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A Legal Options Approach to EC Company Law

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In recent years, legal options (ex ante and ex post choices created by law) have gained acceptance in the European Union. Notwithstanding the move toward soft law measures, the EC's appetite for options or pro-choice company law provisions remains unclear. There are significant barriers to the EC's ability to promote efficient regulatory choice due to interest group pressures, diffuse control over the agenda-setting process, and a limited capacity to anticipate and meet a wide range of Member State demands.

This article shows that bringing options to the forefront of company law reform can reduce costs for small and medium-sized firms and provide clear benefits to companies that differ in their ownership and control structure from most large public corporations. Switching to a company law regime with different sorts of options can have a good effect on stakeholders as well. As a regulatory strategy, we advocate a step-by-step change, beginning with the adoption of a limited number of opt-in provisions.

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A. INTRODUCTION

Legal options are not a new thing. For many years, default rules and a variety of option techniques have been used in a wide range of contexts. More recently, default rules have been used in the US, for example, to accommodate the diversity in organization, capital structure, and lines of business. They clearly are a dominant strategy for governments that want to facilitate innovation and supply a set of rules that appeal to different business parties' preferences. Perhaps more importantly, a default approach can supply small and medium-sized firms with rules that can provide value by lowering formation and operation costs. Unlike mandatory rules, which are necessary under certain conditions to ensure financial disclosure, limit collective action problems and protect shareholders' and creditors' interests, the terms specified in a default rule are not immutable. With default rules, parties are free to opt out and choose among different rules.

Economic theory has emphasized that, where contracts are silent or incomplete, options provide firms with an array of contractual terms on particular subjects (such as capital contributions, dividend rate, management remuneration and tenure) that encourages efficient contracting. Options provide a framework that allows parties to reduce information problems and lower the cost of contracting that they otherwise would have to pay. Default rules, in particular, can enable shareholders to protect themselves from managerial opportunism by simply relying upon rules that presumptively are biased in their favor.

There is some debate as to whether options provide a promising alternative to corporate law regimes based on mandatory rules. On the one hand, there are a number of situations where a mandatory rule would benefit shareholders against the self-interested conduct of insiders. There can also be some circumstances where a mandatory rule may be desirable to protect third parties. Further, a switch to an enabling regime may impose excessive costs for firms that cannot simply opt out and into a legal regime that is consistent with their own interests. On the other hand, an options approach can ensure that

companies are able to select arrangements that may cause fewer difficulties, can allow for reductions in transaction costs and promotes the institutional environment that could facilitate choice between regulatory regimes. Some scholars, moreover, argue that a policy of facilitating choice is likely to enhance individual options pricing and may well, in certain circumstances, give rise to welfare effects.

However, regardless of the extent to which options may inflict damages on some parties or may be more costly than the benefits created, there is sufficient evidence that their value can be considerable and that expanded choice over corporate law rules is desirable given the high costs of mandates that govern the affairs of companies in the EU. In the United States, the state law's enabling structure supplies firms with few mandates and provides a menu of default rules that help firms economize on transaction costs such as drafting, information and enforcement costs. The enabling approach does not prevent firms from defining the relationship between the participants inside the firm and the representation of the firm in its dealings with outside participants, particularly creditors.

To be sure, there are areas where mandates are required. U.S. state law addresses managerial opportunism *ex post*, imposing fiduciary constraints against self-dealing transactions and oppression of minority shareholders. However, although the fiduciary regime imposes a duty of care, the standard of care is minimal. Mandates can also significantly facilitate the freedom of choice. U.S. states meet the diverse requirements of close corporations, for example, by offering a menu of distinct legal business forms which act as off-the-rack default packages which parties can use to structure a firm. If a particular state has sufficient incentives, its lawmakers may innovate and tailor the state's legal business forms to match market preferences.

While state corporate law generates many options in the US, lawmakers in European correspondingly have few incentives to allow companies to choose between legal rules. On the one hand, several prominent scholars have argued that the absence of state competition in the EU may explain why lawmakers, on both the EU and national level, have for so long advocated the use of mandatory rules over an

enabling regime. To the extent that corporations have been unable to opt into a different corporate law regime, lawmakers face few pressures from organized interest groups to provide default rules that would allow firms to contract into their preferred legal arrangement. Under this view, the promise of regulatory competition will provide incentives for governments to give credible assurance to firms that lawmakers can be relied on to supply optimal legal rules which are attractive to many different types of firms.

While the choice-enhancing role of regulatory competition is well established, the empirical evidence is less unified on the question of whether the threat of competition induces governments to promulgate value-enhancing default rules (Bratton and McCahery 1997; Bar-Gil, Barzuza and Bebchuk 2001; Bebchuk and Cohen 2005). In this paper, we contribute to the literature by focusing on a related question: If the EC's company law reform program has not yielded regulation that firms require, will the options approach proposed here help?

A central issue in the debate has been whether the EC's reliance on a narrow range of legal mechanisms has been the main factor constraining the move toward choice. This is important because existing theory and practices suggests that the process of providing for more flexible law, such as those provisions introduced by best practice recommendations, fails to control for the distinctively mandatory characteristics of its "comply or explain" features (Wymeersch 2005).

In this context, the EC has sought to introduce wide-spread reforms (Communication on Modernizing Company Law and Enhancing Corporate Governance in the EU – A Plan to Move Forward, 'Action Plan', European Commission 2003). While many of the reforms address the need to align principal-agent interests, particularly in the wake of the Enron and Parmalat scandals, by providing more shareholder oriented rules, there is a sense that the reforms are also designed to move the EU toward delivering more cost-effective regulation.

Thus, the EU legislative agenda has been designed to deal with cross-border mobility, board structure, financial and non-financial

disclosure, director and management remuneration, appointment of auditors, managers' and directors' conflicts of interests, and shareholder voting rights. To accommodate these wide-ranging regulatory reforms, the prevailing EU regulatory strategy is to rely on a combination of directives, recommendations and self-regulation. The conventional wisdom is that the EC Action Plan will succeed in creating the type of legal framework needed to enable firms to compete more effectively in a dynamic and changing business environment. While few question the potential benefit of the reforms, several commentators wonder whether alternative legal strategies could be used to deliver more effective results (Hopt 2005; Davies 2006).

In the absence of evidence to the contrary, we are also less than sanguine about the EC's capacity to create a more flexible set of legal strategies which is sufficiently responsive to the need for better regulation and is likely to have a positive impact on economic growth, employment and productivity. We argue that pro-choice measures offer an alternative to mandatory harmonization when abstaining from regulating is not an alternative. Indeed, an options system is preferable to a mandatory regime since it favors shareholder welfare as the basis for assessing regulatory reforms. Regulatory intervention through legal options, moreover, poses a more limited threat of regulatory mistake and also address the very real cost problems caused by a single regulatory strategy.

This article develops various justifications for a EC company law reform strategy that uses opt-in and opt-out rules. It can be expected that opt-ins and opt-outs will make a difference by providing firms with a set of rules allowing them to respond better to market needs and other risks. In addition, the regulation of EC company law through legal options has two political economy advantages over the present approach. First, the use of options permits the EC and Member States to limit the risk of disruptive intrusions by the European Court of justice (ECJ) in the company lawmaking process. Second, to the extent that options are preferred by interest groups and companies, they will have strong incentives to support the approach through

increased demand for their use in most corporate law areas.

Naturally there is concern that optional arrangements may be subject to behavioral shortcomings. Some studies suggest that default rules can induce cognitive distortions that can have significant effects when people treat them like endowments. On this view, even if a default rule is biased in favor of a group of individuals, it will have no positive impact on these people. Moreover, there is evidence that also points to the stickiness of default rules making it more difficult for firms to opt out of legal provisions. On the other hand, many commentators have observed that these results are at odds with the widely accepted intuition that default rules may have little impact on distribution. Moreover, even if cognitive defects are sometimes difficult to overcome, it is argued that switching to default rules may have desirable effects by improving welfare (Sunstein 2002). Finally, since we think the possible cognitive problems associated with defaults rule are not substantial in a corporate environment (see also Arlen, Spitzer and Talley 2002), it makes great sense to provide for options so as to achieve the benefits that cannot be accomplished by harmonized mandates.

That said, there are good reasons for recommending a cautious, piece-meal approach to the introduction of options into the law-making process at this stage. First, putting too many reform items on the agenda may create the very same implementation delay and complexity issue than under the mandatory harmonization approach. Second, it is always preferable to adopt a step-by-step approach when introducing new regulatory mechanisms, especially when there is a risk of legal diversity becoming excessive.

This article will proceed as follows. Part B summarizes the flexible elements of EU company law. Part C will assess the impact of the evolution of EU company law policy changes on regulatory arbitrage and competition. Part D evaluates the benefits of a pro-choice approach. In Part E, we advocate a step-by-step approach focusing on a limited number of options to allow for the advantages of choice without the welfare reductions associated with too many choices. Part F concludes by discussing the future of the pro-choice

approach in Europe.

B. Toward a Flexible Approach to EU Company Law

This part considers the implications of the significant change of EC company law policy in favor of a flexible approach that relies on soft law measures.

I. The Evolution of EU Company Law

The EC has built a record of company law reform that enjoys a mixed reputation. Early legislation has been praised for quickly developing a company law infrastructure that was in some important respects similar to the corporate law structures in most Member States. Second, the Commission was successful in implementing laws that facilitated cross-border trading by minimizing the risk of companies or their transactions being considered void in other Member States. Third, the adoption of accounting and capital maintenance rules aimed at protecting minority shareholders and creditors secured some enthusiasm for Commission efforts in devising mechanisms dealing with financial assistance and disclosure.

In the past two decades, however, the situation has changed. A series of high profile legislative efforts by the European Commission, ranging from the regulation of takeover bids to establishing new business entities, ran into conflict with the European Parliament. What explains the shift in legislative policymaking authority encountered by EC? Influential theories of EU lawmaking emphasize that the policy-making space became be very limited due to the mixed motives of Member States (Pollack 2003). The presumption that Member States should want to weaken, not strengthen the Commission's company law agenda, has led some scholars to entertain the possibility that major company law reforms are not considered important enough for member governments to mobilize resources to achieve legislative compromises (Wouters 2000).

In order to regain significant agenda-setting powers and the

ability to conclude agreements, the EC eventually reversed its legislative strategy in this area. Standard public choice theory would explain the shift in terms of organized special interest groups persuading Commission policymakers that the group's preferences would serve the policymakers' own political interests and become useful in putting together a winning coalition. (Dixit and Londregan 1998). Naturally there are numerous other explanations to consider. It is surely no coincidence that the Commission sought to counter the moves of member governments that seek to block reforms by placing the Lisbon Council's objectives as a top priority.¹ Similarly, the EC may have had an incentive to take an early position on the US corporate scandals in order to shift expectations of domestic voters, which could be expected to guide member governments' subsequent behavior. This is clearly represented by the efforts of the Internal Market Commissioner to have the High Level Group of Company Law Experts reach beyond their original mandate to recommend certain audit and accounting rules regarding publication of annual accounts.²

Perhaps more fundamentally, the EC has responded to the direct political influence of the European Court of Justice' (ECJ) decisions on freedom of establishment.³ These ECJ decisions have challenged the core elements of the *siège réel* (real seat) doctrine, thus questioning some of the main principles enshrined in the company law frameworks in the majority of Member States. A growing number of studies have demonstrated the direct effect of the ECJ's judgments on cross-border mobility of start-up companies (Becht, Mayer and Wagner 2005).

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

² See http://europa.eu.int/comm/internal_market/en/company/company/news/01-1237.htm.

³ Cases C-212/97 Centros Ltd. V. Erthvers-og Selskabsstyrelsen, [1999] ECR I-1459, [1999] 2 CMLR 551 (Centros); Case C-208/00, Überseering BV v. Nordic Construction Company Baumanagement GmbH (NCC), [2002] ECR I-9919 (Überseering); and Case C-167/01, Kamer van Koophandel en Fabrieken voor Amsterdam v. Inspire Art Ltd (NL), [2003] ECR I (Inspire Art).

These judgments are available at <http://europa.eu.int/cj/en/content/juris/index.htm>.

With regard to established companies, the impact of the ECJ case law is subject to debate, as it remains costly for them to switch from one Member State regime to another. Nonetheless, these decisions have increased the attractiveness of regulatory arbitrage which may make it easier for corporations to select among legal rules from diverse company law codes.

These disruptive features have induced the EC policymakers to adopt a less constraining legislative approach. For example, the Commission proposed - in a radical departure from its previous policy -, that Member States be allowed to opt-out of Articles 9 (board neutrality) and 11 (break-through rule) of the Takeover Bids Directive. The proposal was received favorably by Member States, ending a regulatory deadlock that had lasted for more than a decade.⁴ The Commission has subsequently created a large and growing number of soft law initiatives that link together national governments' and EU policymakers' concerns to succeed in transforming their relationship concerning agenda setting and implementation of corporate law.

The provision of flexible corporate law rules has many advantages. In particular, the greater range of choice in policy-making instruments makes it easier to avoid the costs of relying on rigid instruments alone. The Commission can choose to: 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 originally adopted in the Accounting Directives); 3) enact 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 flexible approach adopted by the Takeover Bids Directive); and 6) and abstain from legislating.⁵

⁴ Directive 2004/25/EC, [2004] OJ L 142/12.

⁵ Furthermore, reformers can combine approaches. For example, the Takeover Bids Directive allows Member States to opt-out of its board neutrality and prohibition of

C. Impact on Regulatory Arbitrage and Competition

Overall it is intuitive that while many of the policy changes discussed above can have some impact on regulatory arbitrage, their practical effect on cross-border mobility, charter competition and freedom of choice is so far quite limited. Exit taxes or workers' protection and other social constraints are more important to more choice than the Commission's new soft law approach to company lawmaking.

It is well known that tax constraints are a significant barrier to mid-stream re-incorporations. The ECJ's ruling in *Daily Mail* shows clearly that re-incorporations will trigger exit taxes on hidden reserves, effectively restricting the demand for chartering.⁶ Conversely, there is evidence that corporate law does not significantly constrain tax-driven firm mobility.⁷ The same is true for social constraints. The attractiveness of incorporation or reincorporation is often seriously reduced by having no effect on applicable labor law – a situation that is likely to persist over the longer run, given unwavering opposition to the adoption of EU corporate governance provisions that would affect the scope of German co-determination requirements. Note also that corporate law considerations are unlikely to significantly affect labor-driven firm mobility.

On the other hand, the ECJ recent rulings on freedom of establishment can and do challenge the existing EC tax landscape. Since 2000, the ECJ has repeatedly ruled that tax provisions were precluded by the freedom of establishment principle if they

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.

⁶ Case 81/1987, *Regina v. H.M. Treasury and Comm'rs of Inland Revenue, ex parte Daily Mail and General Trust Plc*, [1988] ECR 5483.

⁷ See Glenn R. Simpson, *EU's Tax Changes Scatter Corporations*, THE WALL STREET JOURNAL (European ed.), October 9, 2003 at A6.

discriminated between domestic and foreign subsidiaries, and more generally between domestic and international groups. More importantly, Member States have generally proven unsuccessful in trying to justify such discrimination by arguing that they are necessary to ensure the coherence of the national tax system or the need to preserve the tax base.⁸ This is both in sharp contrast with the ECJ's previous reluctance to challenge tax barriers to cross-border activities (as exemplified by *Daily Mail* and *Bachmann*⁹) and in line with the recent ECJ's pro-freedom of incorporation and reincorporation cases.

As a consequence of these tax cases and the implementation of the amendments to the merger directive,¹⁰ commentators are confident that the current tax barriers to cross-border reincorporation will be removed shortly by the ECJ (Schön 2003). Such optimism finds support in the *de Lasteyrie du Saillant* judgment.¹¹ The ECJ ruled in favor of an individual who moved to France from Belgium and objected to having to provide a guarantee in respect of a tax bill on the future sale of a shareholding. The Court indicated that the principle of freedom of establishment precluded a Member state keen to prevent a risk of tax avoidance from taxing latent increases in value when a taxpayer transfers his residence outside that State.

While the pattern in ECJ case law suggests that the Court is likely to rule in favor of restricting Member States from levying corporate exit taxes on foregone claims and hidden reserves, this is by

⁸ See e.g. Case C-324/00, *Lankhorst-Hohorst GmbH vs. Finanzamt Steinfurt*, [2002] ECR I 1179 – a German tax case; Case C-168/01, *Bosal Holding BV vs. Staatsscretaris van Financien* [2003] ECR I-9409 – a Dutch tax case; Case C-446/03, *Marks & Spencer plc vs. David Hasley (HM Inspector of Taxes)*, not yet reported – a UK tax case..

These judgments are available at <http://europa.eu.int/cj/en/content/juris/index.htm>.

⁹ Case C-204/90 *Bachmann* [1992] ECR I-249.

¹⁰ See the Council Directive 2005/19/EC [2005] OJ L 58/19, amending Council directive on the common system of taxation applicable to mergers, divisions, transfer of assets and exchanges of shares concerning companies of different member states, Council Directive 90/434/EEC [1990] OJ L 225/1.

¹¹ Case C-9/02, *Hughes de Lasteyrie du Saillant vs. Ministère de l'Economie, des Finances et de l'Industrie*, 2004 ECR 2409.

no mean certain. Moreover, should the ECJ eventually do so, the main beneficiaries (larger established companies) may be worse off from changes in the *status quo*. Pro-taxpayer case law is likely to trigger tax measures at the domestic and international level that could prove more costly than the gains from greater freedom of movement (Hertig 2004). Hence, there is some evidence that Member States, in particular the UK, systematically adjust their tax laws to minimize the impact of ECJ judgments and that freedom of establishment case law is driven by smaller rather than larger firms – an indication that the latter generally do not expect to significantly gain from it.

This does not mean that only those firms that can afford reincorporation will benefit from regulatory arbitrage and regulatory competition in the corporate law area. The trend set in train by the Centros, Überseering and Inspire Art judgments has directly influenced the policy space of the European Commission. Hence, the introduction of the new directive on cross-border-mergers,¹² and announced plans for a directive on the cross-border transfer of the administrative office of firms can be considered as initiatives that evidence the shift toward a mobility-oriented lawmaking agenda. In addition, various Member States have responded to demands of domestic firms for innovative company law terms. An ever-wider array of Member States, such as Ireland, UK, Luxembourg and the Netherlands, have prioritized the creation of corporate law rules that directly benefit footloose foreign companies operating in other jurisdictions. But others, France and Germany in particular, have the more specific objective to make reincorporation in the UK less economically attractive (see also Heine 2003; Vermeulen 2003). Given these pressures, it now becomes easier to understand why EC policymakers - with fixed positions - have agreed to adopt a new legislative model that fosters diversity and allows (some) choice.

¹² Directive 2005/56/EC, [2005] OJ L 310/1.

D. The Benefits of a Pro-Choice Approach

This section examines the advantages of a pro-choice approach as applied to corporate law, taking into account the economic theory of incomplete contracts, the risk of opportunistic behavior and endowment effects.

1. Economic Theory of Incomplete Contracts and Default Rules

As many corporate contracts are incomplete, the economic theory of incomplete contracts can play an important role in deciding how to resolve conflicts when there is a missing term or a contract is opaque (Bratton, Hviid and McCahery 1996). A contract is complete only if all relevant contingencies and corresponding control rights are specified unambiguously. Still, parties may deliberately choose non-contingent contract or be unable to design a contract that deals with all contingencies *ex ante* (Hart and Moore 1998).

The literature predicts that a particular type of agreement may be incomplete due to informational asymmetries and limitations in contractual language. The intuition behind this approach is that the parties could most likely write a complete contract if they could focus on a breach and through backward induction develop a full set of governing optional terms. Whether parties can depend on backward induction to deal with their long-term contracting problems is, however, questionable (Posner 2003).

Law and economics theory has produced an impressive variety of gap-filling alternatives to deal with the incompleteness of corporate contracts. Prominent scholars have argued that corporate law should provide a single set of gap-filling rules that hypothetical parties would have bargained for (Easterbrook and Fischel 1991). The adoption of an efficient set of default rules provides firms with opportunities and solutions that otherwise would not be available and reduces transaction costs of opting into specific terms. Naturally, business parties who find the default rule undesirable would remain free to opt out and contract

into a term they prefer.

In recent years, scholars have challenged whether market-mimicking rules encourage efficiency, positing that under other circumstances the majoritarian default rule does not have any efficient effects at all, and that courts presumably will find it more complex to apply such defaults to all types of firms (Posner 2003; Ben-Shahar 2004). A contrasting approach is offered by scholars who endorse the penalty default doctrine. In this view, suppletory rules that parties would not have chosen for themselves, called ‘penalty defaults’, may prove more efficient than majoritarian defaults because they force parties to share information with third parties who might be affected by the contract (Ayres and Gertner 1989). However, even if penalty defaults could limit negative externalities, it is not clear at all whether the doctrine could become effective generally (Posner 2003).

A more straightforward alternative approach to a single set of state-supplied defaults is to encourage lawmakers to supply a wide-range menu of corporate law options. We argue that, given the dire experience of so many European countries with mandatory corporate law regimes, passing reforms that allow corporations to select from a menu of contractual provisions is likely to result in significant benefits. More specifically, the next section will show how a corporate law regime using both opt-in and opt-out rules can yield benefits to business parties and shareholders.

2. Opt-In and Opt-Out Rules in EC Company Law

It follows from the above discussion, that if the European Commission were to introduce reforms designed to provide a menu of optional substantive rules, the resulting legislation could increase the incentives to reduce transaction costs, thereby increasing shareholder value. Given the ever-changing nature of the business environment, an effective enabling approach ideally should also include both opt-in and opt-out procedures (Joll and Sunstein 2005). To illustrate this point, lawmakers could draft an opt-in provision that allows shareholders a choice in favor of a rule that will give them the right to sue directors (a

procedural option) or to benefit from appraisal rights (a substantive option) in case of a squeeze-out.

The shift toward an opt-in/opt-out approach could also diminish member government conflicts and regulatory deadlocks and thus increase the value of the EC company law regime. The beneficial effects are likely to include the development of a richer regulatory menu and allow for alternative contractual arrangements when abstaining from law-making is not an alternative. In the past, such situations may have led to the adoption of mandatory corporate law arrangements that were biased in favor of one set of contracting parties or another (O'Hara 2000; Rachlinski and Farina 2002; Korobkin 2003). By giving business parties the opportunity to opt-in alternative to biased and costly rules or to opt-out of them through internal bargaining, their interests can be protected against regulatory interventions that they deem inefficient. Another potential benefit of this approach is that firms can benefit directly from the choice of a-la-carte legal rules without having to re-incorporate into a friendlier Member State company law regime.

Conversely, the uncertainty surrounding a policy permitting business parties to decide among options may create some skepticism about the wealth effects of this approach. There are a number of reasons. First, allowing shareholders to opt into or out of EU or Member State's rules could undermine, given heterogeneous preferences of Member States, the incentives of the Commission to propose and implement legislation. In particular, moving from a mandatory harmonization regime or an "abstain or comply" approach to a clear choice regime with multiple alternatives may increase (albeit probably only slightly) the chances of deadlock by preventing the emergence of clear majorities. Second, the process of introducing enhanced contractual choice could significantly increase the number of legal options available thereby making it more difficult and costly for business parties to ascertain and select the most appropriate rule.

Finally, while the presumption is that parties tend toward efficient outcomes, it may be necessary for regulators who care about efficiency to introduce the conditions which enable the parties to

achieve the result. In some cases, this will require the creation of stringent mandatory provisions, rather than defaults, in order to constrain opportunistic behavior. Economic theory indicates that costly opportunism typically occurs at the entry or exit stages. This means that minority investors could be better off with a mandatory provision, such as a fair value squeeze out rule, as a protection against opportunism by controlling shareholders and managers. Some commentators argue, moreover, that stringent mandatory rules can protect entrepreneurs from early stage hold-up problems, which is likely to promote social welfare by facilitating the absolute number of start-ups (Hyytinen and Takalo 2005). What emerges from these arguments is the observation that policymakers must, when designing mandatory rules and legal options, find the proper balance between the different interests and ensure that parties reach efficient agreements.

3. The Endowment Effect and Legal Options

It is well known that cognitive distortions, such as the endowment effect, can explain why economic actors do not always reach efficient outcomes. The endowment effect, which is reflected in people's preferences for the status quo, can be observed in laboratory experiments. To be sure, the cost of the endowment effect for markets remains uncertain (Glaeser 2004; Plott and Zeiler 2005) and the regulatory implications are not yet well understood (Korobkin 2003). Yet the behavioral analysis of legal options is a robust literature that takes seriously the implications of cognitive biases for legal rules and economic welfare (see Bar-Gill 2005; Jolls and Sunstein 2005).

From a behavioral perspective, corporate law reformers considering a switch to a legal options approach should pay special attention to stickiness issues. We know that lawmakers can reduce the cost of contracting by providing off-the-shelf provisions that permit parties to avoid the costs of negotiating and drafting a customized term. What remains unclear is the extent to which the benefits resulting from economic actors taking advantage of such provisions are reduced by the costs imposed by the existence of default rules on

firms for which it would be efficient to opt-out. In particular, opting-out may prove expensive or even overly costly because of stakeholders' preference for the standardized norm provided by the default rule.

Conversely, offering firms a set of opt-in provisions that depart from "comply or explain" corporate governance codes may prove efficient. It could make it less costly for firms to exit inefficient one-size-fits-all rules by reducing the transaction and reputation costs of justifying to investors why they are not in compliance with a good practice recommendation. But opt-ins may have their drawbacks too. For example, investors may resist the opting into a more favorable EU regime because a status quo bias makes them prefer the existing national corporate law regime or because they do not want the firm to adopt an approach that deviates from the mean (Sunstein 2002).

More generally, it could also be argued that default rules can deter the opportunistic conduct of majority shareholders and managers more effectively than the current mandatory regime. For example, adopting an unlimited liability default rule for corporate tortfeasors could have significant redistributive consequences for contract creditors (Hansmann and Kraakman 1991). On the other hand, such a default rule does not necessarily benefit the intended group (Sunstein 2002).

It is difficult to compare these advantages and disadvantages in the abstract, even more so considering that cognitive biases are context specific. On the other hand, it appears that there is no indication that legal options should be avoided provided some attention is given to their efficiency in terms of status quo or other bias, such as excessive optimism.

Overall, we argue that adopting pro-choice provisions will prove advantageous to the interests of firms and investors. The opportunity to select rules that firms prefer without having to reincorporate in another Member State is likely to lead to significant cost-savings. These advantages are unlikely to be offset due to capture by interest groups, excessive diversity, and cognitive uncertainties. First, adopting entry/exit voting rules should prevent one constituency (managers

controlling shareholders, minorities) from acting opportunistically. Second, any increase in legal diversity should benefit most European firms as their needs tend to differ across classes. Some firms may suffer higher costs because of reduced standardization, but this should not prove sufficient to outweigh the benefits for other firms (Berglöf and Burkart 2003). Third, and most importantly, adopting a step-by-step approach, under which a limited number of legal options are tested during an introductory phase, should limit the risk of regulatory inefficiencies or distortions.

E. Step-by-Step Reform Recommendations

In this section, we develop a set of reform suggestions based on the investigations above. It is crucial to note that most studies suggest that a new regulatory approach cannot be expected to be incorporated within the existing framework without proper consideration and assessment regarding the impact on other rules and regulations as well as the effect of such an approach for investors, creditors and other stakeholders (European Policy Forum 2004a; 2004b).

A law reform proposal based on our regulatory choice model may prove complex and thus place a burden on EU policymakers and regulators. Moreover, a legal options approach is likely to create significant market and regulatory uncertainties. In this respect, we propose that implementation should occur initially in only a handful of areas. Adopting a simpler, unbundled approach makes it possible to pay closer inspection to the respective merits of the default measures and their effectiveness in practice.

In the next sections, we examine the company and governance law areas that are best suited to mandates and the areas that would benefit, in principle, from legal options. This will permit us to propose a step-by-step approach allowing for early adoption of a limited number of opt-ins and opt-outs. A trial introductory phase would permit benchmarking and testing of their use and potential impact.

1. Mandatory requirements

As noted above, the introduction of default rules does not eliminate the need for mandatory requirements to address contracting problems of firms. A good example is corporate disclosure, an area in which regulatory mandates have significant coordination and standardization advantages. It is worth noting also that legal options may have to be complemented by mandatory procedural rules (Hertig and McCahery 2004). In the next section, for example, we will show that EU opt-in or opt-out provisions would make little sense as a governance mechanism in controlling shareholders environments, unless reinforced by mandatory approval requirements such as minority shareholder or judicial ratification.

In recent years, the EU has adopted a fair number of transparency requirements. Despite the demand for more disclosure and the importance of such information for asset allocations, scholars have questioned the effectiveness of these reforms without the creation of an agency, such as a European SEC, to induce firms to make reliable and accurate disclosure of financial and non-financial information (Hertig and Lee 2003). Since none of the crucial enforcement mechanisms or institutions are likely to be introduced in the short term, it may not make much sense to propose new corporate disclosure requirements that will end up increasing the cost to firms and provide little additional information to investors.

Still, it appears that the mechanism of disclosure is particularly crucial for investors, especially in light of the sequence of increasingly blatant misinformation by public companies (culminating with the Parmalat scandal), and the emphasis given by policymakers to it, despite the absence of effective enforcement bodies, is understandable. Hence, the EU has recently adopted new auditing standards as well as requirements to rotate auditors on a regular basis and to designate a single, fully responsible auditor for groups of companies.

Various commentators question the efficiency of some of these new reforms for protecting the interests of investors. 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 level of gatekeeper supervision could reinforce investor confidence (Jain, Kim and Rezaee 2004) and prevent auditor liability from becoming prohibitive (Coffee 2002). A case can thus be made for new auditing firm regulation that addresses some of the perceived technical shortcomings and the conflicts of interest problems that have contributed to costly governance failures.

Restoring investor confidence has particular appeal in the EU context and has led to calls for EU lawmakers to liberalize the barriers to private enforcement (Hertig and McCahery 2003). Given the importance of ensuring effective financial reporting and limiting opportunism, lawmakers could simply mandate that all shareholders of firms incorporated in the EU have the right to sue for breaches of shareholder voting rules and for violations of managerial or controlling shareholder fiduciary duties. At the same time, Member States could also be required to establish courts specialized in shareholder litigation, with the French Tribunal de Commerce, the German Handelsgericht or the Delaware Chancery Court as possible models. Finally, the EU could further introduce reforms that lead to the adoption of pre-trial discovery procedures and mass litigation devices such as class actions and contingent fees. Such a shift would build on mechanisms that already exist (in law or in fact) in several Member States and therefore appear to reinforce and extend upon the institutions that exist in these countries.

Yet there are a number of objections that could be advanced against such proposals. First, there is the view that EU policymakers should address only substantive law issues, leaving the enforcement of company law and securities regulation to member governments. While the case can be made for such a delegation, it is not very persuasive particularly in light of the level of harmful activity and the complexity of the regulatory task. In any event, EU policymakers and the Commission naturally assume that the need for effective enforcement is a high priority of the EU. Moreover, given the large number of

Member State enforcement systems that clash with the fundamental objective of providing equivalent levels of substantive protection across the internal market, EU intervention could be considered compatible with the principle of subsidiarity.¹³

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, US 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, these type of reforms are listed among the top 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 US than in Europe. The empirical evidence, however, is mixed (compare Eisenberg et al. 2002; Hersch and Viscusi 2004). The effect of fees reforms on enforcement levels is still another area where there is no clear direction which could give guidance in the debate. For many years, the law and economics literature has suggested that contingent fees are the fuel that has powered US- type litigation. Conversely, an apparently innocuous reduction of filing fees was apparently sufficient by itself appears to have caused an impressive increase in shareholder litigation in Japan (West 2001).

It would seem that these studies make it difficult to summarily dismiss the efficiency of an EU imposed reduction in enforcement barriers. On the other hand, it cannot be disputed that such a reform presupposes a sophisticated economic analysis of the costs and benefits of the proposed measures and their effect on other rules and procedures as well. More importantly, mandatory enforcement reforms would face fierce opposition by Member States who challenge the introduction of litigation on political, cultural or even protectionist

¹³ See Directive 2004/48/EC on the enforcement of intellectual property rights, [2004] OJ L 195/16; Market Abuse Directive 2003/6/EC, [2003] OJ L 96/16.

grounds. In other words, any attempt to impose a reduction in enforcement barriers is likely to face considerable delay or even certain defeat. In short, it would make little sense to propose mandatory requirements in this area at this stage. As far as further steps are concerned, the ease with which the UK has sought to introduce new regulation on auditing and shareholder litigation suggests that some countries would certainly benefit from EU enhanced enforcement through private litigation in order to shore up weak institutions.

2. Finite set of competing legal options

A competing options approach of the kind previously adopted by the EC in the case of the accounting directives, permits Member States to choose among a finite set of more or less conservative standards as well as to exempt small to medium-size firms (SMEs) from specific requirements deemed to be too costly. Our analysis suggests that this approach has important beneficial effects. It makes it easier for firms to identify variations in the Member States' rules. There is some evidence, moreover, that enhanced choice will lead Member States to switch to a less demanding regime for SMEs and hence reduce the regulatory burden for this class of firms.

It is worth pointing out, however, that the experience with the accounting directives has been far from successful. To be sure, whilst there are a number of factors responsible, we suspect that the problems may be due to the options being designed to deal with other regulatory concerns than efficiency. More generally, the experience tends to confirm that it is generally a mistake to impose a fixed menu of options 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.

An additional key point is that adopting a finite set of competing legal 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 preferences. Unfortunately, the likely result will be a set of options which has few benefits and thus all the more difficult to justify. In addition, the existence of multiple options should increase the petrification effect, as amendments would have to be coordinated and should thus be more difficult to pass than when there is only one mandate or one legal option. The potential weakness of the finite set of competing legal options approach suggest that it is not ideally suited to the current institutional and political environment and hence should not be considered as a mechanisms for first step company law reforms.

3. Opting-out of EU provisions

It was argued earlier that an opting-out approach is more efficient than mandates, particularly where there are significant variations in corporate governance and company law regimes across Member States. In such a situation, a single mandatory set of EU provisions would have a different impact in each Member State, with many firms incurring costs far in excess of standardization and other benefits. For example, differences in the use of the open corporate form by smaller firm and shareholder structure (dispersed or concentrated) can considerably affect the efficiency of director independence mandates.

By contrast, permitting Member States or firms to opt out of EU provisions should eliminate most of the costs due to legal diversity. Unsurprisingly, this is particularly relevant in light of the debate on one-share-one-vote. The EC has recently announced plans to introduce legislation that would mandate one-share-one-vote. Most studies indicate that, within the EU, there are voting systems in which blockholders enjoy all or most of the private benefits as a consequence of their use of dual-class stock, non-voting ownership certificates, trust companies, and other cash-flow rights (McCahery et al 2003). However, there are significant differences in voting systems and impact across EU Member States (Deminor 2005).

Given this diversity, the question is whether shareholders would

support a EU proposal where there is some uncertainty about its potential outcome. Indeed, there are complex economic arguments in respect of the efficiency of the one-share-one-vote rule. On the one hand, deviations from the one-share-one-vote rule may decrease controlling shareholders' cost of capital (Hart and Moore 1988) and possibly increase takeover efficiency (but see Coates 2001; McCahery et al 2003). On the other hand, the issuance of dual class voting shares may facilitate the transfer of resources from the company to a large shareholder and lead to the oppression of minority shareholders. Thus shareholders, in balancing these considerations, will have to take account of a large number of factors in determining what capital structure can be expected to produce the highest value. This is a complex firm-specific undertaking, and shareholders may prefer having a one-share-one vote regime that they can opt out of rather than having it imposed upon them.

This one-share-one-vote example is not meant to imply that opt-outs are costless. First, as indicated, stickiness may prevent firms from opting out of all but the most costly EU provisions. Stickiness costs may, however, be reduced by adopting EU provisions that are tilted in favor of shareholders (Bebchuck and Hamdani 2002). Second, allowing opt-outs reduces the standardization advantage of EU law-making, especially when domestic corporate law regimes vary significantly. This is, however, precisely the situation where Member States are likely to oppose or delay mandatory harmonization, but agree on opt-out provisions. Indeed, member government opposition to EU law-making should remain relatively light when they themselves are allowed to opt-out.¹⁴ Naturally, opposition could be more significant when firms also have the right to opt-out, but that can be mitigated by combining Member State opt-out powers and firms' right to opt back into EU law.

That said, most studies indicate that it would be efficient for the EU to adopt legal provisions with opting-out possibilities in many

¹⁴ Opposition will not necessarily be inexistent, as some Member States may fear that the adoption of EU provisions may make opt-outs unsustainable in the long-term.

areas of company law and corporate governance. Such an approach would have a number of advantages. First, it could enable Member States to also opt-out of controversial provisions such as the Takeover Directive's equitable price, squeeze-out and sell-out provisions. Second, new firms could be subject to one share/one vote, no staggered boards, no voting caps, no pyramid structures requirements, but allowed to opt-out in favor of the regime of the Member State they are incorporated in – the latter limitation aiming at insuring some degree of uniformity and transparency. Third, shareholders of both new firms and firms established in new Member States could be recognized standing to sue for breaches of shareholder voting rules and violations of fiduciary duties, but allowed to opt-out in favor of the regime of the Member state they are incorporated in. (By contrast, established firms in pre-2004 Member States could be recognized to opt into such a regime.)

At this stage, however, there are several reasons to caution against the adoption of opt-out provisions in such a large array of corporate law areas. In practice, such a reform could place too many items on the reform agenda, thereby creating the very same delay in implementation that has arisen under the Commission's mandatory company law harmonization program. At the same time, as indicated, it is preferable to adopt a step-by-step approach when introducing new regulatory mechanisms. Finally, the shift to opt-out provisions must remain limited to avoid excessive legal diversity.

4. Opting into EU law

As argued above, EU intervention could also increase firms' choice while avoiding reincorporation issues by supplying firms with selective opt-in provisions that allow them to opt-out of *specific* Member state level company law arrangements – as opposed to the full opt-out brought by reincorporation

The opt-in approach can be cost effective since it provides firms with a small menu of EU provisions that lower transaction costs and increases the degree of standardization and, therefore, legal

certainty. Firms may also be better served by opt-ins that credibly signal a commitment to comply with state-of-the-art regulation. Another important factor is that opt-in provisions can be useful for companies that must address legal difficulties, such as workers' participation requirements.

The opt-in approach, however, may also be compelled by political expediency. Subjecting an EU opt-in proposal on related party transactions, for instance, to a shareholder vote would have no impact on constraining controlling shareholder opportunism – but still looks better than forgoing any intervention. Member States may also favor opt-in provisions to prevent the adoption of more efficient opting-out provisions. A potential example is a proposal on dividend rights for minority shareholders. Likewise, Member States could support opt-in provisions because they are likely to 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, could prove to be less cost effective than expected. In such circumstances, caution is welcome, particularly when there are hard opt-in choices. 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” signaling is important for investors or stakeholders.

Opt-ins seem 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, be required to complement such opt-in arrangements, both to prevent Member States from opposing their adoption and minimize managerial and shareholder opportunism. Thus, opting into EU employee participation provisions could, for instance, be made subject to court ratification.

Similarly, the opting into EU multiple voting and dividend rights provisions or into EU mandatory bid thresholds and exit prices might 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 serve a pro-enforcement function. Under this approach, existing firms in “old” Member States would be encouraged to choose litigation 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 endorse an opt-in measure, to the extent it provides a civil enforcement alternative to criminal investigations and sanctions.

G. Conclusion: the Future of the Pro-Choice Approach

Our review suggests that it might be feasible in the near term for the EU to adopt a legal options approach. However, the EU’s experience could prove short lived if it cannot quickly develop a feasible role for this mechanism. Should options not play the role promised, the Commission could easily slip back into anti-choice mode if it perceives there are better ways to maximize its role in the legislative process. In this respect, the Commission could be expected to revert to a mandatory approach should this secure the support of a law-making majority comprising Member States and members of the European Parliament opposed to regulatory arbitrage and competition.

That said, it may be difficult for policymakers to limit the momentum of the pro-freedom movement that has been opened-up by

the ECJ's freedom of establishment judgments. First, it is well established that legislative attempts to counter major case law developments are usually unsuccessful (Cooter and Ginsburg 1996). Even if it is not unusual to see diverging positions gradually erode toward a common middle ground, this process is time-consuming and firms are unlikely to remain idle throughout the convergence process. Second, access to the pro-freedom path is now substantially controlled by the judiciary and pro-choice Member States, and therefore largely outside the reach of a political alliance comprising the European Commission and anti-choice constituencies.

Moreover, we suspect that Member States and interest groups opposed to regulatory arbitrage and competition may find it preferable to "guide" firms' legal regime strategies through pro-choice EU legislation rather than engage less effective mandatory harmonization exercises. Indeed, given the mentioned history of slow legislative reaction to major case law developments and continued diversity of national governance regimes, one should expect years of intergovernmental negotiations on the possible terms the new mandatory measures. While generally accepted by parties in the past, this cumbersome process is unlikely to prove sustainable in the face of continuing regulatory arbitrage and competition.

By contrast, a pro-choice approach could serve to significantly accelerate the law-making process. More importantly, the approach is likely to permit EU law-makers to set the framework within which regulatory arbitrage and competition take place. Indeed, EU legal options have two major advantages. First, their standardization value automatically extends to the EU as a whole. Second, they allow for selective choices. Firms will be able to opt into those EU provisions they prefer, whereas Member States can only offer full opt-ins (incorporation or reincorporation results in the applicability of the corporate law regime as a whole).

While it is difficult to predict with certainty, we foresee the Commission moving toward the adoption of a pro-choice approach as it provides the best mechanism for successfully adopting and implementing "essential" legislation. This prediction is reinforced by a

variety of other considerations. A review of the legislative history of the Takeover Bids Directive suggest that the key institutional actors within the EU have already recognized there is no longer one approach to regulatory design in corporate law. Moreover, pro-choice arrangements are becoming a favored mechanism to secure benefits in unrelated areas (e.g. trading temporary workers legislation against takeover provisions), to target regulatory beneficiaries (e.g. by allowing sophisticated capital market players to opt-out of investor protection provisions) or to facilitate the EU enlargement process (e.g. by permitting firms in new Member States to signal their commitment to “best practice” by opting into EU corporate law provisions). Thus, while options may not in themselves create efficiency, they are crucial for parties to bargain to such conclusions and can play an important role in promoting the goals of economic integration.

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