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Title
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Author
Hertig, Gerard

Publication Date
2004-02-22

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Revamping the EU Corporate and Takeover Law Agenda

- and Making it a Model for the U.S

Gérard Hertig (ETH Zurich)
and
Joseph McCahery (Tilburg, ECGI)

Preliminary Version Prepared for the
UC Berkeley Law and Economics Seminar
February 23, 2004

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Abstract

Recent corporate scandals, the increasingly pro-regulatory arbitrage stance of the European Court of justice, and EU enlargement have prompted the European Commission to propose sweeping corporate law harmonization reforms and submit to revolutionary pro-choice takeover regulation. This fluid state of affairs provides an opportunity for efficiency-increasing regulatory changes as well as an occasion for interest groups to appropriate the benefits of reform.

However, it is unlikely that the addition of pro-choice approaches to the traditional mandatory harmonization approach will, by itself, cause efficiency losses. This paper thus proceeds to offer recommendations that would, in effect, revamp the EU's regulatory reform Action Plan. We argue that few areas call for the adoption of new mandatory EU requirements, but that in many instances there is a good case for allowing firms to act on their own initiative to opt-out EU provision. This option, however, may not suit the needs and expectations of some types of business parties. Under such conditions, EU lawmakers should, take the opportunity to supply a limited menu of cost-saving opt-in legal terms.

A more difficult question is whether the reform momentum will, in practice, increase firms' freedom of choice and reduce costs, or mainly serve the interests of protectionist Member States and their respective interest groups. The pessimistic view is that the European Commission has only embraced the pro-choice approach because its reduced leverage over the legislative and implementation process has demonstrated that efforts to secure mandatory company law rules are likely to meet delay or paralysis. Because the Commission is interested in maximizing its own role in the legislative process, it can be expected to pursue policy choices that secure the support of Member State governments and interest groups that are committed to legal doctrines designed to stifle regulatory arbitrage and competition. In contrast, the optimists (including the authors) disagree. Not only will it prove difficult for EU law-makers to close down the pro-freedom path opened-up by the European Court of Justice, but its existence will also motivate them to adopt pro-choice EU provisions in certain sensitive issue areas. A move beyond mandatory harmonized rules toward a pro-choice approach will not only displace the substantial control that protectionist groups and governments have over the agenda-setting and legislative process, but could, in time, tilt the balance in favor of a new pro-choice regulatory equilibrium.

With an expanded regulatory menu that caters to the needs of most of the company participants, the model could serves as a promising alternative for US legislators to consider. Adding pro-choices items on the US regulatory menu could be a means to reduce the costs of federal intervention and revamp regulatory competition – both among states and between states and federal authorities.

I. Introduction

European Union (EU) corporate and takeover law-making has enjoyed a mixed reputation over the years. Early legislation has been praised for facilitating cross-border trading by minimizing the risk of companies or their transactions being considered void in other Member States. EU law-makers also received some credit for having adopted accounting and capital maintenance rules aimed at protecting creditors and minority shareholders alike.

In the last twenty years, however, the situation has changed. A series of legislative efforts by the European Commission, ranging from the regulation of takeover to establishing new business entities, ran into conflict with the European Parliament or, when finally enacted, often failed to satisfy the regulatory needs of many firms. Not surprisingly, the European Commission has been derided as a good example of a regulatory body which is unable to translate policy into legislation. An additional charge was that even when the EU has been able to institute legislative provisions, it turned out that these structures were more complex and restrictive than necessary. Given the diminished agenda-setting position of the European Commission and inadequate regulatory framework, the EU thus lost much of its capacity to coherently adjust its company law legislation to meet the ever-changing needs of firms and investors.

Until recently, EU policymakers therefore have had little reason to propose a new round of company law initiatives. However, a number of factors led policymakers to adopt a new Action Plan to reform EU company law. Part of the explanation for this new approach can be traced to the efforts of the European Commission to promote the adoption of legislation crucial to the Lisbon Council's proposal to improve the economic performance of European firms by 2010.[1] Another factor which led to the change in approach was the final July 2001 defeat of the draft 13th directive on Takeovers in the European Parliament, which prompted the European Commission to appoint a High Level Group of Company Law Experts who were asked about the possibility of creating a level playing field for takeovers in Europe. In addition, the corporate scandals on both sides of the Atlantic have made it a political necessity to be seen as undertaking reforms of the

[1] See Presidency Conclusions, Lisbon European Council of June 23-24, 2000 (available at http://ue.eu.int/en/Info/eurocouncil/index.htm

existing regulatory framework. As a result, the European Commission also directed the High Level Group to provide guidance on what legal measures needed to be launched to strengthen and modernize the corporate governance structure in the EU.

Other circumstances have also been instrumental in directing political influence over the European Commission's policy preferences. For example, the recent European Court of Justice (ECJ) decisions on freedom of establishment challenge the core elements of the *siège réel* (real seat) doctrine and may represent an important change in the relationship between Member State preferences and ECJ rulings. In light of these recent cases, the real seat doctrine, according to which corporations are required to have their registered offices in the Member State in which they have their main activities, has been weakened. Hence, some Member State governments may be willing to provide legislation designed to attract incorporating firms. At the same time, Member States that may suffer from the outbreak of competitive lawmaking may push for increased harmonization in order to stem the outflow of firms to more favorable jurisdictions.

Similarly, the EU company law regime is perceived as inadequate for coping with the cross-border mergers and reincorporations that will arise following the accession of new Member States. Therefore, the EU is under pressure to undertake serious changes to ensure that the expansion program is managed effectively. The European Commission's recent unveiling of multiple proposals designed to expand or reform EU corporate and takeover law is broadly in line with these developments. While these proposals include various approaches, the most surprising effect is that legislative results seem to have already materialized: after more than a decade of deadlock, the Takeover Bid Directive was adopted on December 16, 2003. It is perhaps too early to assess whether this is a short-lived harmonization success or the beginning of a new trend. But the last minute integration of "pro choice" provisions in the Takeover Bids Directive suggests that there is still room for more change, as there are surely downsides to following the mandatory law recommendations by the European Commission for a wide range corporate governance and company law issues.

Notwithstanding the remaining inefficiencies in reform proposals, the more decisive issue, however, is whether current regulatory activism, discussed in this paper, is desirable

or not. There is no question that hasty legislative reaction tends to be over-reaching and burdened with inefficient components (Holmström and Kaplan 2003). On the other hand, the present legal and political turmoil can also be seen as an opportunity for efficiency-increasing changes of a kind that could not be implemented in a more serene environment. This paper will argue that even though many of the key EU proposals are unlikely to benefit firms and their owners, it is possible that the "pro-choice" approach, represented in the newly adopted Takeover Bids Directive, could result in the adoption of a set of legal rules that would be beneficial for investors and might have some other advantages as well.

This paper has four parts. Part II examines the merits of the EU's company law harmonization program, with a special focus on the costs of mandatory harmonized provisions for European businesses and on regulatory arbitrage opportunities. Having evaluated the harmonization efforts to date, we move on to assess the emergence of a different regulatory approach that could yield tangible improvements to a wide range of firms and lend considerable support to the policymakers central objective, which is the development of an integrated market in the EU. Part III argues that moving away from mandatory EU provisions that automatically apply at the Member State level toward a framework that allows business parties choice in the selection of legal rules is likely to benefit firms and their owners. Part IV examines the circumstances where it would be reasonable, for a variety of factors, to use optional provisions to govern shareholder affairs. We also review the circumstances where mandatory rules can play an important role. We conclude by showing that protectionist Member States or special interests are unlikely to divert the pro-choice approach to their own benefit. Part V concludes by submitting that the EU's expanded regulatory menu could serve as a model for the U.S.

II. Assessing Change within the EU

Over the past twenty-five years, the EU has managed to enact a core set of provisions for open companies and, to a lesser extent, close companies. EU law-making has mainly been driven by a willingness to protect creditors and to avoid a race to the bottom by adopting "minimum" requirements – an approach also known as "mutual recognition harmonization". As a result, mandatory provisions such as minimum capital requirements,

disclosure rules and accounting standards, play a fundamental role in EU corporate regulation.

Supporters of EU harmonization, however, have made no attempt to develop a comprehensive regime of harmonized company law. The problem is not that EU law-makers do not have these ambitions, but that they do not have sufficient politically influential support at the Member State level. Objections to harmonization have been led by governments that want to prevent an increase in regulatory costs as well as by lobbying groups (e.g., controlling shareholders) that resist changes in the domestic regimes that have, over time, served to protect their interests.

What has been achieved is not only incomplete, it is also rather ineffective (Deakin 2000). For EU law-makers, this at least has the advantage that they cannot be blamed for inflicting significant damage to firms and investors because of misguided harmonization. Conversely, EU legislators cannot be credited for facilitating cross-border mobility or the free choice of corporate form. To the extent that the adoption of mandatory rules has furthered Member States' policies aiming at limiting regulatory competition and reluctance to let firms choose among Member State corporate law regimes, this suggests that EU regulators have benefited from this method of policymaking (Grossman and Helpman 2001).

A number of commentators have pointed out the shortcomings of the EU mandatory harmonization program, and indicated a preference for more diversity in regulation (Berglöf and Burkart 2003). To be sure, empirical work has shown that uniform provisions have the advantage of simplicity and lower administrative costs. However, it has been shown that uniformity is mainly called for when the benefits of regulation are the same for all firms, and is likely to be inferior to regulatory diversity when firms are of different types. If firms are heterogeneous, it is thus efficient to reduce the risk of sub-optimal regulation by providing diversified menus of provisions.

Within the EU context, the common thread in this literature is that, even assuming the need for some degree of harmonization, adopting uniform provisions can prove very costly as well as ineffective in dealing with externality problems. Supporters of EU

harmonization, however, have made no attempt to show the impact of their "minimum requirement" approach on firms – they have not even tried to dispute the evidence that setting "minimum requirements" leaves practically no room for regulatory arbitrage.

An alternative to "minimum" harmonization that allows firms to chose their own company law rules is undoubtedly preferable. In the past, the real seat doctrine that governs in most Member States severely restricted the "firm-driven" alternative, incorporation or reincorporation in another Member State. Indeed, according to the real seat doctrine, corporations that do not have their registered offices in the Member State in which they have their main activities may be considered devoid of legal existence. In recent years, however, the combination of new ECJ case law and the legislative blockage in the EU's company law harmonization program has stimulated considerable interest in regulatory arbitrage and competition. While the real seat doctrine continues to restrict firm mobility, the ECJ's judgments in Centros, Überseering and Inspire Art are likely to foster emerging regulatory arbitrage as well as jump start competitive lawmaking among Member States.[2] As a consequence of these judgments, the legal principles that once limited reincorporation have been swept away, and a broad path has been opened for entrepreneurs to pick the European corporate law they prefer and for Member States that want to adjust their legislation to benefit from this newly acquired mobility. For example, it is now clear that a Member State cannot deny standing to sue to firms having their headquarters on its territory but incorporated in a Member State with less demanding corporate laws. Similarly, the Member State cannot force the headquartered firm to comply with its more demanding capital requirements.

Several Member States have already passed corporate law reforms that position them to benefit from regulatory arbitrage. Admittedly, reformers may have aimed at advantaging domestic firms rather than attracting foreign firms. It remains that, coupled with case law liberalization, their reforms have put regulatory competition on the European map. EU law-makers have contributed to the trend by passing a Takeover Bids directive

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[2] See Case C-212/97, *Centros Ltd. v. Erhvervs-og Selskabsstyrelsen*, 1999 ECR I-1459; Case C-208/00 *Überseering BV v. NCC Nordic Construction Company Baumangement* 2002 ECR I ___; Case C-167/01, *Kamer van Koophandel en Fabrieken voor Amsterdam v. Inspire Art Ltd* (2003, available at curia.eu.int/jurisp).

that allows firms to opt for EU neutrality and break through rules, should their Member State have chosen to keep its own regime by opting out of the EU regime.

It is difficult to predict the degree and impact of regulatory arbitrage and competition within Europe. Conventional wisdom has it that firms' choices should be more a function of taxation or workers' protection and other social constraints than of corporate and takeover law. Tax issues are definitely a serious barrier to reincorporation. As exemplified by the landmark ECJ Daily Mail case, the latter triggers taxes on hidden reserves, effectively restricting demand for incorporating under a different corporate regime. Conversely, there is evidence that corporate law does not significantly constrain tax-driven firm mobility.[3] The same is true for social constraints. The attractiveness of incorporation or reincorporation is often seriously reduced by having no effect on applicable labour law – a situation that is likely to last, as demonstrated by the EU being unable to adopt corporate governance provisions that would affect the scope of German co-determination requirements. But, corporate law considerations are unlikely to significantly affect labor-driven firm mobility.

The evidence, which is insufficient to make any generalizations, seems to suggest that it is essentially new (as opposed to existing) firms that are likely to take advantage of increased choice among regulatory arrangements. For example, the recent leading ECJ cases (Centros, Überseering and Inspire Art) were incorporation, not reincorporation cases. In addition, even new firms may prefer to pick one among the (increasingly diverse) business forms offered by the Member State in which they intend to operate rather than incorporate in a Member State where they do not plan to be active.

Conventional wisdom, however, does not take into account the new tax landscape, recent EU reforms in the corporate area, in particular the possibilities offered by the new pro-choice approach adopted in the 2003 Takeover Bids Directive. First, commentators are confident that the current tax barriers to cross-border reorganization and reincorporation will be removed shortly by the ECJ (Schön 2003). There are indications that the ECJ will move away from Daily Mail and restrict home states from levying an exit tax on hidden

[3] See Glenn R. Simpson, *EU's Tax Changes Scatter Corporations*, THE WALL STREET JOURNAL (European ed.), October 9, 2003 at A6.

reserves of firms that have transferred residence The pending case of Hughes de Lasteyrie du Saillant,[4] which involves an individual who moved to France from Belgium, and was required to provide a guarantee in respect of a tax bill on the future sale of a shareholding that was not taxable after the transfer, may provide the basis for the Court to challenge Member State laws and regulations that enable them to tax hidden reserves on the transfer or residence of an individual or a company. The position of the Advocate-General, who issued a preliminary ruling for consideration of the Court, is that the transfer of a company's residence does not give rise to the right to tax the hidden reserves by home state government. The pattern in the ECJ case law suggests that the Court is likely to rule in favour of restricting member governments from levying exist taxes on foregone claims and hidden reserves. Should the ECJ eventually do so, barriers to reincorporation would be significantly reduced and Member States governments could be forced to become more responsive to the corporate law needs of a wide range of firms.

Second, the EU recently adopted the Statute on the European Company,[5] which should stimulate the incidence of cross-border mergers and incorporations. A significant advantage of the new legislation is that it continues and extends the trend laid out in recent ECJ case law, allowing European Companies to incorporate in a Member State in which they have no business interests without having to fear the application of the real seat doctrine. Consistent with the legislative approach laid out in the European Company statute, the European Commission has also sought to extend the reform agenda by proposing a new company law directive on cross-border-mergers, and announcing plans for a directive on the cross-border transfer of the administrative office of firms. Taken together, these interventions have provided a new momentum for reducing barriers to flexibility and contractual freedom in EU corporate law.

Third, two policy scenarios are likely to emerge as a consequence of the European Commission's Action Plan to Modernize Company Law and Corporate Governance. On the one hand, given the continued diversity of national governance regimes, we expect years of

[4] Case C-9/02 nyr.

[5] Council Regulation (EC) No 2157/2001 of 8th October 2001 on the Statute for a European Company (SE) and Council Directive 2001/86/EC of 8th Oct 2001 supplementing the Statute for a European Company with regard to the involvement of employees, OJ L 294 of 10th Nov 2001.

intergovernmental negotiations on the terms of the measures to be adopted. This cumbersome process is unlikely to prove sustainable and new initiatives are likely to emerge to reduce remaining obstacles to market integration. On the other hand, the recent adoption of the Takeover Bids Directive, suggests that the European Commission is prepared to allow Member States and firms to opt-out of corporate provisions they dislike so long as the adoption of such a pro-choice approach maximizes the chance of passing "essential" legislation. To be sure, the European Commission (still) remains committed to a mandatory approach to company law harmonization. However, the emergence of a pro-choice approach, combined with recent ECJ case law should significantly pressure Member States to become more responsive to regulatory arbitrage, which should lead to increased regulatory competition. In other words, a new "law-maker-driven" alternative to minimum harmonization is likely to emerge, providing a selective choice alternative to mandatory harmonization. Indeed, the new approach allows firms to mark their preference or dislike for *specific* provisions rather than having to embrace or reject a corporate regime in its entirety. This, by itself, should eliminate possibly remaining tax and labour barriers to freedom of choice.

The predicted combination of a decrease in barriers to firm mobility and an increase in available choice is likely to benefit shareholders and enhance efficiency. The US experience, moreover, has shown that even with an uncertain and limited degree of regulatory competition can be expected to have a favourable impact on firm value. Since the EU is an emerging regulatory market, it would be expected that the benefits from competition are likely to be significant.

III. A Menu for Reformers

The foregoing indicates that the agenda for EU company law reform is subject to competing interest group influences, which partially explains the differences in public officials' preferences for corporate law rules, and why good proposals can often coexist with less attractive measures. Clearly some groups are more organized and capable of influencing the policymaking process, and hence this explains the persistence of a policymaking approach that is disfavoured by shareholders and is likely to be inefficient. Naturally there are a variety of other factors, besides pressure group activities, that

influence policymakers when they must chose a set of policies. We have argued that, in the present circumstance, key institutional actors within the EU have started to realize that there may be no one best design for corporate law rules. Significantly, the Commission, which enjoys various levels of agenda-setting discretion and delegated legislative power, can be expected to adopt less restrictive rules that facilitate firm choice if it is deemed to induce effective decision-making and prevent legislative delay. Furthermore, it is highly likely that EU member governments have incentives to adopt legislation that is politically palatable, and thereby can secure other benefits, such as the adoption of sensitive and valuable legislation in a number of non-corporate areas (e.g. trading Takeover provisions against temporary workers legislation).

The EU's adoption of an approach to legal rules that represents a significant departure from the previous state of affairs suggests that the policy environment is changing, making it more complex to make the choice between legal arrangements. Not only is the pro-choice approach substantially different than the traditional continental European approach to harmonization, but it also significantly diverges from the time-honoured Anglo-Saxon reaction to market failures, i.e. substituting diverse state provisions by a single set of mandatory federal requirements (Roe 2003) – the Sarbanes-Oxley Act of 2002 being a recent and telling example.

As a matter of fact, EU reformers may now adopt regulatory approaches that reflect a highly diversified menu, including several pro-choice items. They can: 1) enact mandatory EU provisions (as was generally done in the past); 2) offer Member States a choice among a finite number of EU-defined options (an approach adopted in the Accounting Directives); 3) pass harmonized provisions, but empower Member States to opt-out of them (an approach adopted by the Takeover Bids Directive); 4) enable firms to opt out of applicable Member State provisions by providing substitutable EU provisions (as was also done in the Takeover Bids Directive); 5) adopt a EU regime that firms can opt-out of (which has not been tried yet, but is in line with the approaches adopted by the Takeover Bids Directive); 6) and abstain from legislating.

Furthermore, reformers can combine approaches. For example, the Takeover Bids Directive allows Member States to opt-out of its board neutrality and prohibition of

defensive measures provisions, while enabling firms incorporated in Member States that do so to opt into the EU regime. Or, to take another example, firms could be allowed to opt-out of their domestic regime not only to escape mandatory provision, but also when EU law has a standardization advantage over Member State default provisions.

There are clear advantages in adding pro-choice items on the regulatory menu. First, it means that EU harmonization does not necessarily deprive Member States from pre-existing regulatory powers, as they can be allowed to opt-out of the EU regime. This enables Member States to protect their firms against EU intervention deemed inefficient or unpalatable from a diversity perspective and thus reduces opposition to market integration efforts.

Second, a richer regulatory menu provides an alternative when abstaining from regulating is not an option. In the past, such situations necessarily led to the adoption of mandatory requirements, with a significant risk that the outcome would advantage powerful players (managers, controlling shareholders or financial intermediaries) (O'Hara 2000). Being able to adopt pro-choice rather than mandatory provisions should reduce the ability of interest groups to derive excessive benefits from EU law-making process. At the same time, the availability of pro-choice items allows EU law-makers to efficiently constrain the power of managers or controlling shareholders, as firms can be given the option to opt-out if the costs of the constraints prove excessive (Bebchuk and Hamdani 2002).

Third, pro-choice items permit regulators to adopt provisions that increase firms' ability to respond to market demands. The fundamental advantage of such an enabling regime is that it reduces the cost of contracting by providing off-the-shelf solutions, while avoiding the inadequacies and petrification effects of a mandatory approach. One way of increasing freedom of choice is to allow firms to escape Member State law in favour of EU law. Thus, firms can be given the choice of continuing to be regulated by the applicable Member State law for, say, the entering into transactions with related parties, or chose to opt-into EU provisions governing such transactions (regulatory competition from the top). Another possibility is to permit firms to opt-out of existing or newly harmonized EU provisions. For example, firms could be allowed to adopt merger approval procedures that depart from requirements set by the Third Company Directive. The opt-out right could be

either unlimited, limited to opting into the regime offered by any Member State or restricted to the regime offered by the Member State in which the firm is incorporated.

In short, the enlarged menu provides EU reformers with avenues other than mandatory harmonization when inaction is not an option, and allows for choice enhancing vertical (EU – Member States) and horizontal (among Member States) regulatory competition.

There are, however, also disadvantages in having a richer menu to choose from. First, EU law-makers may adopt optional provisions without considering their costs. Indeed, while the costs of mandatory provisions are well known, law-makers are less aware of the potential stickiness of default provisions. For example, firms may not be able to opt into a regime more favourable than the regime otherwise applicable because such a move would trigger a "comply or explain" rule that would force costly disclosure. Or, to take a more significant example, investors may resist the opting into a more favourable regime because they have become used to the regime that the firm wants to opt-out of or because they do not want the firm to adopt an approach that deviates from the average (see Sunstein 2002; Korobkin 2003; Bohnet and Cooter 2004). The latter example is of significance even for mere EU opt-in provisions: ignoring stickiness may result in law-makers adopting an opting-in instead of a mandatory rule in the mistaken belief that this less interventionist step will suffice to remedy inefficiencies at the Member State level.

Second, heterogeneous preferences among Member States could affect the ability to pass legislation. In particular, moving from a mandatory harmonization or abstain choice to a situation with multiple alternatives may increase the chances of deadlock. Alternatively, an expanded regulatory menu may provide Member States or interest groups with additional mechanisms for crushing the regulatory arbitrage and competition emerging in the wake of recent ECJ case law. For example, anti-choice Member States may be able to arrange for the EU to systematically use the opt-out approach, in order for the regulatory *status quo* to be reinforced through multiple opt-outs.

Third, allowing firms to benefit from vertical and horizontal competition could significantly increases legal diversity and make it more difficult for investors or creditors to

ascertain the applicable regime, thus increasing firms' financial costs. Indeed, there are strong arguments in favour of having at least part of the corporate and takeover law regime imposed at the EU level, given the costs firms occur when they have to identify the most adequate rule and the benefits of standardization for investors, creditors and other stakeholders.

Fourth, optional provisions often require the parallel adoption of mandatory provisions to constrain opportunistic behaviour. Indeed, managers or controlling shareholders could take advantage of the availability of optional provisions to select an arrangement that favour them while imposing significant costs on the firm or minority shareholders. Complementary constraints such as disclosure or voting requirements may thus have to be adopted, which could prove quite costly. For example, qualified majority or non-controlling shareholder approval requirements may facilitate minority shareholder abuses or discourage controlling shareholder from monitoring managers.

Overall, it is unlikely that introducing pro-choice items into the regulatory menu will, by itself, prove detrimental to the interests of firms and their owners. It should not be overly difficult for managers or controlling shareholder to opt-out of inefficient EU provisions, as stickiness has its limits. Similarly, managers or controlling shareholders should be able to prevent the adoption of EU provisions that truly foster minority abuses or significantly hamper monitoring. Even legal diversity should remain within acceptable boundaries, provided that optional provisions are accompanied by adequate disclosure and voting mechanisms. Regulatory deadlocks, for their part, are as likely to produce benefits as to generate costs.

On the other hand, it is obvious that the EU cannot simply shift from a mandatory to a default approach. Mandatory provisions remain necessary, both as an independent strategy and to complement optional provisions. Moreover, optional provisions may prove inadequate in areas where standardization is important. Finally, the risk of having Member States and interest groups opposed to regulatory arbitrage and competition hijack the new approach to foster their own agenda must not be under-estimated.

It follows that developing a model of regulatory choice valid across corporate and takeover law should prove very complex. A variety of well-known trade-offs (for example managerial discretion versus shareholder interests, minority protection versus controlling shareholder monitoring) would have to be taken into account. In addition, the model would have to consider variables such as the applicability of options to established firms and/or new firms and the degree of Member State opposition to provisions that may affect their regulatory power.

The result is that adopting a simpler, unbundled approach can potentially yield more efficient results. In the next section, we will initially identify specific areas where EU intervention could foster efficiency, using the expanded regulatory menu as a framework. We will then evaluate the overall risk of having opponents to freedom of choice unraveling reforms under the new approach.

IV. Matching Reforms and Regulatory Menu

The previous section suggests a series of reasons why an unbundled approach to corporate law making in the EU is likely to prove beneficial to a wide range of firm. The transformations engendered by recent ECJ decisions therefore provides a propitious occasion for promulgating efficiency-increasing proposals, as well as an occasion for influence groups to stimulate lawmakers adopt legislation that suits their own agenda. Despite these concerns, the emergence of a pro-choice trend could, if extended, relieve the pressure of Member State governments to adopt mandatory requirements, by providing a less invasive set of alternatives, and contribute ultimately to more flexibility and efficiency in lawmaking across the EU. In this section, we examine the company law and governance rules that are best subject to mandates and the areas that would benefit from liberalization.

a) Mandatory requirements

It is worth pointing out that the opting out of corporate law does not eliminate the need for mandatory requirements to address contracting problems of firms. In particular, mandatory rules may turn out to be desirable to complement optional provisions (Hertig and McCahery 2004). For instances, the provisions in the Takeover Bids Directive that govern ownership disclosure and the financial details of a takeover bid are necessary to create a

stable and predictable takeover regime in the EU. An additional instance is corporate disclosure. However, the difficulties with establishing this regime are many. Moreover, given that the accounting standards will now be set at the supra-EU level, the effectiveness of EU transparency requirements presupposes the creation of a European SEC (Hertig and Lee 2003). Consequently, since this is unlikely to happen in the short term, it is doubtful, in the present context, whether a discussion of corporate disclosure requirements makes much sense.

In light of the sequence of increasingly blatant misinformation by public companies (culminating with the Parmalat scandal), it is not surprising that the issue of mandatory requirements for gatekeepers such as auditors and rating agencies has been placed on the top of the EC's policy agenda. The European Commission is currently considering the adoption of auditing standards as well as the imposition of requirements to rotate auditors on a regular basis and to designate a single, fully responsible auditor for groups of companies. The Commission is also envisaging forcing auditors and rating agencies to register with Member State authorities. Still, the efficiency of some of these proposals is questionable. For example, even though Italy has been the first (and only) Member State to introduce auditor rotation requirements, it seems that this measure did little to prevent the Parmalat scandal – and may even have contributed to it. On the other hand, imposing some kind of gatekeeper supervision could reinforce investor confidence and prevent auditor liability from becoming prohibitive (Coffee 2003). Since this is the case in the US, a case can be made for new auditing firm regulation that addresses some of the perceived technical shortcomings and the conflicts of interest problems that have resulted in the recent costly governance failures.

Another, related way to reinforce investor confidence would be for the EU to impose the reduction of barriers to enforcement (Hertig and McCahery 2003). The EU could recognize all shareholders of firms incorporated in the EU standing to sue for breaches of shareholder voting rules and for violations of managerial or controlling shareholder fiduciary duties (duty of care and duty of loyalty). Member States could also be required to set-up courts specialized in shareholder litigation, with the French *Tribunal de Commerce*, the German *Handelsgericht* or the Delaware Chancery Court as possible models. Moreover, the EU could compel the adoption of pre-trial discovery procedures and mass litigation devices

such as class actions and contingent fees, building upon mechanisms already existing (in law or in fact) in several Member States.

Two objections can be made to the EU mandating a reduction of enforcement barriers. One would be to refer to the traditional doctrine according to which the EU should only address substantive issues, enforcement being within the purview of Member States. This is not a very persuasive objection. Nowadays, the European Commission considers that the EU can venture into the enforcement area when the wide variety of Member State enforcement systems clashes with the fundamental objective of providing equivalent levels of substantive protection across the internal market.[6]

Another, more fundamental, objection is that facilitating private litigation is not necessarily effective or efficient means to curb internal governance abuses. This is a difficult topic to tackle, not least because the evidence is murky. For example, U.S. class actions were much criticized in the early 1990s as the source of abusive law suits against auditors and civil procedure reforms were passed to curtail their effectiveness. Today, said reforms are listed among the reasons why auditors undertook the more risky and conflicted activities that facilitated the occurrence of corporate scandals in recent years (Coffee 2002). Or, to take another example, the jury system is often considered crucial for damage awards to be larger (and litigation level higher) in the U.S. than in Europe. The empirical evidence, however, is mixed. One study shows that damages are not lower when they are awarded by judges rather than juries (Eisenberg et al. 2002); another study concludes that damages awarded by juries are indeed higher, and that the difference can be significant when it comes to large awards (Hersch and Viscusi 2004). The effect of fees reforms on enforcement levels is still another example of the murkiness of the debate. It has long been argued that contingent fees were the fuel that powered litigation US-style. By contrast, an apparently innocuous reduction of filing fees was apparently sufficient by itself to cause an impressive increase in shareholder litigation in Japan (West 2001).

This shows that one cannot summarily dismiss the efficiency of an EU imposed reduction in enforcement barriers. On the other hand, it cannot be disputed that such reduction

[6] See Proposal for a Directive on measures and procedures to ensure the enforcement of intellectual property rights, COM(2003) 46 final.

presupposes a more in depth analysis of the costs and benefits of the proposed measures. More importantly, the difficulties in assessing the efficiency of litigation proposals will make it an easy task for Member States that oppose them for political, cultural or protectionist reasons to prevent the adoption of any mandatory reform. Thus, rather than face certain defeat with mandatory proposals, enforcement reforms should be made using pro-choice mechanisms.

In short, it makes sense to generally drop attempts to reinforce existing mandatory requirements or adopt new ones. The exception that confirms the rule is putting the regulation of auditors and rating agencies on the EU reform agenda.

b) Choice among a finite menu of EU options

Rather than adopting mandatory arrangements that Member States have limited discretion in implementing, the EU alternatively could allow Member States (or even firms) with the freedom to choose legal rules from a finite number of possibilities. This alternative framework has been adopted in the case of accounting directives to permits Member States to choose among more or less conservative standards as well as to exempt small to medium-size firms (SMEs) from requirements deemed to be too costly. Our analysis suggests that this approach has important upsides. It makes it easier for firms to identify variations in the Member States' rules. Moreover it allows Member States to switch to a less intensive disclosure regime for SMEs and reduce regulatory costs for this class of firms.

However, the accounting directives record is far from successful. This may be due to the options being designed to deal with other regulatory concerns than efficiency. More generally, it confirms that it is generally a mistake to impose a fixed menu from the top. On the one hand, standardization benefits are significantly reduced, as there is no single set of EU provisions that firms and investors can rely upon. On the other hand, harmonization costs are likely to increase. First, adopting a finite menu of EU options approach will reduce Member States willingness to compromise, as they have good reasons to hope that a hard stance will insure the adoption of an option that is close to their own regime. The result is likely to be an inefficient multiple options one, as shown by the accounting

experience. Second, the existence of multiple options should increase the petrifaction effect, as amendments would have to be coordinated and should thus be more difficult to pass than when there is only one mandatory rule.

We therefore conclude that the finite menu of EU options approach is not suited to the current environment and should not be considered for on-going reforms.

c) Opting-out of EU provisions

It should be evident, based on the foregoing, that an opt-out regime is a promising regulatory approach that has many advantages for firms. Our analysis suggests that a defaults approach is appropriate where there are significant variations in Member State corporate governance systems. In such situations, a single mandatory set of EU provisions would have a different impact in each Member State, leading to higher costs and other undesirable effects. As a consequence, there are obvious benefits in the EU adopting provisions with an opting-out possibility, e.g. provisions inspired by the "best" among existing Member State ones. The costs, on the other hand, would be rather limited, at least when it is Member States that are allowed to opt-out of the EU arrangement. Member States are less likely to oppose the adoption of an efficient solution than when the approach is purely mandatory. In addition, the above mentioned stickiness of default rules should play a limited role, as it is less likely to affect states than individual firms. Finally, the risk of an opt-out for mere protectionist purposes is low, as it would be quite easy to successfully challenge limitations to the right of firms active in the opting-out Member State to incorporate in a Member State that has not opted-out of the EU regime.

But opting-out costs could remain acceptable even if it is firms would have to opt-out individually (Bebchuck and Hamdani 2002). Admittedly, Member States may oppose this additional reduction of their regulatory powers. However such opposition is likely to remain light when it comes to providing opt-out rights to new firms (as maintaining the regulatory status quo could mean that they will incorporate in the more market-minded Member States) and for firms incorporated in the new Member States (as the direct application of EU law could have beneficial signalling effects).

Based on the above, the EU could adopt provisions with opting-out possibilities in various areas. First, it could adopt exit rules that are applicable to all firms but enable Member States to opt-out not only as far as mandatory takeover bids are concerned, but also for squeeze-out and sell-out rights. Second, new firms could be directly subject to one share/one vote, no staggered boards, no voting caps, no pyramid structures requirements, but allowed to opt-out in favour of the regime of the Member State they are incorporated in – the latter limitation aiming at insuring some degree of uniformity and transparency. The opt-out could be decided by a qualified majority of shareholders, subject to judicial ratification to prevent minority oppression. Third, shareholders of both new firms and firms established in new Member States should be recognized standing to sue for breaches of shareholder voting rules and violations of fiduciary duties unless a majority of minority shareholders decides to opt-out in favor of the regime applicable in the Member State of incorporation. (By contrast, established firms in current Member States could be recognized to opt into such a regime).

To exemplify the approach, we now turn to examine how opt outs for mandatory bid rule and squeeze out rules could be more desirable than what is currently proposed under the Takeover Bids Directive.

1. *The Mandatory Bid Rule.*—Under the Takeover Bids Directive, the mandatory bid rule can be broken down into two key components: (1) the obligation to make a full bid; and (2) the consideration offered in the full bid. The Directive leaves the definition of the trigger threshold for the mandatory bid to Member States.. The idea is that effective control thresholds depend on national company law. In this regard, diversity is warranted as long as national company law differs. Harmonization of consideration (the equitable price), on the other hand, may preclude value-enhancing takeovers, by preventing regulatory competition to minimize the takeover costs. It is true that regulatory competition may not be strong if national equitable price rules would be complicated, but Member State regulators could design simple rules that foreign shareholders (or 'the market') should be able to understand. For our purposes, it is crucial to see that shareholders from different jurisdictions do not benefit from the introduction of a harmonized rule.

2. *Squeeze Out Rules*. A squeeze-out-right refers to the right (under specified conditions) of a majority shareholder to compel minority shareholders to sell their shares to him at an appropriate price. The commonly supplied justification for providing a squeeze-out option is that retaining a small minority of shareholders can be costly (general assemblies would have to be arranged, shareholders notified etc). As a practical matter, small shareholders have, because control is no longer contestable, little hope of ever capturing the premiums from a control contest. Thus, the exclusion of the few remaining minority shareholders is efficient. In principle, the squeeze-out rules proposed in the Directive are acceptable. Currently most Member States allow majority shareholders, under certain conditions, to compel the holders of the remaining shares to sell those securities so long as adequate compensation is paid to them.

Under article 14 of the Takeover Bids Directive, a majority shareholder can exert a squeeze-out under the constraint that he holds between 90% and 95% of the capital following a full bid (Art 14 1(a)). Alternatively,[7] a squeeze-out can be affected following a bid on the outstanding capital with the constraint that it has been accepted by shareholders representing more than 90% of the outstanding capital (Art 14 1(b)). Share classes are accounted for separately (Art 14 2). The equitable price in both cases can be determined in two ways. First, by a legal presumption on the 'fairness,' namely when the constraint is met that the bid attained 90% acceptances in terms of the share capital at which the bid was directed. In case of a prior mandatory bid, this threshold would not apply for the determination of an equitable price (Art 14 3). The time limit during which the equitable price presumption remains valid is set at three months. Second, in all other cases the squeeze-out price is to be determined by an independent expert (and in case of conflict, an appraisal proceeding) (Art 14 4).[8]

To be sure, there may be considerable confusion as to when the appropriate compensation mechanism applies. Suppose a bidder had no stake in the target before launching the bid. Since at least 90% of the capital is needed to initiate a squeeze-out, this would correspond to at least 90% acceptances. However, if the bidder held an initial stake large enough that a

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[7] It is not so clear whether member states are supposed to have the choice between these alternatives or a bidder.

[8] In the light of the arguments below, one may wonder how an appraisal procedure could be conducted for each class separately.

mandatory bid became necessary, less than 90% acceptances would be needed to satisfy the 90% capital threshold and to ensure that the equitable price presumption applied. However, when the capital constraint is not satisfied--following a mandatory bid--the new controlling shareholder would need to launch a second bid in order to initiate a squeeze-out. Given that the acquirer already has a stake in the company, the 90% capital condition can be reached with less than 90% acceptances (as well as a 95% capital rule if the initial holding was at least 50%). But the equitable price assumption does not automatically apply. Rather, the price can be determined by an independent valuation as stricter conditions on the fair price presumption now apply. Yet if the second bid were to have received a few more percentage points of acceptances, the fair price presumption could have been applied instead.

It is noteworthy that there has been a compromise between the traditions of different member states. While some commentators suggest a harmonized rule would be preferable. In contrast, given that the choice of mechanisms is important, (expert valuation or the fair price presumption) it would be generally inferior to demand member states, with diverse traditions, to choose the harmonized rule on squeeze outs. The Directive appears to have retained appraisal proceeding as a possibility by virtue of choosing not to fully harmonise the squeeze-out thresholds. As is well known, appraisal proceedings are time-consuming and sometimes arbitrary. Moreover, the squeeze-out procedure is not a blueprint for compensation of groups of shareholders in other circumstances. First, it explicitly (in the appraisal proceeding) or implicitly (in the fair price presumption) allocates some bargaining power to the shareholders that are forced to tender their shares. The allocation of bargaining powers under circumstances other than a squeeze-out may be a different issue. Second, the independent expert valuation evaluates the company as a going concern. It does not evaluate the relative weights of different shareholder groups in the distribution (and determination) of the market value of the company. Attempts to do so on the basis of industry data are to some extent arbitrary.

d) Opting into EU law

There are numerous factors that explain why lawmakers may be inclined to adopt provisions that can be opted-in by firms dissatisfied with their Member State corporate and takeover law regime. The approach may be justified by efficiency considerations or be

compelled by political expediency. Regardless of the motivations, an opt-in regime may benefit companies by providing them with a set of simple set menu of harmonized rules that lower transaction costs and provide a higher degree of legal certainty. Firms may also benefit from an opt-in that credibly signals a commitment to comply with state-of-the-art regulation. One important consideration is that opt-in provisions can be beneficial for companies that must deal with legal difficulties, such as workers' participation requirements. For instance, EU intervention could facilitate regulatory arbitrage by supplying firms with a selective opt-out of their Member State's corporate regime – as opposed to the full opt-out brought by reincorporation.

The approach, however, may also reflect considerations other than efficiency. Opt-in provisions may be passed merely to cover-up the inability of the European Commission to effectively address opportunistic behaviour. For example, subjecting the opting into EU provisions on related party transactions to a shareholder vote does little to constrain controlling shareholder opportunism – but still looks better than forgoing any intervention. Admittedly, the opt-in approach may also by favoured by Member States to prevent the adoption by the EU of more efficient opting-out provisions, for example when it comes to dividend rights for minority shareholders. Likewise, Member States may also support opt-in provisions because they should increase legal diversity and either make it more difficult for investors to ascertain the costs of their domestic regime or increase their own corporate law's stickiness.

Thus, under certain conditions, the adoption of opt-in provisions can prove costlier than intuitively expected. In such cases, caution is welcome when choosing opt-ins for existing companies. In our view, the benefits of an opt-in approach should generally exceed its costs in areas where Member States have adopted costly mandatory provisions that cannot be dismantled through mandatory or opt-out EU intervention. In addition, the opt-in approach should be an appropriate one in areas where Member State law is diverse, but standardization or "best practice" signalling is important for investors or stakeholders.

The opt-in approach seems thus particularly suited for dealing with Member State mandatory provisions on employee participation structures, multiple voting and dividend rights, as well as on various takeover issues (board neutrality, mandatory bid thresholds and

exit prices). However, EU mandatory requirements might, in some cases, have to complement these opt-in arrangements, both to prevent Member State from opposing their adoption and minimize managerial and shareholder opportunism. Thus, the opting into EU employee participation provisions could be made subject to third party approval – for example, court ratification. Similarly, the opting into EU multiple voting and dividend rights provisions or into EU mandatory bid thresholds and exit prices could be made subject to qualified majority or minority shareholder approval. As far as standardization and signalization are concerned, new firms or firms incorporated in new Member States should benefit from opt-in provisions that establish simple and transparent procedures for the disclosure and approval of related party transactions (be it self-dealing, compensation agreements, or the appropriation of corporate opportunities). Finally, the opt-in approach could be serve pro-enforcement functions. Under this approach, existing firms in "old" Member States would be encouraged to choose this arrangement. To be sure, managers or controlling shareholders may resist such a move, fearing a reduction of their private benefits due to minority shareholder litigation. However, it may not even be necessary to give the majority of minority shareholders to power to exercise the opt-in option for it to be effective. As recent events of shown, managers or controlling shareholders may too support an opt-in, to the extent it provides a civil enforcement alternative to criminal investigations and sanctions.

f) Capturing the pro-choice approach

As we discussed in Section III, introducing pro-choice items into the regulatory menu is not, by itself, likely to be detrimental to the interests of firms or their owners. On the other hand, protectionist Member States or special interests may seek to influence or distort the pro-choice approach for their own benefit. For example, both groups may attempt to take advantage of the recognized need for complementary mandatory provisions to foster reforms that curtail the scope of optional provisions or make their adoption impossible. Alternatively, they may pursue a different course to prevent reform by making irrelevant but attention diverting pro-choice proposals. In this situation, it is likely that opponents of the pro-choice will attempt to influence the European Commission by supporting legislation in these areas designed to stifle regulatory arbitrage and competition. Accordingly, we have seen that the European Commission has only contribute positively to

allowing opt-outs of mandatory arrangements because it has found to have limited stakes in or unable to pass mandatory, value-decreasing arrangements. The result may be that the EC, in order to give rise to a new policy agenda, could thus be tempted to forge an alliance with opponents of regulatory arbitrage and competition, even though its main preferences are to create the conditions for economic and capital market integration.

To be sure, different outcomes are possible. Even if an alliance comprising the European Commission and powerful anti-choice constituencies should exert its influence to change the agenda, the groups may find it difficult to adopt overriding legislation that curbs the pro-freedom path opened-up by the ECJ (Cooter and Ginsburg 1996). As a matter of fact, access to that path is now controlled by entities outside the reach of such an alliance, pro-choice Member States and the judiciary. More importantly, anti-choice activists will not be able to capture the EU law-making process to the extent necessary to prevent the adoption of at least some pro-choice provisions. While it often will be possible to argue that the benefits they provide are not large, it will generally prove impossible to claim that they are costly. As a result, the protectionist machine will face an increasing number of sand grains, some of which sufficiently grip it to tip the balance

V. The EU as a Model for the U.S.

The U.S. regulatory environment is comparable in some respects to the EU structure. In both cases, federal intervention interacts with regulatory competition at the state or Member States level. There is also evidence of regulatory capture in the U.S. and the EU alike. In the U.S., state corporate law-makers are keen to take into account managerial interests, whereas in most if not all EU Member State stakeholders (creditors and employees) interests significantly influence company law making. On the other hand, there is divergence to the extent inasmuch as regulatory competition is (or has been) more intense between US states than Member States in the EU. Also, U.S. federal authorities are more powerfull than their EU counterparts. The SEC has proved way a more active than the European Commission, whereas the U.S. Congress has federalized corporate law in a way that makes EU legislators look insignificant in comparison.

We have seen recently that the federalization of US corporate law has been on the increase, which correlates with a decline in the incidence of competition between states. Up to now, severe incursions remained limited to specific issues, such as going private transactions, self-tender, dual class recapitalizations and institutional investor voting (Roe 2003). The recent corporate scandals have resulted in what some call an evisceration of the basic federalistic structure (Bainbridge (2003). Against this background, the fact is that it may be beneficial to import some of the EU's pro-choice arrangements which could reduce the costs of federal intervention while, at the same time, offer firms the prospect of renewed freedom of choice.

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