaction cost explanation, a corporate law system's tendency to invite suit in these transactions, equip shareholders with critical voting and appraisal rights, and the ease and certainty with which legal opinion can be retrieved under a comprehensive, well developed body of case law become critical. Greater predictability assists in structuring the transactions and reduces firms' operating cost.[163] Even among race to the bottom proponents the issue of takeover defense is critical.[164] The following section investigates the explanatory power of these assertions with regard to Europe and highlights some particularities.

i. Implementation of Merger Programs

Quite plausibly, the integration of European markets may call for a consolidation in certain branches and could ignite a wave of European-scale mergers. However, there does not seem to be a clear structural deficit in Member States corporate laws that would drive corporations out of certain jurisdictions. In fact, the Merger Directive has largely created a level playing field among Community members with regard to substantive law. Conceivably, it could be a motivating factor if one jurisdiction would already facilitate cross border business combinations. An ephemeral one, though. The proposed Cross Border Merger Directive would largely take away the advantage in this important realm.

[163] Romano, *supra* note 15, at 244-59.

[164] E.g. Bebchuk & Ferrell, *supra* note 21; Subramanian, *supra* note 111.

With the cross border merger procedure under the proposed directive largely approximating the harmonized practice proscribed for domestic mergers,[165] the latitude for corporate law arbitrage seems minimal, especially because no jurisdiction seems to have an advantage in the administration and adjudication of the harmonized law.

ii. Initial Public Offerings

The IPO-explanation in principal is relevant for Europe given that corporate law does have an effect on firm value that can be captured by the founders in a public offering. If this effect, due to a more diverse legal environment, is of even greater magnitude than in the relatively uniform setting encountered in the United States, the gains could be more significant and hence might constitute a strong reincorporation motive.

A conceivable way to boost corporate value could be the incorporation in a shareholder friendly jurisdiction. Buying for a moment the assertion that common law jurisdictions essentially provide a climate more hospitable to shareholder interests,[166] a strong case for reincorporation in the United Kingdom could be made. Moreover, commentators praise the favorable attitude of British corporate law towards unsolicited tender offers – a key element in reducing managerial agency cost.[167] However, consistent with the above said,[168] the pro-takeover bias does not catch the essential aspect where the founders do not sell their equity stake entirely but remain controlling or at least strong blockholders. The resulting ownership structure reduces takeover likelihood anyway and concomitantly

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165 *Supra* IV.B.1.

166 This is one of the posits in the influential La Porta et al. series of articles, *see e.g.* La Porta et al., *supra* note 114, at 1132.

167 Stith, *supra* note 110, at 1582-1591.

168 Supra III.J.

diminishes the problem of managerial agency cost. Furthermore, some of the hailed institutions of common law, like individual shareholder law suits enforcing director's and controlling shareholder's fiduciary duties may not be too efficient in the end.[169] Other features of successful shareholder protection in common law countries seem to diametrically oppose common law traditions and are therefore not present in all common law countries, e.g. the securities laws in the United States under the detailed and comprehensive statutory system of the Securities Act of 1933 and the Securities Exchange Act of 1934 and the SEC rules promulgated thereunder. Conversely, shareholder protective institutions typically attributed to common law seem to fit quite well in civil law systems.[170] Moreover, civil law countries have made significant efforts recently to bolster up investor protection.[171] In sum, it is not self-evident where to reincorporate to accommodate shareholder interest, leaving European public or wannabe public companies without a clear incentive to migrate.

iii. Takeover defenses

In today's European setting vital challenges for the corporate entity controllable by corporate law seem conceivable only in the takeover context. Hence choosing a re-

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[169] For critical assessments of the situation in the United States *cf.* Roberta Romano, *The Shareholder Suit: Litigation without Foundation?*, 7 J. L. ECON. & ORG. 55 (1991); Daniel R. Fischel & Michael Bradley, *The Role of Liability Rules and the Derivative Suit in Corporate Law: A Theoretical and Empirical Analysis*, 71 CORNELL L. REV. 261 (1986).

[170] E.g. TRÖGER, *supra* note 115 (developing a fiduciary duty based system to tame the power of dominant stockholders under German corporate law); WALTER G. PAEFGEN, UNTERNEHMERISCHE ENTSCHEIDUNGEN UND RECHTSBINDUNG DER ORGANE IN DER AG [ENTREPRENEURIAL DECISIONS AND LEGAL BONDS OF ORGANS OF THE STOCK CORPORATION] (2002) (showing that a system of individual shareholder lawsuits is inherent in German corporate law).

[171] Cf. Infra V.A.2.b.

stricting or permissive takeover regulation may constitute a crucial parameter in a European race. For example, the pertinent section of the German takeover code gives the executive board (*Vorstand*) together with the supervisory board (*Aufsichtsrat*) wide discretion when deciding whether or not to fend off unsolicited bids.[172] However, it requires the takeover defenses deployed according to this decision to be established and legitimized on grounds of other provisions of corporate law, to wit what can be used as a shark repellent is determined by general corporate law. Here recent reforms prohibiting multiple voting stock, voting caps et al. have seriously reduced the means at hand.[173] Given the fierce lobbying efforts of German managers regarding takeover friendly European legislation,[174] it seems plausible that they do have a propensity to resort to takeover hostile incorporation havens. But it seems questionable whether shareholders will go along. With a dominant blockholder hostile takeovers are not an issue anyway. In public companies with dispersed shareholding, ownership structures incrementally resemble U.S. patterns with large institutional investors dominating. These sophisticated shareholders will probably not accept an anti-takeover motivated reincorporation – just like palpable anti-takeover devices like the staggered board cannot be implemented in the United States once (insti-

[172] Wertpapiererwerbs- und Übernahmegesetz [WpÜG] (Takeover Act), v. 20.12.2001, § 33 (BGBl. I 3822).

[173] *Cf.* Gesetz zur Kontrolle und Transparenz im Unternehmensbereich [KonTraG] (Control and Transparancy Act), v. 4.3.1998, Art. 1 (BGBl. I 786).

[174] *Cf.* Tobias Tröger, *Deutsches und Europäisches Übernahmerecht* [*German and European Takeover Law]*, in: REFORM DES AKTIENRECHTS, DER RECHNUNGSLEGUNG UND DER PRÜFUNG [REFORM OF STOCK CORPORATIONS LAW, SUBMISSION OF ACCOUNTS AND AUDITING] 135, 138-39, 165-66 (Dietrich Dörner et al. eds., 2d ed. 2003).

tutional) shareholders are on board.[175] If reincorporation occurs prior to the firm's IPO, markets can be expected to detect the clear anti-takeover angle of the move and discount share prizes accordingly. The situation in Europe arguably differs in an important respect from the scenario in the United States where corporations ostensibly still move from takeover friendly to (moderately) takeover hostile jurisdictions, i.e. from California to Delaware.[176] Due to Delaware's monopoly position and the accompanying positive network externalities the migration in the United States yields also efficiency gains in the corporate law ambit which in part or fully offset the negative impact of takeover hostility, thereby making the net effect on shareholder value less significant. With no potential anti-takeover jurisdiction in a similar position the overall welfare decreasing impact of reincorporation would be more drastic, triggering more rigorous shareholder opposition or investor discounting respectively. To conclude, it seems that reincorporating to entrench the corporate fortress seems relatively unlikely.

iv. Employee Participation

Although not a total singularity in Europe,[177] German codetermination presents the most incisive model.[178] Under the assumption that codetermination lowers the effi-

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[175] *Cf.* Lucian A. Bebchuk, John C. Coates, IV & Guhan Subramanian, *The Powerful Antitakeover Force of Staggered Boards: Theory, Evidence & Policy*, 54 STAN. L. REV. 887, 900 (2002).

[176] Subramanian, *supra* note 111, at 1854.

[177] For an overview of employee participation in the European Union *cf.* Eddy Wymeersch, Current Company Law Reform, Initiatives in the OECD Countries – Challenges and Opportunities, 30-36 (SSRN Working Paper Collection, Feb. 2001) (available at http://ssrn.com/abstract=273869).

[178] For an overview of the regulations *see* Herbert Wiedemann, *Codetermination by Workers in German Enterprises*, 28 AM. J. COMP. L. 79, 79-81 (1980).

ciency of the supervisory board (*Aufsichtsrat*) as a monitoring institution,[179] or hampers typical venture capital contracting,[180] the de-facto choice to get rid of this hindrance could be seen as a move sponsored by incorporators. The question to be revisited here is less if incorporators would deliberately chose a corporate governance system avoiding codetermination but rather if they are able to exercise their will.[181]

v. Opt out of Minority Protections

From a blockholder's perspective, restrictive standards dealing with majority-minority conflicts, might, constitute a motive to re-incorporate the dominated company in a more lenient jurisdiction. But this seems to be a move that is boldly directed against minority shareholders and could not be concealed easily. As a result, it would entail detrimental consequences with regard to the firm's ability to refinance. Of course, if the need to address capital markets is not present, sanctions executed through market forces do not mount a serious threat.[182] But, in times of incremental competition in the Single European Market the necessity to raise new funds in equity markets is growing, rendering possible retributions dealt through market mechanisms meaningful.

With regard to the German law of groups of companies (*Konzernrecht*) the situation is slightly more complex. The purpose of this unique part of German stock corporation law is to restrain a dominant shareholder who is trying to exploit the company and its

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[179] Katharina Pistor, *Codetermination: A Sociopolitical Model with Governance Externalities*, *in* EMPLOYEES AND CORPORATE GOVERNANCE 163-193 (Margaret M. Blair & Mark J. Roe, eds. 1999).

[180] Ronald J. Gilson, *Globalizing Corporate Governance: Convergence of Form or Function*, 49 AM. J. COMP. L. 329, 352-53 (2001).

[181] *See also supra* VI.B.1.

[182] EASTERBROOK & FISCHEL, *supra* note 15, at 216-217.

minority stockholders. The pertinent rule prohibiting the dominant stockholder to exercise her influence to the detriment of the company[183] resembles the duty of loyalty standard as established in U.S. corporate law.[184] The critical feature of the German system is its requirement of extensive reporting and auditing of the relations between the dominant shareholder and the dominated firm.[185] This lavish and costly regime is widely regarded as inefficient, leaving the dominant shareholder significant latitude to extract private benefits.[186] From an incorporators perspective it could indeed be a sensible choice to opt out of the German law of groups of companies. First she could signal to equity markets her credible commitment to minority protection by picking a more efficient system and she could save cost by getting rid of the reporting and auditing obligations. However, some caution seems warranted. The gains such a move yields seem relatively punctiform and the magnitude of achievable efficiency enhancements is hard to assess.[187] Hence, it seems unlikely that the prospect of getting rid of the law of groups of companies alone could motivate a foreign reincorporation.

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[183] § 311(1) AktG.

[184] *Cf.* Sterling v. Mayflower Hotel Corp., 93 A.2d 107, 109-110 (Del. 1952); Jones v. Missouri-Edison Electrical Co., 144 F. 765, 777 (8th Cir. 1906); May v. Midwest Refining Co., 121 F.2d 431, 439 (1st Cir. 1941).

[185] §§ 312-314 AktG.

[186] For an overview of the varying assessments existing among German corporate law scholars *cf. e.g.* Bruno Kropff, *Vor § 311 Rdnr. 23-29* in: MÜNCHENER KOMMENTAR ZUM AKTIENGESETZ, BAND 8 [MUNICH COMMENTARY ON THE STOCK CORPORATION ACT, VOL. 8] (Bruno Kropff & Johannes Semler eds., 2d ed. 2000).

[187] Although the critique attaching to the law of groups of companies is old, empirical data is largely lacking making it impossible to determine the actual detrimental impact of the regulation.

vi. Conclusion

The aforesaid leaves an ambiguous impression. Yes, there are considerations that could motivate cross border incorporation in the European scenario. But every aspect seems to have countervailing facets or tempering circumstances. However, this is not too surprising. The choice of corporate law in an environment where no jurisdiction has a striking edge over the other corporate law providers (like Delaware had over New Jersey or New Jersey had over the rest of the states) is a complex decision, requiring a comprehensive weighing and balancing of pros and cons. The attempt to highlight possible motives should be seen as an effort to point out aspects that play a central role in the decision making process, although they rarely, if ever, can justify the incorporation choice alone.

3. The Role of Legal Counsel

A short remark with regard to the role of corporate counsel seems worth pausing for an instant. While the role of the bar in lobbying for attractive corporate law is frequently considered[188] another impact of the legal profession on possible re-incorporation decisions is pointed out less often. It seems plausible that nationally rooted corporate counsel will be the brakesmen when it comes to re-incorporation decisions if the companies' migration to them means loss of business because they cannot provide their services with regard to foreign corporate law.[189] Yet, the decisive verb "cannot" does not seem

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[188] *Cf. infra* V.A.2.a note 229.

[189] Dammann, *supra* note 46, at 77-82. For the United States *see* ROMANO, *supra* note 15, at 43-44 (observing exactly this constraining force with regard to corporate counsel in the U.S.); similar Daines, *supra* note 26, at 1584-86, 1595 (finding that interests of corporate counsel play an important role in reincorporation decisions creating a bias for well mastered Delaware law).

justified, because as already said, corporate counsel will be able to obtain the necessary skills to render multi-jurisdictional advice and will consequentially have no reason to impede reincorporations. This is even truer with regard to the cross border mergers or associations of large and medium sized European law firms. Moreover, even reasonably specialized local attorneys will not automatically have to refer their corporate clients to members of the bar in the Member State of incorporation. Rather sooner than later they will be able to counsel pseudo-foreign corporations in the normal course of business and will only have to defer to external colleagues in more complicated matters and where it comes to litigation.[190] This also relativizes the argument that well-meaning corporate counsel, having the corporate interest in mind might discourage reincorporation because of the cost associated with the entailed change of attorney. Certainly, the assumption that attorney's will become able to counsel reasonably in each of the twenty-five Member States' corporate law is unrealistic. However, as has been outlined above, only persistent and palpable features of a well accessible corporate law system warrant migration choices from an incorporator's perspective. Within these limits, corporate counsel will be able to master the challenge of making themselves sufficiently familiar with foreign corporate law, rendering it largely superfluous to prevent companies from reincorporating due to selfish motivations.[191]

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[190] Similarly, the Delaware bar does not play a significant role in advising corporate clients in the normal course of business, *cf*. Macey & Miller, *supra* note 31, at 493; Kahan & Kamar, *supra* note 26, at 697-698 (presenting data on the comparatively small extra-revenues generated by the Delaware corporate bar).

[191] The converse view (Dammann, *supra* note 46, at 50, 79-80) underestimates the capability of corporate law practitioners. It is not rocket-science to adapt from a one-tier to a two-tier board system and vice versa or to learn about the different relevance of precedents or cope with unfamiliar forms of employee participation.

V. Initiators, Competitors, and Referees in the European Market

Where the legal environment allows for cross border choice of corporate law[192] a lasting competition will be sparked off if demand and supply meet in a market.[193] It has been pointed out that the prospect of rivaling corporate statutes is not new for Europe.[194] The impact of the modern permissive conflict of laws rule depends crucially on incorporators' just analyzed incentives to subject their business organization to a foreign corporate law system as well as rulemakers' incentives to accommodate the needs of corporate decision makers i.e. legislatures' propensity to continuingly provide and improve the desired set of rules. If luring corporations into their jurisdiction is an attractive operation for Member States, they will be responsive to the demand sides' preferences. Welfare considerations will call for putting limits on market forces where they produce negative externalities and consequentially create a desire for referees in the European competition for corporate charter.

After having studied the conceivable motivations of European corporations to incorporate it is time to turn to the side of the suppliers.

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[192] On the current deficits impeding reincorporation choices of existing entities in Europe *supra* III.A.

[193] The sporadic prediction that even under the real seat theory a vigorous race for laxity in the European Union was to be expected did not come true. Terence L. Blackburn, *The Unification of Corporate Laws: The United States, the European Community and the Race to Laxity*, 3 GEO. MASON INDEP. L. REV. 1, 89-91 (1995) (arguing that Member States have greater incentives to induce choice of law under the real seat rule because the establishment of the administrative headquarters would provide benefits from jobs and taxes far exceeding franchise revenues).

[194] David A. Charny, *Competition among Jurisdictions in Formulating Corporate Law Rules: An American Perspective on the "Race to the Bottom" in the European Communities*, 32 HARV. INT'L. L.J. 423, 428 (1991).

A. Member States

It could be regarded as a basic insight of the American debate that the consequences of an integrated market for corporate law significantly depend on the evolution of a dominating monopolist. Be it a specter or a benedictory prospect,[195] the question whether a dominant supplier of corporate law will evolve in Europe seems to warrant scrutiny.

1. European Delaware? – The Potential for a Competition with a Clear Winner

The proverbial Delaware-effect was triggered by the historical singularity of a tiny state capitalizing on vigorous antitrust regulation in the then dominant state of incorporation.[196] Self-evidently, with antitrust law widely centralized on the supranational level[197], a similar driving force will not be present in today's Europe. However, even if no sweeping wave of reincorporations will occur, there might be Member States within the Union with incentives to lure corporations into their jurisdictions over the long run. Theoretically, some of Delaware's features appear replicable.

It was Delaware's special responsiveness to embrace the demands of corporate decision makers that fostered its position over the years.[198] This sensibility to corporate

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[195] High-ranking officials have (even before Cary's drumbeat) regarded it as a prime task of European corporate law legislation to evade the evolution of a European Delaware, Schmitthoff, *supra* note 12, at 9; Kolvenbach, *supra* note 12, at 711-12.

[196] *Cf. supra* II.E.

[197] Merger control and cartel surveillance are conducted by the Commission under EC TREATY artt. 81 and 82 and the regulations promulgated under art. 83.

[198] Again, this can be seen positively as a beneficial responsiveness to the needs of the business community, *e.g.* ROMANO, *supra* note 15, at 9 or as the detrimental knuckling down of the pygmy facing managers opportunistic desires, *e.g.* Cary, *supra* note 24.

demands can be explained as a direct function of the small size of the polity where only few legislative projects rank higher on the agenda than the amendment of the corporate statute.[199] Moreover, this characteristic responsiveness is not an ephemeral phenomenon but a persistent hallmark of Delaware's commitment.[200] The dependency on franchise revenues and the substantial investments that do not have significant value unless Delaware retains its preeminent position in the incorporation business – e.g. the judicial and the administrative expertise; the extensive body of case law – render it a corporate law provider credibly committed to the needs of the business community. This commitment is further amplified by the Constitution which requires a supermajority of two-thirds of both houses of Delaware's General Assembly to amend the corporation code.[201] The question is whether any of the Communities members is situated similarly.

a. The Unions Smaller Members

Assuming for the purpose of analysis that European institutions indeed lift the current ban on state of incorporation franchise fees,[202] the magnitude of the immediately achievable benefits might only induce smaller states to make an effort to supply corporate

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[199] Curtis Alva, *Delaware and the Market for Corporate Charters: History and Agency*, 15 DEL. J. CORP. L. 885 (1990) (purporting that institutional arrangements in Delaware strictly limiting the number of agents involved in the process of making corporate law account for Delaware's supremacy); Leo Herzel & Laura D. Richman, *Delawares Preeminence by Design*, in: THE DELAWARE LAW OF CORPORATIONS AND BUSINESS ORGANIZATIONS F-I, F-2 (R. Franklin Balotti & Jesse A. Finkelstein eds., 3d ed. 1998) (outlining Delaware's public policy and its institutional consequences).

[200] ROMANO, *supra* note 15, at 37-44.

[201] DEL. CONST., art IX, § 1 (2004).

[202] *Cf. supra* III.C.

law as a bait, catering to the needs of corporate decision makers.[203] Although with regard to size, there might be jurisdictions comparable to Delaware,[204] some doubts with regard to their attractiveness may be raised.

To warrant the cost associated with reincorporation in a foreign jurisdiction the benefit for corporations considering such a move must be substantial and persistent. In the mid 1980s, American scholars have reported the cost of reincorporation in the United States at an average of $ 40.000 with a range between some thousand dollars and more than one million.[205] With regard to the far greater informational and technical problems in Europe the cost will presumably be much higher. Moreover, the focus on the act of reincorporation in a foreign jurisdiction seems too narrow an approach for Europe, where managing a company under a foreign corporate law regime steadily entails higher cost.[206]

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[203] Although Delaware is defraying 15-20% of its budget with franchise fee revenues totaling to some hundreds of millions of dollars (Roe, *supra* note 29, at 594; for exact numbers *cf.* ROMANO, *supra* note 15, at 7), the amount still seems relatively marginal compared to larger EU member states budgets.

[204] *See* Carney, *supra* note 24, at 308. With regard to the number of citizens Luxemburg, Cyprus and Malta are smaller than Delaware (which has a population of 783.600 citizens according to the 2000 Census. http://factfinder.census.gov/servlet/BasicFactsTable?_lang=en&_vt_name=DEC_2000_PL_U_QTPL&_geo_id=04000US10 (last visited 2/6/2004). As the freedom of establishment expands to the members of the European Economic Area (EEA), Treaty Establishing the European Economic Area, artt. 31 and 34, Liechtenstein and Island are in the game too.

[205] Romano, *supra* note 15, at 246 (1985).

[206] For a practitioners view *cf.* Roger Kiem, *Das Centros-Urteil des Europäischen Gerichtshofs – Praktische Gestaltungs- und Reaktionsmöglichkeiten aus dem Blickwinkel der Gesellschaften [The Centros-Judgment of the European Court of Justice – Possibilities of Practical Design and Reaction from the Companies' Perspective]*, *in*: GESELLSCHAFTSRECHT IN DER DISKUSSION 1999 [Corporate Law in the Discussion 1999] 199, 210 -214 (Gesellschaftsrechtliche Vereinigung ed. 2000).

Although, again this seems to be an aspect assessable only on a case-by-case basis,[207] the general point persists – the substantial cost have to be compensated by significant benefits from the choice of corporate law. Furthermore, it was emphasized that the superiority of a foreign corporate statute must be unambiguous. Among the commonly mentioned advantages explaining Delaware's predominance are its elaborate body of case law, its specialized and experienced judiciary and administration, and an expert bar, factors which, for obvious reasons, cannot easily be duplicated from scratch. If no external factors other than corporate law considerations broadly understood put pressure on corporations to migrate, the expenditures necessary to create a serious incentive to reincorporate/incorporate abroad might exceed the amount small Member States are able or willing to spend in order to become an attractive incorporation haven. The occasional assertion that smaller states could easily compensate for institutional deficits in their judicial systems by "hiring highly regarded lawyers from other Member States as judges, thereby boosting the reputation of their courts" appears naive.[208] Besides the fact that "hiring" foreigners as judges might stir political objections, it is by no means sufficient to install some prominent figureheads to create a competitive process of adjudication. It seems noteworthy in this context, that Delaware's positive network externalities today fostering its preeminent position developed gradually over time as a consequence not as the cause

[207] *E.g.* It seems too general to extrapolate from rules governing the international competence of courts with regard to the companies' internal affairs that foreign incorporations will always lead to higher cost of adjudication abroad (*e.g.* KIENINGER, *supra* note 75, at 173; Dammann, *supra* note 46, at 25-34). Especially closed corporations will be able to channel a good share of corporate law disputes into arbitration proceedings. Which jurisdiction's substantive law the arbitral tribunal will apply does not seem to boost litigation cost.

[208] Dammann, *supra* note 46, at 92.

of the first wave of reincorporations. Hence, there is no example of a jurisdiction deliberately creating comparable advantages as significant part of its corporate law package. There is no evidence that such an endeavor can be pursued at bearable cost.[209] However, it is conceivable that some of the small states already have a foundation on which they could built a Delaware-like corporate law system with its surrounding public and private institutions consequentially facing lower entrance cost.

(a) Malta, Cyprus, Island

There is no evidence that either Malta, Cyprus, or Island currently has an infrastructure allowing or even facilitating building a Delaware-like corporate law package.

(b) Liechtenstein

Liechtenstein has in the past attracted out of state incorporations. However, the ticket the principality fares on is not the specific quality of its corporate law, but an extremely favorable tax system, basically exempting companies that do only have their registered office in Liechtenstein as well as holding companies from corporate income taxes.[210] In fact, in light of the provided tax benefits Liechtenstein's eclectic corporate law is at least partly tailored to serve ventures that are set up for tax purposes and do not operate a business other than asset management. With regard to genuine business organizations the principality's corporate law system does not provide any advantages, in fact it simply imports successful forms of organizations from various jurisdictions.[211] Delaware's history shows that simply copying foreign corporate law does not suffice to attract

[209] Very optimistic with regard to small Member States Dammann, *supra* note 46, at 94-97.

[210] SELE, *supra* note 76, at 145-146, 183.

[211] KIENINGER, *supra* note 75, at 196-198.

incorporations.[212] This is truer than ever in times where in Europe's large economies legislative bodies move fast to improve corporate law quality and keep constantly amending the corporate codes, and where the judiciary seems to pick up this reform oriented spirit.[213] Other relevant advantages, like Delaware's network externalities are not present in Liechtenstein. It cannot be ruled out that a crack down on the tax haven will force Liechtenstein to look for new sources of income with providing good corporate law to attract incorporations becoming an option. However, this is highly speculative. Suffice it to say that the current state does not provide significant advantages for Liechtenstein if it should consider embarking on such an endeavor.

(c) Luxembourg

American corporate law scholars long before recent developments suggested another principality's attractiveness as an incorporation haven even under a real seat theory regime – Luxembourg.[214] Yet, Luxembourg's success in providing financial services is also largely based on its favorable tax regime and puts the Member State in a similar position with Liechtenstein. Moreover, Luxembourg differs in a significant respect from Delaware – it is considerably larger. In 2003 the states income totaled € 6.349 million (approx. $ 7.600 million),[215] while Delaware's figure for the same fiscal year was $ 2.436

[212] *Supra* II.E.

[213] *Cf. infra* V.A.2.b and VI.B.

[214] Alfred F. Conrad, *The European Alternative to Uniformity in Corporation Laws*, 89 MICH. L. REV. 2150, 2194 (1990-1991).

[215] STATEC, LUXEMBOURG IN FIGURES, *available at* http://www.statec.lu/html_de/statistiques/luxembourg_en_chiffres/index.html.

million.[216] For franchise taxes to play a comparable role like in Delaware, Luxembourg would have to incur about three times Delaware's revenues. This does not seem very likely taken into account that Delaware attracted more than half of the public companies incorporated in the United States.[217] Of course, even a smaller source of income might be attractive.[218] Yet, a substantially smaller net income from franchise fees in relation to the state's total budget would reduce Luxembourg's dependency on the chartering business and would render its commitment as a stable, non-reneging corporate haven far less credible.

b. Larger European States

Even without a tiny Member State duplicating Delaware's success a preferred state of incorporation might emerge. The Netherlands have been said to be attractive because of their pro-managerial rules regarding share-ownership and mergers.[219] The United Kingdom was promoted as European Delaware because of its shareholder oriented culture and corporate law.[220] Yet, these States are not the Cary-style pygmies. The

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216 State of Delaware, Office of the Budget, Fiscal Year 2005 Governor's Recomended Budget, Financial Summary 2 *available at* http://www.state.de.us/budget/budget/fy2005/operating/05opfinsumcharts.pdf.

217 Similarly skeptical KIENINGER, *supra* note 75, at 191.

218 It has been purported that Luxemburg's gross domestic product is roughly only half the size of Delaware's indicating that the taxable economic activity is substantially smaller rendering extra franchise fee revenues all the more appealing. An observation that holds also true for a couple of accession states. Dammann, *supra* note 46, at 90.

219 Charny, *supra* note 194, at 430.

220 BRIAN R. CHEFFINS, COMPANY LAW: THEORY, STRUCTURE AND OPERATION 426-30 (1997); according to Elvin R. Latty, *Pseudo-Foreign Corporations*, 65 YALE L. J. 137, 166, n. 130 (1955) England was the European Delaware of the second half of the nineteenth century.

absence of constituency interest group inspired rules in U.S. corporate law has been noted by analysts.[221] The reasons for this were plausibly outlined pin pointing Delaware's unique situation, creating legal externalities with regard to employees, communities, creditors etc.[222] Exactly this scenario is lacking in both the Netherlands and the United Kingdom which gives reason to believe that their corporate law package is in fact less attractive for incorporators than purported.[223] With regards the Netherlands this is amply illustrated by its relatively far reaching employee participation.[224] Moreover, with management playing a less dominant role in the reincorporation decision process some doubts may be cast with regard to the appeal of a pro-managerial corporate law.

Finally, critical parts of the United Kingdom's allegedly shareholder friendly corporate law offering depend not only on reincorporation but sometimes require additional connections with its jurisdiction, which augments the burden to be shouldered in order to subject the business organization fully to British corporate law. The City Code on Takeovers and Mergers (City Code), widely acclaimed as a successful example of investor protection, applies to public companies considered by the Panel on Takeovers and Mergers (Panel) to be resident in the United Kingdom, the Channel Islands or the Isle

[221] Carney, *supra* note 24, at 317.

[222] Roe, *supra* note 30.

[223] Merkt, *supra* note 110, at 559-60 makes this point, albeit somewhat narrower, when he argues that from the perspective of managers advantages gained by opting-out of certain constituency protective regulations (codetermination) have to be paid for by inverse disadvantages (takeover vulnerability; stronger shareholder position). Yet, the stricture on management's perspective presupposes the classical agency conflict in a public firm with dispersed ownership – a scenario which is less frequent in continental Europe reducing the importance of management's self-interest. Likewise, management's interest does not play a central role if the re-incorporation occurs in the wake of an IPO of a so far closely held firm.

[224] Wymeersch, *supra* note 177, at 32-35.

ers (Panel) to be resident in the United Kingdom, the Channel Islands or the Isle of Man. According to the understanding of the Panel this residency requires incorporation and place of central management in one of the mentioned jurisdictions, augmenting the price to pay in order to obtain the City Code's investor protection to a transfer of the administrative headquarters.[225] Assuming that the City Code as a private self regulation need not comply with the freedom of establishment as defined in the EC-Treaty, a so understood residency requirement is under no pressure to be reinterpreted in accordance with the ECJ's holdings in *Centros*, *Überseering* and *Inspire Art*.[226] Hence, a critical part of investor protection in public companies is in fact tied to a transfer of the company's administrative seat, which evokes disadvantages able to sap the benefits of superior corporate law. The ambiguity surrounding the attractiveness of the law governing British private limited companies has been outlined above.[227]

In sum, at the outset none of the larger Member States appears as the natural winner in a European race. Moreover, no jurisdiction can claim significant advantages in terms of a superior corporate law administration or adjudication. Once again the lack of

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[225] The City Code in its Introduction provides in pertinent part:

> The Panel will normally consider a company to be resident only if it is incorporated in the United Kingdom, the Channel Islands or the Isle of Man and has its place of central management in one of those jurisdictions.

PANEL ON TAKEOVERS AND MERGERS, THE CITY CODE ON TAKEOVERS AND MERGERS A8 (6th ed. 2000).

[226] The City Code expresses the collective opinion of those professionally involved in the field of takeovers and does not have the force of law. *Cf.* PANEL ON TAKEOVERS AND MERGERS, *supra* note 225, at A1-A2.

[227] *Supra* IV.A.

clear advantages compelling incorporators to move to a specific jurisdiction proves to be pertinent.

2. Prospects for Competition without a European Delaware

It is a recently articulated "revisionist" view of the classical positions in the American debate, that other states, due to economic entry barriers and political factors do not actually compete with Delaware in the chartering market and do not make significant efforts to attract incorporations.[228] The implications of this posit for the European scenario seems pretty straightforward. If Member States due to a lack of incentives rather resemble non-competing U.S. states there will be no race towards wherever. Consequentially the task for a quasi-federal regulator, who would not have to serve as an umpire in the race, would have to be defined differently. But is it indeed inconceivable that there is competition without the driving force of profit maximization? This section scrutinizes possible incentives of Member States' regulators in a scenario without franchise fees driving the chartering market.

a. Pressure from the Bar and other Corporate Counsel

The notion of Delaware's bar as a powerful interest group influencing the state's legislation in corporate law is common and was developed early in the American debate.[229] Moreover, in the early wave of incorporations in New Jersey, the trust-hospitable

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[228] *Supra* II.C.

[229] Cary, *supra* note 24, at 668, 686-688; Alva, *supra* note 199, at 904-15; Macey & Miller, *supra* note 31 (arguing that the bar pushes for regulation that increases the likelihood of litigation and enhances the value of lawyers' service).
For a prominent modern example *cf.* David S. Schaffer, Jr., *Delaware's Limit on Director Liability: How the Market for Incorporation Shapes Corporate Law*, 10 HARV. J.L. & PUB. POL'Y 665, 684-685 (1987) (Outlining how the Delaware statute to opt-out of director's negligence liability was drafted in a Wilmington law office and was

regulation was at least in part a product of successful lobbying efforts of attorneys who had their own interest at heart.[230]

It is at least questionable whether the bar in any Member State will be capable of exercising noticeable pressure to induce legislation. The "tight club" formed by the Delaware bar, the judiciary, and the states lawmakers,[231] constitutes a special microcosm not easy to duplicate. Furthermore, taken the cross-border fusions of the largest European law firms into account, there is good reason to believe that powerful players will lack the incentives to exercise pressure to promote a specific national corporate law.[232]

b. Pressure from Corporations and Investors

Some scholars have pointed to the self-interested influence the DuPont family exercised when shaping Delaware's corporate institutions in order to protect their managerial and shareholder interests.[233] National legislatures have recently promulgated a host of statutes protecting shareholders and other investors – for example Germany has made considerable efforts to improve its allegedly underdeveloped and provincial capital mar-

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marched through the legislation process without substantial amendments.) But *see also* EASTERBROOK & FISCHEL, *supra* note 15, at 216-217 (arguing that the bar would not receive substantial rent from such efforts).

[230] Butler, *supra* note 38, at 161-162.

[231] Univocally acknowledged as a fact by race-combatants, *see* Cary, *supra* note 24, at 690-92; Winter, Jr., *supra* note 15, at 255.

[232] The converse position expressed by Dammann, *supra* note 46, at 58, 77-82 (pressure from local bar will induce Member States to compete "vigorously") seems to overestimate the clout of the corporate bar as an, albeit well organized, interest group in larger Member States. Moreover, it is largely based on the disputable assumption that lobbying efforts will be stirred by the local bar's loss of business in the event of foreign reincorporation (for a critique of this posit *see supra* IV.B.3).

[233] Charny, *supra* note 194, at 427-28.

kets regulation[234] and its stock corporation law[235]. These efforts were unanimously hailed by German firms. This indicates that enhanced competitiveness of integrated product markets and the growing need for equity financing garnered in globalized capital markets create incentives for large companies to care more about the investor protective quality of corporate law, rendering their securities more attractive. It is conceivable that these needs of key economic players together with a growing number of stockholders may pressure legislators to constantly improve existing provisions. But, the persuasiveness of the argument depends on the importance of capital markets for corporate finance and the number and magnitude of investors which historically differed between the United States and Continental Europe.[236] Furthermore, without a predominant jurisdiction at the outset, lobbying efforts will be equally directed towards lawmakers in every country where a substantial number of firms are currently incorporated. In this situation, the market for corporate charter might not give additional incentives and the possibility to simply leave a "bad law jurisdiction" might not put considerably higher pressure on legislators to respond. However, the view that legislators would not care about substantial immigration from their corporate law jurisdiction[237] does not reflect the responsiveness to corporate interests characterizing recent years. It seems more accurate to assume sensitivity for indicators like corporate migration and the success of specific jurisdictions. In all the men-

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[234] Most notably the Tender Offer and Takeovers Act (WPÜG), the Fourth Financial Market Promotion Act (Viertes Finanzmarktförderungsgesetz, v. 21.6.2002, BGBl. I 2010 (2002)).

[235] Transparency and Publicity Act (Transparenz- und Publizitätsgesetz, v. 19.7.2002, BGBl. I 2681) and the KonTraG.

[236] *Cf.* Rajan & Zingales, *supra* note 118, at 15-16.

[237] KIENINGER, *supra* note 75, at 190-191.

tioned major reform projects in Germany, comparative arguments played an important role in justifying the new regulation. The point is, that it seems more likely that sensitive European legislators will constantly improve their corporate law than that they will idly watch national corporations leave their jurisdiction.

B. Private Regulators

The case for private regulators as providers of corporate law has been made in the United States with the objective to create viable competition for the monopolist (Delaware).[238] In the European scenario without a dominating state the need to introduce new players in order to spark of competition is less pressing. However, there are some indications that corporate legislatures are willing to defer some authority to private self regulators.[239] Yet, the prospect of these bodies substituting public legislation in large is unrealistic at the moment.

C. Lawmaking at the European Level - Institutional Impediments for a Powerful Role of European Institutions

European legislative institutions are not infrequently perceived as cumbersome, bureaucratic and slow. Most of the Union's directives and regulations in the field of corporate law and securities regulation were the result of long struggles and political compromises. Especially Germany's insistence on codetermination and other member states

[238] Choi & Guzman, *supra* note 36, at 968-972 (2001).

[239] The German Corporate Governance Code (available at http://www.corporate-governance-code.de/ger/download/DCG_K_D200305.pdf) is designed and constantly amended by a self-regulatory body (*Regierungskomission Corporate Governance*). The private rulemaker's authority results from a provision in the German stock corporation act (§ 161 AktG) that confers regulatory authority. The provision further compels listed companies to publicly declare their compliance or explain their non-compliance.

fierce opposition to this position in the past have paralyzed (Structure of Public Limited Companies[240]) or at least heavily delayed (European Company[241]) long pursued legislative projects. Although corporate law directives today can be passed under EC TREATY art. 251 with a qualified majority of the Council and a majority of votes cast in Parliament, doubts persist, whether European legislation will be able to function as a counterweight to state legislatures comparable to Federal institutions in the United States, assuming that the threat of preemption has to be realistic in order to influence Member States.[242] However, the legislative competence conferred upon the Union would not restrain Community actors to play a countervailing role in a European race,[243] although the

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[240] The project started as early as 1972 with the Proposal for a Fifth Directive on the Coordination of Safeguards which for the Protection of the Interests of Members and Outsiders, Are Required by Member States of Companies within the Meaning of Article 59, Second Paragraph, with Respect to Company Structure and to the Power and Responsibilities of Company Boards, COM(72)887 final, 1972 O.J.(C 131) 49. This initial proposal was amended three times (COM(83)185 final, 1983 O.J. (C 240) 2; COM(90)629 final, 1991 O.J. (C 7) 4 and COM(91)372 final, 1991 O.J. (C 321) 9) and finally withdrawn by the commission (COM(01) 763 final, 2004 O.J. (C 5) 20) when the conflicts raised by the proposal's mandatory employee participation rules seemed insurmountable. The Commission does not seem to be apt to press ahead with the project anytime soon.

[241] The first initiative leading to the SE-Regulation was taken in 1970 with the Proposal for a Council Regulation Embodying a Stature for The European Company, COM(70)600 final, 1970 O.J. (C 124) 1. This first proposal was amended in 1975 (COM(75)150 final) 1989 (COM(89)268 final, 1989 O.J. (C 263) 69) and in 1991 (COM(91)174 final, 1991 O.J. (C 176) 1). The final compromise on employee participation which provides default rules that can be overridden by an agreement between management and employees was outlined by the "Davignon Report" of a high level group the Commission established in 1996.

[242] On this aspect already Roe, *supra* note 29, at 644.

[243] *Cf*. EC-TREATY, art. 44(2)(g) which authorizes Community legislation to coordinate

> to the necessary extent the safeguards which, for the protection of the interests of members and other, are required by Member States of companies or firms within the meaning of the second paragraph of Ar-

ECJ has recently hinted that it will scrutinize the limitations of the Treaty's competences more seriously.[244]

VI. Choice of Law's Limits

The real seat-doctrine chooses the administrative headquarter as relevant criterion because the relation between a corporation and a jurisdiction established by the location of a firm's executive office ostensibly warrants having the organization's internal affairs governed by the laws of the pertinent legal system as the one most intensely affected by the corporations activities.[245] The ECJ's rejection of the real seat doctrine as the general rule in conflict of corporate laws does not discredit or obliterate the underlying policy rationale as a whole but only makes it clear that within the Single European Market corporate law regimes have to be regarded as equivalent (although not uniform) at the outset. However, this does not preclude that with respect to certain aspects of a corporation's internal affairs, the relation with a Member State other than the incorporating jurisdiction is indeed strong enough to justify the enforcement of domestic standards.

ticle 48 with a view to making such safeguards equivalent throughout the Community.

[244] A recent decision of the ECJ (Case C-376/98, Federal Republic of Germany v. European Parliament and Council of the European Union. Directive 98/43/EC - Advertising and sponsorship of tobacco products, 2000 E.C.R. I-8419; but *see also* Case C-491/01, The Queen v. Secretary of State for Health, ex parte British American Tobacco (Investments) Ltd and Imperial Tobacco Ltd., 2002 E.C.R. I-11453) can be read in a way that the Court will enforce the limits of the legislative competences under EC-Treaty Art. 95.

[245] Werner F. Ebke, *The "Real Seat" Doctrine in the Conflict of Corporate Laws*, 36 INT'L LAW. 1015, 1027-29 (2002).

The idea of limiting the consequences of mutual recognition is not unfamiliar in the United States.[246] California and New York have promulgated pseudo-foreign corporation laws prescribing the application of certain regulations of domestic corporate law with regard to corporations that carry out most of their activities or have a majority of stockholders in the State but are incorporated elsewhere.[247] Although the constitutionality of these statutes is unsettled,[248] they at least indicate that some polities, embracing the state of incorporation rule at the outset feel the need to protect some critical institutional compromises between corporate constituents agreed upon for their forum.[249]

A. Legal Scope for Restrictions

Whether the enforcement of domestic standards comes dressed as the application of the real seat doctrine as a particular and limited exception to the general state of forma-

[246] For early attempts *see Mansfield Hardwood Lumber Co. v. Johnson*, 268 F. 2d 317 (5th Cir. 1959), where the Fifth Circuit tried to secure a minimum standard of investor protection at that time not guaranteed by Delaware corporate law by means of a subtle interpretation of conflict of laws rules. Today the case would presumably be brought under Rule 10b-5, i.e. a minimum standard is established on the federal level.

[247] CAL. CORP. CODE § 2115 (2004); N.Y. BUS. CORP. LAW § 1317-20 (2004). For an overview of these statutes LEWIS D. SOLOMON ET AL., CORPORATIONS: LAW AND POLICY 206 (3d ed. 1994); Deborah A. DeMott, *Perspectives on Choice of Law for Corporate Internal Affairs*, 48 L. & CONTEMP. PROBS. 161, 164-66 (1985); Kersting, *supra* note 8, at 25-31.

[248] On the issue *see* Norwood P. Beveridge, Jr., *The Internal Affairs Doctrine: The Proper Law of a Corp.*, 44 BUS. LAW. 693, 709-15 (1989); Richard M. Buxbaum, *Delaware Supreme Court Finds the State-of-Incorporation Version of the Internal Affairs Doctrine Embedded in the United States Constitution*, 15 CAL. BUS. REP. 173 (1994); Richard M. Buxbaum, *The Threatened Constitutionalization of the Internal Affairs Doctrine in Corporation Law*, 75 CAL. L. REV. 29 (1987); Kersting, *supra* note 8, at 31-36.

[249] On a further example (United Kingdom) *see* Ebke, *supra* note 245, at 1030-31 (2002). *See also* Detlev F. Vagts, *Extraterritoriality and the Corporate Governance Law*, 97 AM. J. INT'L L. 289, 293 (2003) (discussing the extraterritoriality of certain corporate governance regulations under Sarbanes-Oxley)

tion rule or whether the relevant regulation is implemented by ways of a pseudo-foreign corporation law is of minor relevance. Doctrinally, both variations could be squared with the freedom of establishment which is not without limits. In fact, it is subject to the common constraints established in EC TREATY art. 46 which balances the right of settlement with overriding policies. Case law has refined and supplemented the limits of the freedom of establishment and invented a four-factor test.[250] Non-discriminatory measures suitable and necessary to fulfill imperative requirements in the public interest can rightfully limit the freedom of establishment.[251] It is too narrow an approach to limit Member States' maneuvering space to abuse or fraud prevention, thereby denying any authority to implement (imperative) public policy considerations.[252]

The European discussion has focused so far on whether it is conceivable that this imperative requirements doctrine can be invoked with regard to a need for protection of creditors and employees, or fiscal considerations.[253] The ECJ has made clear that it will

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[250] Case C-55/95, Reinhard Gebhard v. Consiglio dell' Ordine degli Avvocati e Procuratori di Milano, 1995 E.C.R. I-4165. For a thorough analysis in the corporate context cf. Eidenmüller & Rehm, *supra* note 3, at 169-180.

[251] *Infra* II. 4.

[252] *See also* Kersting, *supra* note 8, at 64-67 and 70-71 who argues that only a directive could open the necessary latitude to enforce domestic public policies (labor participation and minimum capital requirements). Yet, this position leads to the problematic result that European secondary law would empower Member States to encroach upon the Treaty's fundamental freedoms. Generally on the binding character of the freedom of establishment with regard to the European legislator, Leible, *supra* note 3, at 539-544.

[253] It is worth noticing that the discarded modern version of the real seat doctrine had exactly the focus of insulating national solutions concerning employee or creditor protection from the eroding consequences of corporate law shopping, *cf.* Carney, *supra* note 24, at 315-18; Ebke, *supra* note 245, at 1027-34. See also Kersting, *supra* note 8, at 51 (pointing out that the goal can only be accomplished if the real seat theory is applied universally). Historically, the real seat doctrine was introduced in

not be too lenient in these respects,[254] at least with regard to creditor protective devices of questionable efficiency and regulations only sloppily justified by a blanket reference to purposes of protecting fairness in business dealings and effective tax assessment.[255]

B. Creditor Protection

Minimum capital requirements were at issue in two of the three leading cases brought before the ECJ. From the outset, the Court has expressed or implied a great deal of skepticism towards this form of creditor protection, and has explicitly ruled out the imposition of this form of creditor protection on foreign private limited liability companies.[256] Given the rather technical character of creditor protection, this seems warranted

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France during the 19th century to prevent legal arbitrage observed with regard to French companies following the lures of less austere Belgian corporate law, RICHARD M. BUXBAUM & KLAUS J. HOPT, LEGAL HARMONIZATION AND THE BUSINESS ENTERPRISE: CORPORATE AND CAPITAL MARKET HARMONIZATION POLICY IN EUROPE AND THE U.S.A. 174 (1988).

[254] Under the restrictive approach favored by the Court, the concern that the uncertainty about how far Member States could go in enforcing domestic standards with regard to foreign corporations could deter cross-border reincorporation, Micheler, *supra* note 7, at 526, does not seem too compelling. After *Inspire Art* it seems that only in very limited circumstances domestic laws of the Member State of the administrative headquarters/principal place of business can override the corporate law that travels with the corporation from its state of formation.

[255] Case C-167/01, Kamer van Koophandel en Fabrieken voor Amsterdam v. Inspire Art Ltd., 2003 WL 102001, Celex No. 601J0167 at §§ 135, 140 *available at* http://europa.eu.int/eur-lex/.

[256] With regard to stock corporations harmonized European law mandates a minimum capital throughout the Union. *Cf.* Second Council Directive 77/91 of 13 December 1976 on coordination of safeguards which, for the protection of the interests of members and others, are required by Member States of companies within the meaning of the second paragraph of Article 58 of the Treaty, in respect of the formation of public limited liability companies and the maintenance and alteration of their capital, with a view to making such safeguards equivalent, art. 6(1), 1977 O.J. (L 26) 1, 7 (hereinafter: Capital Directive).

under policy considerations.[257] In fact, the question may be asked whether some of the highly complicated doctrine collateralizing the minimum capital requirement really contributes to creditor protection and whether the attempts to opt-out are signs of the beneficial forces of a race to the top.[258] In other circumstances German adjudication has developed in the sense of going back from highly artificial, separate doctrines towards internationally more compatible veil piercing approaches.[259] This kind of rethinking of encrusted legal institutions is obviously beneficial (although it may sometimes only reinforce the outcomes) and could be amplified by the freedom of establishment which – at least –

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[257] *See also* the mentioned plan of the European Commission to develop an alternative creditor protective system no longer based on minimum capital requirements, *supra* note 139.

[258] Luca Enriques & Jonathan R. Macey, *Creditors versus Capital Formation: The Case against the European Legal Capital Rules*, 86 CORNELL L. REV. 1165 (2001) (disputing the virtue of European minimum capital requirements); High Level Group of Company Law Experts, *supra* note 139, at 82 (same). For a defense of European minimum capital principles *see* Wolfgang Schön, *Wer schützt den Kapitalschutz? [Who Protects Capital Protection?]*, 166 ZHR 1 (2002).

[259] The German Supreme Civil Court (*Bundesgerichtshof*) had developed in a line of cases the doctrinal figure of the qualified factual group of companies (*qualifizierter faktischer Konzern*) which had the effect of holding the dominant managing stockholder who had a conflict of interest personally liable for a limited liability company's debt in case of bankruptcy. This liability was based on an unsustainable analogy to provisions in the stock corporation act (§§ 302, 303 AktG). *Cf.* Entscheidungen des Bundesgerichtshofs in Zivilsachen (BGHZ) [Decisions of the Supreme Civil Court] 95, 330, 334-335 (Autokran); BGHZ 115, 187 (Video); BGHZ 122, 123 (TBB). In a remarkable step backward, the Supreme Court reacted to harsh criticism from commentators and explicitly made clear that the cases had to be regarded as veil piercing action thereby clarifying the underlying policy question and burying the blurring doctrine. *Cf.* BGHZ 149, 10, 13 (Bremer Vulkan); BGHZ 151.181 (KBV). For a detailed analysis by an influential Supreme Civil Court judge *cf.* Volker Röhricht, *Das neue Konzept des Bundesgerichtshof zur Gesellschafterhaftung bei der GmbH [The Supreme Civil Court's New Concept of Shareholder Liability in the Limited Liability Company]*, *in*: GESELLSCHAFTSRECHT 2003 1 (Hartwig Henze & Michael Hoffmann-Becking eds. 2004).

compels to take a comparative perspective. Hence, the freedom of establishment should not be impeded by entrenching national solutions in the field of creditor protection.[260]

It seems remarkable that in the United States a far reaching harmonization of creditor protection can be observed. Bankruptcy law is completely federalized and supplemented by the Uniform Fraudulent Conveyance Act and the Uniform Fraudulent Transfer Act respectively. The doctrine of equitable subordination was mainly developed by Federal courts.[261] Only the veil-piercing doctrine remains in the realm of state law and some significant divergence can be observed here.[262] On the other hand, in Europe a critical part of creditor protection will remain in the domain of member states. Harmonization only reaches the conflict of laws rule for insolvency proceedings but leaves the substantive law in the Member States untouched. Moreover, the relevant section of the regulation refers to the jurisdiction where "the centre of a debtor's main interests" is located,[263] which, according to the thirteenth recital of the regulation's preamble, should "corre-

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[260] Another doctrinal angle from which to tackle strict national capital pay-up and maintenance requirements might result from European secondary legislation. Understanding the Capital Directive as imposing not only minimum but also maximum standards would considerably limit the band for permissible national solutions within the range of its application. However, the ECJ has expressed some skepticism with regard to this position in Case 42/95, Siemens AG v Henry Nold, 1996 E.C.R. I-6017 (holding that the capital directive does not prevent a Member State from granting and protecting a shareholder right of pre-emption beyond what is provided for in the directive). Generally HENRIK DINKRUTH, DIE KAPITALRICHTLINIE, MINDEST- ODER HÖCHSTNORM? [THE CAPITAL DIRECTIVE, MINIMUM- OR MAXIMUM STANDARD?] (1998).

[261] ROBERT C. CLARK, CORPORATE LAW 52-54 (1986); WILLIAM T. ALLEN & REINIER KRAAKMAN, COMMENTARIES AND CASES ON THE LAW OF BUSINESS ORGANIZATIONS 141 (2003).

[262] Kahan & Kamar, *supra* note 26, at 717.

[263] Council Regulation 1346/2000 on Insolvency Proceedings, art. 3(1), 2000 O.J. (L 160) 1, 5.

spond to the place where the debtor conducts the administration of his interests on a regular basis".[264] Clearly, this designation of the real seat doctrine as the relevant conflict of laws rule will not contribute to a smooth and frictionless interplay of bankruptcy and corporate law. With regard to the choice of corporate law, the fact that reincorporators cannot by mere incorporation pick the applicable insolvency law should not play a central role, because in the state of formation/reincorporation the remote prospect of having to reorganize a failed business should not be too relevant anyway.

1. Employee Protection

The explicitly "political" character[265] of codetermination as a specific distributional settlement between corporate constituents makes it questionable whether a simple opt-out can be legitimized. Hence, although generally freedom of choice will be granted, opting-out of codetermination might be barred. Imposition of codetermination upon pseudo foreign corporations is frequently regarded as justified under EC-TREATY art. 46 EC.[266] To be clear, the relevant query under the imperative requirements doctrine is not whether German style codetermination as such is the imperative requirement in the public interest. In fact, the relevant aspect is whether it constitutes an imperative requirement to defend a Member State's political settlement regarding the distribution of participatory

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[264] *Id.* at 2.

[265] Gilson, *supra* note 180, at 354 seems to underestimate the labor movements rigor.

[266] *E.g.* Wulf-Henning Roth, *Case C-212/97,* Centros Ltd. v. Centros Ltd. v. Erhvervs- og Selskabsstyrelsen, *Judgment of 9 March 1999*, 37 COMMON MKT. L. REV. 147, 155 (2000); Ebke, *supra* note 7, at 648-49. But *see also* Simon Deakin, *Book Review*, 33 INDUS. L.J. 92, 93 (2003) (arguing that the new interpretation of the freedom of establishment will make it harder to sustain corporate law institutions providing employee voice); Wouters, *supra* note 6,at 134 (against sustainability of German model); Eidenmüller & Rehm, *supra* note 3, at 184-85 (same, with an overview of the German discussion).

rights within the firm. Consequentially the follow-up question to be asked is whether there is a less restrictive way to achieve the *defense* of the fundamental settlement.[267] Other than in more technical domains like creditor protection where the competing doctrines pursue the same end (e.g. adequate creditor protection), codetermination lays down a politically charged (constituency oriented) conception of the firm to which other (shareholder oriented) models cannot be regarded as equal. Where a polity settles this fundamental policy question of corporate governance in a certain way,[268] the mere fact of being a member in a more or less economically defined Union – the freedom of establishment is a tool to establish the Common Market – cannot legitimately transform the fought for political settlement to a default rule. The anti-democratic tendencies of corporate law arbitrage become unacceptable where legislators run the risk of loosing the ability to determine the fundamental policy principles of the legal regime under which corporations in their jurisdiction shall operate – a scenario which is far less likely to occur where corporate law is confined to attenuating the management-shareholder conflict.

Acknowledging the aforesaid, the question becomes, whether Germany and other polities similarly situated will make an effort to preserve their system.[269] It should not be

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[267] The deviant view of Eidenmüller & Rehm, *supra* note 3, at 174, that it is sufficient if foreign rules pursue the same goal albeit in a different, less far reaching manner, neglects the fundamental character of the political compromises underlying the various labor participation models.

[268] The seminal work setting the tone in the German academic literature was WALTHER RATHENAU, VOM AKTIENWESEN [ON THE NATURE OF STOCKS] (1917). For an American perspective on the fundamental distinction between constituency approaches and shareholder primacy conceptions *cf.* William T. Allen, *Our Schizophrenic Conception of the Business Corporation*, 14 CARDOZO L. REV. 261 (1992).

[269] Some commentators even argue that German codetermination applies *de lege lata* to foreign corporations, *cf*. Bernhard Großfeld & Susanne Erlinghagen, *Internationales Unternehmensrecht und deutsche unternehmerische Mitbestimmung [International*

overlooked, however, that the existing concept of Codetermination are increasingly under pressure and reform proposals on the national level seem to gain ground.[270] However, these concepts frequently acknowledge a fundamental justification for participatory elements in corporate governance, thereby adhering to a team production model of the firm,[271] potentially in need of defense against corporate law arbitrage.

Although the technical challenge to draft rules securing that codetermination persists regardless of the state of incorporation should not be underestimated,[272] it does not

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Company Law and German Entrepreneurial Codetermination], 48 JURISTEN ZEITUNG (JZ) 217, 222 (1993) (arguing that codetermination is part of the indispensable German *ordre public*); Curt Christian von Halen, *Das internationale Gesellschaftsrecht nach dem Überseering-Urteil des EuGH [Conflict of Corporate Laws after the ECJ's Überseering-Judgement]*, 57 WERTPAPIER-MITTEILUNGEN (WM) 571, 577 (2003) (same); Helge Großerichter, *Ausländische Kapitalgesellschaften im deutschen Rechtsraum: Das deutsche Internationale Gesellschaftsrecht und seine Perspektiven nach der Entscheidung „Überseering" [Foreign Corporations in German German Conflict of Corporate Laws and its Perspectives after the Judgment]*, 41 DEUTSCHES STEUERRECHT (DStR) 159, 169 (2003) (same). Against this view Christine Windbichler & Gregor Bachmann, *Corporate governance und Mitbestimmung als "wirtschaftsrechtlicher ordre public" [Corporate Governance and Codetermination as "business law ordre public"]*, *in* FESTSCHRIFT FÜR GEROLD BEZZENBERGER ZUM 70. GEBURTSTAG 797, 803-04 (Harm Peter Westermann & Klaus Mock eds. 2000) (arguing that the non-uniform regulation of codetermination in Germany prohibits the extraction of an indispensable principle); Riegger, *supra* note 151, at 519 (same).

[270] *E.g.* the expert-group proposal suggesting to substitute a consultation panel for the traditional model of employee representatives on the supervisory board, Christian Kirchner et al., Berliner Netzwerk Corporate Governance: 12 Thesen zur „Modernisierung der Mitbestimmung" [Berlin Network Corporate Governance: 12 Theses regarding "Modernization of Codetermination"] (Dec. 5, 2003) *available at* http://www.bccg.tu-berlin.de/main/publikationen/12-Thesen-Papier.pdf.

[271] *Cf.* Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247 (1999).

[272] *Cf.* Horst Eidenmüller, *Wettbewerb der Gesellschaftsrechte in Europa [Competition of Corporate Laws in Europe]*, 23 ZEITSCHRIFT FÜR WIRTSCHAFTSRECHT (ZIP) 2233, 2243 (2002) (pointing to the difficulties resulting from the single-board structure of certain foreign corporations); Erich Schanze & Andreas Jüttner, *Anerkennung und Kontrolle ausländischer Gesellschaften – Rechtslage und Perspektiven nach der*

involve the task faced at the creation of the European Company, where legislators, aiming at the protection of the status quo which exists in the companies forming the SE, had to synchronize widely diverging legal regimes (and ended up in a cumbersome procedural compromise).[273] The required hammering down of codetermination on foreign structures poses a different, arguably less complex task.

VII. Existing and Prospective Harmonization

With regard to choice of corporate law in the European Union the dominant practice of far reaching harmonization of central domains of national corporate law has two relevant angles, one more descriptive the other with fundamental policy implications. Firstly, harmonized areas of corporate law drop out of the range of regulations capable of motivating cross-border reincorporations.[274] Secondly, the newly gained freedom of cross-border establishment sheds new light on the justifiability of harmonizing initiatives on the supranational level. A frequently used rationale for corporate law directives was

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Überseering-Entscheidung des EuGH [Recognition and Control of Foreign Companies – Legal Postion and Perspectives after the Überseering-Rulings of the ECJ], 48 DIE AKTIENGESELLSCHAFT (AG) 30, 35 (2003), (propsing a solution based on the Davignon-Report which prepared the SE-compromise. *Cf.* Group of Experts, European Systems of Worker Involvement, Final Report (May 1997) *available at* http://europa.eu.int/comm/employment_social/labour_law/docs/davignonreport_en.pdf).

[273] Where the prior negotiations between management and employee representatives do not yield a mutually satisfactory agreement and the companies involved in the creation of the SE were previously covered by rules regarding employee participation, standard principles on employee participation will apply, *cf.* Council Directive 2001/86 supplementing the Statute for a European company with regard to the involvement of employees, 2001 O.J. (L 294) 22 [hereinafter: SE Employee Paricipation Directive].

[274] The point was illustrated with regard to the harmonization brought about by the Merger Directive, *see supra* IV.B.2.i.

the aspiration to level the playing field for European companies, grinding from top down the competitive inequalities caused by diverse national corporate statutes. Now, that it is up to incorporators to choose the most suitable jurisdiction for their venture, this justification for supranational activity is rendered mute. The playing field is leveled – as long as transaction cost do not impede the use of the endowed freedom – because firms can in principle opt out of burdensome regulations and do no longer need legislature's assistance to overcome competitive disadvantages imposed by corporate law. In this setting, the role of the European legislation shifts and every single piece of legislation in the corporate ambit has to be re-assessed with a view to the new scenario. It has been noted early in the American debate that the mere fact that large firms engage in interstate commerce does not in itself warrant federal chartering.[275] Analogously, in the European context, cross border activity of corporations does not compel supranational chartering.

The following will outline the adequate role of a superordinate European legislature in a system of mutual recognition of national corporate laws within the Community. Yet, at first a European particularity deserves a brief notice – the European Company as a business organization chartered on the European level.

A. The European Company – A Supranational Alternative and Balancing Weight?

The European Company (*Societas Europaea* (SE)) is designed as a business organization chartered on the European level. Hence, it is in principle not subject to the diversity of Member States' corporate statutes. However, the idea of creating a stand-alone European entity to facilitate multinational business ventures obviously did not survive the

[275] Winter, Jr., *supra* note 15, at 253.

tenacious and off-peeling political process of the SE-Regulation's adoption.[276] To conceal insurmountable conflicts among Member States, central aspects of the European Company's organization were left open for the national laws to fill-in the gaps. A prominent example is the structure of the organ(s) responsible for the SE's operations. The SE-Regulation grants founders of a SE the choice, to either adopt the single board system or to opt for a two-tier structure in the corporate charter.[277] Yet, the corporate governance structure under each available system is only rudimentarily outlined in the SE-Regulation, requiring constant references to the rules promulgated in the Member State of the registered office.[278] Other significant instances illustrating the SE-Regulation's need of completion by national laws are, among others, the powers delegated to the shareholder meeting,[279] directors liability,[280] and the standard rules for employee participation

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[276] Reality belies the ceremonially optimistic words of the regulation's preamble according to which "[t]he provisions of such a Regulation will permit the creation and management of companies with a European dimension, free from obstacles arising from the disparity and the limited territorial application of national company law", SE-Regulation, Preamble, seventh recital.

[277] SE-Regulation, art. 38(b).

[278] SE-Regulation, artt. 39-45.

[279] SE-Regulation, art. 52. states that shareholder meeting shall decide on matters determined by the Regulation, the SE Employee Participation Directive and

> on matters for which responsibility is given to the general meeting of a public limited-liability company governed by the law of the Member State in which the SE's registered office is situated, either by the law of that Member State or by the SE's statute [i.e. its charter] in accordance with that law […]

[280] SE-Regulation, art. 51 subjects SE's management, supervisory and administrative organs to liability, "in accordance with the provisions applicable to public limited-liability companies in the Member State in which the SE's registered office is situated".

when the prior negotiations on the subject fail.[281] In sum, the SE's corporate governance structure seems significantly shaped by national corporate laws, rendering the vision of a truly autonomous, supranational form of organization a sham.

Furthermore, the access of incorporators to the European legal entity is somewhat limited. Originally, the formation of an SE should be confined to situations where existing companies wished to cooperate or restructure themselves in a form of organization suited to the dimensions of the Single Market i.e. very large companies. However, the restrictive approach has been watered down significantly. Now, the SE can be formed by (1) an asset merger of public limited companies provided at least two of the public companies are subject to the law of different Member States; (2) a formation of a joint SE holding company by public limited companies or private companies provided at least two of the companies are from different Member States or have a branch or subsidiary in another Member State for at least 2 years; (3) a formation of a joint SE subsidiary by any type of company, firm or legal entity provided at least two of the organizations are from different Member States or have had a branch or subsidiary in another Member State for 2 years.[282] The persistent requirement of a sustained cross-border element at the time of

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[281] SE Employee Participation Directive, art. 7 provides, in a nutshell, that absent an agreement to the contrary, the rules laid down by the Member State of the registered office in compliance with the directive's guidelines (*cf.* SE Employee Participation Directive, Annex, Part 3) apply to determine the extent and the procedures of employee participation in the supranational entity.

[282] *Cf.* SE-Regulation, art. 2(1)-(4). In addition, art. 2(5) gives Member States the option to provide that a company with a head office outside the Community may participate in the formation of an SE if the company is formed under the law of a Member State, has its registered office in that Member State and has a real and continuous link with a Member State's economy.

the SE's formation renders the European corporate form unsuitable for small businesses or start-ups.

Within the scope of the likely application of the SE-Regulation, on the other hand, some corporate law scholars see the fact that the supranational entities have to be formed from scratch anyway together with the perception that the SE is structured to serve as a holding company as ideal preconditions for a more or less unimpeded corporate law arbitrage.[283] At the outset, this is consistent with the aforesaid. Under the assumption that the typical business venture legally framed as a SE will be a large and relatively complex one, the claim that individual determinants will drive the decision and the consequential persistence of a plurality of important corporate laws gather additional plausibility. The individual character of a multinational holding company or joint-venture seems to entail that the variety of incorporator's needs is typically broader, rendering a case-by-case choice of jurisdiction even more likely. However, the assertion that the already mentioned rule[284] according to which the SE has to have its registered office where its head office is located, i.e. the company's main administrative seat,[285] does not seriously hamper the movement of companies,[286] needs to be tempered.[287] The label "multinational

[283] Luca Enriques, Silence Is Golden: The European Company Statute As a Catalyst for Company Law Arbitrage, (Eur. Corporate Governance Inst., Working Paper No. 07/2003, 2003).

[284] *Supra* note 9.

[285] This interpretation becomes evident when looking at the other official languages which use terms like *administration centrale*, *administración central*, *Hauptverwaltung* et al.

[286] *Cf.* Enriques, *supra* note 283, at 6.

[287] The following assumes the questioned validity of SE-Regulation, artt. 7, 8, *supra* note 9 at 4-6 in light of EC-TREATY artt. 43, 48. For a critical view on the provisions as

firm" should not disguise the national roots of these firms. It is a serious obstacle to corporate law shopping if a SE emanating from a merger of German and French firms has to establish its administrative seat in the United Kingdom in order to avail itself of English company law. And, it has to be added, national corporate law only serves to fill the gaps left by the SE-Regulation, rendering it even more questionable if the advantages incurred by choosing a more favorable corporate law can offset the cost associated with the establishment of the administrative seat in a third country. Moreover, many projects of the magnitude envisioned for the SE will appear on the radars of national politics and given the interest of important nations to keep key industries "national",[288] the SE's migration to a third country might attract opposition. Certainly, subjecting the venture to the law of a foreign jurisdiction is not an equivalent of having its shares acquired by a foreign institution. However, the interest of retaining control over the firm's affairs in the domestic realm seems endangered in a nontrivial respect, if it becomes subjected to the discretion of foreign legislature.

Even if this skepticism is not shared, the catalyzing impact of the SE strongly depends on the workability of the SE-Regulation as a whole, a question which reaches far beyond the scope of this analysis. However, with cross-border mergers a reality, it is well conceivable that incorporators rather avail themselves of the familiar forms of national corporate laws, dooming the SE to irrelevance.

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detrimental impediment for the movement of European Companies *see e.g.* JANET DINE & PAUL HUGHES, EC COMPANY LAW 9[10] (2002).

[288] Most recently France's politics of creating "national champions" lead to the French government taking clear sides in the takeover battle between Sanofi and Novartis over Aventis, John Carreyrou, Anita Raghavan & Gautam Naik, *In Face of French Resistance, Swiss Giant Enters Takeover Fray*, WALL ST. J., April 23, 2004, at 1.

B. Reappraisal of Existing Harmonization

1. Observable and Desirable Harmonization Policies

Since the beginning of the European Union's harmonization program various directives covering a broad range of corporate law topics have been promulgated. The First Company Law Directive provides a uniform system of publicity for all companies.[289] The Capital Directive (Second Company Law Directive) lays down minimum requirements for the formation of public companies and the maintenance, increase and reduction of their share capital. The Merger Directive and the Sixth Company Law Directive[290] regulate mergers between public companies and the division of an existing public company into separate entities respectively. The Fourth Company Law Directive contains detailed rules regarding the drawing-up of the annual accounts of individual companies.[291] The Seventh Company Law Directive regulates under which circumstances and in which manner corporations with subsidiaries have to prepare and disclose consolidated annual accounts.[292] The Eighth Company Law Directive aims at insuring auditor independence and diligence and lays down minimum requirements for

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[289] First Council Directive 68/151 of 9 March 1968 on co-ordination of safeguards which, for the protection of the interests of members and others, are required by Member States of companies within the meaning of the second paragraph of Article 58 of the Treaty, with a view to making such safeguards equivalent throughout the Community, 1968 O.J. (L 65) 8-12.

[290] Sixth Council Directive 82/891 of 17 December 1982 based on Article 54 (3) (g) of the Treaty, concerning the division of public limited liability companies, 1982 O.J. (L 378) 47-56.

[291] Fourth Council Directive 78/660 of 25 July 1978 based on Article 54 (3) (g) of the Treaty on the annual accounts of certain types of companies, 1978 O.J. (L 222) 11-31.

[292] Seventh Council Directive 83/349 of 13 June 1983 based on the Article 54 (3) (g) of the Treaty on consolidated accounts, 1983 O.J. (L 193) 1-17.

and diligence and lays down minimum requirements for their education and training.[293] The Eleventh Company Law Directive regulates disclosures to be made by branches of foreign corporations.[294] The Twelfth Company Law Directive compels Member States to make available in their corporate statutes the single-member limited liability company.[295] Finally, the Thirteenth Company Law Directive deals with the legal framework for unsolicited takeover bids.[296]

The spirit of the harmonization approach differs radically from the underlying policy assumptions of a system of mutual recognition enabling corporate law arbitrage within the Community. In an early statement concerning the policy goals of corporate law harmonization Clive M. Schmitthoff described the role of EU legislation as guaranteeing minimum standards for shareholder and creditor protection which were otherwise imperiled to erode.[297] In fact, this implied a relatively far reaching approximation of corporate statutes or even a "virtual unification of national company laws".[298] The ambitious policy

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[293] Eighth Council Directive 84/253 of 10 April 1984 based on Article 54 (3) (g) of the Treaty on the approval of persons responsible for carrying out the statutory audits of accounting documents, 1984 O.J. (L 126) 20-26.

[294] Eleventh Council Directive 89/666 of 21 December 1989 concerning disclosure requirements in respect of branches opened in a Member State by certain types of company governed by the law of another State, 1989 O.J. (L 395) 36-39.

[295] Twelfth Council Company Law Directive 89/667 of 21 December 1989 on single-member private limited-liability companies, 1989 O.J. (L 395) 40-42.

[296] Directive 2004/25 of the European Parliament and of the Council of 21. April 2004 on takeover bids, art. 12, 2004 O.J. (L 142) 12 [hereinafter: Takeover Directive].

[297] Schmitthoff, *supra* note 12, at 9. It is a remarkable parallelism that the modern American debate was sparked off by a call for federal "minimum standards", *cf.* Cary, *supra* note 24, at 696-705 (1974).

[298] Id. at 9.

goal of supplying a uniform standard of protection for various corporate constituencies, sometimes denounced as the supranational collateralization of successful rent seeking efforts in corporate law,[299] was mirrored in the detailed and constraining style of regulation featured by early directives. Although the regulatory vigor sure has abated over the years,[300] leading up to the now prevailing concept of directives providing only a framework to be filled by national legislation, the policy goal of guaranteeing minimum standards persists. However, the analysis conducted so far indicates that the prospect of a race to the bottom is not equally striking in the European context. Consequentially, it is not enough to abstractly claim the necessity of supranational regulation to prevent the erosion of desirable protective standards.

EC TREATY art. 5, the concept of subsidiarity, provides a (fuzzy) standard that can be interpreted in a way that harmonization can only be legitimized where leaving corporate lawmaking to Member States would lead to inferior results with regard to the integration of the Single Market.[301] The principle apparently interacts with the legal basis or corporate law harmonization that limits the scope of objectives the Union's legislators can legitimately pursue. EC TREATY art. 44(1)(2)(g), the most important legal basis for corporate law harmonization, permits Community lawmaking with regard to safeguards protecting members of the company and "others" only "to the necessary extent" to attain

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[299] Carney, *supra* note 24, at 318-27.

[300] For the "generational stages" of corporate law directives cf. CHARLOTTE VILLIERS, EUROPEAN COMPANY LAW – TOWARDS DEMOCRACY? 28-48 (1998).

[301] Art. 5 EC TREATY allows Community intervention "…only if and in so far as the objectives of the proposed action cannot be sufficiently achieved by the Member States and can therefore … be better achieved by the Community".

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the freedom of establishment which itself serves the function of integrating the Single Market. In other words, all legislative actions in corporate law must realize or improve the functioning of the common market in a way Member State regulation could not accomplish.

Even though the Commission, contrary to the aforesaid, considers legislative acts in corporate law aiming at the integration of the internal market as falling into the Union's exclusive competence, untrimmed by the principle of subsidiarity,[302] at least from a policy perspective existing and foreseeable harmonization has to be reassessed. It has to be scrutinized whether some directives are superfluous or even put detrimental limitations on corporate law arbitrage or whether they still fulfill desirable functions within the reinforced system of mutual recognition of corporate forms. The following does not undertake a comprehensive assessment of the full scope of approximated corporate law but tries to outline and exemplify the relevant aspects by distinguishing between rule types.

2. Distinction of Rule Types

American corporate law scholars have long suggested that the idea of a uniform race either towards the top or towards the least common denominator is oversimplified. Decentralized rulemaking may work in some contexts but may fail to produce optimal outcomes in others.[303] Hence, harmonization seems warranted with regard to ambits of corporate law where uniformity – for various reasons – yields higher benefits.

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[302] FORSTINGER, *supra* note 8, at 33.

[303] For early accounts of this distinguishing approach: Charny, *supra* note 194, at 441-456; Bebchuk, *supra* note 25.

a. Focal Point Rules

A certain uniformity of ground rules has its value because it standardizes the typical investor contract and thereby reduces transaction cost.[304] This is especially true for the set of corporate law rules where consensus on the rule and its uniform enforcement is more important than its substance. Due to the rather technical character of these rules and the – within reasonable limits – tolerable arbitrariness of their content, the wholesome experimentation associated with decentralized rulemaking[305] will not yield significant additional benefit to offset the disadvantages dealt by the lack of uniformity. Under this rationale European accounting standards as set out in the Fourth and Seventh Company Law Directive can be justified as facilitating the comparative assessment of firms. Similarly, the scheme of publicity drawn-up by the First Company Law Directive can be vindicated as desirable promulgation of focal point rules.

b. Standards Counterbalancing Opportunistic Reincorporation Choices

The pessimistic view on incorporation decision in the United States suggests that some jurisdictions may be chosen even though they provide a set of suboptimal rules from a shareholder perspective.[306] Managers and incorporators exploiting informational asymmetries may be able to obtain shareholder consent or attract investors' interest in a public offering although the corporate law governing the internal affairs of the corporation may have a bias favoring managerial or blockholder interests. It is a slightly different

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[304] Charny, *supra* note 194, at 436.

[305] *See supra* II.A.1.

[306] *Cf. supra* II.B. With respect to the following especially *see* Bebchuk, *supra* note 25, at 1458-84.

angle of the same aspect, that those who de-facto control incorporation decisions[307] have some clout to pressure for corporate law rules serving their interest. Certainly, how far corporate law can go astray from desirable results depends on the informational efficiency of capital markets and their ability to identify the inferior corporate law,[308] as well as the constraints other mechanisms such as the market for corporate control, the product market and the managerial labor market put on management opportunism. Assuming that these mechanisms only insufficiently confine management, harmonization can be justified as necessary counterbalance remedying market imperfections.

However, important with regard to the European scenario is the conclusion drawn earlier that the risk of a downward creep in critical corporate law rules is much more virulent where the regulator indeed only serves the interest of management or incorporators i.e. assumes the function of a franchise-fee accumulating profit maximizer. In a polity where all corporate constituents have a voice in the process of corporate lawmaking, a pro-managerial tilt seems less likely. Where the superordinate legislature cannot claim the advantage of a less biased position in the process of corporate lawmaking – like the Federal government according to race to the bottom proponents can in relation to Delaware[309] – the argument that the setting of “minimum standards” frequently constitutes a

[307] Merging the existing corporation into the foreign shell requires board initiation of the procedure, *cf. supra* note 32. Combined with the assumption that managers can bring about suboptimal shareholder decisions, they practically control the reincorporation in a company with dispersed ownership.

[308] However, the clear superiority of one set of rules over the other most of the time is hotly debated, *e.g.* in his classic reply Ralph Winter pointed to the superiority of exactly the Delaware laws William Cary cited as prime examples of the race to the bottom.

[309] For the various calls for partial or alternative federalization of corporate law *cf. supra* II.D.2.

detrimental cementation of a misguided corporate law policy, gains momentum. In this view, it may not be such a miserable shortcoming of the recently adopted Takeover Directive to leave Member States great latitude in regulating management's permissible responses to a hostile takeover bid:[310] If one day the regulation of available takeover defenses becomes a major determinant in incorporation decisions throughout Europe, as is the case in the United States,[311] it may prove beneficial that corporate law shopping was not ruled out by comprehensive harmonization. Without a Delaware-like dominator, it is well conceivable that a Member State will establish itself as an investor friendly incorporation haven actually competing with more restrictive jurisdictions which shut down the market for corporate control for firms subject to their legislature. In this scenario, true competitive experimentation seems possible with all the potential benefits it entails.

c. Rules Creating a Public Good among Shareholders

Centralized regulation is sometimes justified with the creation of a public good for shareholders.[312] Individual shareholders would choose a regime that maximizes their personal wealth but can be suboptimal from a social perspective that aims at overall welfare maximization for the entirety of investors. In this scenario, harmonization could be

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[310] Takeover Directive, art. 12, allows Member States to opt out of the board passivity rule set forth in art. 9 with respect to companies which have their registered office on their territory, but must give these companies, to wit their shareholder meetings, the right to opt in the passivity rule individually. Member States may also allow the shareholder meeting of corporations that generally apply the board passivity rule to opt out if the firm becomes the target of a hostile bid launched by a would-be acquirer that herself does not apply the board passivity rule.

[311] Bebchuk, Cohen & Ferrell, *supra* note 21; Bebchuk & Ferrell, *supra* note 21; Subramanian, *supra* note 111.

[312] Charny, *supra* note 194, at 448.

justified as creating and fostering the public good which would be impaired by egoistic incorporation choices.

Yet this view seems questionable on two grounds. Firstly, the theoretical foundation is assailable. With diversified portfolios the individual shareholder interest equals the interest of a shareholder totality. Secondly, the argument does not fit well into the European context. A viable market for corporate control and the agency cost reducing effects it entails are sometimes regarded as a public good. [313] However a need for centralized regulation seems only to exist where the detrimental effects of an effective shut-down of the control market accrue outside of the responsible legislature's territory – a situation that requires a dominating state like Delaware with no considerable number of firm's actually situated within its borders. Where legislation does not only create the described kind of externalities it can be assumed that Member States will be able and willing to pursue the public good adequately, or are at least not structurally worse situated than the supranational lawmaker.[314]

Similarly, mandatory disclosure regimes create a public good because they allow a more intelligent comparison of investment opportunities and thereby enhance allocational efficiency. However, again, it is unclear whether indeed centralized regulation is required or if national legislators would be capable of providing an extensive disclosure regime for firms addressing capital markets. In fact Europe will have to struggle with the

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[313] *Id.*, at 448-49.

[314] Consequentially the astute analysis undertaken for the United States concluding that centralized regulation is warranted where corporate law rules involve externalities (*cf.* Bebchuk, *supra* note 25, at 1485-95) cannot serve as a template for European legislators.

full range of arguments advanced in the American[315] and international[316] discussion about regulatory competition in securities laws.

d. Rules Creating a Public Good among Third Parties

Where social welfare is associated with accommodating non-shareholder interests, harmonization may prove necessary to promote these interests that would be neglected by incorporators. It is a key aspect in this context, that the continental European constituency approach towards corporate law makes certain regulations protecting third parties (e.g. employees, creditors) more vulnerable with regard to legal arbitrage, because third party interests would be disregarded more easily by shareholders and management alike.

However, centralization may not be the solution because diversity among European polities persists and there is no evidence that without a Delaware-like dominator the interests of corporate constituents would be culpably neglected even if corporate law arbitrage is widely possible. Moreover, it was demonstrated that where national compromises between corporate constituents are critical determinants of a polity's self-

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[315] *E.g.* Roberta Romano, *Empowering Investors: A Market Approach to Securities Regulation*, 107 YALE L.J. 2359 (1998) (arguing for allowance of competition between states and federal rulemakers in securities regulation); ROBERTA ROMANO, THE ADVANTAGE OF COMPETITIVE FEDERALISM FOR SECURITIES REGULATION (2002) (same).

[316] *Cf.* Stephen J. Choi & Andrew T. Guzman, *The Dangerous Extraterritoriality of American Securities Law*, 17 NW. J. INT'L L. & BUS. 207, 231 (1996); Stephen J. Choi & Andrew T. Guzman, *Portable Reciprocity: Rethinking the International Reach of Securities Regulation*, 71 S. CAL. L. REV. 903 (1998) (advocating international issuer's choice of applicable securities laws). For an illuminative synthesis of the various "race" debates *cf.* Frederick Tung, Lost in Translation: From U.S. Corporate Charter Competition to Issuer Choice in International Securities Regulation (March 8, 2004, Loyola LA Public Law and Legal Theory, Research Paper No. 2004-8) *available at* http://ssrn.com/abstract=515088.

understanding, the European framework allows Member States to protect their political idiosyncrasies.[317]

VIII. Conclusion

Regardless of the favorable new European state of incorporation rule, the outlook for a vigorous competition for corporate charter between Member States seems hazy. However, this is not to say that incorporators will not embrace the newly won opportunities of the more diversified range of organizational forms offered to legally frame their ventures. The importance of the legal set-up for the business enterprise will induce incorporators to take the possibility of choosing a foreign corporate law to govern their firm's internal affairs into account, leading to some company law arbitrage.[318] Yet, the analysis undertaken indicates that the process of evaluating the choices at hand is complex and has to take the whole corporate law package a certain jurisdiction has to offer into account. It is the – frequently hard to determine – net balance that matters. Certain rules and standards may be value decreasing from a shareholder perspective (*e.g.* pro-managerial takeover law) but these disadvantages might be offset by welfare enhancing regulation of other aspects of corporate law (*e.g.* investor friendly disclosure rules). More generally, the detriments of weaker substantive law may be outweighed by a superior administration and – more importantly – an efficient judiciary. With no Member State having a clear and comprehensive advantage at the outset and – disregarding the highly unlikely possibility

[317] *Supra* VI.A and VI.B.1.

[318] For the general concept of distinguishing between regulatory competition and legal arbitrage *see* Stephen Woolcock, *Competition among rules in the single European market*, in INTERNATIONAL REGULATORY COMPETITION AND COORDINATION – PERSPECTIVES ON ECONOMIC REGULATION IN EUROPE AND THE UNITED STATES 289, 298 (William W. Bratton et al. eds. 1996).

of a lift of the current ban on U.S.-style franchise fees – no unique incentives to polish domestic corporate law in order to become the most attractive incorporation haven, the prediction can be dared that no predominant state of incorporation will emerge in the short run. In the absence of a compelling threat to the corporate entity and in light of relatively high transaction cost associated with cross-border reincorporation, mainly newly founded companies will be in a position to make use of the reinforced freedom of establishment. In this scenario, if at all, only a slow process of corporate migration will occur, leaving Member States enough time to copy the leading jurisdiction and amend their corporate statutes accordingly. However, the brief comparison of the English and the German private limited liability company has illustrated, that, even with regard to substantive law only, many alleged advantages of one jurisdiction are in fact ambiguous, rendering even the occurrence of a dominant state with regard to first-time incorporations unlikely. Where no jurisdiction can claim advantages that are independent of the individual incorporators' situation (e.g. Delaware's positive network externalities) the choice of corporate law is predominantly dependent on the facts of the individual case. Hence, there cannot be a one-size-fits-all scenario; rather many jurisdictions will have a relevant voice in a European concert.

As a consequence the specter of suboptimal outcomes in regulatory competition associated with the monopoly position assumed by tiny Delaware is not too frightening with regard to Europe, rather the beneficial forces of corporate law arbitrage seem to be more prominent. Hence, the need for a powerful counterbalance on a superordinate level is less pressing, rendering the political and institutional limitations of the European legislature less grave. Moreover, polities are in a position to protect their idiosyncratic politi-

cal compromises. As a consequence, European approximation efforts have to be reassessed. In practice another challenge will lie in the smooth calibration of foreign corporate law elements and neighboring fields of the national legal systems. It is a duty for European corporate law scholars to take on these challenges that seem crucial in order to bring to bear the potentially beneficial forces of possible corporate law arbitrage inherent in the new European scenario.

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