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Abstract

Despite recent developments in ECJ case law, the ability of EU firms to choose among corporate law regimes remains restricted. However, Member States have started to show interest in supplying competitive business forms and firms seem keen to use them. On-going reviews of EU governance and takeover law can be seen as an attempt to complete the set of minimum requirements that put a floor to a "race to the bottom." This paper suggests that most of the proposed harmonization, however, is likely to be ineffective or to promote bureaucratic uniformity rather than enable market-driven diversity.
Indeed, disclosure, board structure and director liability proposals as currently structured are unlikely to satisfy the needs of shareholders. Moreover, reforms aimed at the establishment of a permanent structure providing advice on future EU regulatory initiatives and at requiring Member States to adopt director disqualification mechanisms are likely to result in excessive regulatory intervention. Similarly, many provisions of the proposed Takeover Bids Directive can be expected to hamper rather than enhance the development of a competitive corporate control market.
By contrast, the authors recommend regulatory changes that facilitate private litigation, as this should be beneficial for shareholders and could enable regulatory competition without stimulating a "race to the bottom." Finally, the authors endorse a default arrangement for takeovers that would allow firms to choose to be governed by either the proposed Takeover Bids Directive or existing Member state law.

Keywords: Company law, corporate governance, European integration, EU harmonization, private litigation, regulatory competition, takeovers, Takeover Bids Directive

JEL Classifications: F15, G38, K22

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The important role played by investor protection in the world economy is now widely accepted. In particular, it is generally recognized that corporate governance institutions play an essential role in limiting the agency problems that result from conflicting interests, in particular between managers and shareholders or among shareholders.

Recent empirical studies in the U.S. and Europe provide evidence of a correlation between corporate governance and the share price.[1] In light of this comparative research, lawmakers, who are under pressure to undertake reforms following corporate scandals across jurisdictions (see the Ahold, Enron, Global Crossing, Mannesmann, Swiss Life, Vivendi, and WorldCom affairs), have begun to diagnose weaknesses in their existing legal regimes and propose new arrangements. In a sense, the recent corporate governance failures have provided the ideal circumstances under which lawmakers can focus on identifying the institutions and practices that may ameliorate the defects in corporate performance. Yet, one should refrain from jumping to the conclusion that government policymakers are likely to solve agency problems through a new round of policy commitments and legal provisions designed to address governance deficits. Even if government regulators agreed on the need for reform, there would still exist a problem that surfaces in all comparative corporate governance debates: namely, which packages of reforms offer optimal results for a given national system?

Indeed, whilst lawyers and economists applaud good corporate governance, the concept has many different meanings. The traditional legal approach to shareholder protection, which favors mandatory provisions driven by fairness and equality considerations, significantly differs from "hardcore" law and economics approaches, which consider that only contractible default rules can increase investor welfare. Likewise, "captured" policy makers focus on protecting their constituency, viz. controlling shareholders or top managers, whereas their more independent colleagues have so far arranged to introduce codes of best practices designed to foster socially responsible conduct on the part of directors and executive officers.

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1 See e.g. Dennis C. Mueller and B. Burcin Yurtoglu, *Country Legal Environments and Corporate Investment Performance*, 1 GERMAN ECON. REV. 187 (2000); Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Schleifer and Robert Vishny, *Legal Determinants of External Finance* 52 J. FIN. 1131 (1997).

Unfortunately, an apparent weakness of this polarized situation is that it can lead to the conclusion that the aim of corporate governance, and more generally corporate law and securities issuer regulation, is to maximize a single value. By contrast, recent research on the relation between economic development, shareholder and financial market structure, political and cultural components on the one hand, and corporate and securities laws on the other hand, provides the basis for a strong challenge of the "one-size-fits-all" model. To be sure, it is generally accepted that, for example, it is important for directors and executive officers to be responsive to the interests of shareholders rather than merely pursue their own financial and ego concerns. One cannot, however, ignore the existence of regulatory tradeoffs or that jurisdictions are not homogeneous. For example, increasing managerial responsiveness to the interests of shareholders as a class may be detrimental to minority shareholder and other stakeholder interests. Similarly, underlying legal, economic and social structures vary from one national system to the other or even from region to region.

The implications for EU corporate law reform are clear: there is no simple model for corporate regulators to use when designing reforms. While current efforts to modernize European Union (EU) company law and to create a takeover regime are influenced by shareholder value maximization considerations, one must not forget that there are political barriers to transplanting the Anglo-Saxon approach in continental Europe. Given the important differences between corporate governance systems in Europe, the appropriate regulatory approach is to provide firms with the freedom to select the regulatory environment that suits their needs. We argue that an institutional environment that gives firms the opportunity to match rules to complement their firm characteristics and stages of development can offer significant costs advantages. Analyzing the EU's reform packages on corporate governance shows that the current proposals are too static and incomplete in their formulation and do not provide legal substitutes that may be essential for introducing incentives and promoting competition. Our analysis also highlights that the proposed Takeover Bids directive raises a few problems for Continental European corporate governance systems by proposing a break-through rule that would, in effect, alter the structures of ownership and concentration of voting rights of firms. Our claim is that this rule would reduce the substantial differences between ownership structures and takeover defenses based on EU company law. We conclude that the tensions that result from the EU's reform packages on corporate governance and takeovers could give rise to few tangible governance benefits and may serve to eliminate the diversity in corporate structures, which may not be ultimately beneficial.

This paper proceeds as follows. Part I will examine the recent trends in regulatory arbitrage and competition in Europe.[2] The analysis demonstrates that a competitive environment for reincorporations has yet to develop. We show the even if incentives to compete are present, state competition may be subject to structural barriers that inhibit the evolution of rules. Although we conclude that the real seat doctrine will continue to restrict firm mobility despite recent European Court of justice (ECJ) case law, we explain that Member States have started to show interest in supplying new business statutes. Their motives are threefold: (1) to improve the environment of small and medium size businesses by actively attempting to attract investment or business; (2) to promote the competitiveness of indigenous industries by adopting the most favorable business form: (3) to respond to competitive threats posed by offshore jurisdictions. We argue that should the future bring an increase in the number of firms migrating to the most favorable jurisdictions, as envisaged by the ECJ in *Centros* and *Überseering*, the pressure from interest groups on states to adopt responsive legislation can be expected to increase.

Contemplated EU corporate law reforms are analyzed in Part II. The dominant view among corporate law scholars has been that the EU's approach to harmonization has the advantages of encouraging simplicity and lowering administrative costs for firms. However, supporters of the EU harmonization program have made no attempts to show empirically that the implementation of company law directives has resulted in the desired effects. In contrast, we argue that uniform rules often leads to higher costs for different types of firms and that this approach to legal change is cumbersome and not sufficient to regulate externality problems. Recently, the European Commission has adopted an action plan that should address the remaining gaps in the harmonization process and strengthen the Commission's role as a driving force in corporate law reform. Though we support the Commission's desire to introduce arrangements that are more flexible and fill in the gaps of EU corporate law, we are skeptical about the merits of this action plan and whether it will lead to extensive changes in corporate law

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2 Regulatory arbitrage refers to firms' choice of the legal regime that best suits their preferences, whereas regulatory competition refers to regulators' attempt to attract or not to loose firms due to a more favorable legal environment. See Stephen Woolcock, *Competition among Rules in the Single European Market*, in INTERNATIONAL REGULATORY COMPETITION AND COORDINATION 289 (W.W. Bratton et al. eds, 1996). Strong national preferences or path dependence may result in regulatory arbitrage in the absence of regulatory competition. See Klaus Heine and Wolfgang Heiner, *European Corporate Laws, Regulatory Competition and Path Dependence*, 13 EUR. J. L. AND ECON. 257 (2000).

practice. More importantly, those planed changes that could make a difference are more likely to favor bureaucratic intervention than to facilitate transactions. In our view, this approach is unfortunate, as more enabling or market-oriented litigation mechanisms might contribute to the freedom of choice while encouraging regulatory innovation.

Part III discusses the current efforts to adopt a EU takeover law regime. EU experts defend the introduction of two legal principles (viz. board neutrality and the break-through rule) to create a level playing field for EU takeovers and provide the basis for the transition to a dispersed ownership structure. In the main, we argue that the level playing field concept is not a suitable approach for takeover regulation. We contend that board neutrality and the break-through rule should be evaluated on separately on their own merits. On the one hand, the case for the EU takeover regime lies in the provision of simple rules that avoid some of the costs and difficulties of complex rules of differing national regimes. We recognize that imposing a single, simple board neutrality rule is preferable to diversity for transparency reasons. It is also sound to require Member States to adopt a mandatory bid rule to prevent expropriation from minority shareholders while permitting the emergence of value-increasing bids. On the other hand, we demonstrate that there are good reasons to reject the highest price rule, as Member States should have the power to set equitable exit prices for minority shareholders. Moreover, we believe that a EU break-through rule should be a default rule rather than a mandatory or irreversible choice rule. Part III turns from considering select provisions of the proposed Takeover Bids directive to analyze a choice-enhancing proposal that would allow firms to opt into the proposed EU regime or elect to be governed by state law. We advocate a EU takeover regime that would offer firms the choice to be governed by the proposed EU takeover code or State law alternatives, which could stimulate the competitive pressures between states and lead to better takeover rules. Part IV concludes.

I. Reflections on Regulatory Arbitrage and Competition

Two central trends are clearly beginning to emerge regarding state competition. First, the evidence suggests that, while regulatory competition remains close to non-existent within the EU, the appearance of new judgments from the ECJ can support the inference that regulatory arbitrage is an imminent possibility. Second, the threat of state competition, which is less attractive to weakly responsive states, such as France and Germany, can provide a new impetus for EU harmonization. We begin our examination of regulatory competition by discussing, in Part I. A., how the European Court of Justice has signaled its willingness to move in the direction to

allow states to compete for reincorporations. Part I. B. will then assess the need for harmonizing corporate law in the EU.

A. An Emerging Path

One of the most important debates in European company law is whether a 'market for corporate law' will ultimately emerge within the European Union, and if so, whether it will be based on a Delaware-like model in which companies can freely select their country of incorporation.[3] This is, of course, a politically charged question and therefore a somewhat undifferentiated debate. In particular, commentators often fail to distinguish between corporate finance, company formation and restructuring issues.[4] Conversely, competition between states in the U.S. is generally assumed to be very active, whereas recent research shows that reality is subtler.[5] However, there is evidence that domicile choices by U.S. corporations can affect their value and/or provide significant benefits for their managers and controlling shareholders.[6] The absence in Europe of anything resembling American charter competition must therefore mean that there are substantive regulatory barriers to jurisdictional competition.[7]

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3 See, e.g., Werner F. Ebke, *Centros—Some Realities and Some Mysteries*, 48 AM. J. COMP. L. 623, 625-628 (2000) (explaining that competitive lawmaking has become a dominant theme in European company law); Brian Cheffins, COMPANY LAW: THEORY, STRUCTURE AND OPERATION 421-51 (1997) (explaining the potential role of the market for incorporations for deepening European economic integration).

4 See Stefan Grundmann, *Regulatory Competition in European Company Law – Some Different Genius?* in CAPITAL MARKETS IN THE AGE OF THE EURO (G. Ferrarini et al. eds., 2002).

5 See e.g. Marcel Kahan and Ehud Kamar, *The Myth of State Competition in Corporate Law*, 55 STAN. L. REV. 679 (2002); Lucian A. Bebchuk and Assaf Hamdani, *Vigorous Race or Leisurely Walk: Reconsidering the Competition over Corporate Charters*, 112 YALE L. J. 553 (2002).

6 See Lucian Bebchuk, Alma Cohen, and Allen Ferrell, *Does the Evidence Favour State Competition in Corporate Law?* 90 CAL. L. REV. 1775 (2002); Robert Daines, *Does Delaware Law Improve Firm Value?,* 62 J. FIN. ECON. 525 (2001).

7 See Simon Deakin, *Regulatory Competition versus Harmonization in European Company Law,* in REGULATORY COMPETITION AND ECONOMIC INTEGRATION 190, 205 (D. Esty and D. Geradin eds., 2001).

To start, EU company law can be viewed largely as an incomplete and rather ineffective set of provisions.[8] The reasons: Member States have been repeatedly unable to agree on important substantive issues, the pro-decentralization presumption resulting from the EU subsidiary principle, and lack of implementation of EU directives by Member States.[9]

This has allowed for continuing diversity in Member State corporate law.[10] On the other hand, the rather strong divergence about the "optimal" corporate regime has had the effect of sustaining significant opposition to regulatory arbitrage and competition.

U.S. commentators, in particular, have argued that change is imminent. Cross-border acquisitions by firms that have cheaper access to external capital, because of higher investor protection levels, should bring corporate governance amendments.[11] The replacement of banks by institutional shareholders, as the main corporate governance actor, should have a similar effect.[12]

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8 See, e.g., Klaus J. Hopt, *Common Principles of Corporate Governance in Europe*, in CONVERGENCE AND DIVERSITY IN CORPORATE GOVERNANCE REGIMES AND CAPITAL MARKETS 175 (J. A. McCahery et al. eds., 2002) (arguing that the EC has done little to enact measures that regulate the relations between shareholders and managers or with minority investors rights); John C. Coffee, Jr., *The Future as History: The Prospects for Global Convergence in Corporate Governance and Its Implications*, 93 NW. U. L. REV. 641, 651 (1999) (contrasting federal systems that permit a market for incorporation with the different market and institutional environment of jurisdictions that are not committed to a reincorporation regime).

9 See Jan Wouters, *European Company Law: Quo Vadis?*, 37 COMMON MKT. L. REV. 257, 275 (2000).

10 See, e.g., Erik Berglöf, *Reforming Corporate Governance: Redirecting the European Agenda*, *in* EUROPEAN ECONOMY: A EUROPEAN FORUM 93 (1997).

11 See Andrei Shleifer, *Comments on Hellwig,* On the Economics and Politics of Corporate Finance and Corporate Control, *in* CORPORATE GOVERNANCE, THEORETICAL AND EMPIRICAL PERSPECTIVES 135 (X. Vives ed., 2000).

12 See, e.g., Jeffrey N. Gordon, *Deutsche Telekom, German Corporate Governance, and the Transition Costs of Capitalism*, 1998 COLUM. BUS. L. REV. 185.

In other words, transformations occurring in the market place will result in increased convergence of rules.[13]

In contrast, many European scholars are not as optimistic about the prospects for market-induced reform, given the existence of a strong coalition of interest groups and other path dependent forces.[14] In particular, the repeated failures to pass a Directive on Takeovers shows the power of those who benefit from the *status quo* to block transformational measures.[15]

Of course, institutional barriers at the EU level are not the sole or even main reason for past regulatory and judicial conservatism.[16] Under the *siège réel* (real seat) doctrine, which is followed by the majority of EU Member States, a corporation must be incorporated in the Member State where it has its central administration. As a result, opting into another Member State's corporate law is often unattractive because of significant tax implications, especially for corporations that have used conservative accounting to build-up hidden reserves. This barrier to regulatory arbitrage and competition is compounded by employee participation structures, German co-determination being the best known but not the only example. Indeed, by reducing the ability of legislators to respond to managerial or shareholder preferences, employee participation favors regulatory conservatism.[17] Judicial conservatism, for its part, has at least as much to do with Member States' reluctance to facilitate or merely permit shareholder litigation than result from EU law deficiencies.

It would be wrong, however, to underestimate the tension created by market changes. ECJ case law is a good indicator, given the Court's record in providing early warnings regarding forthcoming legal reform. As a matter of fact, the ECJ's recent decisions in *Centros* and

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13 Ronald J. Gilson, *Globalizing Corporate Governance: Convergence of Form or Function*, 49 AM. J. COMP. L. 329 (2001).

14 See Erik P.M. Vermeulen, THE EVOLUTION OF LEGAL BUSINESS FORMS IN EUROPE AND THE UNITED STATES 153 (2003).

15 See also Mark J. Roe, *Rents and their Corporate Law Consequences*, 53 STAN. L. REV. 1463 (2001) (providing a theoretical explanation).

16 See also Vermeulen, *supra* note 14, 154.

17 See Eddy Wymeersch, *A Status Report on Corporate Governance Rules and Practices in Some Continental European States*, *in* COMPARATIVE CORPORATE GOVERNANCE: THE STATE OF THE ART AND EMERGING RESEARCH 1045 (K. J. Hopt et al. eds., 1998).

Überseering could eventually undermine the real seat doctrine and set the stage for effective regulatory arbitrage and competition among Member States.[18] To be sure, commentators may still take refuge behind a phalanx of obscure and convoluted statements in the ECJ case law in order to defend the real seat doctrine.[19] We, on the other hand, expect the ECJ to continue along the doctrinal path it developed in *Centros*. In this respect, it is worth pointing to the *Überseering* case, which involves a Dutch close corporation that had moved its headquarters to Germany. The ECJ ruled that such a corporation could not be denied the capacity to bring legal action before the courts of the Member State in which it has its central administration on the ground that its home/foreign corporate law regime does not satisfy host/domestic corporate law requirements.

As a consequence of *Centros* and *Überseering*, start-up firms should be able to incorporate under the corporate law regime they deem most favorable among the regimes offered by the various Member States. Established firms should be able to take advantage of the newly available European Company Statute to similar effect.[20]

In this context, the UK could become the leading jurisdiction for European incorporations.[21] Indeed, UK legislators have moved fast to develop a menu of new corporate forms that caters to the needs of entrepreneurs, while its courts are respected and productive – characteristics that have significantly contributed to Delaware's U.S. dominance.[22] Admittedly, charter revenue may not be sufficient to prompt UK legislators to engage into sustained

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18 Case C-212/97, *Centros Ltd. v. Erhvervs-og Selskabsstyrelsen*, 1999 E.C.R. I-1459 (1999), 2 C.M.L.R. 551 (1999); Case C-208/00 *Überseering BV v. NCC Nordic Construction Company Baumangemen*t. Compare Case 81/1987, *Regina v. H.M. Treasury and Comm'rs of Inland Revenue, ex parte Daily Mail and General Trust Plc*, 1988 E.C.R. 5483.

19 See Harald Halbhuber, *National Doctrinal Structures and European Company Law*, 38 COMMON MKT. L. REV. 1385, 1409 (2001).

20 See Luca Enriques, *Silence is Golden: The European Company Statute As a catalyst for Company Law Arbitrage* (Working paper, March 2003 – available at ecgi.org). Note that *Centros* does not seem to facilitate cross-border restructurings of existing corporations. See Peter Behrens, *Centros and the Proper Law of Companies*, in Ferrarini et al., *supra* note 4, 503.

21 See also Vermeulen, *supra* note 14, 155-7.

22 See, e.g., Bernard S. Black, *Is Corporate Law Trivial? — A Political and Economic Analysis*, 84 NW. U. L. REV. 542, 590 (1990); Roberta Romano, *The State Competition Debate in Corporate Law*, 1 J.L. ECON. & ORG. 225 (1985).

regulatory competition.[23] On the other hand, additional incorporations will mean increased revenue for UK accountants and lawyers – which is one of the main reason why Delaware legislators keep their corporate law in tune with market demands. It is true that UK accountants and lawyers are still rather passive when it comes to making corporate law responsive to the demands of the market place, especially compared to their Delaware counterparts. However, U.K. lawyers and accountants will adjust fast as soon as it will become clear that regulatory competition magnifies both the benefits of attracting new business and the risks of losing existing clients – especially in an environment that is less mature than the U.S. regulatory market.[24]

The likeliness of this scenario is reinforced by early reactions to recent UK company law reforms. Major jurisdictions, such as France and Germany, are reacting with uncharacteristic speed to adopt legislation aiming at minimizing firm migrations to the UK.[25] Smaller jurisdictions, such as Ireland and Luxembourg, may join the fray and decide to act entrepreneurial themselves, tempted by what they could see as a chance to get additional chartering revenue.[26]

B. Harmonization and the Regulatory Competition Debate in the EU

The question, then, is whether corporate law regulation should be left to Member States rather than undertaken at the EU level.

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23 See Cheffins, *supra* note 3, at 435 (explaining that the United Kingdom, unlike Delaware, does not impose a franchise tax or an annual fee on incorporated firms and does not charge fees for amendments to the corporate constitution).

24 Compare Lucian A. Bebchuk and Alma Cohen, *Firms' Decision Where to Incorporate*, J. L. & ECON. (forthcoming, October 2003) (U.S. firms display a substantial "home state bias" in favor of incorporating in the State in which they are located).

25 For France, see Pierre-Henri Conac, LA REGULATION DES MARCHES BOURSIERS PAR LA COB ET LA SEC (2002): for Germany, Theodor Baums, *Company Law Reform in Germany,* 3 J. CORP. L. STUD. __ (2003); see also Gregor Bachmann, *Grundtendenzen der Reform geschlossener Gesellschaften in Europa, Dargestellt am Beispiel des britischen Reformprozesses und der Europäischen Privatgesellschaft*, 30 ZEITSCHRIFT FÜR UNTERNEHMENS – UND GESELLSCHAFTSRECHT 351, 365 (2001).

26 Note that double taxation treaties and other tax issues may reduce the charter benefits of regulatory competition. See Cheffins, *supra* note 3, 435; ECJ *Ponente Carni Spa* [1993] ECR 1947.

Those favoring centralization believe it is necessary to eliminate barriers to trade, as well as distortions of competition.[27] Moreover, it allows for the internalization of significant spillovers. Proponents of legal federalism, on the other hand, rely on the economic theory of jurisdictional competition to support devolutionary initiatives.[28] They claim that regulatory competition shapes a wide range of regulatory outcomes at Member State and local levels because menus of regulation figure prominently in the location decision of firms and factors of production. Such regulatory outcomes tend to correspond to citizen/firm preferences, since only public goods and regulatory restrictions for which citizens are willing to pay will survive.[29] Two conditions, however, must be satisfied: (1) lower level regulation must not generate significant externalities; and (2) borders must be open for the free movement of capital and labor.

Debates within the EU aimed at reconciling both positions are strongly affected by the importation of the regulatory competition concept and its races to the top and to the bottom stories. According to the race to the top story, uniform rules carried the risk of regulatory capture (by managers or controlling shareholders), while competitive diversity would lead to regulation tailored to the need of local preferences, deter opportunism, and encourage regulatory innovation. According to the race to the bottom story, in absence of effective harmonization, national level lawmaking would involve complexity, uncertainty, and undesirable competitive deregulation.

By linking together mutual recognition of corporate law systems, subsidiarity (viz. law-making is restricted to the Member State level unless credible circumstances support harmonization) and minimum requirements, EU lawmakers have created a legal structure that supplies a degree of useful tension between regulatory competition and harmonization. In particular, EU lawmakers have recognized that, while mutual recognition is necessary for the operation of a well-functioning market for legal rules, asymmetric information could undermine

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27 Robert B. Inman and Daniel L. Rubinfeld, *Rethinking Federalism,* 11 J. ECON. PERSP. 43 (1997).

28 See e.g., Roberta Romano, THE GENIUS OF AMERICAN CORPORATE LAW 1-40 (1991); Roberta Romano, *The Need for Competition in International Securities Regulation,* 2 THEORETICAL INQUIRIES IN LAW 1 (2001).

29 Barry Weingast, *The Economic Role of Political Institutions: Market Preserving Federalism and Economic Development*, 1 J. L. ECON. & ORG. 1 (1995).

the willingness of actors to participate in the market.[30] To shed light on this problem, let us examine a concrete example. We assume that a Member States is unable to reject corporations organized under another Member State's law to avoid more restrictive domestic requirements. In these circumstances, we can expect difficulties to arise when it is complicated and costly for investors and creditors to evaluate the quality of the non-domestic corporate law system.

Taken alone, mutual recognition could also make it easier for managers to reincorporate in a Member State that has an anti-takeover regime that suits their interests rather than those of shareholders. Furthermore, following the eastward expansion of the EU in 2004, new Member States will come under increased pressure to make changes in their company law rules in order to compete for inward investment. This is likely to have a direct effect on the level of minority shareholder and non-trade creditor protection.[31] In addition, some new Member States are likely to adopt inefficient business forms in order to attract firms that will operate outside their jurisdiction, thus internalizing charter and other benefits while externalizing costs.

In other words, mutual recognition presupposes that Member States remain empowered to restrain foreign business forms that do not offer minimum protection to investors, creditors and other stakeholders. This, in turn, means that "minimum requirements" must be defined centrally for regulatory competition to be significant. Indeed, as we know from past and current EU experiences, diversity resulting from decentralized definitions should permit ample room for Member States to limit regulatory competition to trivial levels.

The task of defining "minimum requirements" can theoretically be left to the EU judiciary, but such a procedure is rather slow and piecemeal. In practice, minimum requirements are rather designed by the EU legislative, where regulatory capture generally leads to the adoption of over-inclusive mandatory rules that excessively limit regulatory arbitrage and competition.

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30 Henri Tjiong, *Breaking the Spell of Regulatory Competition: Reframing the Problem of Regulatory Exit,* 66 RABELSZ 66, 83 (2002).

31 Daniel Berkowitz , Katharina Pistor and Jean-Francois Richard, *The Transplant Effect*, 51 AM. J. COMP. L. 163 (2003); Bernard S.Black , Reinier Kraakman and Anna Tarassova, *Russian Privatization and Corporate Governance: What Went Wrong?*, 52 STAN. L. REV. 1731 (2000).

With respect to corporate law, this means that EU harmonization has tended to favor the interests of managers and stakeholders such as controlling shareholders and lenders. On the other hand, regulatory capture has not reached Delaware levels. As already mentioned, centralized rule-making has remained incomplete and conservative, interest groups and other path dependent forces having made it difficult to depart from the status quo.

However, recent corporate governance scandals involving publicly-traded firms, the generally recognized need to improve the integration of the EU's capital markets, and increasingly pro-mutual recognition ECJ case law have given a new impetus to EU regulatory efforts. Hence, the European Commission has recently undertaken further harmonization of corporate and takeovers law. We discuss these harmonization attempts in Part II and III and analyze whether they are needed to facilitate transactions or enable regulatory competition.

II. THE PROPOSED EU COMPANY LAW REFORMS

Part I examined the prospects for state competition in corporate law in the EU. In this Part, we assess the proposals of a group of experts that were commissioned by the EU to review its corporate law Directives and make recommendations for reform. Their report, published in November 2002, recommends simplifying existing rules, the elimination of barriers to cross-border transactions and better freedom of choice between alternative forms of organization, but does not make any fundamental proposals.[32]

While this outcome may reflect a consensus that no further harmonization is necessary to allow for regulatory arbitrage or prevent regulatory undercutting, it is more probable that a conjunction of vested interests continues to favor the status quo. Interest groups opposed to regulatory competition or market integration had no reason to push for significant reforms. Interest groups favorable to freedom of choice also had few incentives to undertake concerted action to influence the reform agenda. Indeed, experience shows that harmonization efforts often result in costly compromises that raise rather than decrease barriers to cross-border activity.

That said, the report makes various specific recommendations that are of interest for a transaction facilitation and regulatory competition analysis. First, a permanent structure should be established to provide the European Commission with independent advice on future regulatory

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32 See *Report of the High Level Group of Company Law Experts on a Modern Regulatory Framework for Company Law in Europe* (November 2002, available at europa.eu.int).

initiatives, whereas Member States should establish enforcement agencies to sanction unfit directors. Second, it is proposed to further harmonize disclosure, board structure, director liability and capital requirements.

The European Commission has adopted most of the experts' recommendations in its recently published action plan.[33] In addition, the European Commission is also considering reinforcing EU provisions on statutory audit.[34] We believe, however, that most of the considered changes would prove ineffective. More unfortunately, those considered changes that could prove effective are, with one exception, likely to favor bureaucratic intervention whereas some market-oriented mechanisms have been expressly rejected.

A. Ineffectiveness

The proposed reforms are likely to prove ineffective for two, somewhat related, reasons: The EU is not a principal regulatory player, and its proposals are unlikely to make a difference.

The EU plays second fiddle to more global or powerful bodies when it comes to disclosure requirements for listed firms. For example, EU influence in the accounting area is at best indirect, due to the central role of played by the Financial Accounting Standard Board (FASB) and the International Accounting Standard Board (IASB).[35] Similarly, firms and Member States alike are more concerned by national securities regulators' practices than by to-be-implemented EU requirements. In other words, as long as there is no European SEC, EU activism in the corporate disclosure area is likely to prove largely irrelevant.[36]

Moreover, even if one assumes that the EU can play a disclosure role, the proposed rules are unlikely to provide previously unknown information to the controlling shareholders that

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33 Action Plan on Modernizing Company Law and Enhancing Corporate Law in the EU (May 2003, available at europa.eu.int).

34 Communication from the Commission, Reinforcing the Statutory Audit in the EU (May 2003, available at europa.eu.int).

35 See Regulation (EC) No 1606/2002 on the application of international accounting standards [2002] OJ L 243/1.

36 See Gérard Hertig and Ruben Lee, *Four Predictions about the Future of EU Securities Regulation*, J. CORP. L. STUD. (forthcoming, Fall 2003)

dominate both listed and non-listed EU firms.[37] A far as minority shareholders are concerned, any improvement in their situation presupposes that they can credibly threaten to request a special investigation. This does not seem realistic, considering the 5% threshold to be met by shareholders of listed firms and the limited benefits of transparency requirements for shareholders of non-listed firms.[38]

Board structure and liability proposals are also unlikely to make a difference. For example, requiring that firms must have a choice between one-tier and two-tier boards is of limited value, given that one-tier companies can imitate two-tier decision-making by using committees.[39] Similarly, forcing companies to explain why individual non-executive directors are qualified to serve on the board in their particular role is a requirement that is past its prime. Or, to take another example, harmonizing the definition of "shadow" directors and requiring Member States to adopt wrongful trading provisions will have little or no impact unless these requirements are coupled with an enforcement mechanism – a topic that we will discuss below.

Moreover, assuming again that EU law could make a difference, for example when it comes to the setting-up of audit committees or director independence and remuneration, they mostly duplicate requirements that already exist at the Member State level.

Capital formation and maintenance proposals could prove less ineffective, but most are of rather marginal importance. For example, the proposals to eliminate expert valuation requirements would only make a difference if they were generally applicable and not merely limited to some contributions in kind. Similarly, extending creditors' rights to require security for all restructuring transactions is unlikely to be useful for those creditors that are not already secured.

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37 THE CONTROL OF CORPORATE EUROPE (F. Barca and M. Becht eds., 2002); Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer, *Corporate Ownership around the World*, 54 JOURNAL OF FINANCE 471 (1999).

38 For a more optimistic view, see e.g. Klaus J. Hopt, *Modern Company Law and Capital Market Problems, Improving European Corporate Governance after Enron*, 3 J. CORP. L. STUD. (forthcoming, Fall 2003).

39 See Henry Hansmann and Reinier Kraakman, *The Basic Governance Structure*, in THE ANATOMY OF CORPORATE LAW (R. Kraakman et al. eds., forthcoming 2004).

B. Fostering Bureaucracy

In their report, the experts commissioned by the EU recognize that cross-border corporate mobility and restructuring must be facilitated. However, they generally favor increased uniformity over facilitating regulatory arbitrage and competition to achieve such a result.

Such bias is relatively harmless as long as it merely affects the fine-tuning of what constitutes minimum requirements. On the other hand, it could have very damaging consequences if it translates into excessive regulatory intervention. In our opinion, the chances of such an outcome are very real.

Admittedly, proposing to reinforce auditor monitoring by replacing self-regulatory regimes through state supervisory is a move that is both likely to improve investor confidence and prevent auditor liability to become prohibitive in the wake of the Enron and similar accounting scandals.[40]

However, the prospects are much less positive in other areas. First, proposing to set-up a permanent body to provide advice on future EU regulatory initiatives favors state intervention as the members of such a body are likely to be rewarded for regulatory activism. Second, the report's underlying philosophy is that listed firms should be subject to a certain level of uniform and compulsory detailed rules, i.e. their autonomy must be much more restricted than for closed corporations. It may well be that the availability of a rather rigid European company form may prove beneficial, as long as firms remain free to choose among a rather broad range of alternative corporate forms.[41] Nevertheless, current proposals seem both to foster unnecessary changes and reduce the alternatives available to listed firms.

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40 Reputation and litigation issues are related, given that the former is eroded by the latter. Conversely, introducing state supervision should enhance auditor reputation as well as induce legislators and courts to keep the liability risk within reasonable limits. See also John C. Coffee, *The Acquiescent Gatekeeper: Reputational Intermediaries, Auditor Independence and the Governance of Accounting* (Working Paper 2001, available at www.ssrn.com).

41 See Henry Hansmann and Reinier Kraakman, *Agency Problems and Legal Strategies*, in Kraakman et al., *supra* note 39; Lucian A. Bebchuk and Allen Ferrell, Federal Intervention to Enhance Shareholder Choice, 87 VA. L. REV. 111 (2001).

For example, it is proposed that director nomination and remuneration must be decided exclusively by non-executive directors who are in the majority independent as defined by EU law. Such a rule cannot be considered essential for preventing "race to the bottom" problems. Moreover, to the extent it is not drafted in very broad terms and thus ineffective, it is unlikely to take into account EU diversity. The same objections apply to proposal that squeeze-out and sell-out rights should be given to shareholders that have acquired, at the minimum, 90%, or, at the maximum, 95% of the capital of listed firms. Or, to take another example, given the limited scope of EU capital maintenance requirements (they do not apply to closed corporations) and the debatable persuasiveness of their critics,[42] it is far from clear why the EU should undertake reforms in this area.

Third, it is proposed to impose director's disqualification at the EU level. UK practice shows that the disqualification sanction may deter violations of the wrongful trading rule and other fiduciary duties. Nevertheless, as made clear by early UK experiences and a comparison with France, an effective disqualification mechanism presupposes the existence of a well-funded enforcement agency.[43] It is difficult to understand why the existence of such agency is a minimum requirement for regulatory competition to be acceptable. Moreover, assuming that the EU must reduce barriers to enforcement, it certainly would be preferable to use more market-oriented mechanisms.

Indeed, it is quite obvious that litigation by minority shareholder is rare in Europe, which in turn permits managers and controlling shareholders to pay significantly less attention to corporate law requirements than their U.S. counterparts.[44] Given that listed firms in continental

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42 See Peter O. Mühlbert and Max Birke, *Legal Capital – Is there a Case Against the European Legal Capital Rules?*, 3 EUR. BUS. ORG. L. REV. 695 (2002); Luca Enriques and Jonathan Macey, *Creditors Versus Capital Formation: The Case Against the European Legal Capital Rules*, 86 CORNELL L. R. 1165 (2001). In particular, we are not persuaded that limitations regarding the acquisition of own shares or financial assistance by the company in case of third party acquisition of its shares are as damaging as alleged.

43 See also Gérard Hertig and Hideki Kanda, *Creditor Protection*, in Kraakman et al., *supra* note 39.

44 See Enriques, above note 20.

Europe still have quite concentrated shareholder structures, there is a good case for facilitating shareholder access to justice.[45]

A combination of four market-oriented measures may prove sufficient EU contribution to reducing barriers to enforcement. First, shareholders should be recognized standing to sue, regardless of the number of shares they own and the direct or indirect nature of the alleged damage to their interests. Second, Member States should be required to allocate shareholder litigation to specialized courts, building upon either the Delaware Chancery, the French *Tribunal de commerce* or the German *Handlesgericht* models. Third, the legality of contingent fees (which are already a common albeit often concealed practice throughout Europe) should be introduced. Introducing such a reform would likely serve to reduce the incentive gap between European and U.S. shareholder litigation. Fourth, cross-border litigation, including cross-mass litigation and temporary injunctions should be facilitated – for example by making it easier for attorneys to represent multiple clients, by facilitating discovery or by eliminating remaining obstacles to intra-EU recognition of judgments.

The obvious advantage of such measures is to force managers and controlling shareholders to better take into account the interests of minority shareholders due to the increase in the litigation threat. To be sure, facilitating litigation is also potentially costly and therefore safeguards against abusive litigation may be needed. It may also prove necessary to adopt transition or grand fathering provisions to reduce negative midstream effects for established firms. We believe, however, that the adoption of mitigating mechanisms can wait until experience has been gathered with new enforcement mechanisms.

In particular, expressed fears about abusive enforcement are more likely to reflect a status quo bias rather than frivolous litigation concerns. Moreover, EU minimum requirements are low enough to make it unattractive for Member States from engaging in races to attract frivolous litigation. Conversely, EU minimum requirements are high enough to prevent Member States from engaging in welfare reducing races to protect managers and controlling shareholders against minority shareholder activism – including those planning a takeover bid. In other words, the facilitation of minority shareholder litigation seems unlikely to have immediate negative

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45 See Gérard Hertig, *Regulatory Competition for EU Financial Services,* in Esty and Geradin, above note 7, 218.

effects regarding enforcement levels or investor and stakeholder expectations regarding established firms.

Unfortunately, the introduction of litigation friendly procedures does not constitute a part of the reform agenda. For example, collective action mechanisms are summarily dismissed by the experts' report, whereas improvements in shareholder standing to sue are not even discussed. This reluctance to consider private litigation mechanisms is not only regrettable because it reflects a bureaucratic rather than market-oriented approach to corporate law. In the context of enlargement, the failure to adopt strong court-centered reforms increases the risk that Member States will enforce corporate law according to a protectionist or otherwise political agenda. The approach is also an obstacle to the competitiveness of the legal profession across Europe, as the fostering of private litigation would make it profitable for European law firms to modernize and compete with U.S. law firms within and outside the EU. In turn, this may even reduce the U.S. litigation risk of European firms if the threat of EU litigation brings them to improve their legal risk management systems.

Our point here is that the proposed EU corporate law reforms are likely to be either ineffective or unnecessary to ameliorate market failures. In addition, they bring the risk of excessive state intervention (supervision of auditors excepted) while ignoring the much needed private action mechanisms. Our own view is that an alternative approach, that addresses corporate law reform in terms of supporting the introduction of non-statutory mechanisms in key areas of company regulation while strengthening the incentives for the enforcement of director's duties, will lead to a fundamental change in the pattern of EU company law.

III. THE PROPOSED TAKEOVER BIDS DIRECTIVE

Part II questioned whether the EU's approach to creating a modern regulatory framework for corporate law in Europe is likely to facilitate competitive law making across the EU. In this Part, we discuss the regulatory impact of the European Commission's latest efforts to devise a set of "level playing field" regulations for takeover bids.

The October 2, 2002 draft Takeover Bids Directive is largely inspired by proposals made by a group of experts (the High Level Group).[46] It aims at setting minimum requirements for corporate conduct and transparency in the takeover context.

More specifically, the Takeover Bids Directive provides for: (1) strict board neutrality on the part of the target board; (2) a mandatory bid rule that ensures that an offeror cannot obtain a controlling stake without making a controlling bid; (3) break-through rules which stipulate that, during the period of acceptance of a bid, any restrictions on the transfer of securities contained in the articles of association and contractual arrangements (but not in national legislation) are not enforceable against the offeror; (4) disclosure rules according to which the offeror must announce his intention to make an offer and make public an offer document containing at least a minimum of information; and (5) 'squeeze-out' and 'sell-out' rules that would have to be implemented at a fair price.

Like the earlier draft 13th Directive, the draft Takeover Bids Directive met resistance from Germany and other Member States on several substantive issues.[47] As with general company law, the central regulatory problem is determining the optimal balance between harmonization and diversity. One benefit of the proposed Directive lies in the provision of simple common rules (e.g., board neutrality) that avoid some of the costs of having complex and differing national regimes On the other hand, it is far from clear that Member States with different laws and traditions will be served by some harmonization proposals.[48]

It is worthwhile emphasizing that a key issues in the debate on the proposed Directive relates to whether the "level playing field" concept is necessary for the regulation of hostile takeovers in Europe. To the High Level Group, rules aiming at balancing regulatory advantages are a pre-requisite to the emergence of an integrated market for corporate control. To others, current Commission proposals create a level playing field in process but not outcome.

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46 See *Report of the High Level Group of Company Law Experts on Issues Related to Takeover Bids* (January 2002, available at europa.eu.int).

47 See EUR. PARL.DOC. (COM(2002) 534 –C5-0481/2002 –2002/0240(COD)) (2002) (summarizing the problems posed by the draft).

48 See *Id.* at 14 (proposed Amendment 16 of Article 5(1), which provides for a uniform definition of the mandatory bid threshold trigger).

More fundamentally, however, the debate is about whether concentrated control should be significantly reduced in Europe.[49] The desirability of a dispersed ownership system is unlikely to be persuasive to blockholder systems, particularly in the absence of evidence of the comparative advantage of the two systems.[50] On the other hand, shareholder structures tend to become less concentrated and there is a growing awareness of the need to protect shareholders against the related increase in managerial opportunism, as well as the necessity to generally protect minority shareholders against controlling shareholder opportunism.

While we welcome proposals that aim at keeping managerial discretion and controlling shareholders' private benefits within acceptable limits, we are skeptical, however, of the promised advantages of the level playing field concept. The approach that we rather favor is to adopt a few EU mandatory rules and to limit further EU intervention to improving companies' freedom to choose the regulatory environment in which they wish to operate. Hence, each provision proposed by the EU should be assessed on its own merits.

Below we begin our examination by discussing the market for corporate control (A). We then look at the proposed board neutrality rule (B). Next, we examine the draft mandatory bid rules, in particular the Commission's equitable price proposal (C), and the break-through rule, which has been proposed by the High Level Group and endorsed subsequently by the rapporteur on Legal Affairs and Internal Market of the European Parliament (D).[51] Finally, we review the level playing field concept (E) and take into account the recently suggested opt-in approach (F).

A. The Market for Corporate Control

Concentrated ownership structure makes the successful conclusion of hostile takeovers difficult, if not impossible, in Continental Europe. However, many commentators have shown that other factors may decrease the probability of hostile acquisitions. For example, when the target company has widely dispersed ownership, no individual shareholder affects the success of the

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49 Jeffrey N. Gordon, *An International Relations Perspective on the Convergence of Corporate Governance: German Shareholder Capitalism and the European Union, 1990-2000,* in CONVERGENCE AND PERSISTENCE IN CORPORATE GOVERNANCE (J.N. Gordon and M.J. Roe eds. 2003, forthcoming).

50 William W. Bratton and Joseph A. McCahery, *Comparative Corporate Governance and the Theory of the Firm: The Case Against Global Cross-Reference,* 38 COLUM. J. TRANSNAT'L. L. 213, 230 (1999).

51 See EUR. PARL. DOC., *supra* note 47 (proposed Amendments 28 and 29 of Article 11).

tender offer (free rider problem), which may prevent bidders from recovering the costs of their bid (e.g., information and search costs).[52]

Various schemes can overcome the free-rider problem.[53] Allowing the bidder to freeze out remaining shareholders at a price below the target's full value after the completion of the takeover may ensure that free riders will tender at a price where the bidder achieves a profit.[54] Similarly, permitting the bidder to acquire an initial toehold in the target company will allow the bidder to retain some of the public benefits of the eventual takeover gains.[55]

The free-rider problem, however, does not arise if there are sufficient private benefits of control left in the firm for the new majority shareholder to finance its bid. Also, there is no free-rider problem when shareholders are uncertain about the success of the proposed bid. Even if the bid price is below the stand-alone value of the target firm, dispersed shareholders may be under pressure to tender because they expect other shareholders to tender.[56]

The above argumentation shows that, in order to increase the flow of takeover bids, it is necessary that minority shareholders neither participate in the full value of the firm nor be induced to tender for a bid that leaves them worse off than before the bid. Whether or not increasing takeover flows is efficient is the subject of debate. Some argue that takeovers create value improvements by exploiting buyer and seller synergies. Others point to the higher number of value-decreasing bids and the high costs associated with takeovers that are primarily motivated by managerial compensation and the expropriation of the target firm's stakeholders.

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52 Sanford J. Grossman and Oliver Hart, *Takeover Bids, the Free-Rider Problem, and the Theory of the Corporation*, 11 BELL J. ECON. 42 (1980).

53 Lucian A. Bebchuk, *Efficient and Inefficient Sales of Corporate Control*, 109 Q. J. ECON. 957 (1994); Mike Burkart, Denis Gromb and Fausto Panunzi, *Why Higher Takeover Premia Protect Minority Shareholders*, 106 J. POL. ECON.172 (1998).

54 George Yarrow, *Shareholder Protection, Compulsory Acquisition, and the Takeover Process*, 34 J. INDUS. ECON. 3 (1985).

55 Andrei Shleifer and Robert W. Vishny, *Large Shareholders and Corporate Control*, 94 J. POL. ECON. 461 (1986).

56 Lucian Bebchuk, *Toward Undistorted Choice and Equal Treatment in Takeovers*, 98 HARV. L. REV. 1695 (1985).

Given the trend towards less concentrated ownership across Europe and the increasing awareness of the need to protect minority shareholders against controlling shareholder opportunism, EU policymakers must attempt to balance a tradeoff. On the one hand, they should promote policies that make takeovers less costly and thus produce more bids; on the other hand, they have to insure for shareholder protection and equal treatment.[57]

B. Board Neutrality

Consequently, a recurrent theme in EU takeover policy discussions concerns the balance that policymakers must strike a balance between protecting shareholders from the effects of managerial opportunism (represented in the form of pre and post bid defenses) by adopting a board neutrality rule and deferring to the judgment of management.

In the main, the debate in corporate legal theory over takeovers falls into two broad schools of thought. The board defense approach holds that shareholders are unable, due to limited experience, collective action and coordination problems, to make informed choices in the takeover context. Hence, boards should be permitted to erect defenses on the grounds that they are better placed to protect the interests of shareholders.

In contrast, the shareholder choice perspective holds that boards are self-interested in their response to takeover bids and consequently should not be permitted to create defenses.[58] Not only does board discretion reduce welfare by limiting the disciplinary effect of takeovers, but it also reduces shareholder value by attracting only friendly deals, allowing managers to extract a disproportionate share of rents produced by such transactions. While there is no doubt that shareholders are disadvantaged in ordinary day-to-day business decisions, proponents conclude that shareholders are best positioned to take the ultimate decision in a takeover bid.

Dissatisfaction with the shareholder choice approach has led recently to the emergence of a hybrid view which holds that undistorted shareholder choice may be insufficient to remove

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57 Erik Berglöf and Mike Burkart, *Break-through in European Takeover Regulation?,* (Working Paper, 2002).

58 Lucian A. Bebchuk, *The Case for Empowering Shareholders* (Working Paper, 2003).

most of the barriers to takeovers.[59] In particular, it is argued that managers can simply entrench themselves further by employing pre-bid defenses embedded in a firm's contractual arrangements.[60]

Against this background, the issue with the draft EU regulation of takeover bids becomes the extent to which its board neutrality rule is required. It has been argued that the policy choice between board neutrality and board discretion depends on the relative efficiency of capital markets.[61] If there are sufficiently large externalities in the takeover context, board intervention can be justified. The main trade-off entails bad managers entrenching themselves by rejecting value enhancing tender offers against good managers seek to maximize shareholder value by rejecting value reducing tender offers. While there is good arguments that support both sides of the trade-off, empirical evidence is not available.[62]

It is therefore useful to take into account the role of board neutrality provisions in a key Member State, Germany. The 2002 Takeover Act is consistent with the general 'duty of neutrality' that prohibits the management from taking any unilateral action to frustrate the hostile takeover offer. However, shareholders can authorize target management to implement defense mechanisms such as: i) issuance of new shares, ii) buy-back of shares (generally limited to ten percent) and iii) sale of key assets and other major transactions.[63] Moreover, the 'duty of neutrality' does not apply to acts that would also have been performed in the ordinary course of performance, such as looking out for a competing offer and acts approved by the supervisory board of the target company.[64]

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59 Marcel Kahan and Edward Rock, *Corporate Constitutionalism: Antitakeover Charter Provisions as Pre-Commitment*, U. PA. L. REV. (forthcoming 2003); Richard E. Kihlstrom and Michael L. Wachter, *Managing Market Anomalies versus Maximizing Corporate Value*, U. PA. L. REV (forthcoming 2003).

60 Jennifer Arlen and Eric Talley, *Unregulable Defenses and the Perils of Shareholder Choice*, U. PA. L. REV. (forthcoming 2003).

61 Michael L. Wachter, *Takeover Defenses when Finanical Markets are (only) Relatively Efficient*, 151 U. PA. L. REV. 787 (2003).

62 See Kahan and Rock, *supra* note 59.

63 See §§71, 186 *Aktiengesetz* (Stock Corporation Act).

64 See §33 *Wertpapiererwerbs- und Übernahmegesetz* (Securities Acquisition and Takeover Act, translated in Thomas Stohlmeier, GERMAN PUBLIC TAKEOVER LAW - 2002).

Whether and to what extent the German Act constrains management remains unclear. On the one hand, the range of actions that target management may undertake on its own is quite limited and the use of defense mechanisms that require shareholder ratification must be approved by 75% of voting shares, which in fact is a considerable impediment to overcome. In addition, actions that directly alter the shareholder structure may be subject to shareholder approval.[65] Moreover, the target's management and supervisory boards must not breach their fiduciary duty to loyalty and care.

On the other hand, there is no apparent agreement in the literature regarding the scope of shareholder authorization requirements. [66] In addition, it is argued that supervisory board approval can be used to override shareholder decisions.[67] Moreover, the managerial fiduciary duties are defined with respect to the interests of shareholders, employees and the interests of society as a whole, which leaves room for considerable discretion.[68]

The German situation shows why it might be preferable for reasons of transparency to have a single, simple EU rule on board neutrality. To the extent it does not affect the allocation of decision-making power in the general course of the company's business, the strict board neutrality rule currently proposed by the EU is justified.

C. The Mandatory Bid Rule

Article 5 of the draft Takeover Bids Directive is designed to trigger a full mandatory bid when the bidder acquires a percentage of voting rights that confers on him the control of the target. Member States should determine both the percentage of voting rights conferring control and the

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65 See the *Holzmüller* doctrine, Entscheidungen des Bundesgerichtshofes in Zivilsachen BGHZ 83 (1982), 122.

66 See Hartmut Krause, *Die Abwehr feindlicher Übernahmeangebote auf der Grundlage von Ermächtigungsbeschlüssen der Hauptversammlung*, 57 BETRIEBS-BERATER 1053 (2002); Uwe H. Schneider, *Die Zielgesellschaft nach Abgabe eines Übernahme – oder Pflichtangebots,* 47 AKTIENGESELLSCHAFT 125 (2002).

67 Christoph H. Seivt and Kristian J. Heiser, *Die neue Vorschlag einer EU-Übernahmerichtlinie und das deutsche Übernahmerecht*, 2002 ZEITSCHRIFT FÜR WIRTSCHAFTSRECHT 2193.

68 Heribert Hirte, *Verteidigung gegen Übernahmeangebote und Rechtsschutz des Aktionärs gegen die Verteidigung,* 31 ZEITSCHRIFT FÜR UNTERNEHMENS – UND GESELLSCHAFTSRECHT 623, 643 (2002) (quoting the justification for the law given by the German government).

method of its calculation.[69] Member States should also adopt rules on information.[70]

The strongest argument in favor of the mandatory bid rule is that it provides an exit mechanism for shareholders who do not tender in connection with a takeover bid. It also decreases market uncertainty, which enables the bidder and shareholders to capitalize on the cost of the bid and on the cost of exit respectively. On the other hand, if the bidder must obtain control from a blockholder, the mandatory bid rule is likely to prevent the incumbent blockholder from getting compensation for the loss of enjoyment of the private benefits of control. The implication, of course, is that a mandatory bid rule should avoid value-decreasing takeovers but may preclude some value-increasing takeovers – for example, when private benefits are necessary for the controlling shareholder to engage into monitoring management in the interest of all shareholders.

The notion of the 'equitable exit price' is the key in the proposed mandatory bid context. The draft Takeover Bids Directive adopts the highest price rule recommended by its experts (whereas Member States can grant exemptions under certain circumstances). Minority shareholders must be offered the highest price paid for the shares of the relevant class in a period between six to twelve months prior to the bid in market and over-the-counter transactions.[71]

In this context, imposing a mandatory bid rule at the EU level but leaving the definition of the trigger threshold to Member States is a sensible approach: Some protection of minority shareholders is guaranteed, while room remains for differences among Member States. On the other hand, mandating the highest price as the "equitable exit price" prevents regulatory competition to minimize the costs in terms of precluded value-enhancing takeovers. Arguably, regulatory competition may not be strong if national equitable price rules are complicated, but there are better ways than mandating the highest price rule to take care of this issue.

One way would be for the EU to adopt an "equitable exit price" rule that equates a prescribed percentage discount on previous block trades. Another, possibly cumulative, option would be to prescribe offering the stock market price in a specified period prior to the bid. For example, the voluntary German Takeover Code in place before 2002 specified the highest stock

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69 See Art. 5(1), 5(3) Draft Takeover Bids Directive.

70 See Art. 6(3) Draft Takeover Bids Directive.

71 See Recommendation II.2 of the High Level Group Report, *supra* note 48; Art. 5(5) Draft Takeover Bids Directive. Compare Art. 32(4) Swiss Stock Exchange Law (the exit price cannot be less than 75% of the highest price paid by the bidder in the past twelve months).

market price in the three months prior to the bid as the "equitable exit price". In other words, the stock market price rule is seen as guaranteeing all shareholders the stand-alone value of the firm.

D. The Break-through Rule

The High Level Group of Experts appointed by the European Commission proposed a novel idea called the break-through rule. The rule is intended to eliminate a wide variety of pre-bid defenses that are viewed as significant impediments to the emergence of a well-functioning cross-border takeover market.

The major break-through rule provides that a bidder should be permitted, upon the acquisition of 75% of cash flow rights (or any relevant threshold not higher than 75% set forth by the Member States), to convene a general meeting of shareholders at short notice and impose one-share one-vote. Thus, any mechanisms or structures that deviate from the principles of shareholder decision-making and proportionality between risk-bearing and control will be "broken through".

So, for example, upon reaching the required threshold, the bidder will be permitted to: (1) amend the articles of association and other constitutional documents; (2) remove any pre-bid takeover defenses approved by shareholders; (3) remove voting caps and differential voting rights; (4) remove provisions denying voting rights; (5) remove voting rights on non-risk bearing capital; (6) appoint, suspend, and dismiss the board members other than those appointed by third parties; (7) determine the composition of the board; (8) remove any staggered and/or fixed period provisions; and (9) override special control rights attached to golden shares.

The defensive device that is receiving most attention in the political debate is the multiple voting right share structure. For this reason, the break-through rule will be analyzed in the light of such a structure.

The designers of the break-through rule assert that no single form of corporate charter is optimal. In the context of takeovers, however, they claim that one type of corporate charter arrangement is preferred, namely a one-share-one-vote structure. In this regard, increasing takeover incidence has become a goal in itself that will eventually determine the contents of a firm's corporate charter.[72]

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72 Berglöf and Burkhart, *supra* note 57.

Proponents of the break-through rule argue that a dual class regime lowers the probability of a takeover and reduces, in turn, the incentives of managers to undertake value-maximizing projects for the benefit of the firm's residual investors. In contrast, supporters of dual class stock argue that dual class shares produce a number of desirable effects including: (1) protection against shareholder opportunism and misjudgments due to lack of information (2) protection against predatory bid tactics, (3) reduction of agency problems, and (4) compensation for greater firm specific risk.

A rigorous analytical framework of (non)optimality conditions of the one share one vote rule in takeover context was introduced by pioneering works of Grossman and Hart, and Harris and Raviv.[73] Though the proposed settings differ in some respects, the authors' general conclusion is that distribution of voting rights affects the value of the firm and, under qualifying conditions (almost always), the one share one vote rule is not value maximizing.

The consequences of dual class shares are well documented in the U.S.[74] A number of empirical studies point out that anti-takeover provisions merely influence the takeover probability and the premium of the target firm.[75] Most empirical studies, moreover, have found that takeover defenses have little or no impact on bid outcomes.[76] This is consistent with practicing lawyers' positions about takeover defenses not doing much harm and mattering only at the margins.[77]

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73 Sanford J. Grossman and Oliver Hart, *One Share-One Vote and the Market for Corporate Control*, 20 J. FIN. ECON. 175 (1988); Milton Harris and Arthur Raviv, *Corporate Governance: Voting Rights and Majority Rules*, 20 J. FIN. ECON. 203 (1988).

74 John C. Coates IV, *Explaining Variations in Takeover Defenses: Blame the Lawyers*, 89 CAL. L. REV. 1301 (2001).

75 Sheryl Hannes, *The Hidden Virtues of Antitakeover Defenses (Wo*rking Paper , 2002).

76 James A. Brickley, J.L. Coles and R. L. Terry, *Outside Directors and the Adoption of Poison Pills*, 35 J. FIN. ECON. 371 (1994).

77 See Lucian Bebchuk, John C. Coates IV and Guhan Subramian, *The Powerful Antitakeover Force of Staggered Boards: Theory, Evidence, and Policy*, 54 STAN. L. REV. 887 (2002) (analyzing empirical evidence on effect of takeover defenses).

Finally, even if one would look at the whole picture, not merely takeover events, various studies show that the company value consequences of dual class structures is ambiguous.[78]

Unlike in the U.S., there are few empirical studies in Europe that analyze the wealth effects of pre-bid defenses by shareholders. A recent study investigates the performance of Danish firms that adopted dual class shares for period between 1995 and 1999.[79] It shows that unprotected firms do not outperform firms protected by dual class stock. One offered explanation: other corporate governance mechanisms, including blockholder monitoring, appear to limit managerial opportunism.

Based on the above, the efficiency implications of dual class stock, and thus of break through rules, are inconclusive. More importantly, Berglöf and Burkart argue that the break-through rule is inconsistent with the mandatory bid rule.[80]

The main effect of the break-through rule is to transform a bid for a company with a concentrated ownership structure into a dispersed bid. If the incumbent controlling shareholders have access to sufficient funds to launch a counter bid, the bidder will in turn be forced to bid at least as much as the incumbent shareholder. The maximum bid of the incumbent shareholder will include the sum total of his private benefits and the stock market valuation of the target firm. But, if the incumbent is financially constrained, the bidder will not offer more than the public value of the target firm after the completion of the takeover.

As a result, the bidder's dominant strategy will be to use the break-through rule as a means of acquiring control, even if the incumbent management is in principle willing to enter into negotiations. In legal terms, the break-through rule leads to the acquisition of control not by passing a threshold on voting share holdings but by effecting a change in a corporate charter. It is, however, unclear whether such a control transfer would trigger a mandatory bid. If a mandatory bid is not triggered, the problems associated with two-tier takeover bids would be reintroduced.

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78 G. Grullon and K. George, *Managerial Incentives, Capital Structure, and Firm Value: Evidence from Dual Class Stock* (Working Paper): Randall Morck, Andrei Shleifer and Robert Vishny, *Managerial Ownership and Market Valuation: An Empirical Analysis*, 29 J. FIN. ECON. 293 (1988).

79 Caspar Rose, *Corporate Financial Performance and the Use of Takeover Defenses*, 13 EUR. J. L. ECON. 91 (2002).

80 *Supra* note 57.

At the same time, under the assumption that an incumbent shareholder is not willing to tender, the break-through rule does not open up the possibility of effecting a squeeze out to the new controlling shareholder. Another important implication of the break-through rule is that it could alter ownership structures and concentration of voting rights. For example, some predict that break-through rule might induce firms—particularly new firms--to substitute a dual-class structure with a pyramiding structure.[81] Such a step may in turn give rise, among other things, to problems related to monitoring, managerial incentives, and liquidity.

Summing-up, imposing specific break through rules is not only likely to result in inconsistency and uncertainty, it is also unlikely to contribute to the emergence of a competitive market for corporate control.

E. Reevaluating the Level Playing Field Concept

Supporters of the on-going reforms may submit that, even if EU reforms do not contribute to the emergence of a competitive regulatory environment, harmonization is, nevertheless, necessary to assure a level playing field.

For example, it has been argued that EU takeover law should not permit a French company to acquire a German company if the differences between French and German law gives a French bidder a systematic advantage. Correspondingly, the EU experts have argued that the break-through rule and board neutrality are necessary to create a level playing field for takeover bids. Similarly, some members of the European Parliament have endorsed a reciprocity claim also made by the EU experts, according to which Member States should be permitted to block bids from a third country to prevent distortion in competition due to differences in legal rules – especially between U.S. and E.U. firms.

In our view, it is far from clear that reciprocity is ultimately the basis upon which the European Union has to make its policy choices. Interestingly, supporters of the level playing field have made little attempt to justify their policy reform efforts on economic grounds.[82] Our analysis

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81 But cf. Gordon, *supra* note 49 (arguing that pyramids are not a low-cost substitute for firms going public).

82 See Ronald J. Gilson, 'The Political Economy of Takeovers: Thoughts on Harmonizing the European Corporate Governance Environment,' 61 FDM. L. REV. 161, 192 & n. 95 (arguing that "in the

questions whether it can be taken for granted that the differences in national regulatory policies should be regarded as the basis for a reciprocity process. To the extent that jurisdictions have divergent regulatory policies, the sources of the differences may be due to a range of factors (i.e., preferences, endowments, technologies, etc.). Substantive legal differences alone may not reflect significant economic differences in the competitive advantage between states. In sum, because there is little empirical evidence that differing national preferences and regulatory policies have any effect on trade patterns, we argue that legislators should not be distracted by arguments based on equal treatment.

F. Opting In Menu

Recently, the growing uncertainty about the passage of the Takeover Bids Directive has prompted the Commission to launch a new compromise proposal. Stimulated by the Portuguese delegation, it has proposed the adoption of a EU Takeover Code comprising a menu of simple provisions. In particular, A firms would opt in to the break-through rule, while B firms would opt out by default, retaining their pre-bid defenses. Managers of B companies will not be allowed to launch a bid for A firms.

The Portuguese approach amounts to (partly) allowing companies to choose the takeover regime they prefer. Two broad issues derive from such approach: (1) which provisions of should be mandatory and which should be enabling; and (2) which rules should govern takeover contests of firms with different corporate charters.

In our view, the first step is to have takeover rules unbundled. Board neutrality and mandatory bid rules are a different matter than selecting voting arrangements, mandatory bid thresholds or exit prices for minority shareholders. On the one hand, the Code should impose the board neutrality and mandatory bid rules across the EU. On the other hand, the Code should offer a menu of simple and transparent opt-in provisions - the incorporation regime remaining applicable otherwise.

The second step should be to design a set of opt-in provisions regarding share classes, mandatory bid thresholds and exit prices for minority shareholders. For instance, the Code might offer opt-in provisions for three types of shares, each having different voting and dividend rights. What matters, of course, is simplicity and transparency. If one or more of the X, Y, Z share

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absence of an economic justification for hostile takeovers, the reciprocity claim seems much more of a political justification for harmonization.").

classes were to be adopted, the incorporation regime would not remain applicable and the opt-in as well as its consequences should be made transparent for investors.

Similarly, the Code could provide a menu of opt-in provisions regarding mandatory bid threshold (e.g. 33% or 50%) and exit prices for minority shareholders (e.g. average stock market price in the six moth preceding the bid or highest stock market price in the three months preceding the bid). Here again, the incorporation regime would remain not remain applicable and the opt-in as well as its consequences should be made transparent for investors

The third step would be to decide whether decisions to opt in should be left with management or shareholders – and if it is shareholders, what share class would be admitted to vote. We would recommend leaving the opt-in decision with shareholders, with participation of all holders of voting rights.

The fourth and final step has to do with the applicable law for takeover contests between firms with different regimes. It is submitted that companies that have opted for EU rules are bound to them whether they become a bidder or a target. The opt-in approach presumes shareholder choice and stock market pricing of a variety of corporate governance arrangements. It follows that lawmakers should drop the demand for reciprocity in the sense that the same rules must apply for every party in a takeover contest.

Since the EU menu would coexist with national codes, we expect stock markets to react to firms' decision the opt-in, which could result in regulatory competition and the introduction of lower cost forms of regulation at the Member State level. Conversely, should the EU menu fail to satisfy market demand, firms may still stick with their incorporation regime or opt out of the EU regime back into Member State law.

IV. CONCLUSION

In this Article, we have sought to assess the prospects for competitive lawmaking in the EU. Under the present conditions, we have shown that a competitive environment for regulatory arbitrage and regulatory competition is beginning to develop. In reviewing the recent history of EU company law reform, we argued, moreover, that the introduction of further harmonization of disclosure regulation is unlikely to create significant advantages for investors.

We also put forward the claim that proposed board and liability reforms will be ineffective and that institutional and enforcement proposals will increase State intervention rather than facilitate cross-border activity. Instead, we propose to reduce barriers to enforcement by

adopting four market-oriented measures: granting standing to sue to all shareholders, requiring the setting-up of specialized courts, stating the legality of contingent fees and facilitating cross-border litigation - for example by making it easier for attorneys to represent multiple clients, by facilitating discovery or by eliminating remaining obstacles to intra-EU recognition of judgments

We assessed, furthermore, the recent efforts of the Commission to create a takeover bids regime. We have shown that a minimized harmonized regime would enhance transparency and shareholder protection. First, we argued that the board neutrality rule should apply to takeover bid situations, not least because of shareholding structures tending to become less concentrated in continental Europe. Second, we suggested that the mandatory bid rule is a sound device to prevent expropriation from shareholders. It also limits the two-tier bid, which reduces the pressure to tender problem.

We have also demonstrated that there are good reasons to reject the break-through rule and the level playing field approach. In particular, there is no question that the break through rule violates the principle of shareholder decision-making upon which the board neutrality rule is based. There is also a logical inconsistency between the break-through rule and the mandatory bid rule. Furthermore, the break-through rule might lead firms to choose unattractive, value-deceasing capital structures.

Finally, we have developed a default approach for the design of the proposed EU Takeover Code, which allows firms to select legal arrangements that meet their needs. We argue that the default approach gives Member States incentives to adopt the proposed Takeover Bids Directive. Furthermore, we show that offering firms the choice to opt out of the EU takeover regime and opt in to state law could lead to some competition between suppliers of rules and encourage innovation in corporate law. This approach, if adopted, would lead to the selection of better takeover law rules and contribute to the development of an active cross-border takeover market in the EU.

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