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## **Summary**

In this paper, we lay out the structure of the regulatory competition argument and consider how the structure of EC company law has become more responsive to the market-place as a consequence of decisions by the ECJ and the corporate law-making process in the EU. We also assess the advantages of the pro-choice approach over the mandatory EC company law regime. Furthermore, we show the legal options model which develops menus of default rules to regulate transparency, accounts and director liability. This paper argues that a step-by-step approach implementing options is likely to yield higher benefits than mandatory corporate law provisions. We recommend a limited number of opt-in and opt-out provisions that would reduce conflict and perhaps be socially optimal.

## ***Legal Options: Toward Better EC Company Law Regulation***

*Gerard Hertig\* and Joseph A McCahery\*\**

Since the 1980s, legal options have been the subject of heated debate in the United States, and such debate has already led to a number of important reforms. Default rules and a variety of option techniques now feature in a wide range of contexts. In particular, they have been employed to accommodate the diversity in organisation, capital structure and lines of business. Increasingly, options have begun to play an important role in shaping the EU company and securities law rules that we observe today. Similarly, law-makers at the Member State level are injecting elements of optional law into the current round of reforms on economic policy and company law.

These debates about options have largely focused on the economic impact of switching a particular default rule. Options are often heralded by proponents as providing firms, where contracts are silent or incomplete, with an array of contractual

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terms on particular subjects, such as capital contributions, dividend rate, management remuneration and tenure, which encourage efficient contracting. A basic insight into this line of research is that default rules can create beneficial effects where standardisation *ex ante* is not yet feasible, and in that sense the defaults create a system of rights that parties are free to contract around. With legal options, parties are permitted to opt out of default terms and can select a particular rule that suits their needs. This approach, as proponents argue, is necessary as it allows business parties to reduce information problems and lower the cost of contracting that they otherwise would incur.

On the other hand, opponents argue that, despite the positive features of options, there are a number of situations where a mandatory rule would certainly benefit shareholders against the self-interested conduct of insiders. There are, it is argued, strong reasons to believe that under some circumstances a mandatory rule may be desirable to protect third parties. Moreover, the use of a mandatory rule may be justified where the law or regulation in question is uncertain or unclear. Proponents of this approach argue that if a switch to an enabling regime imposes excessive costs for firms, then it may not be justified to have firms choose legal terms, in particular, if the choice is suboptimal for the firm.

A significant part of the modern debate on options has involved the balancing of potential benefits and costs in comparison to mandatory rules. Many legal scholars have approached their analysis of options by pointing to the important ways in which options are likely to influence the productivity of firms. According to this view, options can ensure that companies are able to select arrangements that may cause fewer difficulties, allow for the possibility of efficiency-enhancing measures that can

be expected to reduce transaction costs, and promote the institutional environment that could facilitate choice between regulatory regimes. In particular, a strain of the finance literature that has been influential in corporate legal scholarship has argued that facilitating choice is likely to enhance individual options pricing and may well, in certain circumstances, give rise to welfare effects. For some proponents, such a regime is also likely to have a significant effect on the preferences and behaviour of individuals. However, regardless of the extent to which default rules may inflict damage on some parties or may be more costly than the benefits created, there is sufficient evidence suggesting that the value of options is 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 and make it difficult for company participants to adopt cost-saving rules that benefit shareholders and control managerial opportunism.

The debate over legal options has also involved the cross-country comparison of their use, revealing some interesting results about the effect of default rules on firm performance. The enabling structure of US state law, for example, supplies firms with few mandates and offers a menu of default rules that allow firms to economise on transaction costs such as drafting, information and enforcement costs, and to limit opportunism and fill in gap-ridden contracts. If *ex ante* constraints are desired, the burden is on the equity holder or creditor to constrain the management with explicit contract terms. The US approach, which leaves central matters unconstrained, encourages firms to take an active role in defining the relationships between the participants inside the firm and the representation of the firm in its dealings with outside participants, particularly creditors. For proponents of this approach, firms have different sets of choices available to solve problems that can inhibit innovation

and reduce productive efficiency.

A familiar complaint in the EU is that firms enjoy too few opportunities to select freely between legal rules and jurisdictions when structuring their relationships. Some scholars argue that the absence of state competition in the EU is the main reason law-makers, on both the EU and national levels, have brought about a burdensome and undesirable system of regulation that provides few incentives and choices for firms to become more efficient. To the extent that firms have continued to face considerable regulatory barriers to opting into a different corporate law regime, then the law-maker would face few pressures from organised interest groups to provide default rules that would maximise social welfare. In this respect, the regulatory competition model suggests provides much-needed incentives for governments to give credible assurance to firms that law-makers can be relied on to supply optimal legal rules which are attractive to many different types of firms.

A central issue in the debate has been whether the EC's reliance on a narrow range of legal mechanisms is the main factor constraining the move toward choice. This is important because existing theory and practice suggest 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 'comply and explain' measures, which are often linked to a country's corporation law and can be interpreted by the courts. In this context, the EC has sought to introduce a widespread set of initiatives in the areas of accounting, auditing, corporate governance and company law based on the need to establish better and more flexible regulatory mechanisms. In order to achieve these aims, the Commission articulated its views on the measures required to improve EU legislation in its Communication on

Modernising Company Law and Enhancing Corporate Governance in the EU—A Plan to Move Forward (‘Action Plan’). As for the Action Plan, the policy decisions taken by the Commission were shaped by the need to align principal–agent interests in the wake of the Enron and Parmalat scandals by providing more shareholder-oriented rules, including offering more shareholder rights, improving transparency and strengthening the position of non-executive directors.

To this end, 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. The prevailing EU regulatory strategy in corporate governance and company law relies on a combination of directives, recommendations and self-regulation to accommodate these wide-ranging regulatory reforms. 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 benefits of the Commission’s reforms, several scholars have asked whether there might be better, lower-cost legal strategies that could be used to deliver more effective results for the benefit of investors.<sup>1</sup> Some authors are less than sanguine whether the EC will be able to determine which menu of rules will have the greatest beneficial effect on shareholders.

This chapter argues that an options system is preferable to a mandatory regime since it favours shareholder welfare as the basis for assessing the proposed regulatory

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<sup>1</sup> P Davies, ‘Enron and Corporate Governance Reforms in the UK and European Community’ in J Armour and JA McCahery (eds), *After Enron: Improving Corporate Law and Modernising Securities Regulation in Europe and the US* (Oxford, Hart Publishing, 2006).

reforms. Regulatory intervention through legal options, moreover, is a more effective policy instrument because it allows firms to pursue cost-saving arrangements that better match their needs. This chapter will explain the beneficial aspects of an EC company law reform policy that makes use of opt-in and opt-out default rules to improve flexibility and firm performance. A limited menu of default rules will be proposed in order to avoid legislative paralysis, and as a means for allowing regulators to assess the effect of options on firm behavior. It can be expected that the proposed opt-ins and opt-outs will improve firm quality by providing firms with an enhanced set of rules allowing them to respond better to market needs and other risks.

There could potentially be concerns that optional arrangements may be subject to behavioural shortcomings. Some studies suggest that default rules can induce cognitive distortions that can have significant effects when people treat them like endowments. This occurs particularly when an entitlement is embedded in a contract. On this view, even if a default rule is biased in favour of a group of individuals, it will have no positive impact on these people. Moreover, there is also evidence that points to the stickiness of default rules making it more difficult for firms to opt out of legal provisions. Even if this point has some validity, 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 a switch in the default rule may have desirable effects by improving welfare.<sup>2</sup> Finally, since it seems likely that the possible cognitive problems associated with defaults rules are not substantial, it makes great sense to

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<sup>2</sup> See CR Sunstein, 'Switching the Default Rule' (2002) 77 *New York University Law Review* 106.

provide for options so as to achieve the benefits that cannot be accomplished by harmonised directives in the field of company law.

That said, there are good reasons for recommending a cautious, piecemeal 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 issues that afflict the mandatory harmonisation approach. Secondly, 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.

The regulation of EC company law through a system of legal options has several advantages over the present regime. First, the use of options permits the EC and Member States to limit the risk of further intrusions by the European Court of Justice (ECJ) in the company law-making process. Secondly, to the extent that the options approach is preferred by interest groups and companies, they will have strong incentives to support the approach through increased demand for the use of options in most corporate law areas.

This chapter will proceed as follows. Part A lays out the structure of the regulatory competition argument and considers how the structure of EC company law has become more responsive to the market-place as a consequence of decisions by the ECJ and the corporate law-making process in the EU. Part B assesses the advantages of the pro-choice approach over the mandatory EC company law regime. Part C applies the legal options model in developing menus of default rules to regulate transparency, accounts and director liability. This chapter argues that a step-by-step approach implementing options is likely to yield higher benefits than mandatory corporate law provisions. Part D recommends a limited number of opt-in and opt-out

provisions that would reduce conflict and perhaps be socially optimal. Part E concludes.

#### A. ON REGULATORY ARBITRAGE AND COMPETITION

This section considers the workings of regulatory competition in the EU, questioning whether corporate law in the EU can be considered the product of competitive market forces. Some commentators contend that questions of regulatory competition are closely related to the questions of mandatory versus enabling rules, and the level of firm choice generally.

While the EU does not have competition between Member States to create the law that governs public corporations, there is evidence that some forms of competition may be emerging. First, the evidence suggests that, while regulatory competition remains close to non-existent within the EU, the appearance of new judgments from the ECJ supports the inference that regulatory arbitrage is an imminent possibility. Secondly, the threat of state competition, which is less attractive to weakly responsive states, such as France and Germany, can remarkably give rise to a mechanism, such as a system of legal options, for establishing freedom of choice without firms having to move anywhere.

Accordingly, one of the most important debates in European company law is whether a ‘market for corporate law’ will ultimately emerge within the European Union and, if so, whether it will be based on a Delaware-like model in which companies can freely select their country of incorporation. This is, of course, a politically charged question and therefore a somewhat undifferentiated debate. In

particular, commentators often fail to distinguish between corporate finance, company formation and restructuring issues.<sup>3</sup> Conversely, competition between states in the US is generally assumed to be very active, whereas recent research shows that the reality is subtler. However, there is evidence that domicile choices by US corporations can affect their value and/or provide significant benefits for their managers and controlling shareholders.<sup>4</sup> The absence in Europe of anything resembling American charter competition must therefore mean that there are substantive regulatory barriers to jurisdictional competition.<sup>5</sup>

To start, EU company law can be viewed largely as an incomplete and rather ineffective set of provisions. The reasons: Member States have been repeatedly unable to agree on important substantive issues, there has been a pro-decentralisation presumption resulting from the EU subsidiary principle, and we have witnessed a lack of implementation of EU directives by Member States. This has allowed for continuing diversity in Member State corporate law. At the same time, the rather strong divergence about the ‘optimal’ corporate regime has had the effect of sustaining significant opposition to regulatory arbitrage and competition.

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<sup>3</sup> S Grundmann, ‘Regulatory Competition in European Company Law—Some Different Gains?’ in G Ferrarini, KJ Hopt and E Wymeersch (eds), *Capital Markets in the Age of the EURO* (The Hague, Kluwer, 2002).

<sup>4</sup> M Kahan and E Kamar, ‘The Myth of State Competition in Corporate Law’ (2002) 55 *Stanford Law Review* 679; LA Bebchuk and A Hamdani, ‘Optimal Defaults for Corporate Law Evolution’ (2002) 96 *Northwestern University Law Review* 489.

<sup>5</sup> S Deakin, ‘Regulatory Competition versus Harmonization in European Company Law’ in D Esty and D Geradin (eds), *Regulatory Competition and Economic Integration* (Oxford, OUP, 2001); J McCahery and EPM Vermeulen, ‘The Evolution of Closely Held Business Forms in Europe’ (2001) 26 *Journal of Corporation Law* 857.

Nevertheless, US commentators in particular have argued that change is imminent. Cross-border acquisitions by firms that have cheaper access to external capital because of higher investor protection levels should bring corporate governance amendments.<sup>6</sup> The replacement of banks by institutional shareholders, as the main corporate governance actor, should have a similar effect. In other words, transformations occurring in the market place will result in increased convergence of rules.

In contrast, many European scholars are not as optimistic about the prospects for market-induced reform, given the existence of a strong coalition of interest groups and other path-dependent forces. In particular, the repeated failures, until recently, to pass a Directive on Takeovers show the power of those who benefit from the status quo to block transformational measures.

Of course, institutional barriers at the EU level are not the sole or even main reason for past regulatory and judicial conservatism. Under the *siège réel* (real seat) doctrine, which is followed by the majority of EU Member States, a corporation must be incorporated in the Member State where it has its central administration. As a result, opting into another Member State's corporate law is often unattractive because of significant tax implications, especially for corporations that have used conservative accounting to build up hidden reserves. This barrier to regulatory arbitrage and competition is compounded by employee participation structures, German co-determination being the best known but not the only example. Indeed, by reducing the ability of legislators to respond to managerial or shareholder preferences, employee participation favours regulatory conservatism. Judicial conservatism, for its part, has

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<sup>6</sup> R Gilson, 'Globalizing Corporate Governance' (2001) 49 *American Journal of Comparative Law* 329.

at least as much to do with Member States' reluctance to facilitate or even permit shareholder litigation as it does with EU law deficiencies.

## **1. The Evolution of EC 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. Secondly, the Commission was successful in implementing laws that facilitated cross-border trading by minimising the risk of companies or their transactions being considered void in other Member States. Thirdly, the EU, having adopted accounting and capital maintenance rules aimed at protecting minority shareholders and creditors, was able to secure 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 policy-making authority encountered by the EC? Influential theories of EU law-making emphasise that policy-making space became very limited due to the mixed motives of Member States.<sup>7</sup> 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

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<sup>7</sup> M Pollack, *The Engines of European Integration, Delegation, Agency, and Agenda Setting in the EU* (Oxford, OUP, 2003).

that major company law reforms are not considered important enough for member governments to mobilise resources to achieve legislative compromises.<sup>8</sup>

In order to regain significant agenda-setting powers and the ability to conclude agreements, the Commission eventually reversed its legislative strategy in this area. No single explanation can be offered for the strategy eventually embraced by the Commission. Standard public choice theory would explain the shift in terms of organised special interest groups persuading Commission policy-makers that the group's preferences would serve the policy-makers' own political interests and would become useful in putting together a winning coalition.<sup>9</sup> Naturally there are numerous other explanations to consider. It is surely no coincidence that the Commission sought to counter the moves of Member State governments that sought to block reforms by placing the Lisbon Council's objectives as a top priority, so as to strengthen their policy goals.<sup>10</sup> Similarly, policy-makers may have had an incentive to take an early position on the US corporate scandals in order to shift the expectations of domestic voters, which could be expected to have guided Member State governments' subsequent behaviour. This is clearly represented by the efforts of the Market Commissioner to have the High Level Group of Company Law Experts reach beyond their original mandate to recommend certain audit and accounting and rules regarding

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<sup>8</sup> J Wouters, 'European Company Law: Quo Vadis' (2000) 37 *Common Market Law Review* 257.

<sup>9</sup> AK Dixit and J Londegan, 'Ideology, Tactics, and Efficiency in Redistributive Politics' (1998) 113 *Quarterly Journal of Economics* 497.

<sup>10</sup> See Presidency Conclusions, Lisbon European Council of 23–24 June 2000, available at <http://ue.eu.int/en/Info/eurocouncil/index.htm>). See also <http://europa.eu.int/comm/internmarket/en/company/company/news/01-1237.htm>.

publication of annual accounts.<sup>11</sup>

Perhaps more fundamentally, the EC has responded to the direct political influence of the European Court of Justice's decisions on freedom of establishment.<sup>12</sup> These ECJ decisions have challenged the core elements of the *siège réel* (real seat) doctrine, challenging 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 the cross-border mobility of start-up companies.<sup>13</sup> 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's regime to another. Nonetheless, the ECJ 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.

Even though these disruptive features have induced the EC policy-makers to adopt a less constraining legislative approach, the existing means of opting out of EC law are in practice quite limited. For example, the Commission proposed, in a radical departure from its previous policy, that Member States and firms be allowed to opt out of Articles 9 (board neutrality) and 11 (break-through rule) of the Takeover

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<sup>12</sup> Case 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* [2002] ECR I–9919 (*Überseering*); and Case C–167/01, *Kamer van Koophandel en Fabrieken voor Amsterdam v Inspire Art Ltd* [2003] ECR \*I I-10155 (*Inspire Art*). These judgments are available at <http://europa.eu.int/cj/en/content/juris/index.htm>.

<sup>13</sup> M Becht, C Mayer and H Wagner, 'Corporate Mobility and the Cost of Regulation', ECGI Law Working Paper N. 70/2006, available at [www.ssrn.com](http://www.ssrn.com).

Directive.<sup>14</sup> The provision of the opt-out was received favourably by Member States, ending a regulatory deadlock that had lasted for more than a decade.

That said, the Commission has subsequently created a large and growing number of soft law initiatives that link together national governments' substantive policy concerns with EU level policy-makers' concerns to succeed in transforming their relationship with Member States in terms of agenda setting and the implementation of corporate law rules. The provision of flexible corporate law rules has many advantages. From an efficiency standpoint, non-mandatory soft law measures can provide a range of value-maximising procedures to firms. Correspondingly, the greater range of choice in the selection of policy-making instruments makes it easier to avoid the costs of relying on rigid instruments alone to implement new measures. 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 harmonised provisions, but empower Member States to opt out of them (an approach adopted by the Takeover Directive);
- 4) Enable firms to opt out of applicable Member State provisions by providing substitutable EU provisions (as was also done in the Takeover Directive);
- 5) Adopt an 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 Directive); or

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<sup>14</sup> Dir 2004/25/EC [2004] OJ L142/12.

6) Abstain from legislating.<sup>15</sup>

## 2. Impact on Regulatory Arbitrage and Competition

Overall, it is also intuitive that while many of the policy changes discussed above can have some impact on regulatory arbitrage, the practical effect of these changes across the board 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 increasing choice than the effect of the Commission's new soft law approach to company law-making.

It is well known that tax constraints are a significant barrier to midstream reincorporations. The ECJ's ruling in the *Daily Mail* case shows clearly that a midstream reincorporation will trigger exit taxes on hidden reserves, effectively restricting the demand for chartering.<sup>16</sup> Conversely, there is evidence that corporate law does not significantly constrain tax-driven firm mobility.<sup>17</sup> The same is true for social constraints. The attractiveness of incorporation or reincorporation is often seriously reduced by such steps having no effect on the applicable labour law—a

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<sup>15</sup> Furthermore, reformers can combine approaches. Eg, the Takeover Bids Dir 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 standardisation advantage over Member States' default provisions.

<sup>16</sup> Case 81/1987 *Regina v HM. Treasury and Comm'rs of Inland Revenue, ex parte Daily Mail and General Trust Plc* [1988] ECR 5483.

<sup>17</sup> See GR Simpson, 'EU's tax changes scatter corporations', *The Wall Street Journal* (European edn), 9 Oct 2003, at A6.

situation that is likely to persist in 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 significantly to affect labour-driven firm mobility.

On the other hand, the ECJ's 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 are precluded by the freedom of establishment principle if they discriminate 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 it is necessary to ensure the coherence of the national tax system or to preserve the tax base.<sup>18</sup> This is both in sharp contrast with the ECJ's earlier reluctance to interfere with tax barriers to cross-border activities (as exemplified by *Daily Mail* and *Bachmann*<sup>19</sup>) and in line with the ECJ's recent pro-freedom of incorporation and reincorporation cases.

As a consequence of these tax cases and the implementation of the Merger Directive,<sup>20</sup> commentators are confident that the current tax barriers to cross-border

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<sup>18</sup> See eg Case C-324/00 *Lankhorst-Hohorst GmbH v Finanzamt Steinfurt* [2002] ECR I-1179—a German tax case; Case C-168/01 *Bosal Holding BV v Staatssecretaris van Financiën* [2003] ECR I-9409—a Dutch tax case; Case C-446/03 *Marks & Spencer plc v 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>.

<sup>19</sup> Case C-204/90 *Bachmann* [1992] ECR I-249.

<sup>20</sup> See Council Dir 90/434/EEC (OJ L-225) on the common system of taxation applicable to mergers, divisions, transfer of assets and exchanges of shares concerning companies of different Member States

reincorporation will be removed shortly by the ECJ.<sup>21</sup> Such optimism finds support in the *de Lasteyrie du Saillant* judgment.<sup>22</sup> The ECJ ruled in favour 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 precludes 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 favour of restricting Member States from levying corporate exit taxes on foregone claims and hidden reserves, this is by no mean certain. Should the ECJ eventually do so, larger established companies would be the main beneficiaries. However, this class of companies may be made worse off by changes to the *status quo*, as the EC reforms are likely to trigger tax measures at the domestic and international level that could prove more costly than the gains from greater freedom of movement.<sup>23</sup> In this case, there is some evidence that Member States, in particular the UK, systematically adjust their tax laws to minimise 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 do not expect to gain significantly from it.

This does not mean that only those firms that can afford reincorporation will

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<sup>21</sup> W Schön, 'EC Company Statute and Taxation: Tax Issues and Constraints to Reorganizations and Reincorporations in the EU', Working Paper, Max Planck Institute (Munich, 2003).

<sup>22</sup> Case C-9/02 *Hughes de Lasteyrie du Saillant v Ministère de l'Economie, des Finances et de l'Industrie* [2004] ECR I-2409.

<sup>23</sup> G Hertig, 'Efficient Fostering of EU Regulatory Competition' (2004) 76 *Swiss Review of Business Law* 360.

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 and led to greater policy-making uncertainty with respect to its reform agenda. Hence, the introduction of the new Directive on cross-border mergers, and the announcement of plans for a directive on the cross-border transfer of the administrative offices of firms can be considered as initiatives that evidence the shift toward a mobility-oriented law-making agenda. In addition, various Member States have responded to the demands of domestic firms for innovative company law terms. An ever-wider array of Member States, such as Ireland, the UK, Luxembourg and the Netherlands, have prioritised the creation of corporate law rules that directly benefit footloose foreign companies operating in other jurisdictions.

But others, France and Germany in particular, have responded by attempting to make reincorporation in the UK less economically attractive.<sup>24</sup> Despite these efforts, nearly 30,000 German entrepreneurs have since 2002 registered their companies as a UK Limited Company \*3 as it is cheaper and less burdensome than registering as a GmbH. While Germany's reputation as a business-friendly environment for start-ups is now under strain, pressures have not built up sufficiently to force through German legislative measures that would involve substantial costs to incumbent groups. At the legislative level, major reforms that would involve deviations from the current rules on the preservation of share capital and the notarial

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<sup>24</sup> See K Heine, 'Regulatory Competition Between Company Laws in the European Union: the *Überseering* Case' (2003) 38 *Intereconomics* 102; EPM Vermeulen, *The Evolution of Legal Business Forms in Europe and the United States* (The Hague, Kluwer Law International, 2003).

deed requirement for the transfer of shares are unlikely to find political support in the near future. Accordingly, German law-makers have recently proposed measures designed to create a modernised GmbH that would make it easier and quicker to incorporate a GmbH, offer a transparent shareholder structure and protect creditors against exploitative and dilutive strategies on the part of the owners of a GmbH.<sup>25</sup>

This analysis offers a positive understanding of the state of regulatory competition in the EU. Naturally, it is quite different from that of the American states in the late nineteenth century. There charter competition was new and unexpected. Competitive response was slow because the home states were mesmerised by antitrust policy concerns. In today's EU, the Member States know all about the possibility of competition as they play their indefinitely repeated game. They have moved to forestall competition in the past, and can be expected to update their strategies to account for ECJ developments. The upshot is that there is little potential for competitive-based law-making to facilitate policy innovation in the short-term. It is in this regard that legal options may be a solution to the absence of a feedback mechanism that induces law-makers to respond to investor preferences.

## B. THE BENEFITS OF A PRO-CHOICE APPROACH

That said, there is an important role for legal options in the EU and Member State law-making processes. Legal options refer to the *ex ante* and *ex post* choices that are created by law. Commentators in Europe have emphasised that law-makers have

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<sup>25</sup> See JA McCahery, EPM Vermeulen, M Hisatake and J Saito, 'The New Company Law: What Matters in an Innovative Economy' [2007] *European Business Organization Law Review* (forthcoming).

tended to introduce choice-enhancing provisions when they have found it difficult and costly to resolve a legislative conflict. This explains why the European Commission, for example, chose to resolve an interest group-induced deadlock over the Takeover Directive by creating legal provisions that allow Member States the option whether to implement the board neutrality and the breakthrough provisions. Even though it is debatable whether the new legislation will have dramatic efficiency or distributional effects, the decision to provide Member States and firms with freedom of choice when no intermediate solutions existed can be considered a credible approach to law reform. Suffice it to say that there is some evidence that allowing Member States to opt out of certain provisions in a piece of proposed legislation may sometimes be the only practical way to ensure that the rules in question, which might be capable of benefiting a large number of firms, become law.

### **1. Economic Theory of Incomplete Contracts and Default Rules**

This section sets out to analyse the main features of the pro-choice approach as applied to corporate law. As many corporate contracts are incomplete, the section will focus on the standard gap-filling approaches that provide definitive default terms for completing contracts. In practice, of course, these approaches are not always suitable for gap-filling because they do not rely on the priority of the bargain. By contrast, we focus on how opt-in and opt-out rules are likely to be a step in the right direction for EC company law.

The economic theory of incomplete contracts is an important foundation for the financial structure of the firm and can play an important role in deciding how to

resolve conflicts when there is a missing term or a contract is opaque.<sup>26</sup> A contract is complete only if all relevant contingencies and corresponding control rights are specified unambiguously. It is worth bearing in mind that parties may deliberately choose a non-contingent contract or be unable to design a contract that deals with all contingencies *ex ante*.<sup>27</sup>

The literature predicts that particular types of agreement may be incomplete due to informational asymmetries and the fact that the inherent limitations of contractual language make it impossible to contract for all future contingencies. The intuition behind this approach is that the parties could perhaps write a complete contract if they could focus on a breach and through backward induction develop a full set of optional terms to govern the contract. For many, there is some question whether parties, despite economic theory's rationality assumptions, can depend on backward induction to deal with their long-term contracting problems.<sup>28</sup>

At the same time, the theory of incomplete contracts has proceeded on the assumption that actions are non-contractable *ex ante* but contractable *ex post*. Since symmetrically informed business parties write contract terms *ex ante* based on their own needs, they expect courts to enforce them even if fundamental terms are left undefined. On this view, courts should not intervene *ex post* since it may leave the parties worse off. In recent years, however, there has been a shift toward a more liberal gap-filling approach which diagnoses the different sources of incompleteness

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<sup>26</sup> WW Bratton, M Hviid and JA McCahery, 'Repeated Games, Social Norms and Incomplete Contracts' in C Willett (ed), *Aspects of Fairness in Contract* (London, Blackstone Press, 1996).

<sup>27</sup> O Hart and J Moore, 'Cooperatives vs. Outside Ownership', NBER Working Paper No 6421, National Bureau of Economic Research (\*4 1998).

<sup>28</sup> E Posner, 'Economic Analysis of Contract Law After Three Decades: Success or Failure' (2003) 112 *Yale Law Journal* 829.

and provides the appropriate gap-filling term.<sup>29</sup>

In recent years, the theory of law and economics has produced an impressive variety of gap-filling alternatives. Prominent scholars have argued that corporate law should provide a set of gap-filling rules that hypothetical parties would have bargained for.<sup>30</sup> The adoption of an efficient set of default rules provides firms with opportunities and solutions that otherwise would not be available and reduces the 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.

Over the 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.<sup>31</sup> A contrasting approach is offered by scholars who endorse the penalty default doctrine which recommends forcing parties, in some situations, to share information as they bargain around default rules. For example, to the extent that the enforcement of a liquidated damages clause can limit externalities to third parties, this ‘penalty’ default may create an important efficiency effect.<sup>32</sup> Even if penalty defaults could limit negative externalities, it is not

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<sup>29</sup> O Ben-Shahar, ‘Agreeing to Disagree: Filling Gaps in Deliberately Incomplete Contracts’ [2004] *Wisconsin Law Review* 389.

<sup>30</sup> F Easterbrook and DR Fischel, *The Economic Structure of Corporate Law* (Cambridge, Mass, Harvard University Press, 1991).

<sup>31</sup> Posner, above n28; Ben-Shahar, above n29.

<sup>32</sup> I Ayres, *Optional Law: Real Options in the Structure of Legal Entitlements* (Chicago, Ill, University of Chicago Press, 2005).

clear at all whether the doctrine could become effective generally, as it does not deal directly with the specific contractual variables discussed in the literature, nor does it necessarily take up the preferred set of damages to impose on the breaching party.<sup>33</sup>

Putting aside this debate, it is suggested that European countries can benefit greatly by adopting reforms that may allow corporations to select from a menu of default arrangements. This chapter will deal with how a corporate law regime using both opt-in and opt-out rules can yield benefits for 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 rules, the benefits of this legislation could result in increased incentives to improve productivity, thereby increasing shareholder value. Yet, given the ever-changing nature of the business environment in which firms compete, an effective enabling approach ideally should include both opt-in and opt-out procedures.<sup>34</sup> To illustrate this point, law-makers could draft an opt-in provision that allows shareholders a choice in favour of a provision giving firm investors the right to sue directors (a procedural option) or a regime which allows them to benefit from appraisal rights (a substantive option) in case of a squeeze-out.

Naturally, the shift toward an opt-in/opt-out approach that could diminish member governments' conflicts and regulatory deadlocks will increase the value of

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<sup>33</sup> Posner, above n28.

<sup>34</sup> C Jolls and CR Sunstein, 'Debiasing Through Law' (2005) (Working Paper, available at <http://ssrn.com>).

the EC company law regime. The beneficial effects are likely to include the development of a richer regulatory menu, allowing for alternative contractual arrangements when abstaining from law-making is not an alternative. In the past, such situations may have led, to the extent that some member governments could constrain the Commission's initiatives, to the adoption of mandatory corporate law arrangements where there was a significant risk that the rules would be biased in favour of one set of contracting parties or another.<sup>35</sup> Still, such arrangements may not cause economic actors difficulties in achieving an efficient bargaining outcome if they are free to substitute an alternative to the mandatory rule. Thus, by giving business parties the opportunity to opt in and opt out of biased and costly rules, their interests can be protected against regulatory interventions that they deem costly and ineffective. Moreover, another potential benefit of this approach is that firms can benefit directly from the choice of *à-la-carte* legal rules without having to reincorporate into a more friendly Member State company law regime.

Conversely, the uncertainty surrounding a policy that permits business parties to decide among optional default rules may create some scepticism about the wealth effects of this approach. There are a number of reasons. First, allowing shareholders to opt into or out of EU law or any Member State's rules could undermine, given the heterogeneous preferences of Member States, the incentives bearing on the Commission to propose and implement legislation. In particular, moving from a mandatory harmonisation regime or an 'abstain or comply' approach to a clear choice

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<sup>35</sup> EA O'Hara, 'Opting Out of Regulation: A Public Choice Analysis of Contractual Choice of Law' (2000) 53 *Vanderbilt Law Review* 1551; J Rachlinski and CR Farina, 'Cognitive Psychology and Optimal Government Design' (2002) 87 *Cornell Law Review* 549; R Korobkin, 'The Endowment Effect and Legal Analysis' (2003) 97 *Northwestern Law Review* 1227.

rule with multiple alternatives may increase (albeit probably only slightly) the chances of deadlock by preventing the emergence of clear majorities. Secondly, 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 default 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 that result. In some cases, this will require the creation of stringent mandatory provisions, rather than defaults, in order to constrain opportunistic behaviour. Economic theory indicates that costly opportunism typically occurs at the entry or exit stages. Under this approach, minority investors would be better off with a mandatory provision, such as a fair value squeeze-out rule, that protects them from 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.<sup>36</sup> What emerges from these arguments is the observation that policy-makers must, when designing mandatory and default rules, find the proper balance between the different interests to constrain opportunism and to ensure that parties reach efficient agreements.

### **3. Endowment Effects and Legal Options**

As discussed earlier, studies of legal options and default rules show that alternative

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<sup>36</sup> A Hyytinen and T Takalo, 'Corporate Law and Small Business Finance: Mandatory v. Enabling Rules' (2005) 6 *European Business Organisation Law Review* 449.

rules can have an impact on distributive consequences. 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. Still, the cost of the endowment effect for markets remains uncertain.<sup>37</sup> Naturally, while there is no denying that the investors may not exhibit significant or systematic cognitive biases,<sup>38</sup> the regulatory implications are not yet well understood.<sup>39</sup> Yet the behavioural analysis of legal options is a robust literature that takes seriously the implications of cognitive biases for legal rules and economic welfare.<sup>40</sup>

Default rules are a potentially attractive option for law reformers. There are two possible arguments supporting the switch to defaults. First, law-makers could reduce the cost of contracting by providing off-the-shelf provisions that are efficient without being sticky. Default rules avoid the costs of negotiating and drafting a customised term, and most economic actors can benefit from a rule that encourages cost savings for business parties. At the same time, offering a firm a set of opt-in provisions that depart from Member States' corporate governance codes may also

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<sup>37</sup> EL Glaeser, 'Psychology and the Market' (2004) 94 *American Economic Review* 408; CR Plott and K Zeiler, 'The Willingness to Pay—Willingness to Accept Gap, the "Endowment Effect," Subject Misconceptions, and Experimental Procedures for Eliciting Valuations' (2005) 95 *American Economic Review* 530.

<sup>38</sup> See also J Arlen, M Spitzer and E Talley, 'Endowment Effects Within Corporate Agency Relationships' (2002) 31 *Journal of Legal Studies* 1.

<sup>39</sup> Korokbin, above n35.

<sup>40</sup> See O Bar-Gill, 'Pricing Legal Options: A Behavioral Perspective' (2005), New York University Law and Economics Working paper, no 04–05; Jolls and Sunstein, above n34.

have the beneficial effect of allowing firms to exit inefficient one-size-fits-all rules while reducing the transaction and reputation costs of justifying to investors why they are not in compliance with a code of good practice recommendation.

Again, it can be argued that default rules can deter the opportunistic conduct of majority shareholders and managers more effectively than the current mandatory regime. For example, flipping over \*5 a current default rule, such as the limited liability default rule, to the presumption of unlimited liability for corporate tortfeasors under some conditions, could have an important deterrent effect, as the redistributive consequences for contract creditors who would capture larger gains would be significant.<sup>41</sup> To be sure, flipping over \*6 the default rule may not—for reasons discussed earlier—serve to benefit the intended group.<sup>42</sup> Secondly, Sunstein also suggests that investors may resist opting into a more favourable 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.<sup>43</sup> Thus, ignoring stickiness may result in EU law-makers adopting an opt-in instead of an opt-out or mandatory rule in the mistaken belief that this less interventionist step will suffice to remedy inefficiencies at the Member State level.

Here again, 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 bias or

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<sup>41</sup> H Hansmann and R Kraakman, 'Toward Unlimited Shareholder Liability for Corporate Torts' (1991) 100 *Yale Law Journal* 1879.

<sup>42</sup> Sunstein, above n2.

<sup>43</sup> *Ibid.*

excessive optimism of confidence. Overall, this chapter argues that adopting pro-choice provisions will prove advantageous to the interests of firms and investors. The opportunity for firms to select rules that they prefer without having to reincorporate in another Member State is likely to lead to significant cost savings. Three possible drawbacks—capture by select groups or interests, excessive diversity and cognitive uncertainties—can be easily addressed by the following proposals. First, adopting entry/exit voting rules should prevent one constituency (managers, controlling shareholders, minorities) from acting opportunistically. Secondly, any increase in legal diversity should benefit most European firms as their needs tend to differ across classes. While some firms may suffer higher costs because of reduced standardisation, this should not prove sufficient to outweigh the benefits for other firms.<sup>44</sup> Thirdly, 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.

### C. STEP-BY-STEP REFORM RECOMMENDATIONS

In this section, a set of reform suggestions based on the above investigation into opt-in and opt-out default provisions is developed. It is crucial to note that when developing a law reform proposal based on the model of regulatory choice, the process may be complex and place a burden on policy-makers and regulators. Most studies suggest that the introduction of an effective new regulatory mechanism cannot be expected to be incorporated within the existing framework without proper

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<sup>44</sup> E Berglöf and M Burkart, 'European Takeover Regulation' (April 2003) *Economic Policy* 171.

consideration and assessment regarding the impact of the instrument on other rules and regulations, as well as the effect of such an approach for investors, creditors and other stakeholders. Therefore, any new shift in regulatory approach will necessarily require proponents to show how the proposed instrument or measure will significantly reduce costs and protect the interests of stakeholders.

That said, any attempt to propose a new EC company law reform based on a default rule analysis will be likely to create significant market and regulatory uncertainties. In this respect, it is proposed that the introduction of the options approach should occur initially in only a handful of areas. By adopting a simpler, unbundled approach it may be possible to pay closer inspection to the respective merits of the default measures and whether they are likely to be effective in practice. In the next sections, the company law and governance law that are best suited to mandates and the areas that would benefit, in principle, from legal options will be examined. This will permit us to propose a step-by-step approach allowing for early adoption of a limited number of legal options. A trial introductory phase would permit benchmarking and testing of their use and potential impact.

## **1. Mandatory Requirements**

As noted above, the introduction of legal options does not eliminate the need for mandatory requirements to address the contracting problems of firms. A good example is corporate disclosure, an area in which regulatory mandates have significant coordination and standardisation advantages. It is worth noting also that legal options may have to be complemented by mandatory procedural rules.<sup>45</sup> In the

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<sup>45</sup> G Hertig and JA McCahery, 'An Agenda for Reform: Company and Takeover Law in Europe' in G

next section, for example, we will show that EU opt-in or opt-out provisions would make little sense as a governance mechanism in a controlling shareholders environment unless reinforced by 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 create credible incentives to induce firms to make reliable and accurate disclosure of financial and non-financial information.<sup>46</sup> 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 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 recent sequence of increasingly blatant instances of misinformation by public companies (culminating with the Parmalat scandal). Hence, the emphasis given to it by policy-makers, despite the absence of effective enforcement bodies, is understandable.

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. However, some commentators question the efficiency of

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Ferrarini, K Hopt, J Winter and E Wymeersch (eds), *Modern Company and Takeover Law in Europe* (Oxford, OUP, 2004).

<sup>46</sup> G Hertig and R Lee, 'Four Predictions about the Future of Securities Regulation' (2003) 3 *Journal of Corporate Law Studies* 359.

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 investors' confidence<sup>47</sup> and prevent auditors' liability from becoming prohibitive.<sup>48</sup> A case can thus be made for new auditing regulation that addresses some of the perceived technical shortcomings and the conflicts of interest problems that have contributed to costly governance failures.

Several comparative studies have shown that another, related, technique to reinforce investor confidence would be for the EU to liberalise the barriers to private enforcement.<sup>49</sup> Given the importance of ensuring effective financial reporting and limiting opportunism, law-makers could simply recognise all shareholders of firms incorporated in the EU as having 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 specialising in shareholder litigation, with the French Tribunal de Commerce, the German Handelsgericht or the Delaware Chancery Court as a possible model. Finally, the EU could further introduce reforms leading 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

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<sup>47</sup> P Jain, J Kim and Z Rezaee, 'The Sarbanes-Oxley Act of 2002 and Market Liquidity' (2003), Working Paper, available at <http://at.ssrn.com>.

<sup>48</sup> JC Coffee, *Gatekeepers* (New York, OUP, 2006).

<sup>49</sup> G Hertig and JA McCahery, 'Company and Takeover Law Reforms in Europe: Misguided Harmonization Efforts or Regulatory Competition' (2003) 4 *European Business Organisation Law Review* 179.

Member States, and would therefore appear to reinforce and extend 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 policy-makers 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 an object, 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 policy-makers and the Commission naturally assume that the need for effective enforcement is a high priority of the EU and, given the large number of Member States' enforcement systems that clash with the fundamental objective of providing equivalent levels of substantive protection across the internal market, the EU has a role that would favour its intervention.<sup>50</sup>

Another, more fundamental, objection is that facilitating private litigation is not necessarily an effective or efficient means of curbing internal governance abuses. This is a difficult topic to tackle, not least because the evidence is murky. For example, US class actions were much criticised in the early 1990s as the source of abusive legal actions \*9 against auditors, and civil procedure reforms were passed to curtail their effectiveness. Today, these types of reforms are listed among the top reasons why auditors undertook the more risky and conflicted \*10 activities that facilitated the occurrence of corporate scandals in recent years.<sup>51</sup> Or, to take another

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<sup>50</sup> See Dir 2004/48/EC on the enforcement of intellectual property rights [2004] OJ L195/16; Market Abuse Dir 2003/6/EC [2003] OJ L96/16.

<sup>51</sup> Coffee, above n48.

example, the jury system is often considered a crucial reason why damages awards are larger (and the level of litigation higher) in the US than in Europe. The empirical evidence, however, is mixed.<sup>52</sup> The effect of fees reforms on enforcement levels is yet 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 to cause an impressive increase in shareholder litigation in Japan.<sup>53</sup>

It would seem that these studies make it difficult summarily to 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, which challenge the facilitation of litigation on political, cultural or even protectionist grounds. In other words, any attempt to impose a reduction in enforcement barriers is likely to face considerable delay or even defeat. In short, it would make little sense to introduce mandatory requirements in this area. On the other hand, 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 enhanced enforcement through private litigation and mandatory disclosure in order to shore up weak institutions.

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<sup>52</sup> See T Eisenberg *et al.*, 'Juries, Judges, and Punitive Damages: An Empirical Study' (2002) 87 *Cornell Law Review* 743; and *cf* J Hersch and W Kip Viscusi, 'Punitive Damages: How Judges and Juries Perform' (2004) 33 *Journal of Legal Studies* 1.

<sup>53</sup> MD West, 'Why Shareholder Sue: The Evidence from Japan' (2002) 30 *Journal of Legal Studies* 351.

## **2. Adopting EU Legal Options**

In this section, it is proposed that the EU should adopt a regime that gives firms the freedom to choose among a menu of legal rules. A first step in this direction would be the adoption of a select number of opt-in provisions.

This menu approach, which was previously adopted by the EC in the case of the accounting directives, permits Member States to choose among more or less conservative standards as well as to exempt small to medium-sized firms (SMEs) from specific requirements deemed to be too costly. It is suggested 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 Commission's experience with the accounting directives has been far from successful. To be sure, whilst there are a number of factors responsible, it seems likely that the problems may be primarily due to the options being designed to deal with regulatory concerns other 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, standardisation benefits are significantly reduced by such an approach, as there is no single set of EU provisions that firms and investors can rely upon. On the other hand, harmonisation

costs are likely to increase. An additional key point is that adopting a finite menu of EU options will reduce Member States' willingness to compromise, as they have good reason to hope that a hard stance will ensure the adoption of an option that is close to their own preferences. Unfortunately, the likely result will be an inefficient set of options which has few benefits and thus is all the more difficult to justify. Secondly, 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 weaknesses of the 'menu of legal options' approach suggest that it is not ideally suited to the current institutional and political environment, and hence should not be considered as an appropriate mechanism for the on-going company law reforms.

#### D. OPTING OUT OF EU PROVISIONS

It was argued earlier that an opting out approach is more efficient than a mandates approach, particularly where there are significant variations in corporate governance systems and company law regimes across the EU. 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 standardisation and other benefits. For example, differences in the use of the open corporate form by smaller firms and shareholder structures (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 indicated that, within the EU, there are voting systems in which blockholders enjoy all or most of the private benefits. This appears to be a consequence of the use in many systems of dual class stock, non-voting ownership certificates, trust companies and other cash-flow rights. To be sure, there are instances of legal systems in which the ‘one-share-one-vote’ rule is central to the control of the company. Moreover, while many European firms commonly use dual class shares, there are significant differences in their impact across EU Member States.<sup>54</sup>

Given this diversity, the question is whether shareholders would support an 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 **\*12** the one-share-one-vote rule may decrease controlling shareholders’ cost of capital<sup>55</sup> and possibly increase takeover efficiency.<sup>56</sup> On the other hand, the issue 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

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<sup>54</sup> Deminor Ratings Service for Investors **\*13**, ‘Application of the One-Share-One-Vote Principle in Europe’ (Mar 2005).

<sup>55</sup> O Hart and J Moore, ‘Cooperatives vs. Outside Ownership’ (1998), NBER Working Paper No 6421.

<sup>56</sup> But see JC Coates, ‘Explaining Variations in Takeover Defenses: Blame the Lawyers’ (2001) 89 *California Law Review* 1301; JA McCahery *et al.*, *The Economics of the Proposed Takeover Bids Directive* (Brussels, Centre for European Policy Studies, 2003).

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, 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 favour of shareholders.<sup>57</sup> Secondly, allowing Member States to opt out of legal rules reduces the standardisation advantage of EU law-making, especially when corporate law regimes vary significantly. This is, however, precisely the situation where Member States are likely to oppose or delay mandatory harmonisation, but agree on opt-out provisions. Indeed, member governments' opposition to EU law-making should remain relatively light when they themselves are allowed to opt out. Naturally, opposition could be more significant when firms also have the right to opt out, but this can be mitigated by combining Member State opt-out powers and the firm's right to opt back into EU law.

That said, most studies indicate that it would be more efficient for the EU to adopt legal provisions with opting-out possibilities in many areas of company law and corporate governance. Such a proposal would have a number of advantages. First, it could enable Member States to opt out of the equitable price, squeeze-out and sell-out provisions in the Takeover Directive. Secondly, new firms would be 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 in which they are incorporated—the latter limitation aiming at ensuring some degree of uniformity and transparency. Thirdly, shareholders of both new firms and firms established in new Member States could be given standing to sue for breaches of

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<sup>57</sup> LA Bebchuk and A Hamdani, 'Optimal Defaults for Corporate Law Evolution' (2002) 96 *Northwestern University Law Review* 489.

shareholder voting rules and violations of fiduciary duties, but be allowed to opt out in favour of the regime of the Member State in which they are incorporated. (By contrast, established firms in pre-2004 Member States could be permitted to opt into such a regime.)

At this stage, however, there are several cautions against the adoption of opt-out provisions in these areas of corporate law. 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 harmonisation programme. At the same time, public choice theory predicts that it is always 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.

### **1. Opting into EU Law**

Opting in to EU law is a key issue which is considered in this section. As argued above, it is submitted that EU intervention could 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 may be cost-effective since it provides firms with a small menu of provisions, lowering transaction costs and increasing the degree of 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 an impact in terms of constraining controlling shareholder opportunism—but still looks better than forgoing any intervention. Member States may also favour 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, the adoption of opt-in provisions, under certain conditions, could prove to be less cost-effective than expected. In such circumstances, caution is welcome when choosing opt-ins for existing companies, particularly when there are hard choices. Overall, it seems likely that the benefits of an opt-in approach will 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 standardisation or 'best practice' signalling is important for investors or stakeholders.

Opt-ins seem particularly suited to dealing with Member States' 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 to minimise managerial and shareholder opportunism. Thus, opting into EU employee participation provisions could, for instance, be made subject to third party approval by court ratification. Similarly, 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 standardisation and signalisation 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 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 power to exercise the opt-in option for it to be effective. As recent events have shown, managers or controlling shareholders may endorse an opt-in measure, to the extent that it provides a civil enforcement alternative to criminal investigations and sanctions.

#### E. CONCLUSION: THE FUTURE OF THE PRO-CHOICE APPROACH

The review presented above suggests that it may be feasible in the near term for the

EU to adopt the options approach. However, the EU's experience with options could prove short-lived if it cannot quickly develop a feasible role for them. Should options not play the role promised, the Commission could easily slip back into anti-choice mode if it perceived that there were better ways to maximise 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.

However, it may be difficult for policy-makers to limit the momentum of the pro-freedom movement that has been opened up by the ECJ's freedom of establishment judgments. It is well established that legislative attempts to counter major case law developments are usually unsuccessful.<sup>58</sup> It is not unusual to see diverging positions gradually eroding toward a common middle ground, but this process is time-consuming and firms are unlikely to remain idle throughout the convergence process. Secondly, access to the pro-freedom path is now substantially controlled by the judiciary and pro-choice Member States, and is therefore largely outside the reach of a political alliance comprising the European Commission and anti-choice constituencies.

Moreover, it seems likely 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 in \*14 less effective mandatory harmonisation exercises. Indeed, given the mentioned history of slow reaction to major case law developments and continued diversity of national

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<sup>58</sup> RD Cooter and T Ginsburg, 'Comparative Judicial Discretion' (1996) 16 *International Review of Law and Economics* 295.

governance regimes, one should expect years of intergovernmental negotiations on the possible terms of 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.

On the other hand, a pro-choice approach could serve significantly to 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 standardisation value automatically extends to the EU as a whole. Secondly, they allow for selective choices. Firms will be able to opt into those EU provisions they prefer, whereas Member States can offer only full opt-ins (incorporation or reincorporation results in the applicability of the corporate law regime as a whole).

Should the Commission be unable to obtain the required majority of Member States to endorse a reform programme based on options, it could revert to its earlier pro-mandatory harmonisation approach bias. More significantly, as demonstrated by the Takeover Bids Directive experience, such a reversal may even further tilt the balance in favour of pro-choice regulation by prompting reactions that will force the Commission to replace mandatory proposals with optional ones.

While it is difficult to predict with certainty, it is foreseeable that the Commission will move toward the adoption of a pro-choice approach, as such an approach provides the best mechanism to maximise the potential for successfully adopting and implementing ‘essential’ legislation. This assumption is reinforced by a variety of other considerations. Moreover, a review of the legislative history of the Takeover Bids Directive suggests that the key institutional actors within the EU have

already recognised that there is no longer one single approach to regulatory design in corporate law provisions. Pro-choice arrangements are seen as a favoured mechanism to secure benefits in unrelated areas (eg trading takeover provisions against temporary workers legislation), to target regulatory beneficiaries (eg by allowing sophisticated capital market players to opt out of investor protection provisions) or to facilitate the EU enlargement process (eg by permitting firms in new Member States to signal their commitment to ‘best practice’ by opting into EU corporate law provisions). Thus, while options do not in themselves create efficiency, they are crucial for parties to bargain to such conclusions. A review of the evidence above suggests that EU company law may be in deficit and that options can play an important role in promoting the goals of economic integration.