Regulatory competition in European company law

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Abstract States have customarily tended to compete with one another. Not always, however, is this tendency, or the underlying methods put to use, obvious. That states (provincial divisions in the US) were competing to attract incorporations by relaxing their regulatory standards, couldn’t be seriously observed and highlighted until mid-1970s. Today, a few would doubt the existence of regulatory competition in corporate law in the US. In this paper, the author examines the issue whether the EU is (likely to be) engaged in regulatory competition in the area of company law. Answering the question in affirmative, the author proceeds to examine the strength of the race to the bottom and the race to the top theories, as developed and argued in the US, for the European setting. Since the legal systems of Member States of the EU have certain very disparate “core values” along which those systems have historically developed, relaxation of standards in the EU would take place against different variables. Because of the multitude of variables, comparable variables are unlikely to yield comparable results; either of the race theories is unlikely to satisfactorily predict the regulatory behaviour of EU Member States. Instead, since “laxation” in respect of one variable would be met by “optimisation” in respect of the other, there is likely to be simultaneous races to the top and to the bottom among the EU Member States.

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Keywords  Regulatory competition · European company law · Race to the top · Race to the bottom · Conflict of laws · Incorporation theory · Real seat theory

JEL Classification  K29 · K22

1 Introduction

Laws between different states differ. The difference (between their laws) is not always the result of a “natural” and “purely domestic” evolution of their systems, but is sometimes motivated by “external” factors, including and particularly the success of foreign systems.¹ This diversity is (on the other hand) exploited by the subjects to their benefit and so the subjects are attracted to the system which provides them with the possibility of deriving maximum benefits. This phenomenon of exploitation is referred to as “regulatory arbitrage”. With a view to availing comparative advantage over other “successful” legal systems, states therefore create legal diversity. This intentional creation of legal diversity by the states, calculated to avail competitive advantages, is, in short, referred to as “regulatory competition.” Simply put, regulatory competition refers to the competition between states, in their capacity as regulators, for attracting resources and mobile factors of production by creating and providing potential subjects with the opportunity to exploit their “different and better” regulatory product.

While regulatory competition and regulatory arbitrage, in some sense, form a vicious circle, there is no eggs-and-hens conundrum here. Legislators may not necessarily compete with each other and yet there may be some arbitrage since arbitrage is related to legal diversity per se, whether or not there is a conscious effort on part of the states to create it. Regulatory competition, on the other hand, is premised on there being at least some arbitrage since the idea of this competition is to engage in competitive exercise in order to avail the competitive advantages. In other words, if there is no regulatory arbitrage, there can be no regulatory competition. Clearly, then, it is regulatory arbitrage that preceded regulatory competition.

Though the meaning or concept of regulatory competition continues to be a “puzzle”,² the academic debate today is focussed on the direction of the races amongst states that enter the regulatory competition. Two theories dominate the debate: race to the bottom theory and race to the top theory.³ The “bottomists” argue that regulatory competition results in a systematic lowering of regulatory standards leading to high costs to the consumers and state as a whole, and thus calls

¹ This motivation is more apparent in the judicial systems of common law jurisdictions, where foreign judicial decisions are often quoted to persuade a court to respond to an issue in a manner it has been dealt with by courts abroad. The ostensible argument cited against adoption of the foreign solution is the need for “domestic adaptation.” This is however not always the real motivation, particularly in states with developed systems of laws, where the real motivation, as would be apparent from this paper, is regulatory competition. The motivation is also discernible in the area of legislations.

² See, Radaelli (2004), Murphy (2004), and, for the origin of this concept, Tiebout (1956).

³ Infra II.C.
for harmonisation and/or intervention at the federal level in the form of centralised law and policy making. “Topists”, on the other hand, argue that regulatory competition has the effect of “stimulat[ing] experimentation, innovation and product differentiation in regulation,”⁴ resulting in “adoption of standards of varying stringency [and creation of more competitive and] efficient laws and enhance[d] social welfare”⁵ based on a simple extension of the principles of competition and free market for ordinary consumer products to the market for regulation. More recently, another approach, referred to as “regulatory co- operation”,⁶ has been put forth and is claimed to better explain, in light of the diversities and complexities of the real world, the “optimal governance [level as] a flexible mix of competition and cooperation”⁷ between regulators. Aside from the debate, there is also support for the view that the “obsession with ‘races’” has led to the arrest of the understanding of international regulatory competition.⁸

The aforesaid theories have been advanced primarily in the context of corporate law in the US. This paper seeks to examine the possibility of regulatory competition, and the applicability of the aforesaid theories, in the area of company law in the EU. To that end, after identifying and highlighting some key features of the European (Company) law in Part III, this paper, in Part IV, examines whether the conditions, as may derived from the fierce debate in the US, for the existence of regulatory competition are found in the EU. Answering that question in affirmative, the paper concludes by professing a “simultaneous races” thesis for explaining the nature and implications of regulatory competition in the EU.

2 Regulatory competition in corporate law: the US debate

2.1 Introduction

Since it is the managers who take the decisions, firstly, of incorporation, and subsequently, of reincorporation, any state interested in attracting incorporations would “create” and “supply” law which is most “favourable” to the management so as to induce the managers into taking “favourable” corporate decisions. At what level does a state wish to pursue the goal of attracting incorporations, determines the vigour (for instance, the frequency of amendment of its corporate law) and status (for instance, its recognition as “public policy” of the state) that would be granted to such goal and the consequent steps that such state would take in order to attain it.

It is often argued that those states, which opt to pursue charter competition, make their laws more attractive to the managers by limiting their exposure to liability, which leads to an overall deterioration of the corporate law standards.⁹ This theory

⁵ Id., p. 33.
⁶ Id., p. 30.
⁷ Id., p. 31.
⁸ See, Radaelli, “Regulatory Puzzle”.
that, in order to secure or maintain for themselves a position of leadership and attraction in corporate charters, states will lax their regulatory standards is commonly referred to as the “race to the bottom” theory.\(^{10}\) This theory was, in the early 1980s, confronted by the “race to the top” theory: the theory that argues that the dynamics of competition apply also to the market for regulation and that competition amongst the states, in fact, leads to the evolution of the most efficient laws.\(^{11}\)

Ever since, the “competition” between these two theories has been fierce. There are strong arguments on either side. While the debate has basically focussed on these two, there have also been some other, more tangential, thoughts which have been shaped around, and carry arguments and characteristics identifiable with, one of the two theories. Nevertheless, the search for the “more correct” of the two continues.

Since the context is transnational,\(^{12}\) before one proceeds to the aforesaid race theories in greater detail, it may be worth time and space to appreciate the various conflicts norms for determining the law applicable to a corporation doing business in one jurisdiction, but which owes its incorporation to the laws of another jurisdiction.

2.2 “Incorporation” and “real seat” doctrines

That a corporation would carry with it, and be governed by, the law of the place of incorporation so far as its internal corporate affairs and validity are concerned,\(^{13}\) wherever it chooses to carry on its actual business and/or central administration, is by what is, in essence, meant by the “incorporation doctrine.” The rival conflicts norm for governing corporate entities is often referred to as the “real seat doctrine”—more locally, also known as “theorie du siege reel”, “Sitztheorie” and “teoria della sede (effective)”—according to which a company is governed by the law of the state where the company has its “real seat”. While there is some disagreement about what amounts to “real seat”; for our present purposes, suffice to say that it is the place where a company has its main establishment and/or most of its major decisions are taken.

The incorporation doctrine is based on the rationale that a company is a “creature[,] of the law”\(^{14}\) and that since without reference to that law, there is no company at all; those affairs which are truly characteristic of a company, and which can, without reference to a company law, not exist, must be governed by the law of

\(^{10}\) The expression was first used by Judge Brandeis in *Liggett v. Lee* 288 U.S. 517, though the theory was most forcefully propounded by William Cary, *Infra* II.C.

\(^{11}\) For an analysis of the American treatment, see, Rees and Kaufman (1958).

\(^{12}\) The difference in substantive regimes of different states makes the choice of the connecting factors important. See, Drury (1998) and *R. v. Secretary of State ex parte Factortame* [1991] 1 AC 603 (ECJ).

\(^{13}\) See, *Henriques v. Dutch West India Co.* (1728) 92 E.R. 494, where this doctrine is believed to have originated. For an analysis of the American treatment, see, Rees and Kaufman (1958).

the place of incorporation.\textsuperscript{15} On the other hand, the argument in favour of the real seat doctrine is that since the state where, and under the laws of which, the “real” activities of a company are carried on, constitutes the “real seat”, the company must be governed, regardless of the place of incorporation, by the laws of such state.

Recognition of companies incorporated in one jurisdiction and having the real seat in another and of companies moving the real seat from one state to another are matters for each individual state to determine as part of its conflicts of laws rules. Due to the difference in the conflicts norms, difficulties arise where a company moves from one jurisdiction to another where the two jurisdictions follow different conflicts norms. The difficulties become acute in a federal set up which permits free movement of companies but not all of whose provincial divisions follow the same conflicts norms.\textsuperscript{16} The risk of non-recognition, of course, hinders the prospects of free movement.

A state that follows the incorporation theory (hereinafter “incorporation state”) as its conflicts rule, effectively gives the managers (a) the choice\textsuperscript{17} to blend the most favourable business regime (by choosing an appropriate business location) with the most favourable (the federalists would argue, the most lax; and, the competitionists would argue, the most optimal) corporate law regime (by choosing an appropriate jurisdiction for incorporation); and, (b) the certainty and predictability that it is this law (of the place of incorporation) alone that would govern (which is, unlike the real seat doctrine, known at the time of incorporation itself). Sometimes, this gives regulatory legitimacy to “pseudo-companies” or “tramp-corporations”:\textsuperscript{18} the single weightiest criticism of the incorporation theory. On the other hand, since the real seat theory looks to the “reality” of the company’s decision making activities and not the “fiction” of its creation by law,\textsuperscript{19} it addresses the possible “forum shopping” argument, thereby preventing, or in any event minimalizing, the evasion of the law of the place where it actually has its central administration.

In view of its characteristics of choice, certainty and predictability, it is believed that the incorporation doctrine motivates or, at any rate, facilitates at least some degree of regulatory competition in corporate law matters.

\textsuperscript{15} See generally, Restatement (Second), Conflict of Laws (1971), S. 301; \textit{CTS Corporation v. Dynamics Corporation} 481 U.S. 69. For an outdated view that being a creature of national law, a (foreign) company cannot be recognised outside such system, see, \textit{Bank of Augusta v. Earle} (1839) P.S.C. 519.

\textsuperscript{16} For an analysis of the problems created in the European context, \textit{infra} Part III.D.2.

\textsuperscript{17} See, for arguments in favour and against the desirability of this freedom of choice, Symposium (1989).

\textsuperscript{18} A pseudo-company is one which is incorporated in a state but carries on its business and administration wholly outside its territorial limits. However, where the only connection with a state is the “naked fact of incorporation” and no more, the courts have taken a more pragmatic view and refused to apply the incorporation doctrine. See, for example, \textit{Mansfield Hardwood v. Johnson} 268 F.2d. 317 in the United States. See also, \textit{Kaplan} (1968), \textit{Latty} (1955); \textit{Kozyris} (1985). Though argued by some, when, to address the concerns of regulating a tramp corporation, the courts apply a “most-closely connected country” type test, it is doubtful whether it is actually and always a reference to the real seat doctrine (though in most cases, it would be).

\textsuperscript{19} Drury, “Recognition of Foreign Corporations”, p. 194.
2.3 “Race to the bottom” theory

In the US, barring some areas such as insider dealing, disclosure etc., corporate law is within the domain of the provincial states. The legislative competence of the provincial states in matters of corporate law, together with the endorsement of the incorporation doctrine in the US, led William Cary—a former SEC Chairman—in his 1974 paper, to painstakingly conclude that a phenomenon towards laxing corporate law standards is taking place in the US, with Delaware taking the lead, and in some sense, modelling the corporate law and deciding the direction for its development for the whole of the US. Cary was of the view that driven by the motive of earning revenue from incorporations, and after taking the lead from New Jersey, this “pygmy” has relaxed standards of directors’ obligations by enacting enabling legislations and laying more emphasis on form than substance, thereby heavily tilting the scales of corporate governance and “indicat[ing] a clearer penchant” in favour of the managers, leaving little for the shareholders. Cary also found that this pro-management view in corporate matters was the “public policy” of Delaware and has influenced heavily not just the legislature but also judiciary, which has “an incestuous relationship with legislators and the practising bar.” The Delaware courts are, he argued, constantly in a jurisprudential dilemma and they seek to carry out this constructive state policy of permissiveness of management conduct. This influence, Cary claimed, is discernible from the relaxation of fiduciary standards in the matters of buying stock from majority or

23 Id., p. 669.
24 For a historical account of the Delaware syndrome, see, Butler (1985) and Alva (1990).
26 See generally, Latty (1965).
27 As to the relationship between separation of ownership from control and profit of the enterprise, which Daniel Fischel understands to be the theoretical foundation for Cary’s “race to the bottom” conclusion, see, Berle and Means (1968) and, Posner (1977) generally.
29 Id., p. 669 and p. 679.
30 Cary gives a detailed account of several decisions from Delaware courts which clearly go to show that the Delaware judiciary has been instrumental in pursuing this state “public policy”: Id., pp. 670–686.
33 For a contrary view of the role of the Delaware courts, see, Arst (1976). Similarly, Winter also believes that the Delaware courts have not been excessive, though admitting generally that “the case law interpreting [Delaware code is not] perfect.” He however hastens to caution as “unrealistic” any “expectations of unvarying correctness”, see, Winter (1977, p. 6). (hereinafter “Winter, “Corporation Theory””).
individual stockholders, proxy contests and takeovers, nature of proxy material, accrued dividends and reclassifications, the de facto doctrine, parent-subsidiary fairness and directors’ duty of care.

This “deterioration of corporate standards,” which Cary termed as “race for the bottom” appears to have been built on the oft-quoted observation (in dissent) of Judge Brandeis of the US Supreme Court that “[c]ompanies were early formed to provide charters for corporations in states where 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.” The test argued to support the race to the bottom can be aptly abbreviated as a “but for” test, i.e. in the absence of (but for) such a competition, states would not set such lax standards—touching or reaching the bottom—to govern the conduct of the intended regulatees. In short, the complaint of the federalists is that the vicious “cycle of regulatory moves […] and ends up with all countries in a position that is worse than the one they could have secured by coordinating their policies.”

To avoid this systematic “water[ing] of rights of shareholders down to a thin gruel” and rampant “abuses of financial capitalism” caused due to this absurd race amongst states, Cary suggested federal legislation and federal standards in the area of corporate law. This is likely to qualify the constitutionality test, notwithstanding the strength of “the principle of state’s rights and the idea that each state is a laboratory.” Uniformity in the proper conduct of corporation, Cary believed, is essential in a management-confidence based capitalist society and if “[t]his unhappy state of affairs” is to be changed, there is a need for federal

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34 Cary, “Federalism”, 672, citing the federal court decision in Mansfield Hardwood v. Johnson 268
36 Id., p. 675, citing American Hardware v. Savage Arms Corporation 37 Del. Ch. 59, Cary comments that “the Delaware courts are reluctant to assist any group seeking a takeover.” Id., p. 677.
38 Id., p. 679, citing Hariton v. Arco Electronics Inc. 41 Del. Ch. 74.
41 Id., p. 663.
42 Id., p. 666 and 705.
46 Id., pp. 696–705.
47 For a detailed discussion of the constitutional challenges posed by federalisation of corporate law in the US, see, Student Note (1972). See also, Nader et al. (1976) for a view endorsing the constitutional desirability of federal law on the basis of the “interstate” or “international” character of the underlying transactions.
49 Id., p. 663.
standards and participation of the federal judiciary.\(^{50}\) An alternative means of federalising corporate law is federal incorporation, by which is meant that the corporations would be incorporated under a federal law providing for mandatory—
as against minimum standards prescribed under the first alternative—provisions for regulating *inter alia* the internal aspects of a corporation.\(^{51}\)

In either case, the emphasis is on repairing the market and avoiding international market failures, through federal intervention, so as to eliminate the detrimental effects.\(^{52}\) In short, the federalists favour harmonisation of regulations at a federal or inter-jurisdictional level to facilitate open markets, minimise non-tariff barriers and prevent competitiveness-driven, welfare-reducing under-regulation\(^{53}\) and to that extent, seek to justify a large expansion of federal legislation in the US and of EC Treaty Article 249-measures in the European Union.\(^{54}\)

This criticism of Delaware’s attitude towards corporate law matters led, at least for sometime immediately after Cary’s article, to a suspension of the untrammelled race for the most lax corporate rules.\(^{55}\) This federalisation suggestion did not however necessarily find support from the federal judiciary in all cases.\(^{56}\) The real impact of this change in attitude, on the position of Delaware, is thus far from clear, though some believe that this would have some adverse effect on its ranking because of the “decreased stability of precedents” and “increased regulatory constraints on corporate activities.”\(^{57}\)

2.4 “Race to the top” theory

Just as any other theory, the race to the bottom theory is not universally accepted. The critics of the theory strongly argue that the markets in reality run in the diametrically opposite direction in that any corporation incorporated in a state that permits management to benefit at the cost of the shareholders would be at a disadvantage in the securities as well as products market and would be susceptible to takeover and the consequent management replacement. Therefore, any state targeting at attracting charters must render “optimal” management-shareholders relations standards.\(^{58}\)

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\(^{50}\) Id., pp. 700–705.

\(^{51}\) See generally, for this suggestion, Nader et al. (1976).

\(^{52}\) Cf., Klevorick (1997).


\(^{54}\) Besides “race to the bottom” also, federalism is justified for (a) the presence of interstate externalities and (b) public choice rationale. Those who oppose “across-the-board” federalisation however argue that federalisation does not constitute the complete elimination of race to the bottom tendencies since there may be other regulatory dimensions where states may compete. See, Revesz (2001) (hereinafter “Revesz, “Federalism””).

\(^{55}\) For a good survey of the changed attitude and reaction of the Delaware courts to the criticism and “popular support”, see, Fischel, “Race Revisited”, pp. 923–941.

\(^{56}\) See, for instance, the decision of the US Supreme Court in Sante Indus, Inc. *v.* Green 97 S. Ct. 1292, where the SC declined to set the fiduciary standards under the Securities Exchange Act, 1934 as the general corporate law standards.

\(^{57}\) Fischel, “Race Revisited”, pp. 941–945.

The competitionists believe that contrary to the view of the federalists, the interests of the shareholders and management are not necessarily conflicting. Though different from a strictly legal perspective, in fact, the two synergise from the economic perspective. In such a scenario, the management, with a view to attaining its economic self-interest, takes decisions which also, incidentally though, benefit shareholders. Thus, the competitionists build a case for state competition in the face of the Berle & Means' ownership-control analysis, which in turn seems to be the theoretical underpinning for the race to the bottom thesis.

The chief criticism of the race to the bottom thesis, as the competitionists argue, is that it is based on a “model of shareholder irrationality” and that, in some sense, it fails to take note of the practical realities that even well-informed and rational investors continue to invest in Delaware corporations. Indeed, the notion of “ownership” of shareholders fails to appreciate that a corporation simply serves “as a nexus for a set of contractual relationships among individuals” and to that extent, the management is rightly entitled to be “entrusted” from a set of disinterested and amateur (contractual) suppliers of capital. Indeed, contrary to the assertions of the federalists, the interests of the shareholders and managers are not inherently incompatible; their argument is based on the theory of free consent: that a party would enter into a contract and surrender any rights in favour of the other only for a *quid pro quo* which it finds sufficiently advantageous. And, the parties must be granted this basic freedom so far as the arrangements do not have a “substantial cost on society or third parties.” The price that the shareholders will be willing to pay for the shares would adequately reflect this denial of decision making power and agency costs; and the market value of the shares would always be reflective of the managerial responsibility: individually and collectively. The nature of management decision making also determines the overall standing in the securities market which factor again tends to discipline management opportunism.

It is further argued by the competitionists that much inefficiency of the managers would often lead to inviting, towards the firm, activity in the “market for corporate control”, thereby “compelling [the management] to make the decision [of where to incorporate] in the shareholders’ best interests” by opting for a state that “offers an efficient set of restrictions.” The states therefore seek to “climb to the

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60 See, Fischel, “Race Revisited”, p. 917.
65 See, Fischel, “Race Revisited”, p. 918.
67 Winter (1964).
68 For a detailed analysis of this argument, see, Manne (1965).
70 Dodd and Leftwich (1980).
top” by providing permissive and enabling corporate law rules that “maximise rather than minimise shareholders’ welfare.”\footnote{71} This value-maximising effect of such competition\footnote{72} is, the regulatory competitionists claim, supported by empirical evidence.\footnote{73} The claim is based on a straightforward cost-benefit analysis: that any “more-than-optimal/existing” disclosure requirements and/or judicial review are likely to increase the cost of decision making and therefore lead to a reduction in shareholder value.\footnote{74} The management would thus “demand” optimal corporate responsibility standards from states; and since managers would run to such states for incorporation, the states in their turn have an incentive to “supply” such optimal regulatory standards. The market forces of demand and supply together with competitive pressures from other “players” in the regulatory market lead to the evolution of the most efficient laws and the modelling of all states’ laws around this efficiency standard.\footnote{75} In this sense, the race to the top theory is an application to corporate law matters of the “survival of the fittest”\footnote{76} theory: the race results in the evolution and survival of the most efficient laws. In short, the argument is that market forces constitute adequate control against management opportunism notwithstanding competitive liberalisation of constraints on managers.

Another criticism, which is directed at the solution advanced by the federalists rather than an attempt to show a logical fallacy in the race to the bottom thesis itself, is that harmonisation does not afford an effective solution to the race in that when the standards actually touch the bottom, the laws would automatically converge and there would be no “incremental incentive to move.”\footnote{77} Thus, it is sometimes suggested that the solution to the alleged race lies not so much in simply spelling out a recommendation for harmonisation, but in determining the level at which it is sought, leaving at diversity everything above this level.\footnote{78}

2.5 Other thoughts

The two races, as stated above, do not represent the entire debate. There are other lines of arguments too—each claiming to better understand and respond to the controversy. In this regard, while not undermining or underestimating the
301 contributions made by others, notable ones are those by Prof. Bebchuk and Prof. Roe. We proceed to appreciate these views.

Lucian Bebchuk, in an attempt to resolve the debate over the merits of state competition, argued that the nature of the consequential race is subject-specific i.e., the “state competition produces a race for the top with respect to some corporate issues but a race for the bottom with respect to others”79 and identified those issues where competition is undesirable, and suggested a “significant expansion of federal corporate law”80 on such issues. His analysis seems to be built on the premise that states have an incentive in always supplying what managers demand. To the extent that the interests of shareholders and managers do not converge, Bebchuk favours federal intervention. He identifies three key issues which leaves ample scope for managerial opportunism, which market forces fail to arrest,81 viz. (a) transfer of significant value from shareholders to managers; (b) issues directly affecting the strength of market discipline; and, (c) transfer between public shareholders and controlling shareholders.82 The real contribution however is his introduction of the concept of “externalities”,83 which contemplates the interests of all parties “not involved in incorporation decisions” and the presence or absence of which has a bearing on the protection afforded by the corporate law rules,84 even where the interests of managers and shareholders converge and the managers have “only the shareholders’ interest in mind.”85 Bebchuk concluded by arguing that the desirable mandatory corporate law rules can be imposed only at the federal level and that there is an inherent inconsistency between mandatory rules and state competition, in that the existence of several state regimes provides an opportunity of “opting-out” at least by reincorporation.86 He favours federalisation of specific issues of corporate law notwithstanding some admitted imperfections of inadequacy of information and possible lobbying by interest groups.87

Mark Roe, on the other hand, broadly argues that the competition for charter is not just limited to states but there is a parallel beauty contest with the federal legislator as well, which together constitutes the “fundamental structure of American corporate law.”88 In light of the predominance and independence of Delaware as the “first drafter” and “caucus”89 in promptly responding in corporate law matters, but whose authority is based on nothing more than the mercy of the

80FL01 80 Id., p. 1440.
81FL01 81 See, Bebchuk (1989).
83FL01 83 Id., p. 1485.
84FL01 84 Id., pp. 1493–1495.
85FL01 85 Id., p. 1485.
86FL01 86 Id., p. 1496. For a strong response to this view, highlighting the acute federal public choice problems, see Kostel, “A Public Choice Perspective on the Debate over Federal versus State Corporate Law” (1993)
86FL02 79 Virginia Law Review 2129.
89FL01 89 Id., p. 2493.
federal legislature, Roe terms Delaware as a “quasi-federal agency.”90 His article focuses *inter alia* on the constitutional division of legislative powers and the public choice structure of the relationship between the states and Washington and shows that the federal legislator has the power to “displace” any or all of the corporate lawmaking powers from the states. While there is a constitutional possibility, Roe concludes that Delaware as well as the shareholders and investors have reasons to resist any move for “federal action.”91 It is therefore seldom that the federal intervention would be triggered, except on some “big issues”. It appears that even before Roe drew up this “sketch”, Bebchuk was referring to these big issues where the managers’ and shareholders’ interest do not match and there is a systematic development of “undesirable” corporate rules. In some sense, then, Roe’s theory is not a “competition” theory, but is really a “competitors’” theory. This analysis gives the corporate charter competition debate, a new dimension: it dispels any argument that the correct variables for study in this debate are limited to states alone. This idea has therefore added the “vertical relationship”92 parameter to this “inter-jurisdictional game.”93

2.6 Analysis and inferences

That there is regulatory competition in the US is not debated today. The debate seems to be actually focussed on the nature, consequences and the desirability of one or the other of the many recommended antidotes. One may however deduce that (a) all are against any law that results in awfully reduced shareholder protection; (b) the incorporation doctrine and the full faith and credit clause have the effect of providing regulatory arbitrage; (c) corporate law is not within the exclusive jurisdiction of either the states or the federation; and (d) some areas are more prone to managerial opportunism than others.

From the US debate the least what can be deduced is that in order for regulatory competition to take place, there must simultaneously exist, both the opportunity for, and the perceived benefit(s) of, competition. For the existence of opportunity for competing there must concurrently be (a) at least some common playing field—some least commonality—to form the basic floor on which to contest; (b) actual or possible access to the relevant market, i.e. the market where potential regulatees are present; (c) legal possibility of demanding and availing competitive advantages94; and, (d) legal possibility for the interested competitors to respond to the market forces by “supplying” law as demanded. All these together create the necessary opportunity for competition. In addition to the legality of competition, the state must also be convinced of the benefit that it will derive from entering into the beauty contest. The benefits need not necessarily be economic, but may also be social or

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90FL01 90 *Id.,* p. 2499.
91FL01 91 *Id.,* pp. 2515–2522.
92FL01 92 *Id.,* p. 2499.
93FL01 93 *Ibid.*
94FL01 94 See, Gibson (2001).
political. Additionally, the benefits may not be tangible or immediately noticeable. This would be particularly so where the benefit is a political benefit.

2.7 Conclusion

Perhaps the basic difference in how one sees state competition depends on one’s view of corporate law. Federalists tend to look at corporate law as a domain for government regulation and intervention whereas the competitionists look at corporate law also as an extension of the law of contract where governmental activity is limited to enforcement of private bargains and cost reduction.95 At a jurisprudential level, the debate therefore boils down to the nature of interest that a shareholder has in a company, i.e., whether the interest is merely pecuniary or is there a “real” ownership interest, and the degree to which such interest aligns with that of the management. Corporate law is then merely the regulatory response to maintaining such an interest: a question that each state decides for itself.96 The desirable limit of government intervention—whether “minimum” or “default” standards setting—is, then, also explained by the same difference in perception. This also explains why competitionists view minimum standards rules as interventionist.

3 European company law: some key features

3.1 Introduction

Having been through two world wars, six (original member) states came together to establish a “closer union” in Europe on the idea “that having economic interests in the other countries [is] a most effective, and perhaps the only, way of preventing wars from taking place in future.”97 One of the ways of doing this was thought to be through the establishment of a free common market “characterised by the abolition […] of obstacles to the free movement of goods, persons, services and capital”98 and other “barriers which divide Europe”99; and for that purpose and to that extent, “the approximation of the laws of member states”100 on the idea perhaps that divergence between member state laws would, contrary to Article 3(g)

96FL01 96 The difference between “pecuniary” and “real ownership” interest is well exemplified in the manner in which the takeover regime is crafted in each of the US and the UK. The US permits whereas the UK prohibits employment of defence tactics by the management. See generally, Rosenzweig (2007).
97FL01 97 Sachdeva (2007).
99FL01 99 Article 3(1)(c), EC Treaty.
100FL01 100 See, Preamble, EC Treaty.
101FL01 101 Article 3(h), EC Treaty.
of the EC Treaty, lead to distortion of competition.\textsuperscript{102} This freedom of movement of persons contemplates \textit{inter alia} the movement and establishment of legal persons.\textsuperscript{103} To confer a meaningful right, the EC Treaty also endorses the principle of national treatment.\textsuperscript{104} However, due to the differences in the national company laws\textsuperscript{105} of member states; this fundamental freedom gives rise to severely complicated issues.

3.2 The harmonisation proposal and its desirability

The disparity between national laws is so wide that there is no “company law” from a European perspective.\textsuperscript{106} The existence of barriers in this field\textsuperscript{107} came to be promptly recognised as a serious problem, the solution to which in the early days of the EC was proposed to be a “virtual unification of national company laws”\textsuperscript{108} suggested on much the same lines as the “race to the bottom” thesis across the Atlantic.\textsuperscript{109} Besides saving information costs and evasion of forum shopping, “centralisation”, the federalists believe, also “minimise[s] the so-called (negative) inter-jurisdictional external effects”\textsuperscript{110} over persons not participating in decision making. The harmonisation proposal, it is argued, thus combines desirable corporate standards with the freedom of establishment and thus “fertilise[s] the national company legislations”\textsuperscript{111} in that it could potentially avoid a European Delaware.\textsuperscript{112}

\textsuperscript{102} Edwards (1999).
\textsuperscript{104} Article 294, EC Treaty.
\textsuperscript{105} See, Hansmann and Kraakmann (2004).
\textsuperscript{107} See, Villiers (1997).
\textsuperscript{108} Schmitthoff (1973). See generally for a very strong view that “the Community cannot tolerate the establishment of a Delaware in its territory”, \textit{ibid}. For a lucid history of the EC company law, see, Edwards (1999). This early consensus for harmonisation grew at around the same time as the “race to the bottom” cry across the Atlantic: Deakin, “Regulatory Competition versus Harmonisation in European Company Law” in Esty and Damien (2001) (hereinafter “Deakin, “Competition versus Harmonisation””).
\textsuperscript{109} See, Kolvenbach (1990).
\textsuperscript{110} Grundmann (2007).
\textsuperscript{111} Schmitthoff (1976).
\textsuperscript{112} See, Enriques (2004) and Charny (1991) (hereinafter “Charny, American Perspective””): there is no reason to fear the Delaware syndrome in the EU. \textit{Cf.}, Edwards (1999) 3 arguing that divergences in the national company laws “may be expected to create a European ‘Delaware effect’”. See also, Armour, “Who Should Make Corporate Law” arguing a case for regulatory competition and against harmonisation in Europe.
The legal basis for an EC-level measure is embedded in the EC Treaty itself\textsuperscript{113}; the appropriate measure being acting “by means of directives.”\textsuperscript{114} By the very definition then, the company law standards set by the EC are “binding, as to the result to be achieved […] leav[ing] to the national authorities the choice of form and methods.”\textsuperscript{115} Unlike a Regulation, therefore, a Directive is not “directly applicable” and must be implemented by way of a national legislation. This constitutes a “weakness of this type of instrument” and the consequent harmonisation sought to be achieved through it.\textsuperscript{116} In this regard, ECJ’s willingness to accord “vertical direct effect to unconditional and sufficiently precise provisions of a directive” and the Commission’s ability to “monitor national implementation” are neither free from difficulty nor fully practicable.\textsuperscript{117}

The harmonisation drive in the area of company law has followed a not-so-consistent pattern.\textsuperscript{118} The “result to be achieved” in the Article 249-sense, it appears, was more precisely defined in the first few years of the harmonisation programme. The heavily prescriptive approach noticeable in the first-generation directives faded in wake of the expansion of the EU\textsuperscript{119} and its growing political agenda,\textsuperscript{120} including the demand for greater provincial autonomy and the emphasis on the subsidiarity principle.\textsuperscript{121} This led to the relaxation of the nature of reforms which were now made less prescriptive and more “frameworkish,”\textsuperscript{122} albeit not necessarily more successful.\textsuperscript{123} Some of the fundamental issues and key concepts have remained contentious and without agreement.\textsuperscript{124} Each of these factors has led

\textsuperscript{113} Article 44(2)(g), EC Treaty provides the legal basis for “making equivalent throughout the Community,” “by coordinating[…] the safeguards … required by member states of companies or firms within the meaning of the second paragraph of Article 48.” The consequence of choosing an incorrect legal basis for legislation is the risk of its annulment by the ECJ.

\textsuperscript{114} Article 44(1) read with Article 94, EC Treaty.

\textsuperscript{115} Article 249(3), EC Treaty. The position of a maximum harmonisation directive is however slightly different.

\textsuperscript{116} Edwards (1999).

\textsuperscript{117} Id., pp. 10–11.

\textsuperscript{118} See, Villiers (1998).

\textsuperscript{119} Edwards (1999).

\textsuperscript{120} For a vividly expressed account of development of EC company law, including the influence of the growth of the political agenda, Wouters (2000) and citations therein.

\textsuperscript{121} Infra, III.D.1.f.

\textsuperscript{122} Villiers (1998).

\textsuperscript{123} Deakin, “Competition versus Harmonisation” pp. 194–195.

\textsuperscript{124} All the company law systems in the EU form a spectrum, at the one end of which is the UK and the other, Germany. In a blatant language, therefore it is not incorrect to suggest that they are the only two real company law systems in Europe. Any harmonisation exercise is then only an attempt to reconcile the UK concepts with the German. Some of these contentious issues include employee involvement, minimum capital requirements, creditor protection, structure and constitution of the board, control structures, modes of corporate control and the conflict of laws rules for recognition of “foreign” companies. The categorisation of company law systems into “insider” and “outsider” systems quite adequately brings out these differences. See for this categorisation, Mayer (1997).
the company law directives to “contain numerous alternatives and options, so that their contribution to harmonisation is perceived by some as illusory.”

“Harmonisation” however does not reflect the whole company law scholarship in the EU. Other solutions, including regulatory competition, reflexive harmonisation and co-opetition are often suggested. Opposition to harmonisation is sometimes also based on the reasoning that the race to the bottom thesis prepared for and argued in the US has no application in the EU setting in that the diversity is so wide and well developed and the historical factors that led to the emergence of Delaware as the clear leader are lacking in Europe; and that to that extent there is no threat of a European Delaware. Nevertheless, some much weaker form of the Delaware syndrome has been taking place in Europe since a long time. Before we proceed to the question of assessing the existence and nature of regulatory competition in EU company law, we must in brief discuss the differences between the US and the EU systems in order to best appreciate the extent to which EU may learn from the US experience and utilise the US debate.

3.3 Comparing US and EU: how much to learn

The corporate regulatory structure of the US is not as similar to that of the EU one as, on the first glance, it appears to be. This section of the paper highlights some of these differences. The most important being that unlike in the US, the boundary between the member state and the Community competences is still being evolved in the EU. The EU legislative process, besides being slower, is still more akin to international treaty drafting than to federal law making.

In the specific area of corporate law, companies in the EU do not have the same choice as in the US and the pattern of incorporation in EU is “substantially different.” Moreover, no EU member state is expected to earn incorporation duties to constitute such a considerable portion of its tax receipts as does Delaware. The competition debate is in any event in its nascent stages in the EU and has not been adequately analysed from a legal perspective. The differences in

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127 Cheffins (1997).
129 Cf., Grundmann however considers that the constitutional framework in the EU is the same as in the US. The integration goal is the EU equivalent of the full faith and credit clause; and the subsidiarity principle, of the internal affairs doctrine: Grundmann (2001) (hereinafter “Grundmann, “Different Genius””).
132 The proponents of regulatory competition in Europe primarily have been economists and the few legal scholars tend to take, contrary to the European legislator, a pragmatic line with respect to this concept: Grundmann, “Different Genius” p. 566.
language,\textsuperscript{133} forum for litigation,\textsuperscript{134} and frequency of minority litigation\textsuperscript{135} together with the fact that the nineteenth century factors that led to emergence of Delaware are lacking in the present day EU makes an observer complacent that even though in the present state of things, some systems are clearly more attractive,\textsuperscript{136} the Delaware syndrome would not arise in the EU. All these factors explain that the regulatory products are much less similar and accordingly limit the extent to which one may draw from the US discussion.

Despite these known difference, any literature examining regulatory competition in the EU invariably discusses the debate in the US. This work also illustrates this path dependence in that a clear understanding of the theoretical underpinnings of the arguments and of the solutions suggested is essential in order to prepare a well adapted “indigenous” model of regulation for the EU. And, for this purpose, we now more closely examine the working of the European “federal” system.

3.4 European intervention: nature and modes

The “Europeanised” company law comes from two institutions: (a) the European Council and (b) the European Court of Justice (hereinafter “the ECJ” or “the Court”). While emanating from the same mandate, these two institutions play very different roles in shaping up the company law. This, we will see, has implications from the point of view of regulatory competition.

3.4.1 Legislative intervention

The European Council is essentially engaged in a harmonisation exercise, thus leading to the convergence of the national laws at a “general” level and the minimisation of legal diversity. The EC legislative intervention has been generally dealt with in some detail in Part III.B above and here we will focus only on the principle of subsidiarity as a limitation upon it.

3.4.1.1 The subsidiarity principle

The political and legislative process in the EU is strikingly different from that in the US. In the US, there is a clear constitutional demarcation of powers between the federation and the states. In the EU, on the other hand, the Community has legislative jurisdiction in respect of “areas which do not fall within its exclusive competence”, where it can lawfully “take action” strictly in accordance with the principle of subsidiarity, only if and in so far as the objectives of the proposed action cannot be sufficiently achieved by the member states.\textsuperscript{137}

\textsuperscript{133}Kirchener (2004).
\textsuperscript{134}Dammann (2004).
\textsuperscript{136}See, John Armour, “Who Should Make Corporate Law”.

\textsuperscript{137}Some efforts have been made in the past to show that UK would be obviously the favoured jurisdiction. Armour, for instance, identifies absence of minimum capital requirements, flexible character of the UK company law, expert and business friendly judiciary, rich body of precedents and the consequent predictability, self-regulatory rules for listing and takeovers providing the advantages of continuous update and rulemaking by relevant business experts, presence of strong interest groups and lobbies. See, John Armour, “Who Should Make Corporate Law”.
states and can therefore, by reason of the scale or effects of the proposed action, be better achieved by the Community.”\(^{137}\) This legislative competence is further qualified as barred from “go[ing] beyond what is necessary to achieve the objectives of [the] Treaty.”\(^{138}\)

The subsidiarity principle in the EU\(^{139}\) forms a treaty basis for testing the level of regulatory activity and the extent of federal intervention.\(^{140}\) This principle also raises a treaty-based presumption of decentralisation in favour of the EU, in sharp contrast with the US, where such a presumption can “rest on policy grounds” only.\(^{141}\) In short, subsidiarity is a “prescription to regulate wherever possible at a decentralised level.”\(^{142}\)

### 3.4.1.2 Conclusion

Harmonisation by EU-level action is only a means, the end being a market economy with free competition. Perhaps the Treaty would not care too much of the means adopted till the time the final objective is attained by lawful means. However, the political settings in which the Treaty was first signed, and subsequently amended, forced a preference for member state level action to “automatically” lead to the establishment of the common market. Thus, in the final versions of the Treaty, the attitude is not as much “carefree” and there is a strong preference for member state action, the EC-level action to come only in default.

### 3.4.2 Judicial intervention

The ECJ, on the other hand, focuses at a “specific” level on the alleged contraventions of *inter alia* the EC Treaty, including the free movement of companies. This facilitates free movement and at the same time does not compromise legal diversity, and therefore forms solid ground for regulatory competition.

The status of the ECJ can be equated to a constitutional court since it has the power of “judicial review”, by which is, in short, meant, the power of a court to review the propriety and legality of the actions of the other organs. The ECJ has the power of setting aside any actions, including member-state, and EC secondary, legislation for an alleged violation of an EC Treaty provision. It thereby induces levelling down between the member states.\(^{143}\) In the area of company law, the Article 43-conferred freedom of movement constitutes the primary bedrock against

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\(^{137}\) Article 5(2), EC Treaty.

\(^{138}\) Article 5(3), EC Treaty.


\(^{140}\) Revesz, “Federalism” 1, p. 19.

\(^{141}\) *Id.*, p. 20.

\(^{142}\) Grundmann (2007).

\(^{143}\) Deakin, “Competition versus Harmonisation”, p. 199.
which the ECJ tests member state actions.\textsuperscript{144} With little guidance on its limits,\textsuperscript{145} the Court has, starting with the famous \textit{Cassis de Dijon} decision,\textsuperscript{146} expanded the classes of rules that are within the purview of its review. In testing the consistency, the Court employs “broad, effects based tests”\textsuperscript{147} and, has interpreted the freedom of establishment as to refer not only to overt discrimination but also to national measures that obstruct the effective exercise of the freedom.\textsuperscript{148}

3.4.2.1 \textbf{ECJ and the freedom of establishment} Beginning with \textit{Centros}, the Court has shown its strong commitment to the agenda of establishment of the common market by giving a wide interpretation to \textit{inter alia} the freedom of establishment.\textsuperscript{149} The judgments in the \textit{Centros}, the \textit{Uberseering}, the \textit{Inspire Art},\textsuperscript{150} and the \textit{Viking Line}\textsuperscript{151} cases show that the Court is not against legal diversity \textit{per se}, but those “specific” national rules that cast more onerous compliance requirements on companies from other member states or refuse to accord recognition and status as enjoyed by them under the home state law since this has the effect of deterring them from establishing in such member state.

The first three of the abovementioned cases\textsuperscript{152} reflect the Court’s response to the interface between the real seat doctrine and the freedom of establishment. In each of the cases, the Court found that since the relevant impugned national rule denied recognition to the companies validly established under the law of another member state, it impeded the common market and was accordingly inconsistent with Article 43. The Court further found that in none of the cases, the impugned rules met the \textit{Gebhard}\textsuperscript{153} test for qualifying as an “exception.” In totality therefore at least some of the four each cases of “entry” and “exit” restrictions—that may arise when a company moves from and into “incorporation-incorporation”, “incorporation-real”, “real-incorporation” and “real-real” member states—have been answered to remove obstacles, leaving others for future consideration!

\begin{itemize}
\item \textsuperscript{144}FL01 While there is a principle of supremacy of EC law and therefore a national rule can be set aside for inconsistency with EC secondary legislation also, since the appropriate measure in company law matters arises. See generally, Alter (2001).
\item \textsuperscript{145}FL01 \textit{Keck} and \textit{Mithouard} Cases (Case C-267/91 and C-268/91) [1993] ECR I-6097.
\item \textsuperscript{146}FL01 \textit{ReweZentral AG v. Bundesmonopolverwaltung fur Brantwein} [1979] ECR 649, establishing \textit{inter alia} the “mandatory requirements” doctrine.
\item \textsuperscript{147}FL01 Deakin, “Competition versus Harmonisation” p. 198.
\item \textsuperscript{148}FL01 Munari and Terrile (2001) (hereinafter “Munari, “\textit{Centros} and Corporate Market””).
\item \textsuperscript{149}FL01 Abundant material is available as comments on each of these decisions and the implications these decisions have for (a) the freedom of establishment; (b) the harmonisation programme and (c) the conflicts norms in Europe. See generally, Ebke (2000).
\item \textsuperscript{150}FL01 Case C-167/01 \textit{Kamer van Koophandel en Fabrieken voor Amsterdam} v. \textit{Inspire Art}.
\item \textsuperscript{151}FL01 C-438/05 \textit{International Transport Workers Union} and \textit{Finnish Seamen’s Union} v \textit{Viking Line ABP}.
\item \textsuperscript{152}FL01 See, for a very well considered and thoughtful comment on the effect of these three cases on freedom of establishment in EU, Hirt (2004).
\item \textsuperscript{153}FL01 \textit{Reinhard Gebhard} v \textit{Consiglio dell’Ordine degli Avvocati e Procuratori di Milano} (Case C-55/94) \textit{ECR} I-4165. The precise scope of the test is not clear but it seems that the standard required to make a case for an exception is actually higher than it appears to be from the express language.
\end{itemize}
In *Viking Line*, the Court, on the other hand, extended the scope of Article 43 to cover non-state entities also in that a contrary ruling would result in the compromise of abolition of obstacles, and thus held that Article 43 indeed has “horizontal direct effect.”

With “important, potentially the most important” barriers disappearing as a result of Court pro-activism, the playing field is becoming increasingly open and levelled. And, some path dependence is expected from the Court. This clearly facilitates regulatory competition since it effectively makes available to the managers, the wide choice of regulatory regimes since the opting into of any regime by means of incorporation would guarantee the recognition of a company’s valid formation and legal capacity wherever it goes and establishes the real seat. This, thus brings a much desired freedom of choice for the operation of the common market and which, without court-based federal intervention, was “apparently impossible.” On the whole, the ECJ has adhered strictly to the letter and spirit of the Treaty and has assumed a “pivotal [role in determining the] pace and role of legal integration […] and] has tended, in practice, to favour deregulation.”

### 3.4.2.2 An EU incorporation doctrine?

The question of establishment of an EU incorporation doctrine is not free from difficulty. The jurisprudence is still developing and a host of issues need to be addressed before anything conclusive may be said in response to this question.

What may however be said with some conviction is that the question of choosing between incorporation and real seat doctrines interests the EC only when, and to the extent, the adherence to one of the two doctrines has some bearing on the freedoms under the EC Treaty. Any conclusive settlement of these conflicts rules does not seem to be a first thing on the agenda of the ECJ also since the question emerges only as a collateral issue and is required to be answered only to enable the referring national court to resolve the matter before it. Clearly however, the real seat doctrine hinders the Article 43/48 freedom more than the incorporation doctrine, and is accordingly more susceptible to an adverse holding from the ECJ.

It is however unlikely, at least in the near future, that the ECJ would hand down a broad ruling against the real seat theory generally, and till the time the ECJ does so, the precise consequences of a change in applicable law by purporting to exercise a treaty freedom would remain, at best, speculative. In any event, it is logical to doubt that the Court would prohibit a host state from applying its local law in totality,
including its mandatory rules, especially those based on public policy,\(^\text{161}\) to the extent that such application qualifies for the *Gebhard* standard. This is so since restrictions may be justified under *Gebhard*, and so any pure version of the incorporation doctrine is not implied by the EC law. While there is no Community solution or instrument\(^\text{162}\) so far, the EC law has modified the extent to which the theories—and more so, in respect of (several versions of) the real seat theories—can be applied in practice.

Nevertheless, in view of the present mood of the Court and of the fact that the preferred-conflicts norm question invariably arises in the context of the freedom of establishment, it may be concluded that there is *incidentally* a clear preference for\(^\text{163}\)—though not establishment of—the incorporation doctrine.

### 3.5 Conclusion

We have seen from our discussion here that the integration of EU is a relatively recent phenomenon and that the means adopted for integration are peculiar. The harmonisation resulting from EC legislations does not always diminish the available choices. Similarly, the judicial process of the ECJ is heavily loaded with the freedom agenda and has tended to create much choice for the companies and opportunities for export of the regulatory product for the member states. We now proceed to the questions of existence and nature of regulatory competition in the EU company law.

### 4 Regulatory competition in EU company law

#### 4.1 Analysis and inferences

##### 4.1.1 EC legislation

While Community-level legislation has the effect of reducing diversity in company laws, it does not endeavour to completely eliminate it. In fact, the aim is quite the contrary and the Commission recognises “the importance of national diversity, and the championing […] of measures which will allow companies to increase their jurisdictional mobility.”\(^\text{164}\) To accommodate the diversity of legal traditions and

\(^{161}\) For some alternative means to safeguard the “significant legitimate [national] interests”, see, 

\(^{162}\) While the EC Regulation on the Statute for a European Company of 8 October 2001 (“the Statute”) does provide for a “real seat” arrangement, it may not be still correct to say that there is some Community instrument or solution governing the matter, since the Statute governs “specifically” the matter with respect to SEs and not other companies. Secondly, the Statute merely requires the registered office and the head office to coincide. This in itself shows that the Statute was not intended to suggest a preference for either model and yet avoid the difficulties of the question of applicable law since, if the two coincide, by the application of either doctrine, the same result followed. Thirdly, Recital 27 further

\(^{163}\) See, Grundmann (2007).

environments, future harmonisation efforts are expected to be undertaken only on a
case-sensitive basis, i.e. in the areas that have been identified to be crucial for the
functioning of the internal market, but in no more. A total level playing field is
“essentially unattainable, and if attained, would go a long way toward destroying
the very comparative advantage that makes trade (and, to a large extent, European
integration) desirable.” Harmonisation is therefore about some disparate set of
provisions.

The subsidiarity principle and the Treaty requirement for “directives” together
form a strong legal basis against diversity-elimination. The requirement of the use
of “directives” particularly leaves the member states with a great deal of discretion
in choosing the means for achievement of the final results. The movement from
prescriptive to “reference to standards” to framework legislations has further
given the member states enough policy space to manoeuvre attractive company laws
because of the “alternatives and options” available. Its effect on the competition
much depends on how much of the substantive rules of member states are sought
to be harmonised. Moreover, all EC legislations do not necessarily and
exclusively “harmonise” national laws, some, for instance the SE Statute,
Mergers Directive, Takeover Directive, also “create” sui generis legal rules to
ensure freer establishment. On the whole, therefore, it may be said that the EC
harmonisation process induces rather than impedes opportunity for competition.

4.1.2 ECJ jurisprudence

The ECJ has constantly favoured abolition of all barriers to freedom of
establishment in the EU. The process of the Court is less political and relatively
more prompt than that of the EC Council. ECJ’s unwillingness to easily allow a case
to qualify for the Gebhard tests of reasonableness and proportionality also points in
the direction. This, in turn, ensures that no system is significantly more restrictive,
and therefore unattractive, than the others.

From the point of view of regulatory competition, the only major cause of
concern then remains the Court’s upholding of “exit restrictions” in Daily Mail.
However, it may be argued that any member state wishing to compete for
incorporations would favour rules that facilitate than retard the common market.
Any policy against eliminating exit restrictions would make its look less attractive

166 Revesz, “Federalism”, p. 28.
169 See, Deakin, Id., pp. 209–217 for the idea of “reflexive harmonisation” as to the effect of
substantive and procedural harmonisation.
170 As a good illustration, one may refer to EC Regulation 44/2001 on Jurisdiction and Recognition of
Judgements.

172 Cf., Deakin, “Competition versus Harmonisation” 199: “The Court’s approach is ultimately
founded on the logic of legal integration and not that of regulatory competition.”
since it is well known that the power to exit smoothly, should something go wrong, is always an initial incorporation concern.\textsuperscript{173} But, for established companies, the problem is not fully addressed since states may choose to block outward-reincorporation instead.\textsuperscript{174} Nevertheless, it may be added here at once that the Court’s later rulings that “the ‘leaving’ situation represents a sufficient internal market element to make the fundamental freedom applicable”\textsuperscript{175} have raised some hope. The question then is how far \textit{Daily Mail} will survive after the \textit{Terhoeve} and the \textit{Hughes de Lastreyie}\textsuperscript{176} decisions.

The likely emergence, even though fortuitously, of a potential EU incorporation doctrine has further promoted the case for regulatory competition. The refrain by the ECJ from rendering any general holding\textsuperscript{177} of inconsistency of the seat doctrine is also evidence of its consciousness and inclination to sustaining legal diversity. This attitude is also supported by the European law principle of proportionality. Thus, the ECJ decisions, in fact, confer legitimacy upon regulatory competition. Some authors go a step further and argue that the EC Treaty itself “requires” regulatory competition by simultaneously providing for the principle of subsidiarity and the objective of an integrated common market.\textsuperscript{178} This view is supported by the argument that the Treaty contemplates only “coordinate[n] of safeguards,”\textsuperscript{179} “approximation of laws”\textsuperscript{180} or “harmonisation of legislation”\textsuperscript{181} each of which falls short of unification, identity or uniformisation.\textsuperscript{182} In this sense, the ECJ is merely carrying out its mandate of preventing a “state of siege.”

4.2 Exploring the possibility of regulatory competition in EU

In Part II, we concluded that regulatory competition, which is built on legal diversity and arbitrage, takes place when the opportunity to compete exists alongside benefit(s) that the state may derive from competing. A common playing field, market access and possibility of demanding and of consequently supplying laws together provide to states, the opportunity to compete, and forms the

\begin{footnotesize}
\begin{enumerate}
\item[173FL01] See, Romano (1993).
\item[176FL01] Hughes de Lastreyie du Saillant v. Ministere de l’Economie, des Finances et de l’Industrie [2004] 3 \textit{Common Market Law Review} 39: imposition of “exit” taxes on natural persons held to contravene the freedom of movement of persons. While not necessarily a very persuasive precedent, the case law on freedom of movement of natural persons may be used to show the trend of the Court to such an issue.
\item[177FL01] The ECJ does not seem to be drawing a distinction between the common law concepts of \textit{ratio decidendi} and \textit{obiter dicta}. In this sense, it is difficult to argue that the Court must restrict itself to the facts of the case and the precise question referred to it by a national court in its preliminary reference.
\item[178FL01] Keber (2000).
\item[179FL01] Article 44(2)(g), EC Treaty.
\item[180FL01] Article 94, EC Treaty.
\item[181FL01] Article 93, EC Treaty.
\end{enumerate}
\end{footnotesize}
theoretical basis for suggesting the existence of regulatory competition. In this Part, we consider whether the four prong test suggested in Part II is met in the European setting. That each EU member state has a company law and this constitutes the least common playing field providing the basic floor, on which the member states may contest, is susceptible to little attack. This paper therefore considers the remaining three prongs:

4.2.1 Market access

In order for competition of any sort—and that applies equally to regulatory competition—to take place, there must be more than one player in the relevant market. In regulatory competition, a state may actually create monopoly in its own favour by: (a) blocking the subjects from having access to other regulators; and, (b) blocking other regulators from having access to its subjects, and may, thus, eliminate competition.\footnote{See, Grundmann, “Different Genius”, p. 569. The German version of the real seat doctrine affords an illustration of the former; and the Reservations under the WTO GATS Agreement by several states illustrate the latter.}

However, a “supranational body,” whose power to act emanates out of an international treaty to which a State is a party, may require—if properly within the mandate and scope of the treaty provisions—such state to withdraw such restrictions and allow other regulators the requisite market access. This is precisely the position of the European Union vis-a-vis the member states and therefore, the member states (or potential “players” in the regulatory contest) have actual or, at least, potential market access. This character of the EU, together with its commitment to the “freedom of establishment” as well as the “subsidiarity-integration policy,” suggests that the “market access” part of the test is made out in the EU.

4.2.2 Possibility of demanding and availing of competitive advantages

This paper has vehemently argued that there is a clear growing preference for the “incorporation doctrine,” which has the effect of enhancing choice—both direct and indirect\footnote{See, Omar (1999), Werlauff (1999).}—for the companies to combine most favourable business locations with most favourable regulatory regime. Additionally, the EU also provides for “good informational opportunities.”\footnote{See for a powerful advancement of this view, Grundmann, European Company Law 95-109 and Grundmann, “Different Genius” p. 561 onwards.} There is evidence that the companies in the EU have begun to “exploit this diversity.”\footnote{Romano (1996) (hereinafter “Romano, “American Exceptionalism”) and Cheffins (1997).} Thus, there exists the possibility of demanding as well availing competitive advantages in the EU.
4.2.3 Possibility of responding to market forces

It has been seen that the peculiar nature of the EU harmonisation process provides rather than takes away the necessary impetus and incentive for competition. The basis for member state action arises out of the proportionality and subsidiarity principles of EC law. Besides this, the directive based harmonisation\(^\text{187}\) and the judicial bias for deregulation—encourage the member states to respond to the market forces.

4.2.4 Incentives

And, there is good incentive for the member states for doing so. Despite the predicted minimal proportionate increase in the tax revenue attributable to increased corporate charter, the likely increase in the amount in absolute figures would be enormous. Incorporations moreover would get vast business to the services sector, particularly to lawyers, accountants and investment bankers, who are expected to be weighty interest groups in pressurising for further attractive regulatory standards. This may also contribute to “values less readily calculated, such as prestige,” both in terms of a “position of leadership” of the state as well as prestige in academics based on the consistency of approach followed in the code.\(^\text{188}\)

Since there are in the EU both the opportunity of, and the incentive for, attracting companies, it is suggested that there is indeed a high likelihood for regulatory competition to develop among the EU member states in the area of company law.

4.3 Towards a more sustainable theory of regulatory competition in EU company law

When we talk about “regulatory competition,” we are talking not about ordinary business competitors—which interests are essentially, if not exclusively, economic—but about states: sovereigns who choose to give up part of their standard-prescribing power for some other considerations, including attracting mobile resources, they consider more significant. Statehood is a complicated phenomenon and it has as much, if not more, political and social context as the economic. Why a state acts in a way it does, cannot completely be explained by an economic analysis of its activity alone.\(^\text{189}\) Then, to consider regulatory competition solely from the economic point of view without also taking into account the political and social dimensions is to miss the point.\(^\text{190}\) To assume otherwise would be to illogically oversimplify macroeconomics and public regulation.

\(^{187}\) Deakin, “Competition versus Harmonisation”, p. 212.

\(^{188}\) Grundmann, “Different Genius” pp. 570–571.

\(^{189}\) See, Ebke (2005).

\(^{190}\) Hertig-McCahery, “Regulatory Competition”, pp. 1–34.
Taking a multidimensional view of things, in this paper, in predicting the nature of regulatory competition in EU company law, I argue that both the races to the top and to the bottom would take place simultaneously and that it is only this model of regulatory competition that would be stable and sustainable.

While moving towards it, it must be noted that EU is still not a constitutional union and at present, after the Lisbon Treaty, the prospects of its being one, do not appear plausible in the immediate future. Member states therefore tend to see the European Union as an opportunity to avail some economic advantage of integration than a political necessity. Their feeling of being sovereigns and independent does not seem to have gone still (nor was it perhaps intended to). This, together with their long established and time tested legal systems, social set up and political considerations, afford the member states the reason to resist any temptation and proposal of complete (substantive and procedural) unification. Their disparate historical, cultural and civilisational settings explain the development of the sometimes-irreconcilable disparities in their legal rules, public policy and regulatory systems. During the process of evolution, these systems have developed some “core values” which are characteristic of each system and the systems have come to be identified with such values and policies. For EU member states, letting go of, or in any manner compromising, such characteristic concepts implies redoing the foundation of their systems. The risk of an “identity crisis” is a sufficient detriment for them against any attempt to unification.

However, this is not to suggest that there may be no regulatory competition in the EU, but that the nature of this competition cannot be stated to be an (over)simple model of race either to top or to bottom. In the peculiar EU circumstances, the two races are likely to take place simultaneously and that a stable and sustainable state of affairs can result only from a continuous and automatic process of balancing of the races. It must be clarified here that “the two races take place simultaneously” is a proposal distinct from Esty & Geradin’s “co-opetition” theory, for the latter approaches the debate from the standpoint of the suggested remedies and the former proposes to start from and examines the nature of the problem itself. To explain further, co-opetition theory argues for a flexible mix of competition and cooperation, whereas I propose that the EU model would instead be a flexible mix of races to the top and the bottom. This is the typical manner in which the member states of the EU are likely to react to each other.

The degree and extent of the reaction of a member state to the relaxation of regulatory standards by another member state depends primarily on the reaction of another member state.
the prospective firms, particularly if the existing firms exercise their freedom of establishment and move out of the first member state and are reincorporated in the second.

In reacting to the relaxation of regulatory standards by the second member state, the first state may either (a) impose “exit” restrictions in order to retain its incorporations; or, (b) may, in order to attract more incorporations, either (i) “deteriorate”196 its own regulatory standards in the exact same fashion as the second member state or (ii) come up with “innovation” and creativity to devise a more nuanced way of relaxing its regulatory standards. The theoretical and practical impossibility of deteriorating equally and simultaneously at all (the exact same) fronts itself creates choice in the process of deterioration. This necessitates “innovation” as an alternative. The so-called “deterioration” or “innovation” of its regime by the first state may come (A) along the same variable as did the second member state or (B) along a different variable. Clearly, there are limits to innovation or deterioration at any single front. A perpetual “race” to the top (innovation) or bottom (deterioration) is therefore not sustainable though it may for sometime remain profitable. It is here that the states will have to make choice of “how much” and “on what front” to deteriorate and/or innovate.

Whatever manner it chooses, any relaxation by the first member state may lead the second to react by amending its regulatory standards further; which may in turn lead to a reaction from the first state and so on. The member states would carry on this “ping pong ball game” till a point they consider sustainable; but only until this point, and no more.

The likelihood that the states would react along different fronts is much greater in the EU since the member states have historically exercised these choices during the evolution of their significantly different “core values.” I advance a path dependency argument to suggest that the member states are expected to proceed along different fronts even in future. Clearly, each State has several control variables, which it may put to use to attain any particular objective (including, attracting incorporation). The extent to which a State would put one control variable to use in preference to another would depend upon what value does the State have for such a control variable based on its proximity to or distance from any core value of that State.

In the area of company law, on the basis of the analysis and inferences detailed in the previous section, it is suggested that the EU company law provides the legal basis and practical existence of such choice in the form of a variety of packages of offerings197 emanating from the member state regimes and accordingly, the ping pong ball game would be played along many different variables, according to varying member state priorities. The long drawn ideological battles for (or against), and the mitigated final versions of some of the Community measures, like the Takeover directive and the SE Statute, evidence this difference in priorities.

Employee involvement and board structure are only two well known and widely

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196FL01 I use the term “deterioration” to indicate a bottom race phenomenon and “innovation” or “optimal”
196FL02 for the top race phenomenon.
197FL01 See also, Grundmann, “Different Genius?” Grundmann infers greater choice from this variety. The
197FL02 opportunities of arbitrage would include for instance, cross-border mergers, cross-border takeovers,
197FL03 European Company, moving real seat, changing law even while maintaining the physical location.
accepted illustrations. As has been seen, much of this difference is attributable to the core values of those systems. In view of this, it may be concluded that in the EU company law, there is bound to be multifacety of variables which would be required to be considered before any pattern of races may be predicted.

The “race possibility curves” in different states are likely to therefore be drawn along more than (and not merely) one variable since corporate governance does not mean management-shareholder relationship alone, but includes a host of other stakeholders, which are properly covered within the purview of the national company laws. The steepness of this curve—representing the extent to which each member state is willing to compromise proportionate to a unit increase in (re)incorporation—depends on the proximity of the variable involved to the system’s core values. It is, for example, well known that Germany values the variable of “employee participation” more than most other member states in the EU. The UK, on the other hand, does not emphasise much on this variable. If, now, for instance, the UK were to “relax” its rules requiring employee participation (assuming that the UK company law had that requirement) in order to induce the management to incorporate/reincorporate their companies in the UK, it is highly unlikely that Germany would also relax its employee participation requirement. Germany may, instead, bring down the incorporation fee or relax its rules on accrued dividend and reclassifications or relax its rules on directors’ duty of care. A relaxation by Germany of its rules on directors’ duty of case may not, in turn, invite a similar relaxation from the UK, which may weigh fiduciary duties more than Germany does.

Because of the multitude of variables, comparable variables are not likely to yield comparable results. Therefore, European regulatory competition is not about observing that states are relaxing, the important question is identifying the variable along which the relaxation is taking place.

This movement along different variables is what the race theories seem to lose sight of. The federalists argue that regulatory competition leads to race to the bottom and creates the “laxest” laws. The competitionists on the other hand, argue for a race to the top and the creation of the “most efficient” laws. It is these superlative degrees in “laxest” and “most efficient” that I find a difficulty agreeing with. However, as stated above, the process of either deteriorating or innovating, contrary to these races theories, remains only a process which in reality can never reach its predicted end (“bottom” or “top”).

Undoubtedly, regulatory competition has some influence on the regulatory standards and as a result of regulatory forces; there is some movement in such standards. In other words, the regime becomes “laxer” or “more efficient” than it would be in the absence of regulatory competition. However, this “laxation” or “optimisation” would be pursued only to a point where the relaxation along one control variable would be adequately compensated by a corresponding benefit along.

198FL01 198 By “variable” is meant, each of the fronts capable of compromise, whether or not a state chooses to compromise on such front. Various choices are available to a state: Winter, “Corporation Theory”, pp. 259–260. I use the term “front” also in the same sense.
198FL02 199FL01 199 Romano, “American Exceptionalism” pp. 138–146.
another. This effect would take place since several possible permutations and
combinations of the corporate standards are on offering as different packages in
different member states. This means that the laxation along one variable would be
met by the optimisation along the other, such that at a point when the opportunity
cost of regulatory deterioration is not so met, no movement would take place either
towards the top or towards the bottom. This position, being not sustainable, would
again lead to regulatory movements characterised by a reshuffling of goals of
member states.\textsuperscript{200} This would be because: (a) a state in a position of comparative
advantage at one front starts utilising its resources towards the other; and (b)
Community action at least in areas of exclusive or mixed competencies, particularly
eemanating from the ECJ, cannot be wholly excluded. This would further permit
creation of disparate optimal systems of corporate governance and the motive of
attracting companies would again incentivise relaxation, and a further balancing of
the races. This model of the simultaneous races, albeit along different variables,
would thus be the only sustainable model of regulatory competition in the European
company law.

5 Summary and conclusions

The tough puzzle of regulatory competition has generated wide academic interest
for last at least five decades. The two extreme positions taken by scholars regarding
charter competition in the US are particularly notable in this regard. The potential of
this competition to lead the states to “relax” their corporate regulatory standards to
a point that the standards touch the bottom ebb as some argue, or, the top ebb as do
the others, have captured academic focus for long. There are as many conclusions as
the scholars!

The possible effect of the integration of Europe, characterised by the freedom of
establishment, on the member state company law regimes has been of major
concern in the recent times. There are equally disparate conclusions to the academic
debate on this side of the Atlantic also. In view of the ongoing debate, this paper
inquired into and affirmatively answered the question of possibilities of regulatory
competition developing in the EU company law.

The paper has concluded that any model that tries to predict the nature of
regulatory competition in the EU along one variable and along one (economic)
dimension appears to be an oversimplification. Aside from the often argued theories
of race to the top or race to the bottom, in light of the evolution of some very
different national “core values” and the peculiar features of EU (company) law, this
paper has endeavoured to put forth the sustainable model of “simultaneous” races:
that the deterioration and optimisation take place simultaneously along different
variables, the degree and extent of which best represent the “legitimate national
interest” of each member state.

\textsuperscript{200} The “reshuffling of goals” is however not destructive of the “core values” concept introduced at the
beginning. That phenomena like reshuffling and reordering take place is supported by some of the
widely (though not unanimously) accepted theories in jurisprudence see, for example, Kelsen’s
grundnorm and Hart’s primary and secondary rules. See, Hart (1961) and Knight (1967).
Acknowledgments The author wishes to extend his heartfelt thanks to Prof Jonathan Rickford and Dr David Kershaw (both, London School of Economics) from whose teachings in class and discussions, the author had substantial to draw. The author also wishes to thank Sachin Sachdeva and Yamini Mahajan for their fruitful discussions and thoughtful remarks. Usual disclaimer applies.

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