REGULATORY COMPETITION VERSUS HARMONISATION IN EUROPEAN COMPANY LAW

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Simon Deakin
ESRC Centre for Business Research
University of Cambridge
Austin Robinson Building
Sidgwick Avenue
Cambridge
CB3 9DE

Phone: 01223 335243
Fax: 01223 335768
E-Mail: sfd20@econ.cam.ac.uk

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Abstract

The harmonisation of company law in Europe has done little to remove diversity in the legal systems of the member states. The impact of directives has been significant in certain areas, such as basic accounting standards and the rules of capital maintenance. Nevertheless, the continuing divergence between 'insider' systems, which place a strong emphasis on stakeholder forms of representation, and 'outsider' systems, which stress liquid stock markets and the protection of shareholder interests, is reflected in the failure of the member states to reach agreement on a number of key proposals, in particular the model constitution for transnational enterprises which is contained in the draft European Company Statute. At the same time, the prospects of US-style regulatory competition emerging in the near future are remote, since this would also require harmonisation, in this case of the rules of conflict of laws. However, diversity is in many ways a strength of the European company law systems, which, paradoxically, 'reflexive' harmonisation has sought to preserve while also encouraging innovation in forms of self-regulation in the corporate and financial spheres. Co-evolution based on diversity at the level of national legal systems, coupled with encouragement from transnational norms for devolved solutions, is a more likely path for European company law than the type of convergence around a single, dominant regime which appears to characterise the Delaware effect in the US context.

Key words: regulatory competition, corporate law

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1. Introduction

European company law exemplifies the limited extent to which harmonising measures have led to greater uniformity in the private and commercial laws of the EU member states. Although important Directives have been adopted in relation to a number of areas including accounting requirements and rules relating to the maintenance of share capital, taken together they fall a long way short of establishing a systematic code relating to the formation and governance of companies. Numerous initiatives in the field of company law currently remain in a state of suspended animation; these include proposals for a model European company statute, standardised rules for public companies, and a framework for the regulation of takeover bids.

This looks like good news for advocates of greater regulatory competition in the EU: diversity in the laws of the individual member states has survived attempts at harmonisation, making it possible for member states to experiment in their search for efficient and workable rules of company law, as seems to be the case in the United States. However, the other side of member state autonomy is the absence of an effective market for incorporations in the EU. The possibility of a market for incorporations has been blocked, in part, by the operation of national-level rules of the conflicts of laws which limit the degree to which a company can choose its applicable law - the so-called *siège réel* doctrine. National-level laws also differ widely in their attitude towards the movement of companies from one jurisdiction to another, that is to say, their reincorporation across jurisdictional boundaries. The draft Fourteenth Directive, which aimed to provide a common solution to the issue of reincorporation, has in effect been abandoned, at least for the time being. For these reasons, the mechanisms of corporate entry and exit which, in the US context,

have brought the corporate law systems of the states directly into competition with one another, simply do not exist within the EU.

There are signs that this picture of relative stability may not last. The catalyst for change has been the *Centros* decision of the European Court of Justice,[1] which, in the views of some commentators, promises (or threatens) to undermine the *siège réel* doctrine by characterising it as an obstacle to freedom of establishment under the EC Treaty. As we shall see further below, the *Centros* case, in itself, is unlikely to lead to the end of the *siège réel* doctrine. However, whatever its precise legal scope turns out to be, the *Centros* case has certainly reignited debate on the merits and demerits of a Delaware-style resolution to the current impasse in the European company law programme.

Two related questions arise at this point. The first is concerned with the likely effects of increasing regulatory competition on the company law systems of the member states. Would diversity be preserved and possibly even strengthened, or would regulatory competition lead to *de facto* uniformity as laws converged around a stable set of solutions to the trade-offs between the rights of shareholders and other parties which are implicit in company law regimes? The second question is concerned with the efficiency implications of choosing regulatory competition on the basis of a market for incorporations. In so far as we can identify the kinds of changes in company law systems which regulatory competition of this kind would be likely to induce, would the result be efficiency-enhancing? It is arguable that regulatory competition would lead to the removal of inefficient legal rules which, until now, have been insulated from change by the absence of a market for incorporations. On the other hand, there is a view that freedom of incorporation will put in jeopardy certain mandatory laws which may have efficiency-enhancing effects. Here, the debate over harmonisation intersects with arguments concerning the nature and effects of laws which seek to balance the rights of shareholders with those of other stakeholder groups, in particular employees. Laws of this kind currently operate in several member states.

Providing answers to these questions is inherently problematic. Studies of regulatory competition in the United States disclose a number of possible explanations of the nature and effects of the rise of Delaware as the primary state of incorporation for larger and public companies. These include the ‘race to the bottom’ hypothesis (Cary, 1974); the contrary idea of the efficient selection of rules through competition (Easterbrook and Fischel, 1991; Romano, 1993); and institutional explanations which stress the role of interest-group activity, lock-in and path dependence (Macey and Miller, 1987; Roe, 1993). From a European perspective, it is difficult to get a clear message from the US experience which would be relevant in the different market and instititutional environment of the EU.

To make progress on this issue, some rethinking on the relationship between competition and harmonisation may be required. US debates draw a contrast between those areas of law which are left up to competition between states, on the one hand, and those which are governed by the federal legislature as a ‘monopoly regulator’ (Romano, 1998). In the European context, on the other hand, it is possible to see how harmonisation may complement and even encourage the process of evolutionary adaptation in laws at state level. Certain types of ‘reflexive harmonisation’ may in the end be the most effective guarantor of diversity between national systems, and hence of experimentation in regulatory design. By contrast, unregulated competition between jurisdictions could well eliminate the most significant differences between them, *but* without any guarantee that the system which eventually prevailed would be the most efficient. The apparently paradoxical conclusion, then, is that the harmonisation of company law may represent the best chance of capturing beneficial aspects of regulatory competition, in terms of evolutionary adaptation, within the framework of the single market.

This argument is developed below in the following way. The next section provides some context by outlining the development of EU company law to date, and its relationship to the company law systems

of the member states. General reference is made to those Treaty provisions which are concerned with company law and to directives and regulations in this area. In the following section the focus shifts to the *Centros* case and to the potential effects of a market for incorporations inside the EU. The concept of reflexive harmonisation is then analysed, and its implications are considered in the context of two issues of central importance within contemporary debates, namely employee participation and the conduct of takeover bids. The concluding section argues that the experience of European company law has wider lessons for harmonisation within the EU and, more generally, for the way in which the process of regulatory competition is understood.

2. An Overview of European Company Law

2.1. The place of company law in the legal order of the EU

EU company law has its roots in provisions of the EC Treaty protecting freedom of establishment. Article 43 of the EC Treaty (ex Article 52) provides:

> '…restrictions on the freedom of establishment of nationals of a Member State in the territory of another Member State shall be prohibited. Such prohibition shall also apply to restrictions on the setting up of agencies, branches or subsidiaries by nationals of any Member State established in the territory of any Member State.
>
> Freedom of establishment shall include the right to take up and pursue activities as self-employed persons and to set up and manage undertakings, in particular companies and firms within the meaning of the second paragraph of Article 48, under the conditions laid down for its own nationals by the law of the country where such establishment is effected…'

For this purpose, Article 48 (ex Article 58) provides:

> 'Companies or firms formed in accordance with the law of a Member State and having their registered office, central administration or principal place of business within the Community shall, for the purposes of [the chapter on freedom of establishment], be treated in the same way as natural persons who are nationals of Member States.
>
> "Companies or firms" means companies or firms constituted under civil or commercial law, including cooperative societies, and other legal persons governed by public or private law, save for those which are non-profit-making'.

The power to introduce harmonising measures in the field of company law is essentially ancillary to these rights of free movement for companies. Under Article 44(2)(g) (ex Article 54(3)(g)), the Council can adopt directives aimed at 'coordinating to the necessary extent the safeguards which, for the protection of the interests of members and others, are required by Member States of companies and firms… with a view to making such safeguards equivalent throughout the Community'. In other words, some degree of parity or equivalence in the laws protecting shareholders and 'others' – the latter term could include a range of stakeholder groups (Villiers, 1998: 19) – was deemed by the Treaty's drafters to be necessary in order to remove disincentives to the movement of companies from one member state to another.

During the early development of the Community's company law programme, the case for harmonisation echoed the claims made at around the same time by the 'race to the bottom' school in the USA (Cary, 1974). Thus Clive Schmitthoff's assessment, in 1973, was that without harmonisation, standards of shareholder and creditor protection within the EU would be eroded. In order to avoid a repeat of Delaware, harmonisation, in his view, should aim for the 'virtual unification of national company laws' (Schmitthoff, 1973: 9).

Although this view can be reconciled with the principle of freedom of establishment, on the grounds that ‘unharmonised national safeguards may make establishment too burdensome or even impossible’ (Wolff, 1993: 22; see Villiers, 1998: 19), it arguably goes further than necessary in order to achieve the goal of equivalence or parity between member states. Rather, Schmitthoff’s argument saw Community-level intervention as having a substantive policy goal, namely the preservation of regulations conferring protections on various corporate constituencies, which, it was feared, a Delaware-style effect might otherwise erode.

It was partly this spirit of protective regulation which, along with the goal of ensuring freedom of establishment, motivated the early company law directives, the so-called first generation directives which were heavily prescriptive in their approach (Villiers, 1998: 20; see generally Edwards, 1999). The First Directive, adopted in 1968, laid down certain core minimum standards for both public and private companies and for limited partnerships, relating to disclosure of basic information concerning the company’s constitution and statutes. It also set standards for state laws concerning the validity of obligations entered into by the company with third parties, and the bases for the nullity of a company. The Second Directive, adopted in 1976, laid down a number of basic requirements for public companies, including the obligation to have a minimum paid up share capital as well as rules relating to the maintenance of capital.

This early emphasis on uniformity and prescription soon gave way, however, to more flexible approaches which placed greater stress on member state autonomy. Charlotte Villiers (1998) describes the successive waves of measures as second, third and fourth generation directives. Characteristic second-generation measures were the so-called accounting directives, the Fourth (1978), Seventh (1983) and Eighth (1984). These laid down basic accounting and audit standards in the form of a set of options which essentially represented the predominant approaches which were then in operation in various member states.

The third generation directives reflected the ‘new approach’ to harmonisation which the Commission instituted around the time of the passage of the Single European Act in 1986 and the initiation of the single market programme. The ‘new approach’ began in the context of product standard harmonisation, where it established a principle that Community intervention should be limited to the harmonisation of essential safety-related requirements. It also established the ‘reference to standards’ approach, under which it was presumed that a product which conformed with a standard set by a European-level body, or, failing that, with the relevant national standard, also complied with EC law (Armstrong and Bulmer, 1998: 152). Company law was one of the other areas in which this decentralising approach was applied. Hence the Twelfth Directive on single-member private companies (1989), which was adopted in pursuance of the Community’s goal of promoting the growth of small and medium-sized enterprises, explicitly left a range of regulatory issues concerning disclosure of information and creditor protection to be decided at member state level.

Fourth-generation measures took the process a stage further by adopting a ‘framework’ model for directives. This again favoured the articulation of general principles or standards rather than the promulgation of rigidly prescriptive rules. However, new techniques were also involved. The aim was to achieve policy goals by linking regulatory interventions to the activities and processes of autonomous rule-making bodies, such as industry-level associations and self-governing professional organisations in the financial sector. The draft Thirteenth Directive on Takeover Bids (last amended in 1997) exemplifies this approach, in particular in the scope it provides for its general principles to be implemented through local-level action by self-regulatory bodies (such as, in the UK context, the City Panel on Takeovers and Mergers, which is an entity formed by organisations and professional associations in finance sector rather than a body emanating from the state).

This ‘flexibilisation’ of directives did not, however, make it any easier to reach agreement on some of the key proposals for company law harmonisation which were being discussed at this time. The draft Fifth Directive was first proposed in 1972; further versions appeared in 1982 and 1988, and amendments were most recently made in 1991. This draft Directive essentially laid out a model set of regulations for the governance of public companies. Large parts of the draft were relatively uncontentious. However, the proposal essentially foundered on the issues of board structure and employee representation, thereby suffering the same fate as the so-called Vredeling draft Directive of the mid-1970s which would have introduced forms of employee participation in management decision-making into transnational companies. The original draft of the Fifth Directive provided for a two-tier board structure with employee representation on the supervisory board, more or less along the lines of the German co-determination system. This was later amended to allow for the possibility of a unitary board, but still with a basic requirement of employee representation either at board level or through a consultative council. But these provisions still proved unacceptable to a number of member states, including Britain.

Disagreement on the question of employee representation has also been the main reason for the failure of proposals for a model European Company Statute. The idea of a model constitution for transnational European companies goes back to the earliest days of the Community, and some versions even pre-date the Treaty of Rome of 1957. The first concrete proposal was made by the Commission in 1970; the most recent dates from 1996. The present proposal is for a Regulation which would provide for a European public company (a *Societas Europea*, or SE) to be established through a number of different mechanisms, most of which require the involvement of two or more companies which are governed by the laws of at least two member states. Significant features of the model constitution include the requirement for a minimum paid up share capital (currently 120,000 euros); the identification of the company’s registered office, which must be in the territory of the EU, with its central

administration (an application of the *siège réel* principle); and a range of options on board structure, including two-tier and unitary boards of various kinds. The Regulation is currently attached to a Directive which makes provision for employee representation. As with the draft Fifth Directive, a number of options are made available, ranging from employee membership of a supervisory or a unitary board, the establishment of a consultative council, to a collective agreement setting out the basis for employee participation. The draft SE Directive would also impose certain minimum requirements of information and consultation with regard to employees.

The impasse on the issue of employee representation has been overcome to a certain extent by the adoption in 1994 of the Directive on European Works Councils (the 'EWC Directive'). This Directive adopts a labour law solution to the issue of information and consultation, by requiring transnational companies above a certain size to enter into negotiations with employee representatives for the establishment of a framework for information and consultation. In the event of the failure of negotiations, a default procedure is imposed by law. The passage of the EWC Directive does not solve all the problems associated with the SE proposal, since it does not touch on the question of board structure and membership. The relationship of the EWC Directive to the wider company law harmonisation programme is analysed in further detail below.

2.2. Diversity in the company law systems of the member states

It can be seen from the preceding discussion that progress on harmonisation has stalled, above all, on the question of how to treat stakeholder groups, in particular employees. This failure is a reflection of the divide which exists, at the level of the laws of the member states, between 'insider' and 'outsider' systems of corporate governance (Mayer, 1997). Within 'insider' systems such as those of Germany and France, share ownership tends to be concentrated in the hands of family groups or held in large blocks by other corporations, thereby giving rise to cross-ownership of shares between companies.

Hostile takeovers are extremely rare, with the result that there is only a minimal or embryonic market for corporate control. In some insider systems, although not all, these conditions are reflected in board structure. Germany has the most articulated and deeply embedded system of stakeholder participation in corporate decision-making. Two-tier boards of the kind which exist in Germany for public companies, in addition to providing for formal representation of the interests of a wide range of stakeholders, also offer continuity and a degree of entrenchment for managerial teams.

By contrast, in 'outsider' systems, the predominant mode of ownership in public companies is through the holdings of institutional investors, who strive to diversify their holdings in order to minimise risk and so frequently lack strong ties to particular companies. The interests of shareholders in an active market for corporate control are defended by takeover codes which limit the scope for defensive actions by target managements. A number of other rules, in particular those relating to disclosure of investment information and the prohibition of insider dealing, aim to maintain a high degree of stock market liquidity. Employee representation operates (if at all) through collective bargaining and similar arrangements which lie strictly outside the framework of company law. This is broadly descriptive of the British system which, in most respects, more closely resembles that of the US than those of its fellow EU member states.

It is not surprising that, following the first enlargement of the EC in 1973 to include Britain, Denmark and Ireland, there was strong resistance to the attempt in the first version of the draft Fifth Directive to impose a system based on the German model of 'insider governance'. The emergence of more flexible regulatory techniques in subsequent drafts can be seen as indicating an acceptance of diversity. However, the more recent impasse over the European Company Statute shows that this has not been enough to resolve the debate. The failure to agree now turns on whether it is appropriate to address the issue of stakeholder representation through company law at all.

This, again, is a basic point of divergence in the company law systems of the member states. As just explained, the British system, with a very few exceptions, sees stakeholder rights as mainly lying outside the framework of company law, which is predominantly concerned with the position of shareholders and, to a lesser extent, creditors. An important feature of some ‘insider systems’, of which Germany represents the best example, is not simply that they recognise certain claims of non-shareholder stakeholders which go unrecognised in outsider systems, but that they do so in such a way as to incorporate stakeholder voice directly into the processes of governance and control within companies. The most important illustration of this, as we have already seen, is the involvement of the representatives of employees and in some cases other stakeholders, such as local government and environmental interests, on the supervisory boards of public companies. Other features of stakeholder voice in Germany, such as the system of employee representation through works councils, do not operate at the level of company law as such; in the manner of the EWC directive, they operate through the mechanisms of labour law. However, it is the close linkages between company law and labour law which are important here; in the German context, codetermination and the two-tier board are best viewed as closely interlocking elements of a single system of stakeholder representation.

In the context of directors’ duties, the furthest English company law can go by way of recognition of the interests of non-shareholder stakeholders is the idea of ‘enlightened shareholder value’ (DTI, 1999: 37). In other words, directors may act out of concern for other stakeholder groups if, by so doing, they believe that they will maximise the value of the business and thereby meet shareholders’ interests (which for this purpose may mean their longer term interests). This is quite different from the civil law idea that the company has an interest ‘in itself’ (Teubner, 1994) which serves as a means of reconciling the different perspectives of a number of stakeholder groups, none of which is entitled to priority. In the words of the Viénot report (1995) on corporate governance in France:

> 'In Anglo-Saxon countries the emphasis is for the most part placed on the objective of maximising share values, whilst on the European continent and France in particular the emphasis is placed more on the human assets and resources of the company… Human resources can be defined as the overriding interest of the corporate body itself, in other words the company considered as an autonomous economic agent, pursuing its own aims as distinct from those of its shareholders, its employees, it creditors including the tax authorities, and of its suppliers and customers; rather, it corresponds to their general, common interest, which is that of ensuring the survival and prosperity of the company.'[2]

Hence the French and other 'insider' systems of company law essentially see the business enterprise as having an *organisational* dimension which rests on the contributions made by a number of stakeholder groups, and not simply a *financial* dimension which describes the contribution of the shareholders. This divergence of approach operates at a fundamental conceptual level, so that even the terms used to define the business enterprise in legal terms are not precisely analogous. The English law concept of the 'company', for example, refers to the essentially financial relationship between managers and investors; there is no equivalent to those concepts which recognise the enterprise's organisational dimension, such as the French *entreprise* or German *unternehmen.*

The *siège réel* principle, which identifies the company's registered office with that its central management or administration rather than with its chosen place of incorporation, is part of the same organisational orientation to the legal conceptualisation of the business enterprise. The recent challenge to the *siège réel* principle is therefore also, unavoidably, a challenge to the stakeholder model of company law which has evolved in a number of EU member states. The *Centros* case has brought the debate full circle, back to the concerns of the early 1970s with the 'race to the bottom'. We turn next to a closer analysis of the *Centros* decision and its implications.

3. 'Negative' Harmonisation and Court-led Deregulation: The Implications of *Centros*

3.1. The meaning of negative harmonisation

The *Centros* case can be seen as an example of 'negative harmonisation'. This occurs when state-level rules are struck down by the courts on the grounds of their incompatibility with the principles of free movement and undistorted competition within the internal market of the EC. Since these principles have the status of fundamental rights under the EC Treaty, they are capable of having direct effect in national legal orders in such a way as to confer rights on individual parties. Moreover, thanks to the doctrine of the supremacy of EC law, they take priority over national provisions in the event of a conflict.

Following its landmark decision in the *Cassis de Dijon*[3] case in 1979, the ECJ has massively expanded its jurisdiction in this area with the result that rules in a range of areas concerning product regulation, environmental protection and labour standards have been called into question. The technique used by the Court has been to bring an ever wider body of rules and regulations under the scope of its review, while at the same time expanding, through its case law, the range of potential excuses or justifications which member states can put forward in defence of the rules which are under attack. Broad, effects-based tests have been used to determine when regulatory laws can be deemed to interfere with the circulation of economic resources within the internal market, and a wide meaning has been accorded to certain key concepts (such as the notion of 'undertaking') within the Treaty's competition policy provisions. Some limitations on the reach of this technique have been set, most importantly as a result of the Court's decision in the *Keck* and *Mithouard* cases[4] in 1993, but the general direction of the case-law since the late 1970s is not in doubt (Deakin, 1996).

As a result of its intervention, the Court has placed itself in a pivotal position to influence the pace and direction of legal integration on matters of economic and social regulation. The Court's intervention has tended, in practice, to favour deregulation. Where the Court rules that a particular body of regulation – such as the law governing retail opening hours – is contrary to the principle of free movement, for example, the effect is to induce a form of 'levelling down' between the member states. However, this is not at all the same thing as saying that the Court has set out to encourage inter-jurisdictional competition. On the contrary, by invoking rules aimed at protecting the integrity of the internal market, the Court has often limited the autonomy of member states and thereby restricted the scope for differentiation and experimentation at state level.

Member states can nevertheless draft laws which achieve the purpose originally intended for the regulation in question, but do so in a way which is compatible with the Treaty. This is possible in practice since the Court very rarely strikes down laws on the grounds that they are *per se* illegal – it tends instead to operate a version of the 'rule of reason'. This has the effect that the measure in question may be upheld if, first of all, it seeks to achieve an aim which is regarded as legitimate in this context. The *Cassis de Dijon* case established that the Court could develop categories of legitimate justifications for regulatory policy through its own case-law (the so-called 'mandatory requirements' doctrine) in addition to those provided by the Treaty in Article 30 (ex Art. 36). The second broad requirement is that the particular measure can be shown to be 'proportionate' to the aim being pursued. While there are various versions of the proportionality test, it essentially requires that the measure should be effective in achieving the substantive goal which is being sought, while at the same interfering as little as possible with the operation of the internal market.

To that extent, a significant space for member state autonomy is preserved. Nevertheless, the effect of a Court ruling is often to undermine national-level legislation in a particular area of social and

economic regulation. It may be impossible to predict with any certainty how the balancing of factors which is inherent in the proportionality test will work out. Legislation may be formally valid but in practice a dead letter during the period between the first formal challenge to the Court and the final resolution of the issue, as occurred in the case of UK Sunday trading legislation in the early 1990s (Barnard, 1994).

There is another sense in which 'negative harmonisation' may restrict inter-jurisdictional competition rather than enhancing it. The Court cannot intervene to strike down state-level rules under the *Cassis de Dijon* doctrine if there is an EC Directive or Regulation on the matter in question (assuming that the latter is, itself, compatible with the wider terms of the Treaty). Where such regulation is absent, the Court's intervention is often read as an invitation for the EC legislature to act, and so put the matter beyond doubt. This does not always happen, since obtaining the agreement of the member states may be problematic, even when qualified majority voting is allowed. However, the point is that the *Cassis de Dijon* doctrine is completely compatible with the legislature's intervention to take the issue in question 'out of competition'. The Court's approach is ultimately founded on the logic of legal integration, not that of regulatory competition.

3.2. The uncertain implications of *Centros* for the *siège réel* doctrine

The *Centros* case illustrates the tenuous place which the idea of regulatory competition currently occupies in the EU legal order. At first sight, *Centros* appears to improve the chances of a market for incorporations developing, by casting doubt on the *siège réel* doctrine. At present, EU member states are divided in the approach they take to determining the applicable law of corporate constitutions. The UK, along with Ireland, the Netherlands and Denmark, operates a 'state of incorporation' rule, according to which the applicable law is that of the state in which the company is incorporated or registered. The

effect of the incorporation approach is that the applicable law is a matter of choice for managers of the company or, in the final analysis, for its shareholders; a company can carry on business in one member state while being incorporated in another. The company laws of the state of incorporation will prevail.

This is in contrast to the position in member states which operate the so-called 'real seat' or *siège réel* doctrine. The effects of the *siège réel* doctrine are complex and differ from one state to another, and according to the context which is being considered. Essentially, however, it means that courts will regard the applicable law as that of the member state in which the company has its main centre of operations – its head office or principal place of business. If the company in question has incorporated elsewhere, a number of consequences may then follow. In some instances, the effect will be to deny certain advantages of corporate form to the shareholders; in others, the law of the state in which the company has its head office will be applied over that of the state of incorporation. In either event, the effect of the *siège réel* doctrine is to limit freedom of incorporation; in that sense, it obstructs the emergence of a 'Delaware effect', since one aspect of that is the principle that entities can be incorporated in a state where they have no physical or other business presence.

The legality of the *siège réel* doctrine under EU law has often been called into question,[5] but the issue has gained new prominence as a result of the Court's decision in *Centros* which was delivered on 9 March 1999.[6] In this case, two Danish citizens incorporated a private company of which they were the sole shareholders, named Centros Ltd., in the UK. One of the two shareholders then applied to have a 'branch' of the company registered in Denmark for the purposes of carrying on business there. A 'branch', for this purpose, refers not to a subsidiary company, but simply to a business or trading presence, in one country, of a company which is registered in another country. The Danish legislation on branches is in line with the Eleventh Company Law Directive, which requires member states to have legislation

providing for the registration of branches on the grounds that this is necessary to protect third parties who deal with the company through its branch.

At the time of the registration request, Centros Ltd. had never traded in the UK. The Danish Registrar of companies refused to register the branch as requested, on the grounds that what the company was trying to do was not to register a branch but, rather, its principal business establishment. The Registrar took the view that by incorporating in the UK, which has no minimum capital requirement for private companies, and subsequently seeking to carry on business in Denmark through a branch, the company's owners were seeking to evade the Danish minimum capital requirements which are designed to protect third party creditors and minimise the risk of fraud.

The Court ruled that the refusal to accede to the registration request was contrary to the right of freedom of establishment under Article 43 (ex. Art. 52) of the Treaty, read with Articles 46 (ex. 56) and 48 (ex. 58). It held, firstly, that there was a potential infringement of freedom of establishment in any case where 'it is the practice of a Member State, in certain circumstances, to refuse to register a branch of a company having its registered office in another Member State'. This was because:

> 'The provisions of the Treaty on freedom of establishment are intended specifically to enable companies formed in accordance with the law of a Member State and having their registered office, central administration or principal place of business within the Community to pursue activities in the Member States through an agency, branch of subsidiary.
>
> That being so, the fact that a national of a Member State who wishes to set up a company chooses to form it in the Member State whose rules of company law seem to him the least restrictive and to set up branches in other Member States cannot, by itself, constitute an abuse of the right of establishment. The

> right to form a company in accordance with the law of a Member State and to set up branches in other Member States is inherent in the exercise, in a single market, of the freedom of establishment guaranteed by the Treaty'.[7]

The Court then went on to consider whether the Danish government could show that the refusal to register was justifiable in the circumstances. This involved a consideration of whether there was some countervailing policy objective behind the Danish practice and whether, in the particular circumstances of this case, the proportionality test could be said to be satisfied. The Danish government argued that the registrar's action was intended to maintain Danish law's minimum capital requirement for the formation of private companies. The purpose of this law was:

> 'first, to reinforce the financial soundness of those companies in order to protect public creditors against the risk of seeing the public debts owing to them become irrecoverable since, unlike private creditors, they cannot secure these debts by means of guarantees and, second, and more generally, to protect all creditors, public and private, by anticipating the risk of fraudulent bankruptcy due to the insolvency of companies whose initial capitalisation was inadequate'.[8]

In many ways this was the crux of the case, and the most ambiguous and problematic aspect of the Court's judgment. The Court ruled that the justification offered was inadequate since, in the first place, 'the practice in question is not such as to attain the objective of protecting creditors which it purports to pursue since, if the company concerned had conducted business in the United Kingdom, its branch would have been registered in Denmark, even though Danish creditors might have been equally exposed to risk'.[9] In other words, the registrar's decision failed the proportionality test since it was inconsistent – the vital factor in his refusal was, it seems, the failure of the company to trade in the UK, but this was immaterial to the protection of creditors since they would have been no better off if the company had

previously traded there and, as a result, had been able to get its branch registered in Denmark.

A major difficulty in determining the implications of *Centros* for the *siège réel* doctrine lies in the complexity of Danish law on the status of that doctrine. In most respects, Danish law follows the incorporation rule, and not that of the *siège réel*. Hence there was no possibility, under Danish law, of the registration of Centros in the UK itself being invalid. In essence, then, the Court decided that it was inconsistent, under the proportionality test, for the registrar to refuse to register the branch of a company *which, in all other respects, was treated as a validly-formed entity.* It is therefore quite possible to give *Centros* a narrow reading which does not touch on the validity of the *siège réel* doctrine.

However, the Court's dicta on the scope of the freedom of establishment principle, quoted above, do have clear implications for the *siège réel* doctrine. These dicta can be read as saying that the validity of an incorporation in one member state cannot be called into question in another on the grounds, alone, that the principal business presence or central administration of the company concerned is not located in the state in which it is incorporated. Admittedly, since the *siège réel* doctrine was not clearly before the Court, this interpretation cannot be relied on with any certainty. Had the issue been clearly raised, other governments would have made submissions to the Court, and it is possible that the Court would have held that the doctrine was not incompatible with freedom of establishment. However, after *Centros* it is more, rather than less, arguable that the *siège réel* doctrine does pose a barrier to freedom of establishment, in which case everything will turn on the question of justification. This would be consistent with the Court's practice over the years since *Cassis de Dijon*, which, as we have seen, has been to expand its jurisdiction to review state-level rules against the criteria of market access and transparency, while allowing states considerable leeway through the proportionality test.

However, in *Centros*, the application of the proportionality test shows how problematic the process of review by the courts can be. In addition to the argument which we have already considered, and which was specific to the 'inconsistency' which the Court perceived to exist in Danish practice, it considered two others which are of wider significance for the survival of creditor protection devices. It held, firstly, that 'contrary to the arguments of the Danish authorities, it is possible to adopt measures which are less restrictive, or which interfere less with fundamental freedoms, by, for example, making it possible in law for public creditors to obtain the necessary guarantees'.[10] Secondly, it argued that the Danish authorities were not precluded from coming to an agreement with their British counterparts for dealing with any cases where genuine fraud on the part of company founders could be established; but this had not been shown to be the case here.

Neither of these arguments is particularly convincing as grounds for rejecting the use of minimum capital requirements to protect creditors. A minimum capital requirement may be thought of as a means of ensuring that a certain level of capital is maintained within the company, so that, to that extent, the normal rules of priority in insolvency are observed and the rights of creditors are protected. It may therefore offset negative externalities arising from the abuse of incorporation by under-capitalised firms. It is arguable that a rule of this kind may cause more harm than good, for example by setting up excessive barriers to entry (Easterbrook and Fischel, 1991: 60-62). It may also be the case that a minimum capital requirement is not a particularly efficient means of achieving creditor protection, by comparison with other methods which would interfere less with freedom of establishment (Armour, 1999). However, this is not a matter which can be resolved without evidence of the kind which cannot easily be collected and evaluated by a court. In fact, the Court did not even consider the argument in the terms in which most academic writers have addressed it; its focus on the rights of public creditors and on fraud scarcely exhaust the possible arguments which could have been made in defence of the measure.

This kind of open-textured, policy-orientated issue would seem, on the face of it, to be the kind of question which can much more effectively be addressed through the legislative process. The efficiency of minimum capital requirements could be assessed through a deeper consideration of the relevant evidence. The effect of the reasoning in the *Centros* case, as in similar decisions flowing from the Court's approach to the freedom of movement provisions of the Treaty, is to by-pass the legislature altogether.

3.3. The prospects of a market for incorporations in the EU

Given the uncertainty which surrounds the application of the proportionality test in the context of freedom of establishment, it would seem to be premature to argue that the *Centros* case necessarily implies the end of the *siège réel* doctrine. There are other respects, too, in which the EU's institutional environment is ill-suited to a market for incorporations. Even systems which follow the state of incorporation approach, such as the UK, would not be in a good position to replicate Delaware's success in establishing itself as the leading state of incorporation. Delaware has established its position by attracting *reincorporations* from existing businesses set up in other states. Initial incorporations have formed only a small part of its stock of companies. In contrast to Delaware, UK company law is not fully receptive to reincorporations. The effect of English conflict of law rules is that a company which has been incorporated in one member state cannot be reincorporated in another unless both jurisdictions permit this (which may not be the case under the *siège reél* doctrine, as we have just seen) (Cheffins, 1997: 427).

The problem can be avoided by transferring the business of the company to a company set up in the UK especially for that purpose. However, there is no mechanism specifically designed to facilitate cross-border mergers of this kind. It seems that existing mechanisms, such as a scheme of arrangement under sections 425-427 of the Companies Act 1985, are not appropriate since they involve complex

and expensive procedures whose effects, moreover, may be unclear in so far as they involve a merger between companies from different jurisdictions (Cheffins, 1997: 428).

The end of the *siège réel* doctrine would thus be only the first step in the emergence of a market for incorporations. As Brian Cheffins argues, the right elements would have to be in place on both the 'demand' and 'supply' sides. In the US context, he argues that 'Delaware's success demonstrates that managers of larger corporations find it worthwhile to pay the legal expenses and filing fees associated with switching jurisdictions' (Cheffins, 1997: 431). In the context of the EU, similarly, the willingness of some German and Danish firms to reincorporate outside their home states in order to avoid minimum capital requirements is evidence of pent-up demand.

On the supply side, member states would have to alter their laws to make reincorporation more feasible. Incentives to customise company law regimes to the needs of business owners and managers may exist in the form of tax revenues from incorporation and registration. However, Delaware's position in this respect is highly unusual. Around 20% of the total tax revenue of the state is derived from a combination of incorporation fees, fees for amendments to corporate charters and by-laws, and an annual franchise tax. The state lacks other major sources of income in part because it has very little indigenous industry and a small population. It is the high proportion of incorporation taxes in relation to the overall tax take which provides judges and legislators in Delaware with an incentive to respond to business needs and which, in turn, gives managers and owners confidence that the state will continue to be responsive to new needs (Romano, 1993). It follows that the Delaware effect would not be so easily replicated in the context of state jurisdictions which did not rely to such a high degree on revenues from incorporation. For this reason, there is some reason to doubt whether an EU Delaware could emerge among the member states, few of which would be in a position to become dependent upon company registrations as a source

of tax income. (A closer analogy might be with statelets such as Liechtenstein which are currently outside the EU.)

The nature of the underlying forces tending towards the emergence of inter-jurisdictional competition are also affected by the way in which reincorporations, in the EU context, would be affected by other regulatory controls over business activity. Regulations imposed upon businesses by labour law, as well as tax obligations, tend to apply on a territorial basis, rather than following the law of the company's domicile (Deakin, 1996). Similarly, many aspects of securities laws tend to follow the law of the country in which the transaction takes place rather than the country in which the company is incorporated.[11] The application of insolvency procedures is subject to highly complex rules on conflicts of laws as well as to a number of local-level jurisdictional effects. Because of all these factors, it may make little difference in terms of the company's overall regulatory burden where it is *incorporated*; what may matter more is where it carries on its productive activities (in the case of employment law and tax law) or where its shares are traded (in the case of securities law). Demand-side pressures for a company-friendly company law may, to that extent, be overwhelmed by other cost considerations.

Conversely, the gains to a member state which is able to attract incorporations from businesses carried on outside its own jurisdiction could well be limited. It might be the case, for example, that the fiscal benefits to the state in question would be minimal if the company's profits were taxed elsewhere. This argument would not apply if the territorial application of labour laws and tax laws could be attacked under Article 43 (ex Art. 52) of the Treaty. In the past the ECJ has taken the view that the principle of territoriality can still be applied in both cases notwithstanding the existence of the freedom of establishment principle,[12] but this could change as the Court's case law evolves.

Nevertheless, many of the same factors have been present in the US experience, but have not prevented a market for incorporations

developing there. In part this is because of the role played by the legal and accounting professions, who are most probably the principal beneficiaries of the market for incorporation, in maintaining Delaware's pre-eminent position as the state of choice for incorporation (Roe, 1993). It has been argued that the British professions, as well as the judiciary and the regulatory authorities, would be in a similar position to 'make incorporating under British law an appealing proposition' if the right legal and institutional environment were to be put in place (Cheffins, 1997: 443).

The possibility that it might at some stage in the foreseeable future become UK government policy to encourage reincorporations from other member states certainly cannot be ruled out. The Company Law Review currently being undertaken under the auspices of a steering group set up by the Department of Trade and Industry has noted that UK company law is perceived in some quarters to be more 'business friendly' (DTI, 1999: 96) than the company law regimes of most other EU member states, and contrasts the 'relative structural and institutional flexibility' of UK company law with 'countries [such as] Germany, with inflexible mandatory rules on capital structure and forms of employee participation and split boards, presenting major problems for companies unfamiliar with such systems' (DTI, 1999: 97). The Steering Group also regards the need to supply a 'business-friendly' company law as one issue to be taken into account in the process of company law reform. Research commissioned by the Steering Group for its 1999 Consultation Document found that 'irritants' of UK company law noted by inward investors included the capital maintenance rules, rules relating to directors' loans, difficulties with moving corporate domicile into and out of the UK jurisdiction, and the requirements of the localisation of the register of members in Britain. At the same time, the Consultation Document recognised that measures perceived as 'irritants' by managers might be seen as protective by shareholders, creditors and employees (*ibid.*).[13]

This brings us to the fundamental issue of what the economic consequences would be of the initiation of Delaware-type regulatory competition within the EU.

3.4. The possible consequences of inter-jurisdictional competition over company law within the EU

Discussion of the potential effects of inter-jurisdictional competition in the EU is bound to be somewhat speculative. Nevertheless, an active debate has begun to develop on this subject. Cheffins argues that the UK would benefit from being in a position to establish itself as the preeminent state of incorporation. Tax revenues from incorporations would not be comparable to those raised by Delaware. The registration fee for UK incorporations has fallen in recent years, and it is unlikely to be raised significantly in the near future since government policy has sought to avoid any disincentive for small firm start ups.[14] There would nevertheless be benefits for UK lawyers and accountants and an expansion of employment in related areas of services.

As Cheffins notes (1997: 45), the question of 'whether a market for incorporations would undermine the development of a distinctive European identity', while it might be expected to influence EU-level policy makers, is not a question which is easily susceptible to economic analysis. It is more meaningful to ask what the costs and benefits of the process would be to particular groups (shareholders, creditors and employees) and whether the overall result would be an improvement in the responsiveness of company law to the needs of companies.

The question of whether shareholders would benefit from competition between jurisdictions depends in part on how far shareholders can bring influence to bear on the incorporation decision. In the US context, it would seem that shareholders in public companies are rarely involved directly in the incorporation decision, in large part because, under Delaware company law, a resolution on incorporation

can only be tabled with the agreement of the directors (Bebchuck and Ferrell, 1999). By contrast, it seems highly likely that UK institutional investors would be able to exercise some influence over management on a question of this kind. Regular communications take place, outside the framework of general meetings, between the institutions and senior managers of listed companies. Even where shareholders could not influence managerial decision-making directly, indirect pressure through the capital markets (in the form of the reaction of share prices to managerial behaviour) could be expected to bring influence to bear. In general, the degree of institutional shareholder influence over corporate governance in Britain is very high, as indicated by the production of strongly pro-shareholder regulations in the area of takeovers (Deakin and Slinger, 1997) and board structure (Deakin and Hughes, 1999). Managers would therefore have a number of direct and indirect incentives to avoid decisions which were seen as *clearly* contrary to shareholders' interests.

Given the likelihood that shareholders could influence incorporation decisions to some extent, a more difficult issue relates to whether creditors and employees would be adversely affected by jurisdictional competition. The *Centros* case[15] illustrates how creditors might be affected: if companies had the right to move between jurisdictions at will, they would be able to avoid otherwise mandatory state laws which were designed for the protection of creditors such as, in this case, a minimum capital requirement. In the same way, they could choose whether to observe mandatory laws relating to employee participation or codetermination rights, in so far as the application of such laws was a function of the legal domicile of the company as opposed to its physical or economic presence on the territory of a particular jurisdiction. As noted above, the principle of territoriality tends to determine the application of most labour law rights, rather than the domicile of the company. This is not always the case, however. The German rules on stakeholder membership of supervisory boards relate to the corporate form or legal entity through which an organisation is constituted, and not just to its physical or

business presence. Moreover, EU law may one day take a more critical view of the territoriality principle in labour law.

The mere *possibility* that codetermination laws, for example, could be avoided through reincorporation, might induce states to repeal them. States could act in a self-interested way to remove mandatory laws if, by doing so, they thought they could attract more incorporations or retain those which they had: 'states competing to attract incorporations will have an incentive to focus on the interests of managers and shareholders and to ignore the interests of third parties not involved in incorporation decisions' (Bebchuck, 1992). It seems plausible, then, that a market for incorporations would lead to a reduction in mandatory laws of all kinds, and to an increase in permissive or 'default' rules which leave companies free to bargain around them. This could occur even if little or no movement of companies actually took place, as long as states could rationally take the view that companies would not submit to a mandatory regime which they did not perceive as being in their interests when they could choose between that system and a more permissive one elsewhere.

To determine whether such a result would be desirable, we have to consider whether mandatory laws are likely to be efficient or not. Many commentators have argued that creditors rarely need mandatory protection, since they are often in a good position to bargain for whatever protection they require (Posner, 1976; Easterbrook and Fischel, 1991; Cheffins, 1997). It is also argued that mandatory laws for employee participation are unlikely to be efficient (Cheffins, 1997: ch. 12), although the opposite case has been put (Rogers and Streeck, 1994). For employees, the efficiency case for regulation depends in part on the existence of externalities such as 'reverse free rider effects' which deter individual firms from offering contracts which would otherwise be optimal (Freeman and Lazear, 1994).

In the European context, the longevity and stability of systems which incorporate stakeholder voice into corporate governance processes

suggests that, while such arrangements may not be ideal in all circumstances, they may possess a 'survival value' which is not reconcilable with the view that they are fundamentally inefficient. It is true that these systems have not been subjected to direct competition through the threat of corporate exit in the manner of the US. However, they have been subject to less direct but, in the long-term, highly significant constraints, in the form of product-market competition and other economic pressures on governments and law-makers to maintain effective conditions for business organisation. Moreover, given the degree of diversity which exists between systems, it is likely that there is some degree of matching of the rules and practices of company law to local conditions. Path dependence may also be expected to play a role, in the sense that increasing returns to particular institutional forms lead, if anything, to further divergence between systems over time rather than to convergence. These suggestions are reflected in research which compared corporate governance practices in large British and German companies. The study found that:

> 'there is no "one best" system of corporate governance. Rather, the two systems have different comparative advantages. The British corporate governance system better supports companies in sectors where there is a need to move quickly into and out of new markets and in which there is need for great flexibility in the use of employees. The Germany system, by contrast, better supports companies in sectors that require long-term commitments and investments by employees, suppliers and other "stakeholders"' (Vitols *et al*., 1997: 35).

The crucial determinants of the respective 'comparative advantages' which companies enjoy are the differences in the organisation of capital markets, the rules of company law and the forms of employee participation in the two countries; these are reflected in the different ways in which corporate governance practice has evolved in response to issues of agency costs, delegation and stakeholder participation. For example, the German two-tier board system, with its emphasis on

stakeholder involvement, enables large-scale restructurings to be handled on the basis of consensus. Moderate shareholder pressure, in contrast to the more intense scrutiny of British capital markets, enables strategic, long-term planning to be put in place and implemented. The British system, which concentrates managerial decision-making power in the hands of the board and the chief executive, possesses a 'major advantage' in terms of the speed with which decisions can be taken and implemented, but runs a greater risk of strategic mistakes being made by top management. On the basis of this analysis, the authors of this study argue that, even with the growing internationalisation of investment flows, the two systems are unlikely to converge: 'change can better be characterised as incremental adaptation rather than the wholesale adoption or replacement of corporate governance systems' (Vitols *et al*., 1997: 36).

The US experience suggests that regulatory competition in company law leads, over time, to a fairly high level of convergence between states, with the dominant model one in which mandatory rules are the exception: 'state charter competition has… produced substantial uniformity across state codes, preserving variety in it enabling approach to rules, an approach that permits firms to customise their charters' (Romano, 1998: 2394). Although it would seem that many mandatory rules can be found in the Delaware company law regimes (Coffee, 1989; Eisenberg, 1989), there has been a recent tendency to change mandatory rules into default rules, as in the case of the opt-out with regard to the director's duty of care (Alva, 1990). The minimalist regime of shareholder protection contained in Delaware's Limited Liability Company statute also points to a movement away from mandatory rules (Cohen, 1998).

The suggestion, then, is that in the US context, regulatory competition has led to a system in which company laws are comparatively uniform in content, but where they are also highly permissive. This enables companies to adjust to particular conditions through amendments to the basic default rules supplied by the legal system, although it is not

clear just how far this is translated into variety in the terms of corporate constitutions. In the EU, on the other hand, divergence operates at the level of the law itself, with legal systems making greater use of mandatory rules. This has led, in its turn, to diversity of corporate governance practices between (rather than within) legal systems.

It is not obvious that one approach should be preferred to the other on efficiency grounds. It seems likely that rules which provide for stakeholder involvement can only be made effective through mandatory regulation of some kind, which might not survive the introduction of a US-style market for incorporations within the EU. On this basis, we should expect to look for alternative mechanisms for change within the European systems to those provided, in the US, by regulatory competition. With this in mind, we now turn to a closer examination of the role which harmonisation has played in stimulating reforms within the laws of the member states.

4. Reflexive Harmonisation and Stakeholder Representation

4.1. An outline of the theory of reflexive harmonisation

A number of economic justifications may be offered for harmonising legislation in the field of company law (Charny, 1994; Bebchuck, 1992). A case can be made for company legislation to establish a core of uniform rules which, because of network externality effects, may save on the transaction costs of company formation and thereby promote cross-border capital mobility. In respect of creditor and employee protection, as we have seen, harmonised rules may be necessary to avoid a race to the bottom. It is sometimes argued that where directives set basic standards in this way, they do so in order to establish a parity of costs or level playing field upon competing firms; this kind of justification can be found in some of the earlier company law directives. However, it is doubtful whether this aim can be achieved using the regulatory techniques currently available to the Community legislator, or even whether it is desirable to do so. In the

related field of labour law, most directives set basic or minimum standards as a 'floor of rights' which member states must not derogate from, but upon which they may improve by setting superior standards (Deakin and Wilkinson, 1994). These directives, then, can be thought of as implicitly encouraging a 'race to the top', while ruling out less socially desirable forms of competitive federalism.

The process by which states may observe and emulate practices in jurisdictions to which they are closely related by trade and by institutional connections is more akin to the concept of 'co-evolution' than to that of regulatory competition. Co-evolution assumes that a variety of diverse systems can co-exist within an environment, each one retaining its viability (Teubner, 1993: 52). By contrast, the idea of regulatory competition implies convergence around a single, efficient system which wins out through the competitive process. By placing limits on competition, harmonisation may aim to preserve the autonomy and diversity of national legal systems, while at the same time seeking to 'steer' or channel the process of evolutionary adaptation of rules at state level.

This idea is borrowed from theories of reflexive law which represent an attempt to move beyond a straightforward dichotomy between, on the one hand, 'instrumentalist' theories of regulation and, on the other, 'deregulatory' theories which argue for the removal of all external regulatory controls (Teubner, 1993; Rogowski, and Wilthagen, 1993; Deakin and Hughes, 1999). The problem with instrumentalism, in this context, is the capacity of self-regulating social and economic systems to resist external regulatory interference, in the process frustrating the policy objectives of intervention and undermining the legitimacy of the regulatory process. This phenomenon, well known from studies of regulation at state level, can also be seen in numerous cases of the ineffective translation of directives and other transnational legal instruments into national legal systems. The problem with deregulatory approaches is the excessively optimistic, even Panglossian view which they hold of self-regulating systems such as those of the market. In the light of evidence that

regulatory competition produces rules which, from the viewpoint of economic theory, are far from optimal (Bebchuck and Ferrell, 1999), these theories have to fall back on somewhat unconvincing appeals to the 'long run' benefits of market-based solutions (Easterbrook and Fischel, 1992: 222).

The essence of reflexive law is the acknowledgement that regulatory interventions are most likely to be successful when they seek to achieve their ends not by direct prescription, but by inducing 'second-order effects' on the part of social actors. In other words, this approach aims to 'couple' external regulation with self-regulatory processes. Reflexive law therefore has a *procedural orientation.* What this means, in the context of economic regulation, is that the preferred mode of intervention is for the law to underpin and encourage autonomous processes of adjustment, in particular by supporting mechanisms of group representation and participation, rather than to intervene by imposing particular distributive outcomes. This type of approach finds a concrete manifestation in legislation which seeks, in various ways, to devolve or confer rule-making powers to self-regulatory processes. Examples are laws which allow collective bargaining by trade unions and employers to make qualified exceptions to limits on working time or similar labour standards (Deakin and Wilkinson, 1994), or which confer statutory authority on the rules drawn up by professional associations for the conduct of financial transactions (Black, 1998).

A procedural orientation also implies an important difference in the way in which the law responds to market failures or externalities from the way in which it is normally represented in the law and economics literature. Reflexive regulation does not seek to 'perfect' the market, in the sense of reproducing the outcome which parties would have arrived at in the absence of transaction costs (the so-called 'hypothetical bargaining' standard). This is partly because it is understood that information problems facing courts and legislatures make the process of identifying an 'optimal' bargaining solution extremely hazardous. It is also because of a perception that the

essence of competition is that it is a process of discovery or adaptation, rather than the achievement of optimal states or distributions.

In the context we are considering here, this implies a particular role for the transnational harmonisation of laws. The purpose of harmonisation would not be to substitute for state-level regulation; hence, the transnational standard would not operate to 'occupy the field' in the manner of a 'monopoly regulator' as, it is suggested, is often the case with US federal regulation (for example, in the field of securities regulation (Romano, 1998)). Rather, transnational standards would seek to promote diverse, local-level approaches to regulatory problems by creating a space for autonomous solutions to emerge when, because of market failures, they would not otherwise do so. This may involve what some regard as a restriction of competition, in the sense of ruling out certain options which could be associated with a 'race to the bottom', while leaving others open. As we have seen, this is a familiar technique in labour law, where directives mostly set basic labour standards as a 'floor of rights', allowing member states to improve on these provisions but, on the whole, preventing 'downwards' derogations.

At the intersection of labour law and company law, the EWC Directive[16] is a good illustration of these techniques of reflexive law. As previously explained, the Directive does not set out directly to impose any particular model of employee representation, in marked contrast to the techniques tried out unsuccessfully in the context of the Vredeling proposals and the draft Fifth Directive. What the Directive does is to provide the transnational companies coming under its scope[17] with an incentive to enter into negotiations with employee representatives for the establishment of a works council or a similar mechanism for information and consultation. The incentive is provided in the form of a default procedure which applies in the event of the failure of negotiations. However, employers have a number of opportunities to avoid this outcome. Firstly, employers who agreed an information and consultation procedure of their own with their

employees and implemented it before the Directive came into force are effectively exempted from the provisions of the Directive (or of the national-level law implementing it). Secondly, employers who fail to do this may nevertheless escape the default procedure by arriving at an agreement with a 'special negotiating body' of employees within three years of negotiations beginning.

The Directive operates, then, through a 'penalty default' rule (Ayres and Gertner, 1989; Deakin and Hughes, 1999), in other words, a fallback provision which induces a more powerfully-placed or better-informed party (here, the employer) to enter into a bargaining process when it otherwise would lack an incentive to do so. The justification for the Directive derives from the failure on the part of the member states to put in place similar mechanisms to deal with the particular issue of information and consultation in transnational companies. The Directive can therefore be seen as a response to a coordination failure at the level of the states. However, it takes effect not by imposing a uniform solution but by encouraging *both* member states, through their laws, *and* companies themselves, through negotiations with employee representatives, to develop local-level solutions.

This procedural orientation also influenced the Davignon Report of the Group of Experts (Davignon, 1997), set up to analyse systems of worker involvement, which reported in May 1997. The Report suggested that one way of making progress on the European Company Statute proposal would be to encourage negotiations over the form of employee participation prior to the establishment of an SE. Agreement has still not been reached in the Council, in part because of a failure to reach consensus on the 'default procedure' which would be applied in the event of a failure by the parties to agree. However, it seems likely that, if the deadlock on the European Company Statute is to be broken at all, a procedural solution is the way forward.

It may be suggested, then, that reflexive harmonisation operates to induce individual states to enter into a 'race to the top' when they

would have otherwise have an incentive do nothing (the ‘reverse free rider’ effect) or to compete on the basis of the withdrawal of protective standards (the ‘race to the bottom’). This is done by giving states a number of options for implementation, as well as by allowing for the possibility that existing, self-regulatory mechanisms can be used to comply with EU-wide standards. In these ways, far from suppressing regulatory innovation, harmonisation aims to stimulate it.

4.2. Tensions between market integration and stakeholder representation: the case of takeover regulation

This is not to suggest that the process of reflexive harmonisation is a straightforward one. On the contrary, it is a highly controversial technique. It is called into question, on the one hand, by those who argue for a more comprehensive, centrally-driven approach to the fusion of legal systems. On the other, there are those who stress the merits of market integration, driven by the free movement and competition policy provisions of the Treaty. These tensions are exemplified in the long-running debate over the draft Thirteenth Directive on the Regulation of Takeover Bids. The history of the draft Thirteenth Directive also offers an interesting comparison with US experience.

As noted above, hostile takeovers are a rarity in most EU member states. The major exception is Britain, where a combination of corporate governance practices, certain rules of company law and the City Code on Takeovers and Mergers, the product of self-regulation in the financial sector, have combined to produce a vigorous market for corporate control. Defensive tactics by target boards are virtually ruled out once a bid starts by the rules of the Takeover Code, while shareholder pressure has successfully resisted the introduction of poison pills and similar devices in corporate constitutions of the kind which were used to deflect hostile bids in the US in the 1980s (Deakin and Slinger, 1997).

Much of the American (and British) debate takes it as given that an active market for corporate control generates gains for shareholders, on average, as well as inducing greater managerial efficiency, even though evidence for this proposition is, to say the least, mixed (see Mueller and Sirower, 1998). The continental European debate tends to focus on the negative implications of hostile bids for stakeholder relations. This focus is not surprising, given the existence of alternative mechanisms within 'insider systems' for holding the management of public companies accountable, such as cross-shareholdings, the close involvement of banks in monitoring, and the operations of supervisory boards. The draft Thirteenth Directive cuts across this debate by proposing, in effect, an extension of the shareholder-protection mechanisms of the UK Takeover Code to the other member states; these would include the outlawing of most bid-frustrating tactics by target boards; requirements for the target board to obtain neutral financial advice on the merits of a bid; and the imposition of various duties on bidders, including an obligation of equal treatment with regard to shareholders of the target, thereby ruling out most types of 'coercive' bids.

Opposition to the Thirteenth Directive has come from two main sources. On the one hand, the City Panel on Takeovers and Mergers has resisted it on the grounds that its own relatively informal procedures would be put in jeopardy by any transfer of authority for regulating bids to the courts and/or the European Commission. In response to this objection, the latest version of the Directive allows member states to implement its provisions by way of delegation to a self-regulatory body such as the City Panel. The other set of objections has been raised through the European Parliament, and relates to the weakness of those parts of the Directive which aim to confer a degree of protection on non-shareholder stakeholders.

The current draft of the Thirteenth Directive requires the board of a target company to 'act in the interests of all the company, including employment' when responding to a bid.[18] Similarly, section 309 of the UK Companies Act 1985 requires directors to take the interests of

the company's employees into account when discharging their duties to the company. This provision, despite its superficiality to certain 'third generation' stakeholder statutes in the US, has had little or no effect in terms of protecting employee interests during a bid. Employees have no standing to bring an action for breach of directors' duties by the target board, and section 309 is overshadowed in any event by provisions of the Takeover Code which place directors under a series of specific obligations to ensure that shareholders receive disinterested advice about whether the bid is in their interests (Deakin and Slinger, 1997).

A more concrete measure of stakeholder protection which has been proposed from time to time in the protracted debate over the draft Thirteenth Directive is to require both the bidder and the target companies to engage in a process of consultation with employee representatives during the course of the bid. Rule 24.1 of the Takeover Code merely requires the bidder company to state its intentions with regard to future relations with employees. Offer documents issued by bidders under the rules of the Code nearly always contain a statement to the effect that existing rights of employees will be fully respected. This says nothing more than that the bidder company will respect the company's prior legal obligations to its employees; it has become a formality, which is represented in offer documentation by the use of a standard 'boilerplate' formula (Slinger and Deakin, 1999).

If managements were required to consult with employee representatives in the course of the bid, this could substantially affect the relative balance of power and influence of shareholders and other stakeholder groups. Such information and consultation rights already exist under EU law in respect of decisions for collective redundancies[19] and corporate reorganisations effected through a business transfer.[20] To consult employee representatives, in this context, means to do so with a view to making an agreement (see Deakin and Morris, 1998: 786-788). However, the existing consultation rights do not extend to changes of control by a transfer of

shares, as is the case with a takeover bid.[21] The anomaly persists since in recent drafts of the Thirteenth Directive, concerns about the possibility of lengthy and costly disruptions to bids led to the deletion of any references to employees' consultation rights, as opposed to lesser rights to receive information. The draft Directive currently follows the lead of rule 24.1 of the UK Takeover Code, which, as have seen, merely requires bidders to state their intentions with regard to the future treatment of employees.[22]

This is not the occasion to revisit the debate about whether the market for corporate control always and everywhere operates, as its proponents insist, in the interests of economic efficiency. For present purposes, the interest of the draft Thirteenth Directive lies in the very different way in which this question has been approached in the European and US contexts. In the United States, legal restrictions on hostile takeovers emerged in the 1990s through the process of regulatory competition between states. There is considerable disagreement among corporate law scholars as to the significance of Delaware's adoption of certain elements of the third-generation model of stakeholder statutes. Do the Delaware amendments reflect only a minimal move in favour of stakeholder protection (Romano, 1998), or a more serious breach in the market for corporate control, with serious implications for the protection of shareholder value? If the latter, does this indicate that the process of inter-jurisdictional competition is capable of producing inefficient results, on the basis that state legislatures are unduly susceptible to the claims of corporate managers who are responsible for taking decisions on incorporation and re-incorporation (Bebchuck and Ferrell, 1999)? Either way, a solution of a kind to the conflicting pressures associated with the hostile takeover has been arrived at through a process of decentralised adaptation to changing economic and political circumstances.

In the context of the EU, the same debate has been carried on through a process of negotiation and deliberation over many years. Many of the same interest groups have been involved as in the US: institutional shareholders, legal and financial professionals, trade unions, and

governments at various levels. As the Thirteenth Directive has evolved through various drafts, the price of reaching agreement has been the need to accommodate different interests within the framework of a single legal measure. This has resulted in the kind of 'reflexive' harmonisation which has become characteristic of the single market programme. But the difficulties of reaching a compromise by this route are clear. The danger is that a clear solution to the conflict between stakeholder rights and the pursuit of market integration will not emerge. Moreover, the process illustrates how vulnerable the process of law-making at EU level is to concerted action by powerfully-situated interested groups, and how marginal the role of the European Parliament still is within this process (see Villiers, 1998). These public-choice dimensions of the European law-making process undoubtedly require further analysis and research along the lines opened up by similar US studies of the Delaware effect (see Roe, 1993). What is striking on first impression is how the recent dilution of the employee consultation provisions of the Thirteenth Directive contrasts strongly with the achievement of regulatory competition in producing pro-stakeholder legislation in the US context.

5. Conclusion

The study of European company law has important lessons for our broader understanding of the role of harmonisation within the process of legal and economic integration. The form of harmonising legislation in Europe has moved away from the prescriptive style of the early 1970s, in favour of 'reflexive' regulatory techniques which aim to encourage decentralised forms of self-regulation at member state level and below. By contrast, the principal alternative to this form of reflexive harmonisation – court-led deregulation or 'negative harmonisation', initiated by a rigid interpretation of the freedom of establishment provisions of the EC Treaty – would limit the autonomy of member states in the company law field and thereby induce a greater degree of convergence over time. It has been argued in this paper that if negative harmonisation were to be extended in this

way, it would be at the expense of those mechanisms of evolutionary adaptation which currently operate within member states. There is therefore no guarantee that a process of negative harmonisation would lead to greater efficiency and, indeed, good reason to think that it would not.

In practice, there are limits to what court-led intervention can achieve. The prospects of a Delaware-like effect emerging within the EU in the foreseeable future would be remote even if the *siège réel* doctrine were to fall as a result of some of the broader interpretations being placed on the ECJ's decision in the *Centros* case. The conditions under which the exit-based mechanism of reincorporation could serve as the basis for competition between legal systems do not yet exist. In order for US-style competitive federalism to emerge within company law, some degree of harmonisation of the rules of the conflicts of laws and the practices of the member states relating to incorporation and reincorporation would be required. Thus the question of which issues are appropriate for harmonisation, and the techniques which should be used to implement harmonising measures, cannot be avoided.

From this perspective, a strong case can be made for a form of harmonisation which reflects the different traditions of corporate governance within the member states, rather than attempting to erode those distinctions. This implies a procedural orientation to the law, that is to say, one which aims to promote autonomy at the level of self-regulatory systems both below and beyond those of national governments. Such an approach would find its concrete expression in legal measures which promote mechanisms of collective voice and representation. The European Works Councils Directive is one notable, recent example of this approach. The draft Thirteenth Directive on takeover bids may prove to be another, although, in this case, there is arguably a need for the voices of employees and other stakeholders to be represented alongside those of the institutional shareholders and market professionals who currently dominate the framing and operation of takeover codes.

The enduring contribution of European company law to the wider European project is likely to lie in the further elaboration of these techniques of reflexive regulation. European-level harmonisation is widely but wrongly seen, by analogy with US federal legislation, as blocking processes of innovation and discovery in state laws, thereby preventing the emergence of efficient regulatory solutions. This paper has suggested that it may be more meaningful, in the European context at least, to see harmonisation as a guarantor of diversity in the laws and practices of the different member states, while also encouraging innovation in forms of self-regulation in the corporate and financial spheres. Co-evolution based on diversity at the level of national legal systems, coupled with encouragement for devolved solutions, represents a more likely path for European company law than the type of convergence around a single, dominant regime which appears to characterise the Delaware effect in the US context.

Notes

1. Case C-212/97 *Centros Ltd.* v. *Erhvervs-og Selkabsstryrelsen*, 9 March 1999, (available on the internet at http://europa.eu.int/jurisp/cgi-bin/get).

2. Viénot, 1995, cited in Alcouffe and Alcouffe, 1997: 91.

3. Case 120/78 *Rewe-Zentral AG* v. *Bundesmonoplverwaltung für Brantweinn* [1979] ECR 649.

4. Joined Cases C-267/91 and C-268/91 *Keck* and *Mithouard* [1993] ECR-I 6097.

5. For an account of earlier case law, see Mortimer, 1996.

6. Case C-212/97 *Centros Ltd.* v. *Erhvervs- og Selskabsstryelsen* (available on the internet at http://europa.eu.int/jurisp/cgi-bin/get).

7. Centros, Judgment of the Court, at paras. 26-27.

8. *Ibid.*, para. 32.

9. *Ibid.*, para. 35.

10. *Ibid.*, para. 37.

11. On regulatory competition in securities law, see Licht, 1998 (discussing the effects of multiple listing) and Amihud and Mendelson, 1996 (discussing multiple trading of securities on different stock exchanges without the consent of the issuer). On arguments for and against the creation of jurisdictional competition in securities law, see Choi and Guzman, 1997, 1998; Romano, 1998; Fox, (1997).

12. On labour law, see Case C-113/89 *Rush Portuguesa Ltda*. v. *Office Nationale d'Immigration* [1990] ECR 1417; Davies, 1995; Deakin, 1996; and on tax law, see Case 81/87 *R*. v. *HM Treasury and Commissioners of the Inland Revenue, ex parte Daily Mail and General Trust plc* [1988] ECR 5483, discussed by Mortimer, 1996.

13. *Ibid.*

14. See Freedman and Godwin, 1994; Hicks, Drury and Smallcombe, 1995.

15. Case C-212/97, discussed above.

16. Directive 94/45.

17. The Directive applies to 'Community-scale undertakings', which are undertakings with at least 1,000 employees in the EU as a whole and 150 employees in at least two member states; a similar definition applies to group undertakings operating at Community level. For an overview of the Directive's provisions see Deakin and Morris, 1998: 808 *et seq*. For a valuable discussion of the Directive in the context of a wider argument in favour of using EU-level interventions to maintain national and sub-national diversity, see Streeck, 1999.

18. Article 5(1)(c). See *Official Journal of the European Communities*, C 378, 13.12.97.

19. This legislation dates back to 1975 and is currently contained in the Trade Union and Labour Relations (Consolidation) Act 1992. It is supported by a number of EC directives (in particular Directive 75/129 on Collective Redundancies).

20. The Transfer of Undertakings (Protection of Employment) Regulations 1981, implementing EC Directive 77/187 (the

‘Acquired Rights Directive’).

21. There is a provision for there to be annual consultation over merger plans between company representatives and representatives of employees in the Annex to the EWC Directive. However, it is arguable that this provision, on its own, it unlikely to lead to significant employee participation in decision making on mergers: see Wheeler, 1997.

22. The amended proposal is published in the *Official Journal of the European Communities*, 1997, C 378, 13.12.97. The background to the proposal is explained in Commission document COM (97) 565 final. See also House of Lords Select Committee on the European Communities, *Takeover Bids*, 13th Report, HL Paper 100, Session 1995-96. In June 1999 the member states agreed a common position on the latest form of the draft Directive, and it seems highly likely that it will be formally adopted in the near future.

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