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REGULATORY COMPETITION IN THE EU: A MARKET FOR CORPORATE LAW REGIMES

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Abstract: In the intricate process of EU integration, practice has often departed from principle. While trumpeting the *freedom of establishment*, insufficient harmonisation has allowed Member States to prevent companies from moving their legal seats between jurisdictions. Recently, change came from the ECJ. In a series of recent cases, a fundamental policy shift has taken place in favour of increased mobility for corporations. This paper assesses the potential for regulatory competition for corporate law created by the ECJ's recent interpretation of the *freedom of establishment*. Subsequently, the resulting situation is analysed by conceptualising this competition as an autonomous market for corporate law regimes. Thus, perspectives originating in political science, sociology and economics can complement insights from legal literature on regulatory competition. The result is an increased understanding of the dynamic processes at the root of the development of regulatory and governance structures by EU Member States.

First, the basic principles of regulatory competition as applied to corporate laws are outlined, and the *market* will be conceptualised. In addition, the legal framework conditions that delineate the mobility of companies are analysed, and it is concluded that these leave sufficient scope for market dynamics between Member States and companies to materialise. Second, the main actors in this market, and their interests, are examined. Third, the focus shifts towards the significant risks and uncertainties these main actors

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face, and the strategies pursued to reduce potential problems of risks and uncertainty are evaluated.

The paper concludes with the assessment that proceeding with regulatory competition is likely to improve the quality and innovative capacity of corporate law. However, this road will only prove tenable if the EU is ready to take measures that continue to prevent a race to the bottom, and to put incentives right both for states and companies. Without EU action, the sustainability of the market for corporate law is uncertain.

Keywords: Regulation, Regulatory Competition, Private Regulation, European Union, Freedom of Establishment, Incorporation Decision, Market Dynamics, Corporate Governance, Corporate Law, Managers, Stakeholders.

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Regulatory Competition in the EU: A Market for Corporate Law Regimes

I. Introduction

In the intricate process of EU integration, practice has often departed from principle. While trumpeting the *freedom of establishment*, insufficient harmonisation has allowed Member States to prevent companies[1] from moving their legal seats between jurisdictions. Recently, change came from the ECJ. In a series of recent cases, a fundamental policy shift has taken place in favour of increased mobility for corporations. This paper assesses the potential for regulatory competition for corporate law created by the ECJ's recent interpretation of the *freedom of establishment*. Subsequently, the resulting situation is analysed by conceptualising this competition as an autonomous market for corporate law regimes. Thus, perspectives originating in political science, sociology and economics can complement insights from legal literature on regulatory competition.

This paper proceeds in six steps. First, the basic principles of regulatory competition as applied to corporate law will be outlined, and the *market* will be conceptualised. In addition, the legal framework conditions that delineate the mobility of companies will be analysed. Second, the main actors in this market, and their interests, are examined. Simultaneously, the presence of two prerequisites for regulatory competition is assessed. On the "demand-side", corporations must face a meaningful choice between legislations, and on the "supply-side" there must be incentives for corporate lawmakers to adapt their legislation to the needs of those deciding on the (re)incorporation. Third, the focus will shift towards the risks and uncertainties these main actors face. Fourth, the strategies followed by central market actors themselves to reduce the problems of risks and uncertainty are determined. The focus will be on first and second party regulation. Fifth, we move on to third and fourth party

[1] To avoid unnecessary complications, the terms 'corporation' and 'company' are used interchangeably in this paper to refer to any form of business organisation.

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regulation, as the role of institutions in uncertainty reduction is assessed. Finally, the conclusion of the paper will reflect on the insights obtained along the way.

1. The Nature of the Market for Corporate Laws

Whereas the analytical paradigm of 'markets' usually applies to the private provision of goods and services, it is possible to envisage the state as a producer of services as well. In the case of regulatory competition, the Member State is said to *supply* the service 'rule of law', here specifically a *corporate law regime.* It is a truly remarkable service, which the state can uniquely deliver due to its ability to coerce. Yet, this coercive capacity implies that the *customers*, in this case companies, do not just receive benefits *from* the service, but also choose to be *subject to* it. This choice is made in a special way; due to the limits of sovereignty, the coercive power of governments does not extend beyond the border of a certain geographical area. Companies, in order to switch 'provider', must thus be able to move between jurisdictions. These are the fundamental characteristics of the market under observation. When theorising further about this market, the approach must, however, be further formalised.

1) Formalising the Approach towards the Market for Corporate Laws

Regulatory competition is a particular type of systems competition, applying the market paradigm to services provided by the state – in this case legal rules.[2] Essentially, the competitive pressures create a market for state services. This requires the fulfilment of two conditions. First, companies must be sufficiently mobile to be able to make choices between the various systems. Second, it must be possible to make a choice specifically for corporate law regimes, instead of choosing between

[2] For an overview of the topic, see Siebert, H. & Koop, M. J. (1990) "Institutional Competition. A Concept for Europe?" *Aussenwirtschaft,* 45: pp. 439-462; Oates, W. E. & Schwab, R. M. (1988) "Economic Competition among Jurisdictions: Efficiency Enhancing or Distortion Inducing?" *Journal of Public Economics* 35: pp. 333-335.

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complete bundles of state services. In other words, this second condition requires *type-B regulatory competition*, instead of *type-A*.[3]

The latter distinction is important, and demands further elaboration. In the case of *type-A regulatory competition*, states are said to compete on the basis of legal systems taken in their totality. An otherwise superior bundle, for example with a highly effective system of tax and criminal law, can easily compensate for inferior corporate rules. After all, the corporate law regime constitutes only one facet of the overall choice facing companies. Thus, only when the corporate rules can be chosen separately, a more direct form of competition between corporate law regimes is possible.[4] Such a form of competition is classified as *type-B regulatory competition.* Only this type of competition, being more intense and focussed, can be said to constitute a *de facto* autonomous market for a service as specific as corporate law regimes.[5] Before moving on, it is therefore pivotal to determine whether EU Law in its current state allows for such focussed competition to take place. What follows is an examination of these legal framework conditions.

2) Legal Framework Conditions for the Mobility of Companies in the EU

When assessing the suitability of the legal framework for focussed regulatory competition, the two criteria mentioned above will be used. First, companies must be mobile so that it is possible to choose between jurisdictions. Second, this choice should specifically reflect differences in corporate laws, and not relate to the full bundle of state services.

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[3] This distinction is taken from: Heine, K. & Kerber, W. (2002) "European Corporate Laws, Regulatory Competition and Path Dependence" *European Journal of Law and Economics,* 13: pp. 47-74.

[4] Kieninger, E. (2004) "The Legal Framework of Regulatory Competition Based on Company Mobility: EU and US Compared" *Conference EU Corporate Law Making, Cambridge, Mass. – Section III: Regulatory Competition in the EU.*

[5] This approach takes into account the criticism expressed by Claudio that it is unlikely to expect *de facto* competition between specific parts of 'policy packages', explained in: Claudio, M. (2004), "The Puzzle of Regulatory Competition" *Journal of Public Policy* 24(1): pp. 1-23.

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In principle, corporate mobility should be possible within the EU. The search for the most suitable corporate law regimes by those who decide on (re)incorporations is acknowledged as one of the rationales underlying Articles 49 and 54 TFEU. These Articles provide for the freedom of establishment of natural and legal persons respectively.[6] For this freedom to be effectively exercised, a company should be able to move from one Member State to the other without having to alter its charter or even its legal personality.[7] Yet, its application is not so straightforward, which has resulted in considerable obstacles to corporate mobility for a long time. These obstacles were mostly the consequence of differences in the way various Member States regulate companies and their activities, especially in the sphere of private international law.[8]

Traditionally, two conflicting doctrines have characterised the different positions of the Member States. The first is the *incorporation doctrine*[9], which "provides that a foreign company, created in accordance with a foreign legal system and having its registered office in that foreign state, is recognised as such by the host country".[10] In other words, the applicable law is that of the state in which the company is incorporated or registered, no matter where the company operates. The second doctrine is the *real seat doctrine*,[11] or *siège réel*, on which many variations exist.[12] In essence, this doctrine implies that the applicable law is defined by the place of the company's central administration.[13] A cross-border transfer of the registered office is thus not recognised unless the real seat is simultaneously transferred, which would

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[6] Vaccaro, E. (2005) "Transfer of Seat and Freedom of Establishment in European Company Law" *European Business Law Review*: pp. 1348-1365.
[7] Dorresteijn, A. et al (2009) "European Corporate Law" *Second Edition*: p. 32.
[8] These differences have an especially pervasive quality due to the fact that attempts to harmonisation have failed: Wouters, J. (2000) "European Company Law: Quo Vadis?" *CMLRev* 37: p. 257.
[9] The countries upholding this doctrine are the Netherlands, Switzerland, Denmark, the United Kingdom, and Ireland: Kozyris, J. P. (1985) "Corporate Wars and Choice of Law" *Duke Law Journal* 1: p. 15. German Courts apply the incorporation doctrine where companies from other EU Member States are concerned: Teichmann, C. (2008). *European Company Law (ECL)* 5, no. 4: p. 189.
[10] Dorresteijn, A. (2009) p. 32.
[11] All Member States not upholding the incorporation doctrine (see: supra 7) follow this doctrine. Traditionally, strong supporters include Austria, Belgium, France, Greece, Luxembourg, Portugal, and Spain.
[12] Ebke, W. (2002) "The "Real Seat" Doctrine in the Conflict of Corporate Laws" *The International Lawyer*: pp. 1015-1016.
[13] Kieninger, E. (2004) "The Legal Framework of Regulatory Competition Based on Company Mobility: EU and US Compared" *German Law Journal* Vol. 06 No. 04: p. 744.

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often require dissolving the corporation. Alternatively, a local business that incorporates in a foreign jurisdiction will not be recognised as a legal entity. It is often argued that the real seat doctrine hereby effectively prevents regulatory competition.[14] The question that determines the application of Article 54 TFEU is how these perspectives are reconciled. In the *Daily Mail case*[15], the ECJ ruled that, until the *incorporation* versus *real seat* question was solved by a future convention or legislation, full primary establishment could not be achieved.[16] By sustaining a strict interpretation of the *real seat doctrine,* this ruling constituted a significant barrier to corporate mobility, and thus to regulatory competition.

Given the continued absence of EU harmonising measures, the *Daily Mail* set the standard for over ten years.[17] However, in a series of recent cases the ECJ has revisited this approach and thereby enabled corporate mobility. *Centros*[18] proved to be the catalyst for change, and was quickly complemented by *Überseering*[19] and *Inspire Art*[20]. In *Centros*, the ECJ ruled that a company's choice of its preferred regulatory environment within the EU internal market (the UK), while conducting all its activities in another Member State (Denmark), was an exercise of the rights inherent in the notion of freedom of establishment.[21] The other two rulings confirmed and extended this approach. In *Überseering*, the Court decided that due to Articles 49 and 54 TFEU, "German Law must recognise a foreign company *as it was founded*, provided that it was lawfully incorporated in accordance with the laws of another EU Member State".[22] Finally, in *Inspire Art* the Court judged that restrictive regulations

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[14] This position is adopted by, amongst others; Romano, R. (1993). "The Genius of American Corporate Law": pp. 128-140 and Charny, D. (1991) "Competition Among Jurisdictions in Formulating Corporate Law Rules: An American Perspective on the "Race to the Bottom" in the European Communities", *Harvard International Law Review* 32: p. 423; Dammann, J. C. (2004) "Freedom of Choice in European Corporate Law" *Yale Journal of International Law* 29: pp. 477-544.

[15] Case C-81/87 – The Queen v Treasury and Commissioners of Inland Revenue, ex parte Daily Mail and General Trust PLC (1988).

[16] Dorresteijn, A. (2009) p. 33.

[17] Such a harmonising proposal, although proposed under Art 293 EC (ex 220 EEC), never entered into force: Wouters, J. (2000) "European Company Law: Quo Vadis?" *CMLRev* 37: p. 257.

[18] Case C-212/97 – Centros Ltd v Erhvervs- og Selskabsstyrelsen (1999), especially §21, 22, 24-29.

[19] Case C-208/00 – Überseering v NCC (2002).

[20] Case C-167/01 – Kamer van Koophandel en Fabrieken voor Amsterdam v Inspire Art Ltd (2003).

[21] Craig, P. & De Búrca, G. (2011) "EU Law – Text, Cases, and Materials": p. 782; Kieninger, E. (2004), pp. 744-746.

[22] Case C-208/00 – Überseering v NCC (2002) §80; Kieninger, E. (2004), p. 747.

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could in principle be justified to protect creditors and investors, or to ensure an effective tax inspection system.[23] However, the rules at issue where found disproportionate and unnecessary – and it was indicated that such a decision would be the norm. Generally, therefore, such restrictive regulations were not allowed.[24]

Together, these rulings opened EU corporate law to regulatory competition[25], and the Court fully realised this consequence.[26] As a result, every Member State, irrespective of following the real seat theory, had to accept that a company incorporated in another Member State conducts all its business activity in the host Member State, while continuing to be subject to the *lex societatis* of the home Member State. In that sense, a *mutual recognition principle* similar to that in *Cassis de Dijon* was introduced into the law on freedom of establishment.[27] Many commentators spoke of the 'end of the *real seat* doctrine', as it was considered incompatible with the *freedom of establishment*.[28]

Even though the *incorporation decision* was now relatively free, similar mobility was not achieved at the *reincorporation*-stage. Member States could still "kill" a company at the border by requiring it to dissolve once it moved in or out of its jurisdiction. This issue came before the ECJ in the *Cartesio* case.[29] In a surprising return to the *Daily Mail* judgment, the ECJ rescued and preserved the last elements of the *real seat doctrine*. It upheld the principle that companies are 'a creature of national law'.[30] According to this line of reasoning, only Member States have the competence for creating legal entities, which gives them the power to decide what entities can enjoy

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[23] Craig, P. & De Búrca, G. (2011) "EU Law – Text, Cases, and Materials": p. 782; Kieninger, E. (2004), p. 783.
[24] Dorresteijn, A. (2009) p. 34.
[25] Dorresteijn, A. (2009) p. 37; Generally: Gelter, M. (2008) "The Structure of Regulatory Competition in European Corporate Law".
[26] See, for example, the opinions of the Advocate General in *Centros* (point 20) and *Inspire Art* §138-139.
[27] Case 120/78 – Rewe-Zentrale AG v Bundesmonopolverwaltung für Branntwein (Cassis de Dijon) (1979).
[28] See for example: Gelter, M. (2008); Baelz, K. & Baldwin, T. (2002) "The End of the Real Seat Theory (Sitztheorie): the European Court of Justice Decision in Ueberseering of 5 November 2002 and its Impact on German and European Company Law" *German Law Journal*; Dammann: J. C. (2004), who refers to Centros §40 and Überseering §94-95 in footnote 14.
[29] Case C-210/06 – Cartesio Oktató és Szolgáltató bt (2008).
[30] Case C-210/06 – Cartesio Oktató és Szolgáltató bt (2008) §104.

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freedom of establishment. Otherwise stated, Member States can determine the legal requisite for activating Article 54 TFEU. This implies that, if an action of a company does not suit the Member States' definition of what a company can do (such as moving its real seat, but not its registered seat), it loses its status as a legal entity and is dissolved.

Whereas the rulings from *Centros* to *Inspire Art* had introduced the mutual recognition principle, the ECJ affirmed in *Cartesio* that the basic rules as to what is necessary for incorporation in the first place remain, in the absence of EU harmonisation, for the Member State of incorporation to decide. However, in an *obitur dictum* this power was restricted. Two options where differentiated.[31] First, a company moves its real seat to the territory of another Member State while remaining registered in the home country. In this case, which is tantamount to that in *Cartesio*, Member States have the power to stop this action, as it controls the applicable corporate law. However, a second option is for the company to also convert into a form of company that is governed by the law of the host Member State. In this case, the law of the home country may not require the winding up or liquidation of this company to prevent it from converting.[32] According to the ECJ, Article 54 TFEU protects such practice. In the *VALE* case, the Court gave a similar ruling, but then regarding companies moving *into* the Member State.[33]

3) Conclusion

In sum, the changes in the legal framework conditions increased the mobility of companies in the European Union. While the *Centros/Überseering/Inspire Art* cases gave rise to a more open market for *incorporations*, *Cartesio* and *VALE* left some room for *reincorporation* decisions to be made. Apart from these options, it must be noted that relocation can always be achieved indirectly, through a transnational

[31] Case C-210/06 – Cartesio Oktató és Szolgáltató bt (2008) § 111.
[32] Case C-210/06 – Cartesio Oktató és Szolgáltató bt (2008) § 112-113.
[33] Case C-378/10 – VALE Építési kft (2012).

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merger.[34] To do this, a subsidiary is founded in the host Member State, and the parent company is merged into this subsidiary.[35] The legal framework, then, allows for sufficient cross-border mobility. Additionally, the introduction of the principle of mutual recognition in the cases described above favoured the incorporation doctrine, thus allowing companies to specifically choose between corporate law regimes. In conclusion, the framework conditions accommodate for the fundamentals of regulatory competition.[36]

Even though conditions for a market for corporate laws, with states as suppliers and companies as clients, are present, this does not imply that this market actually emerges. The existence of legal mobility is only a *necessary* but not a *sufficient* condition for competition to take place. There must be significant supply and demand-incentives that cause action by market players. To answer the question whether they have such compelling reasons to engage in the market mechanism, these actors and their interests will now be analysed.

2. The Main Actors and Their Interests

For a market to function, both supply and demand must be present. That is the case only if the main actors from each side – the Member States and companies respectively – face sufficiently significant incentives. This will be assessed now.

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[34] As noted in: Dammann, J. C. (2004) "Community law itself does not guarantee the possibility of transnational mergers, but this does not prevent the Member States from allowing cross-border mergers that do not require transfers of the corporation's real seat. However, when it comes to the willingness of the Member States to take this course of action, the picture is mixed."

[35] Werlauff, E. (2008) "Relocating a Company within the EU" *European Company Law* 5, no. 3: pp. 136-139.

[36] See: Van den Bergh, R. (2000) "Towards an Institutional Legal Framework for Regulatory Competition in Europe" *Kyklos* 53: p. 435-466; Lombardo, S. (2009) "Regulatory Competition in Company Law in the European Union after Cartesio" *European Business Organization Law Review* 10: pp. 627-648; Zumbansen, P. (2006) "Spaces and Places: A Systems Theory Approach to Regulatory Competition in European Company Law" *European Law Journal* Vol. 12, No.4: pp. 534-556.

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1) Supply – Incentives for Member States to Respond to Competitive Pressures

Member States' legislatives must face incentives that cause them to respond to competitive pressure exerted by companies.[37] Three categories of incentives can be distinguished.

First, franchise taxes can provide direct financial incentives, like those driving regulatory competition in the United States.[38] In Delaware, the leading state for incorporations in the US, 10-15% of government revenues is raised by this franchise tax.[39] Such direct financial incentives resulting from the mere fact of incorporation are, however, not allowed in the European Union.[40] Corporate taxes cannot fully substitute this source of direct income either, since most corporate taxes are paid in the physical seat.[41] Due to the rise of the *incorporation doctrine*, the physical and the legal seat of a company no longer need to coincide.

Indirect financial incentives, however, do exist in the EU. This second category encompasses earnings from business activities associated with incorporations, such as law firms, accountants and consultancies. These industries often bring highly specialised and well-paid jobs to a Member State, even if companies do not physically

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[37] Cumming, D. J. & MacIntosh, J. G. (2000) "The Role of Interjurisdictional Competition in Shaping Canadian Corporate Law – A Second Look" *International Review of Law & Economics* 20: 141, pp. 143-144.

[38] "Franchise taxes are collected annually, with the amount depending on the number of authorized shares, corporate assets and authorized capital. On the calculation of the tax base, see 8 Delaware Code §503." Gelter, M. (2008); Drury, R. (2005) "A European Look at the American Experience of the Delaware Syndrome" *JCLS* 5: pp. 1, 3-7.

[39] Roe, M. J. (2003) "Delaware's Competition" *Harvard Law Review* 117: pp. 588, 608-610;

[40] Franchise taxes, or similar taxes introduced by an autonomous decision of a Member State, are prohibited by Articles 2(1) and 10(c) of "The Directive on Indirect Taxes on the Raising of Capital" 69/335/EEC (July 17, 1969).

[41] Cheffins, B. R. (1997) "Company Law: Theory, Structure and Operation": pp. 435-436 Cheffins argues that no significant incentives would be created by tax revenues in the UK, unless corporations would also move their physical seat to that jurisdiction.

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settle there. In this way, incorporations might contribute to the development of an advanced services sector, which can be very beneficial for a nation's economy.[42]

Third, non-financial incentives could play a role in various ways. Governments could, for example, feel that they cannot allow their own corporate forms to become redundant, as this would come at the expense of their influence on corporate organisation. The state could, in other words, loose valuable tools to shape its economy, and thereby to manage risks and uncertainty.

So far, the incentives covered are in line with the *public theories of regulation*, stressing the role of the state in promoting the public good.[43] However, non-financial incentives could very well arise in ways more in line with *private theories of regulation*. Members from the 'incorporation industry', bar associations, and business managers[44] could lobby the state for more responsive Corporate Law regimes to attract foreign firms and capital[45]. As these groups tend to be small, highly organised and economically well-off, they have a strong position from which to promote their interests.[46] They also have good reason to do so, as the benefits of such policies are concentrated in their midst.[47]

In sum, as direct financial incentives are not available, European Member States might be less adamant to respond to competitive pressures than is the case in the United States. However, other incentives are still present and could in theory be

[42] For an analysis of the income from Delaware's advisory business, see: Macey, J.R. & Miller, G.P. (1987) "Toward an Interest-Group Theory of Delaware Corporate Law" *Texas Law Review* 65: pp. 486-487.

[43] Ogus, A. I. (1994) "Regulation, Legal Form and Economic Theory", Oxford: pp. 29-75.

[44] Carney, W.J. (1997) "Federalism and Corporate Law: A Non-Delaware View of the Results of Competition" in: *International Regulatory Competition and Coordination by Joseph McCary & William Bratton.*

[45] Cary, W.L. (1974) "Federalism and Corporate Law: Reflections Upon Delaware" *Yale Law Yournal* 83: pp. 690-692; Bebchuk, L. (1992) "Federalism and the Corporation: The Desirable Limits on State Competition in Corporate Law" *Harvard Law Review* 105: pp. 1443-1510.

[46] Olson, M. (1965) "The Logic of Collective Action: Public Goods and the Theory of Groups", Cambridge: Chapter 1 and 2: Wilson.

[47] Wilson, J. Q. (1984) "The Politics of Regulation", in Thomas Ferguson and Joel Rogers (eds.) *The Political Economy. Readings in the Politics and Economics of American Public Policy,* New York: pp. 82-103.

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sufficient to meet the required supply-side response for regulatory competition to occur.[48]

This theory is backed up by evidence. Since the ECJ's shift, there have indeed been various supply-side responses by Member States. Various legislatures have taken action to make their corporate forms more 'attractive'. Germany, for example, has amended the German GmbHG in 2008, allowing the GmbH and the AG to have its real seat in a foreign country.[49] Additionally, it has introduced the *Unternehmergesellschaft (haftungsbeschränkt)* in 2008, which abolished minimum capital requirements.[50] With the Flex-BV, introduced in 2012, the Netherlands too created a corporate form without minimum capital requirements.[51] In 2003 and 2004, France and Spain introduced new, deregulated forms of limited liability companies, with lower minimum capital requirements and a quicker incorporation procedure.[52] In the UK, the corporate law reform process has as one of its explicit rationales making the UK even more attractive as a home for overseas companies. Considering the importance the financial and legal services in the City of London, it seems plausible that indirect benefits exert sufficient pressure on British legislators to maintain this position.[53]

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[48] A cautionary note is warranted: it is argued that regulatory competition is a myth in the United States, because only Delaware faces significant incentives to be responsive as a relatively small state with a large incorporation sector. For all other states, the interests at stake are considered insignificant: Kahan, M. & Kamer, E. (2002) "The Myth of State Competition in Corporate Law" *Stanford Law Review* 55. As it is unlikely that the EU will face a similar concentration of corporate law activities, as argued by Gelter, M. (2008), this argument could be extended to the EU, as a place where regulatory competition is even less likely to take place. Complementing this observation is the idea that smaller Member States, who face relatively substantial incentives to attract a market for incorporations, are probably unable to take the lead in the EU as larger Member States can offer better services. Nevertheless, this remains a question of degree, as supply-side incentives are present in the EU.

[49] Gesetz zur Modernisierung des Bmbh_Rechts und zur Bekämpfung von Missbräuchen (MoMiG), which amended s. 4(a) GmbHG accordingly.

[50] Leyendecker, B. E. (2008) "Rechtsökonomische Überlegungen zur Einführung der Unternehmergesellschaft (haftungsbeschränkt)" *Gmbh-Rundschau* 6: pp. 302-305.

[51] For an overview of the changes, see: De Brauw Blackstone Westbroek (2012) "Matrix Flex-BV law", Amsterdam; This reform is associated with an increase in European regulatory competition, see: Stam, E. (2012) "Flex-bv: voor Steve Jobs of Tedje van Es?" *Me Judice*, available at: http://www.mejudice.nl/artikelen/detail/flex-bv-voor-steve-jobs-of-tedje-van-es.

[52] In France, this updated corporate form is called *Société à Responsabilité Limitée (S.A.R.L),* the new Spanish corporate form is called *Sociedad Limitada Nueva Empresa*. Both lowered minimum capital requirements and increased the incorporation speed.

[53] See: White Paper Company Law Reform (March 2005), available at: http://webarchive.nationalarchives.gov.uk/+/http://www.dti.gov.uk/cld/WhitePaper.pdf p. 9.

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2) Demand – A Meaningful Choice for Corporations

Under the assumptions of the market system, companies are maximising actors, also in their dealings with the state.[54] Thus, if they can relocate to be subject to a more advantageous corporate law system, it can be credibly assumed that they would do so.[55]

Two conditions must be satisfied for companies to engage in a market for corporate law regimes. First, there must be legal regimes that offer competitive advantages relative to their current jurisdiction. On multiple levels, differences between jurisdictions are more pervasive in the EU than in the United States.[56] Substantively, the law is likely to reflect firmly rooted differences in economic structures between the various Member States. Germany can, for example, be referred to as a *coordinated market economy*, emphasising coordination, cooperation and the explicit recognition of a wide range of stakeholders. Britain, on the other hand, is characterised by a *liberal market economy*, where firms coordinate their activities primarily via hierarchies and competitive market arrangements.[57] This is not to say that one system is better than the other, but rather that different types of companies can experience advantages in different systems:

> "There is no 'one-best' system of corporate governance. Rather, the two systems have different comparative advantages. The British corporate governance systems better supports companies in sectors where there is a need to move quickly into and out of new markets and in which there is need for great flexibility in the use of employees. The German system, by contrast,

[54] Gruber, J. (2011) "Public Finance and Public Policy".
[55] Bar-Gill, O., Barzuza, M. & Bebchuk, L. (2002) "The Market for Corporate Law", National Bureau of Economic Research – Cambridge MA.
[56] For a comparison between Liberal Market Economies (UK) and Coordinated Market Economies (Germany), see: Siems, M. (2002) "Convergence, Competition, Centros and Conflicts of Law: European Company Law in the 21st Century" *European Law Review* 27, 47: p. 54; Regarding the differences in corporate governance policies, see: Mayer, C. (1997) "Corporate Governance, Competition, and Performance" *Journal of Law and Society* 24: pp. 152-176.
[57] Hall, P. A. & Soskice, D. (2001) "Varieties of Capitalism – The Institutional Foundations of Comparative Advantage": Chapter 1.

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better supports companies in sectors that require long-term commitments and investments by employees, suppliers and other 'stakeholders'."[58]

In terms of procedure, differences can be significant as well. It is unlikely that all legal regimes operate with similar efficiency, which suggests that often there are efficiency gains to be made for companies by moving. Legal procedures might, for example, be handled more quickly, more efficiently or with a higher quality in some jurisdictions.[59] Courts in some Member States might specialise themselves in certain (sub) areas of corporate law, and thus build up valuable expertise and a reliable body of precedents.[60] Finally, issues are generally raised earlier in jurisdiction where high volumes of Corporate Law cases are brought to the court, which causes other countries to lag behind.[61] The first condition is clearly fulfilled.

Second, the costs of switching jurisdictions – transaction costs – must not be so high as to cancel out potential benefits. If they were, transactions might be stalled, thus causing a literal 'market failure'.[62] The first major source of transaction costs has, of course, to do with the legal transition itself. Corporations are 'creatures of the law', and often quite complex ones – involving contracts, shareholders and the legal personality. The procedure to switch legal form can be long, risky and expensive, which is a major source of transactions costs.

However, the big differences between Member States on other than purely judicial fronts – creating various sources for transaction costs – may mitigate excitement as well. To start with, the European Union has 23 working languages[63], which offers

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[58] Vitols, S., Casper, S., Soskice, D. & Woolcock, S. (1997) "Corporate Governance in Large British and German Companies", London: Anglo-German Foundation for the Study of Industrial Society.
[59] See: Dammann, J. C. (2004), footnote 121, for a comparison between German and Italian procedures. The statistics show that German Courts handle their cases much quicker than Italian Courts.
[60] Armour, C. J. (2005) "Who Should Make Corporate Law? EU Legislation versus Regulatory Competition" Section 3b, p. 21, argues that the UK is the only EU Member State with a specialist Corporate Law Court.
[61] Gelter, M. (2008).
[62] Douma, S., Schreuder, H. (1998) "Economic Approaches to Organisations", London, Chapter 8: pp. 124-150.
[63] The European Union has 23 official and working languages. They are: Bulgarian, Czech, Danish, Dutch, English, Estonian, Finnish, French, German, Greek, Hungarian, Irish, Italian, Latvian, Lithuanian, Maltese, Polish, Portuguese, Romanian, Slovak, Slovene, Spanish and Swedish, see also: European Commission (2012) "Official EU Languages", retrieved from:

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barriers to businesses by increasing the costs of information transactions and requiring additional investments in human capital.[64] Additionally, differences in *culture* tend to be more profound in the European Union than in the US. This encompasses more than just interpersonal relations; it is reflected in fundamental characteristics of the jurisdiction. Totally different conceptions of markets, the role and power balance of stakeholders[65], and the position of companies in society could make the differences to large to cross. Finally, the role of lawyers is problematic. To be an effective council for moving companies, lawyers will have to be fluent in a great variety of legal cultures and languages. But this requires significant human capital investment, and many lawyers will decide to remain "rationally ignorant".[66] Therefore, the services such multi-jurisdictional lawyers offer tend to be limited and expensive, and thus available only to larger companies.[67] Moreover, companies that consider moving might have to switch law firms, which could be an expensive and time-consuming undertaking.[68]

In theory, then, both incentives to move and impediments to move can be found. [69] Empirics suggest that positive incentives are sufficient to cause a strong demand-side response. The strongest are related to the English Ltd, which has gained significant popularity in the Netherlands[70] and Germany. In the latter case, approximately 40.000 German Ltds. existed in 2006, constituting almost 22% of all newly incorporated

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http://ec.europa.eu/languages/languages-of-europe/eu-languages_en.htm

[64] Gelter, M. (2008).

[65] Romano, R. (1993) notes on p. 127 that some European nations require the representation of employees as well as shareholders in corporate decision-making.

[66] See: Gelter, M. (2008), and: Kirchner, C. & Painter, R. W. & Kaal, W.A. (2004) " Regulatory Competition in EU Corporate Law After Inspire Art: Unbundling Delaware's Product for Europe" *University of Illinois Law and Economics Research Paper* No. LE04-001, this paper assesses the costs of working with foreign law.

[67] Kieninger, E. (2004), p. 769.

[68] See: Dammann, J. C. (2004), footnotes 138-141.

[69] Kieninger, E. (2004); Deakin, S. (2000) "Regulatory Competition versus Harmonisation in European Company Law"; Dammann, J. C. (2004).

[70] Kluiver, H.J. (2004) "Inspiring a New European Company Law" *European Company and Financial Law Review* 1: pp. 122-124, discussing the trend of Dutch companies moving into the UK Corporate Law Regime; Looijestijn-Claire, A. (2004) "Have the Dikes Collapsed? Inspire Art a Further Breakthrough in the Freedom of Establishment of Companies?" *European Business Organization Law Review* 5: p. 397.

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corporations in 2006 (78% GmbH).[71] Overall, the post-*Centros* increase that would be predicted as a consequence of greater corporate mobility is reflected in empirical studies.[72] Both on the qualitative and the quantitative front, there is support for the existence of regulatory competition for corporate laws within the EU.

3) Conclusion

The competitive conditions of supply and demand are met, even though the strengths of these effects are hard to theoretically quantify. However, considering the presence of supply and demand-side responses, *adequate* incentives are likely present for a market in corporate law regimes to arise.

3. The Risks and Uncertainties Facing the Main Actors

The analysis of the actors yielded the conclusion that both are likely to take part in the market mechanism, or alternatively, in the dynamics of regulatory competition. However, implicitly some risks that could plague them once they do have also surfaced. For both the supply and the demand side, these are now surveyed.

1) Supply Side Risks Facing Governments

It has been mentioned above that there is a risk that *private theory or regulation-effects* arise due to the concentration of potential benefits in a small, well-organised and influential group of professionals. If this risk materialises, it is possible that these private gains will come at a cost to the 'public good', for example by diminishing rights for creditors and shareholders. Other areas of corporate law that involve

[71] Eidenmüller, H. (2007) "Die GmbH im Wettbewerb der Rechtsformen" *Zeitschrift für Unternehmens- und Gesellschaftsrecht* Volume 36, Issue 2: pp. 168-211; Becht, M. et al (2008) "Where do Firms Incorporate? Deregulation and the Cost of Entry" *Journal of Corporate Finance* 14: pp. 241-256.
[72] Becht, M. et al (2008).

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significant externalities are disclosure regulation, the regulation of control contests, and corporate social responsibility.[73]

Whether or not such adverse developments take place is subject of a vivid academic debate, centred on the concept of the regulatory race. Most relevant in this respect are the extremes of the debate, entailing the idea that this race can either go to the top, or to the bottom.[74]

Race to the top – The first argument supporting this position is that regulatory competition leads to better law. The starting point of this reasoning is that the government, in line with Hayek's analysis, suffers from a knowledge problem.[75] Thus, the best public policy is unknown, and we cannot assume that the current rules are the optimal legal rules. By allowing for parallel experimentation, Member States engage in a 'discovery procedure'[76] for superior legal rules that, once they have been found, are spread through the competitive pressures of markets.[77] Alternatively, regulatory competition is seen as *counteracting* public choice failures instead of strengthening them, as competitive pressures balance out the influence of interest groups.[78] In both ways, regulatory competition will cause states to offer the type of high quality law that fits the corporations' needs best. The criteria for the 'California effect' to take place are, however, not likely to be fulfilled.[79]

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[73] Bebchuk, L. (1992) "Federalism and the Corporation: The Desirable Limits on State Competition in Corporate law" *Harvard Law Review* Vol. 105, No. 7: pp. 1443-1510.

[74] Claudio, M. (2004) "The Puzzle of Regulatory Competition" *Journal of Public Policy* 24(1): pp. 1-23.

[75] Hayek, F. A. (1978) "Competition as a Discovery Procedure" *in F. A. V. Hayek (ed.) New Studies in Philosophy, Politics, Economics and the History of Ideas,* Chicago; pp. 179-190.

[76] Schumpeter, J.A. (1934) "The Theory of Economic Development – An Inquiry Into Profits, Capital, Credit, Interest, and the Business Cycle".

[77] For an application of the evolutionary concept of competition to interjurisdictional competition and regulatory competition, with a strong emphasis on legal innovations, see: Breton, A. (1987) "Towards a Theory Competitive Federalism" *European Journal of Political Economy* 3: pp. 263-329; Vanberg, V. & Kerber, W. (1994) "Institutional Competition Among Jurisdictions: An Evolutionary Approach" *Constitutional Political Economy* 5: pp. 193-219.

[78] Carney, W. J. (1997) "The Political Economy of Competition For Corporate Charters" *Journal of Legal Studies* 26: pp. 303-329.

[79] Vogel, D. (1995) "The California Effect", in *Trading Up – Consumer and Environmental Regulation in a Global Economy*, Cambridge (Harvard): pp. 1-23, 248-270 – Vogel argues that regulatory competition could result in higher standards due to the '*California Effect*'. In short, the logic runs as follows: two or more countries enjoy the same standard of regulation in a particular field. Suddenly – due to internal political forces, *inter alia* NGOs – one country raises its standards. This means that only

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Second, proponents of regulatory competition point out that this better law benefits companies. Assuming rational decision-makers, relocation to another Member State is considered Pareto efficient[80] – as obtaining this result is supposedly the only incentive to move.[81] The company, in other words, has an advantage due to the better rules of the new system. Many studies have tried to measure this advantage, and indeed found positive effects for firms incorporating in the state that is presumed to have the most efficient legal system (in the US: Delaware). This is true for both share prices[82] and Tobin's Q[83]. These studies, however, have been criticised for their research method[84] and in some cases the result has been contradicted by later findings[85]. However, no

products that meet that higher standard can be sold in this particular country. If this country has a large or highly profitable market, this poses a dilemma to companies: either they differentiate their products, which is unpractical and expensive, or they abide by the same high standard in all countries they sell to. According to Vogel, they are likely to choose the latter. In this case, these companies would benefit from a first-mover advantage if they can lobby other countries to adopt similarly high standards. To those companies, this would entail no additional costs anyway – but since their competitors would have to increase their standards, they do have to pay. In other words, companies that abide by the high standard anyway might lobby for higher standards in other countries. They may be joined by NGOs, forming Baptist-bootlegger coalitions, to further strengthen their claim. In the end, Vogel predicts that such lobbying might cause other countries to increase their standards as well. However, a precondition for this effect to take place is that, in order to do business in the country that initially raises its standards, companies (even foreign companies) have to abide by these standards. Due to the 'mutual recognition' for corporate law regimes in the European Union, this requirement would not be allowed to prevail for corporate laws. Therefore, if a race to the top were to occur in the market for corporate law, the California effect is not likely to have caused it.

[80] The underlying assumption, accepted in Dammann, J. C. (2004), is that "a corporate law regime focused on the maximization of shareholder wealth is also best suited to maximize the welfare of society as a whole", with a reference to: Hansmann, H. & Kraakman, R. (2001) "The End of History for Corporate Law" *GEO. Law Journal* 89: pp. 439, 441 (Pareto efficiency is defined as a situation whereby at least one group gains and no-one else loses, so total value increases).

[81] Parisi, F. & Ribstein, L. E. (1999) "Choice of Law" *in P. Newman, eds., The New Palgrave Dictionary of Economics and the Law (New York)*: p. 236; Lombardo, S. (2009).

[82] Romano, R. (1985) "Law as a Product: Some Pieces of the Incorporation Puzzle" *Journal of Law, Economics & Organization* 1: p. 225.

[83] Daines, R. (2001) "Does Delaware Law Improve Firm Value?" *Journal of Financial Economics* 62: p. 525. This study finds an advantage of 2-3%. ('Tobin's Q' reflects the market capitalisation of companies. It is the ratio of the market value to the replacement value of assets).

[84] The study by Daines, R. (2001) is criticised by scholars who argue that it is an example of reversed causality, since better-managed corporations tend to incorporate in Delaware. See, for example: Bebchuk, L.A. & Ferrell, A. (2001) "A New Approach to Takeover Law and Regulatory Competition" *Virginia Law Review* 87: pp. 111, 137-138.

[85] Subramanian, G. (2004) "The Disappearing Delaware Effect" *Journal of Law, Economics and Organization* 20: p. 32. This study finds that Tobin's Q does no longer show a positive effect after 1996, which is explained by the developments in the market for corporate control favouring managers. It is expected that this trend prevails, as the "just-say-no-defence" – which has increased the power of the board relative to the shareholders further – has recently been established in Delaware. See: Allen, W. T., Kraakman, R. & Subramanian, G. (2009) "Commentaries and Cases on the Law of Business

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negative impact has been found, and when any positive results are mitigated this is often due to market failures (such as Delaware's monopoly power), not because regulatory competition is conceptually flawed. A more important criticism is that most of these studies measure 'firm value' in the wrong way: they only measure the benefits for shareholders, and not for other stakeholders, whereas it is clear that the interests of all stakeholders need not align. Thus, some important shortcomings of the system could be masked.

Race to the Bottom – These doubts lead to the theory of the race to the bottom, whereby not perfection but "laxity"[86] is rewarded. Mirroring the criticisms mentioned above, this theory maintains that states under competitive pressure offer the type of law that works best from the perspective of those making the (re)incorporation decisions, but disregards other constituents.[87] Alternatively, even if no agency problems were present, being subject to few regulations can still be perceived as helpful to the firm. In this case, if one nation lowers its standards (e.g. 'liberalises'), it may attract a large number of foreign companies. However, other nations do not want to see these companies leave, and thus also lower their standards. In the end, there will be a level playing field again, but with lower regulatory standards.[88] The risk for regulatory competition to lead towards the bottom is thus one for the state to take into account.[89]

2) *Demand Side Risks Facing Companies*

First, as suggested above, the principal-agent problems manifesting themselves when managers can go after private benefits pose a serious risk for companies. In two ways,

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Organization". On a side note: these developments in the market for corporate control, which harm the interests of those deciding for reincorporation, could be regarded as a failure of regulatory competition to reach the most efficient situation possible, or at least as a diversion from a 'perfect market'.

[86] In *Liggett Co. v Lee. 288 U.S.-517.558-559 (1933),* Justice Brundeis (diss.) states: "Companies were early formed to provide charters for corporations in states were the cost was lowest and the laws least restrictive. The states joined in advertising their wares. The race was one not of diligence, but of laxity."

[87] More on these agency-risks in the section 'Demand Side Risks Facing Companies', below.

[88] Bebchuk, L. (1992) "Federalism and the Corporation: The Desirable Limits on State Competition in Corporate Law" *Harvard Law Review* 105: pp. 1461-1467.

[89] Sun, J. M., Pelkmans, J. J. (1995) "Regulatory Competition in the Single Market" *Journal of Common Market Studies* 33: pp. 67–89.

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such problems are apparent. First, managers can lobby with legislators for corporate law regimes that increase their powers, specifically with respect to shareholders, so that they are better able to reap private benefits. Second, within companies managers have indeed been shown to extract private benefits – either on their own title or on behalf of dominant shareholders.[90] Total value maximisation could, in other words, be trumped by the maximisation of private benefits. This comes at the costs of other stakeholders connected to the corporation[91], such as creditors[92], but also of involuntary creditors such as tort victims. Such risks are considered to be higher in the EU than in the US, as there are more concentrated shareholders, or 'blockholders', who have a majority-stake the corporation.[93] However, the inclusion of a greater variety of stakeholders in the decision-making process, as is already the case in some Member States, could counter this trend. Finally, as regulatory competition often leads to convergence[94], valuable differences between the corporate law regimes of Member States could disappear, thus harming the interests of specialised companies with particular needs. However, exactly because these differences are valuable, they could also have 'survival value' that maintains them.[95]

Second, uncertainty for companies is related to the legal uncertainty[96] that can be associated with a market for corporate law. The fact that states are, subject to competitive pressure, taking measures to constantly adapt their laws might cause a dynamic equilibrium. The predictability of legal developments is not always aided by

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[90] Bebchuk, L. (1992) pp. 1443-1510.

[91] According tot his theory, (re)incorporation is not Pareto efficient, but Kaldor-Hicks efficient at best, favouring the interests of the decision-makers. (Kaldor-Hicks efficiency is defined as the situation whereby the gain of one or more groups is large enough to potentially compensate for the losses of the other groups. The crucial difference with Pareto efficiency, is that some groups can lose).

[92] "(…) as a result of regulatory competition, creditors have been progressively marginalised from the core of corporate law (…)." Lombardo, S. (2009): p. 631.

[93] Gelter, M. (2008): pp. 36-38.

[94] Romano, R. (1998) "Empowering Investors: A Market Approach to Securities Regulation" *Yale Law Journal* 107: pp. 2359-2430.

[95] Vitols, S., Casper, S., Soskice, D. & Woolcock, S. (1997) "Corporate Governance in Large British and German Companies" *Anglo-German Foundation for the Study of Industrial Society*: p. 36.

[96] The choice for the word 'uncertainty' rather than risk is deliberate and meaningful. Whereas *risks* allow the market to calculate a probability, and thus a monetary value and potential for insurance – *uncertainty* offers no such options. It is therefore harder to cope with uncertainty than with risk. In this case, the choice of legal rule by the court or the legislature is a clear example of uncertainty – representing a probability that is neither mathematical nor *a priori* to be ascertained. See: Knight, F.H. (1921) *Risk, Uncertainty, and Profit* Chicago: pp. 197-232.

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such dynamism. This is especially true if the competitive pressures become increasingly dominant, since (the impacts of) exogenous influences are not necessarily related to the legal culture of the nation of incorporation. Alternatively, uncertainty can plague managers once they switch between different corporate laws.[97]

4. Strategies Followed by the Main Actors to Reduce the Problems of Risk and Uncertainty

The various risks and uncertainties that have been outlined are not simply accepted. Instead, actors directly involved with the transaction, and other parties, have utilised a range of channels to limit them. In line with the model proposed by Levi-Faur, the following two sections will cover three types of private regulation.[98] In this section (section 5), the focus will be on actors *directly involved* in the transaction. Section 6 will direct attention to the efforts of other private parties, and subsequently extend Levi-Faur's model to include the state.

1) First Party Regulation

Solutions by the market have, as first imagined by Adam Smith, been largely guided by the 'invisible hand'.[99] First party regulation refers to the process whereby the market, through the reputation effect, compels actors to engage in self-regulation.

In the case of regulatory competition, the state has a high stake in a strong reputation. It must signal to businesses, whose 'lives' are dependent on a reliable corporate law regime,[100] that it is a credible, trustworthy partner. Once this trust fades, companies are bound to leave. The example of New Jersey, the former 'leader' in the US system, is illustrative. As Woodrow Wilson, then governor of the state, enacted reforms that scaled back corporate privileges, other states did not sit idly by. Instead, they

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[97] Heine, K. & Kerber, W. (2002) "European Corporate Laws, Regulatory Competition and Path Dependence" *European Journal of Law and Economics,* 13: pp. 47-74.
[98] Van Waarden, F. (2011) "Varieties of Private Market Regulation: Problems and Prospects", in Levi-Faur, D. (2011) *Handbook on the Politics of* Regulation, Cheltenham, Edward Elgar.
[99] Smith, A. (1776) "The Wealth of Nations".
[100] See the Cartesio case, where the court emphasises that companies are a 'creature of national law', as mentioned above: Case C-210/06 – Cartesio Oktató és Szolgáltató bt (2008) §104.

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capitalised on the damaged trust, and then Delaware adopted the old New Jersey law and promised stability. The result is well known; Delaware became the new 'leader', and has maintained this position ever since.[101] Reputation is therefore important to states when competing in the market for corporate laws, as the 'buyers' can respond with increasing ease to 'bad behaviour'. This has been acknowledged by states, which indeed embarked on reputation building: government officials and politicians in England and Germany have, for example, publicly advertised their respective legal systems.[102]

The state can take many measures beyond merely advertising itself. The recommended strategies depend on the views taken by the state. First, by 'opening up' to companies and increasing the accessibility of the decision-making process, they can aim to become more responsive to their needs. However, such an approach, by failure of pluralistic lobbying models, could also further skew the input of this process towards a small, powerful group that does not accurately represent the interests of all relevant parties. Alternatively, the state could amend its decision-making structure by allowing for more democratic control, or by explicitly including certain stakeholders.[103] The fact that periodic elections are held in most European Member States, which causes influences on government to fluctuate, can itself be seen as a check on lobbying powers. Finally, the state could allow for more responsive and independently created law by according a wider discretion to courts, which can – as in the common law system – organically develop the case law and tailor decisions to individual situations.

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[101] Allen, W. T., Kraakman, R. & Subramanian, G. (2009) "Commentaries and Cases on the Law of Business Organization".

[102] In a brochure for The Law Society, Jack Straw, Secretary of State for Justice and the Lord Chancellor, states, "England and Wales are the jurisdiction of choice" (2007). The press release can be found here: http://www.epolitix.com/members/member-press/member-press-details/newsarticle/international-business-chooses-england-and-wales-as-their-jurisdiction-of-choice-for-dispute-resolut///sites/law-society/. Similarly, the German Federal Minister of Justice Brigitte Zypries published a brochure on "Rechtsexport" in which she explains: "'Made in Germany' is not just a quality seal reserved for German cars or machinery, it's equally applicable to German law. Fair laws and an efficient judiciary guarantee social harmony, individual freedom and economic success." The law itself is characterised as "global, competitive, cost-effective". The brochure can be found on http://www.lawmadeingermany.de.

[103] The Dutch 'Polder Model' offers potential in this sense, as it includes input from stakeholders that are not always represented by the managers of a company, including employees.

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Companies, too, can employ first party regulation to decrease risks and uncertainty. The reputation effect is not likely to operate based directly on the type of legal regime a company subscribes to, as this is a highly technical act that most people do not fully comprehend. Also, it is unlikely that companies are being 'punished' by the supplier, unless they *break* the law. However, companies are frequently scrutinised by the public for their decisions more generally – even if these are legal. Examples include the actions taken by BP before and after the oil spill in the Mexican Gulf, and Apple's supply chain management at the Chinese Foxconn plant.[104] Such scrutiny limits the scope of potential legal freedom that can *de facto* be utilised, and thus decrease incentives to engage in or even encourage a race to the bottom.[105]

This does not mean that reputation will always ensure companies behave in a socially acceptable way, as they are subject to contradictory incentives. Guided by the desire for profit maximisation, they always make a trade-off between the costs and benefits of their behaviour. The process of maximising benefits and minimising costs could include externalising some costs, even if this harms a company's reputation.

Yet, first party regulation can also operate based on alternative, more internal mechanisms in many companies. For example, another driver of good governance could be the interest of specific stakeholders *within* the company, such as shareholders. To limit the potential for illicit private gains at their costs, shareholders can institute more checks and balances by amending the statutes of a company.[106] Awarding more powers to shareholders, for example by giving them the opportunity to require a confirmation vote on sensitive board actions, is one way of achieving this. However, even though setting new rules and standards may limit risks, it must be noted that unless the board of directors behave truly irrational or demonstrably abandon their duties, it generally is insulated from breach of duty claims by

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[104] See, for example: Krauss, C. (29-04-2010) "Oil Spill's Blow to BP's Image May Eclipse Costs" *the New York Times* – URL: http://www.nytimes.com/2010/04/30/business/30bp.html?pagewanted=all&_r=0

[105] Vogel, D. (2005) "The Market for Virtue – The Potential and Limits of Corporate Social Responsibility", Washington DC.

[106] Allen, W. T., Kraakman, R. & Subramanian, G. (2009) "Commentaries and Cases on the Law of Business Organization".

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shareholders.[107] Some believe that, in the end, only the board itself can decide to decisively change its behaviour for the better.[108] A suggested way to achieve this is to tap into a more individually applicable reputation effect. Arguably, board members who care about their private interest include their *own reputation* in such considerations.

2) Second Party Regulation

Second party regulation takes place where one actor involved in the transaction imposes standards upon the other party. This is only possible when the imposing party is in a position of relative power. The regulatory standards are, in such cases, often imposed as part of the transaction, which can be made conditional on fulfilling them.

States can, and always do, engage in downstream second party regulation. The reason is that, even though they act as suppliers, they also remain the party responsible for the rule of law more broadly. Conditions set by the state are not to be broken, since breaking those is tantamount to breaking the law. This puts the state in a strong position, but there is a catch. The demands set by the state are, especially in the case of regulatory competition, not solely determined by the wishes of the state. Due to continuous competitive pressure, legislatures are limited in their options to choose their desired standards.

Upstream second party regulation by companies on states does exist, as companies can always relocate to another jurisdiction, but will be more informal. It is unlikely that the state offers special conditions to a company to make sure it incorporates under its own system, especially since EU Law generally prohibits state aid to the private sector.[109] If special offers were made at all, the company would thus not be able to rely on such agreements. However, a company could threaten the government to move if certain regulatory changes are enacted, as was the case in New Jersey. One company is not likely to exert significant leverage, but if many companies act

[107] Frankel, A. (23-09-2011) “Want more board accountability? It won’t come via litigation.” *Reuters*
[108] Marcus, L. P. (23-09-2011) “It Is Time to Fix Our Boardrooms” *Harvard Business Review.*
[109] See: Article 107 TFEU.

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together, for example by forming an association, this threat can be immediate and credible.

5. Institutions as Strategies of Uncertainty Reduction

Given shortcomings of first- and second-party regulation, the market is likely to turn to third parties, not directly involved in the transaction. Subsequently, if the market is unable to tackle the problems, the state can step in. These two possibilities are discussed now.

1) Third Party Regulation

Third party regulation occurs if parties not directly involved in the transaction regulate the transacting parties. The first way in which this can be done, can again be described as driven by an 'invisible hand'. Demand produces a commercial supply of information, certification, accreditation or other types of regulatory activity.

First, in a market for corporate law regimes, law firms fulfil the crucial role of supplying expertise and information. Due to complex legal procedures, language barriers and widely differing legal traditions, it is often advisable for companies not to pursue complete information themselves. Even as most legal knowledge is freely available due to the value of transparency in legal proceedings, the pursuit of (close to) perfect information by a non-specialised organisation is simply unrealistic. Rather, strategies of optimisation should be adopted – which imply that most companies will remain 'rationally ignorant'. Nevertheless, if this gap in knowledge were to persist the market would stop functioning, as comparing several corporate law regimes and making a subsequent transition would be virtually impossible.[110] This is when law firms step in. They provide the information that transacting parties lack, and advise on the course of action to be taken. As with any information asymmetry, the one between

[110] Heine, K. & Kerber, W. (2002) "European Corporate Laws, Regulatory Competition and Path Dependence" *European Journal of Law and Economics,* 13: pp. 47-74 (arguing that, due to the fundamental differences between legal systems caused by path dependence, managers fear the uncertainty of foreign jurisdictions, which is exasperated by their lack of knowledge).

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law firms and the companies they advise entails risks – but it is clear that in most cases their interests are aligned and information will be shared amongst the two organisations.[111]

A more problematic scenario could materialise if law firms provide their information to legislatures, who are also likely to face limits to their legal expertise. In this case, interests need not be aligned; we have already seen that law firms have a disproportionate private interest in making the corporate law of a nation attractive for incorporation. When giving advice, they could thus nudge the government in a direction promoting their private interests, but not necessarily the public good.[112] Most legislatures, however, can also rely on government legal staff, to counter such biased information inputs. Overall, law firms can thus be said to provide information and lower transaction costs. They increasingly do so in a way that is in line with the European character of the market for corporate law, for example by opening a 'European Office' in Brussels and obtaining expertise of various legal systems.[113]

Other private parties, too, provide information on legal services. This provision can be highly specialised, as illustrated by a website guiding German start-ups towards the British Ltd. Corporate Form.[114]

The financiers of companies carry out an alternative, and highly interesting regulating role. The greater concentration of banks and other institutional creditors (such as

[111] For the advised company, withholding information will harm the quality of the judicial advice given, often in ways the company cannot possibly foresee. The law firm deals with often-sensitive information on a basis of trust. If this trust is violated, the reputation effect is likely to cause severe damage to the firm.
[112] Romano, R. (1987) "The Political Economy of Takeover Statutes" *VA Law Review* 73: p. 113 (suggesting that, because state law officials have limited resources and limited staff, they therefore cannot devote unlimited resources to information gathering and processing, and are especially susceptible to lobbying).
[113] For example: "Opening an office in Brussels is in line with De Brauw's international strategy. Managing partner Martijn Snoep: "Our clients' focus is more and more international. We increasingly assist our clients in their activities outside the Netherlands and this has led to more dealings with the European Commission. These involve merger control as well as cartels and abuse of dominant position. A presence in Brussels is therefore crucial to safeguard the quality of our services to clients." ": De Brauw Blackstone Westbroek (June 2011) "De Brauw Blackstone Westbroek Reopens Brussels Office", URL: http://www.debrauw.com/News/General/Pages/DeBrauwBlackstoneWestbroekreopensBrusselsoffice.aspx
[114] See http://www.golimited.de.

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pension funds) in Europe[115] is attributed with having sufficient leverage to prevent risk externalisation on third parties such as creditors. These financiers are often-stable shareholders or creditors, and can thus effectively mandate the inclusion of more parties into the calculus of the board – thereby preventing excesses.

Finally, various third parties can be relied upon for scrutiny of the government's legislative tasks. First and foremost, this party is the electorate, aided by the media and united in political parties. Second, interests groups that operate on behalf of other corporate stakeholders such as unions, can exert influence on the legislative activity. Third, academics and professional organisations perform regular research assessing corporate laws and professional practices.

A second way for third party regulatory competition to take place is not through the invisible hand, but rather through the (in)visible handshake. Parties to the transaction can form communities (invisible handshake) or associations (visible handshake) that promote their common interests, and regulate other members. For states, this could entail membership of organisations such as the OECD, which sets standards and produces elaborate reports on the state of, for example, corporate governance in all member states.[116] Companies, on the other hand, can form professional organisations. These organisations can, in order to protect the reputation of their sector, impose standards of appropriate behaviour on all members, sanctioning them when these standards are not met. Such standards can entail 'best practices' to inform and deal with shareholders, creditors and society more broadly, and thus limit discretion in choosing a corporate law regime.

2) *Fourth Party Regulation*

Finally, when private parties are unable to solve the problems associated with regulatory competition, the state can step in. However, the Member State participating in the 'transaction' by providing the regulatory system is unlikely to be a credible,

[115] Beck, T., Demirgüç-Kunt, A. & Levine, R. (2003) "Bank Concentration and Crises" *World Bank Policy Research Paper No 3041* Retrieved from: http://elibrary.worldbank.org/content/workingpaper/10.1596/1813-9450-3041

[116] OECD (2004) "Principles of Corporate Governance".

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effective fourth party regulator. Therefore, when describing fourth party regulation in this context, reference is made to the various European Union institutions.[117]

Several strategies are adopted to regulate the market for corporate laws. First, state practices can be challenged before the ECJ, the independent court at the European level.[118] Second, and more frequently relevant, the EU has issued various Directives setting minimum standards for corporate regimes. Even as states respond to competitive pressures, these standards have to be observed everywhere. They thus guarantee a minimum level of regulation, preventing the excesses of a potential 'race to the bottom'. Thirdly, the development of the "European Company" has set a benchmark for Member States to meet, by providing a clear alternative option.

However, these latter two approaches have been met by strong resistance in practice, as it proved difficult to reach consensus. These differences are made harder to bridge as corporate law touches on very sensitive, deeply rooted policy areas. Disagreement, for example, on the question of employee representation has been the main reason for the initial failure of proposals for a model European Company Statute.[119] Nevertheless, even as not all important issues of corporate law are completely covered, the impact of the harmonisation program is still significant – it reaches from pure corporate law, via securities regulation, financial services and social policy to competition law.[120] The European Company, or Societas Europaea (SE), is a European public limited liability company that opens up new possibilities for the restructuring and internationalisation of European businesses. It still offers flexibility, as the SE may transfer its seat across national borders without winding up. But, most relevant for this paper, together with harmonising legislation is serves as a catalyst for further legal developments.[121] These latter two approaches, offering minimum

[117] It is recognised that, generally speaking, the EU lacks some of the qualities that are beneficial for a fourth party regulator, such as democratic accountability, a monopoly on taxation and the legitimate exercise of violence. However, in the area of corporate law it has evolved to be *the* highest authority, and it is in this context that we refer to the EU as a 'fourth party regulator'.
[118] See for example articles 258, 259, 267 TFEU.
[119] Deakin, S. (2000) "Regulatory Competition versus Harmonisation in European Company Law"; Dammann, J. C. (2004).
[120] Dorresteijn, A. (2009) p. 39.
[121] Dorresteijn, A. (2009) p. 39.

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standards and setting a strong example for competing nations to meet, together preclude the market imperfections that could otherwise endanger the sustainability of the market.[122] They are thus essential to make regulatory competition a truly tenable part of the system.

6. Conclusion

With the recent decisions of the European Court of Justice, the nature of European Corporate Law has dramatically altered. The more solid application of the *freedom of establishment* has made companies more mobile. Given such mobility, we have conceptualised the resulting situation as a market for corporate law regimes, whereby Member States face supply-side incentives to improve law, and to be responsive to the needs expressed by corporations throughout the entire internal market. Similarly, on the demand-side, corporations have the incentive to find the corporate law regime that best fits their needs, even if this is in another Member State. Although we cannot with certainty establish the strength of both incentives, empirical evidence supports the view that they are sufficient, as market activity has indeed arisen.

The interaction in this market has been studied at length in this paper. We have examined what the incentives driving dominant actors are, but also concluded that the existence of such a market poses each of these actors with significant challenges. Various approaches have been assessed, both by the parties central to the transaction as well as by third parties, by which these challenges can be confronted. Finally, we have concluded that the European Union, as a fourth party regulator, can and does play an important role in preventing market failures to materialise. By setting minimum standards, the excesses of the race to the bottom are limited – whereas the creation of a European Company (SE) is likely to spur innovation at the European and Member State level.

[122] Charney, D. (1994) "Competition among jurisdictions in formulating corporate law rules: an American perspective on the "race to the bottom" in European Communities, in S. Wheeler (ed.) *A Reader on the Law of the Business Enterprise,* Oxford; Bebchuk, L. (1992).

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Conceptualising the provision of corporate law as an *autonomous market* has been incredibly valuable in obtaining insights in its intricacies. Yet, as the process has only just experienced take-off, time will allow these assessments to become more nuanced and profound. For now, proceeding with regulatory competition is likely to improve the quality and innovative capacity of corporate law. However, this road will only prove tenable if the EU is ready to take measures that continue to prevent a race to the bottom, and to put incentives right both for states and companies. Without their action, the sustainability of the market for corporate law is uncertain. Even as the principle of a market of corporate laws is sound, the EU has repeatedly shown that practice can deviate from principle. This time, it might be the only institution capable of preventing that from happening again.

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