LEGAL DIVERSITY AND REGULATORY COMPETITION: WHICH MODEL FOR EUROPE?

Centre for Business Research, University Of Cambridge
Working Paper No. 323

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March 2006

This working paper forms part of the CBR Research Programme on Corporate Governance.

Abstract
Two models of regulatory competition are contrasted, one based on a US pattern of 'competitive federalism', the other a European conception of 'reflexive harmonisation'. In the European context, harmonization of corporate and labour law, contrary to its critics, has been a force for the preservation of diversity, and of an approach to regulatory interaction based on mutual learning between nation states. It is thus paradoxical, and arguably antithetical to the goal of European integration, that this approach is in danger of being undermined by attempts, following the *Centros* case, to introduce a Delaware-type form of inter-jurisdictional competition into European company law.

JEL Classification: K22, K31

Keywords: corporate law, labour law, regulatory competition.

Acknowledgements
This paper was first presented at a seminar on 'Governing Regulatory Interaction: The Normative Question' held at the Radcliffe Institute for Advanced Study, Harvard University, in October 2004. I am grateful to my fellow participants, and in particular to the seminar leaders, Viktor Mayer-Schoenberger and Alexander Somek, for comments received.

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Legal Diversity and Regulatory Competition: Which Model for Europe?

I. Introduction

The law-making power of nation states is increasingly being qualified by principles of transnational economic law. These norms – variously described in terms of the 'mutual recognition', 'non-discrimination' and 'country of origin' principles[1] – purport, in the first instance, to remove barriers to the cross-border movement of factors of production. In doing so, they initiate a process in which the law-making power of nation states is subjected to external competitive forces. As states compete with one another to attract and retain scarce economic resources, a new type of market is created, one based on *regulatory competition*.

All markets rest on institutional foundations.[2] These 'rules of the game' are not solely concerned with protecting existing markets, by enforcing contracts and penalizing collusion. At a more basic level, they *constitute* markets by defining the elements of exchange, and in so doing inevitably frame the process of competition. The market for laws is no different. The possibility of regulatory competition only exists because of rules which set limits to what is permissible by way of arbitrage. Often referred to as 'derogations' from the principle of freedom of movement, these constraints might better be thought of as constitutive norms, without which the market process itself would lack necessary form and definition.

There is a tendency to think of competition as a neutral and technical process which serves no particular end, other than the goal of efficiency. Since 'efficiency' is to be understood in terms of the maximisation of the aggregate welfare or, in certain alternative formulations, the wealth of market actors,[3] it is a goal which is likely to command general assent. Legal rules, by contrast, and in particular legislative ones, are seen as serving political goals, which are often redistributive in nature, and so likely to be highly contested. But if markets are, themselves, 'instituted' orders,[4] which cannot operate in the absence of certain normative underpinnings, they too can be seen all too clearly to serve particular purposes and values, values which cannot be reduced to the all-embracing logic of welfare or wealth maximisation. So it is with the case of regulatory competition: outcomes are critically dependent on the way in which the rules of the game are designed.

The design of those rules will for the foreseeable future be perhaps the most pressing issue in global economic governance. A number of models are available for consideration. The experience of federal and quasi-federal

systems of law operating within national and transnational trading blocks will be drawn upon. Thus the US model of inter-state competition provides one possible template for global trading rules. However, it is not the only model available. The western European experience, exemplified in the law governing the construction of the single market, is also an important one, which offers an alternative perspective. In particular, it suggests ways in which the 'framing' of regulatory competition can reconcile the conflicting demands of transnational economic integration and national legal diversity. The distinctiveness of the European approach is nevertheless under threat, in part because it is being compared to an idealized version of the US experience, one which abstracts from its historical origins and glosses over some of its consequences.

To address these themes, this paper will first of all outline rival theories of regulatory competition, and in doing so will compare the assumptions underlying, respectively, the US and European Union approaches to this issue (section 2). It will then contrast the experience of harmonization and convergence in the fields of corporate and labour law in the American and European contexts, drawing out the essential differences between them (section 3). Section 4 concludes by reflecting on the future of the European model.

II. Theories and varieties of regulatory competition

Regulatory competition can be defined as a process whereby legal rules are selected and de-selected through competition between decentralized, rule-making entities, which could be nation states or other political units such as regions or localities. A number of beneficial effects are expected to flow from this process. In so far as it avoids the imposition of rules by a centralized, 'monopoly' regulator, it promotes diversity and experimentation in the search for effective laws. In addition, by providing mechanisms for the preferences of the different users of laws to be expressed and for alternative solutions to common problems to be compared, it enhances the flow of information on what works in practice. Above all, it allows the content of rules to be matched more effectively to the preferences or *wants* of those consumers, that is, the citizens of the polities concerned. In some versions of the theory, the first two of these goals are, in essence, simply the means by which the third is achieved.

The idea of regulatory competition is not new,[5] but it was first formalised within the framework of modern welfare economics in the mid-1950s, in relation to the issue of the production of local public goods. The timing is significant: Tiebout's celebrated paper, entitled 'A pure theory of public expenditure', was, essentially, an application of theories of general equilibrium which were prevalent at the time.[6] The paper constructs a model in which competition

operates on the basis of mobility of persons and resources across the boundaries of local government units within a sovereign state. In the model, local authorities compete to attract residents by offering packages of services in return for levying taxes at differential rates. Consumers with similar wants then 'cluster' in particular localities. The effect is to match local preferences to particular levels of service provision, thereby maximizing the satisfaction of wants, while also maintaining diversity and promoting information flows between jurisdictions.

Tiebout's model is of wider interest because laws, like aspects of local public infrastructure, can be seen as indivisible public goods. By showing formally that they can be understood as products which jurisdictions *supply* in response to the *demands* of consumers of the laws, Tiebout demonstrated the relevance, even to public goods of this kind, of a market analogy. However, in Tiebout's 'pure theory', freedom of movement was *assumed* for the purpose of setting up the formal economic model. The model was aimed at showing that, *given* an effective threat of exit, spontaneous forces would operate in such a way as to discipline states against enacting laws which set an inappropriately high (or low) level of regulation. Tiebout's paper did not set out the institutional conditions which would have to be met for the process of competition to occur in the 'real' world; in common with other applications of the general equilibrium model at this time, these conditions were simply assumed. However, the model could be, and was, used as a benchmark against which to judge institutional measures aimed at creating regulatory competition. Since the mid-1950s, the identification of these conditions has become the central question uniting various new-institutional movements in economics and law; it is no longer adequate simply to assume their existence. Sensitivity to the need to consider the institutional framework has not, however, avoided a tendency on the part of many analyses to present the 'pure model' of unfettered competition as the goal to which laws and institutions should be directed, and the debate over regulatory competition is no exception to this.

The most obvious institutional implication of the Tieboutian model is that regulatory competition, in its various forms, requires a particular division of labour between different levels of rule-making. It cannot work unless effective regulatory authority is exercised by entities operating at a devolved or local level. Law-making powers should be conferred on lower-level units, subject only to the principle that there must be some level below which further decentralization becomes infeasible because of diseconomies of scale.

But even this gives rise to a need for a federal or transnational body which involves superintending the process of competition between the lower level

units. Individual units could shut down competition unilaterally, either by placing barriers to the movement of the factors of production beyond their own territory, or by denying access to incoming capital, labour and services, or both. Hence the central or federal authority has the task of guaranteeing effective freedom of movement. This task, in and of itself, may well require active interventions of various kinds.

Since, in the 'real' world, mobility of persons and of non-human economic resources is self-evidently more limited than it is in the world of pure theory, three prerequisites for making exit effective may be identified. One is the legal guarantee of freedom of movement – entry and exit – for persons and resources. The second is a requirement of non-discrimination, sometimes described in terms of 'mutual recognition' or the concept of 'most favoured nation' status in international economic law. The third is the acceptance of the presence of unwanted side effects of competition: 'externalities' or spill-over effects of various kinds. Even if there is in general a presumption against federal intervention and in favour of allowing rules to emerge through the competitive process, a space remains for harmonization to protect standards against a 'race to the bottom'. Only the most Panglossian or willfully unobservant would deny that this problem exists; the controversy relates to how serious it is, and whether harmonization at the federal level is the best way to deal with it.

According to the school of thought which can be identified with the theory known as 'competitive federalism', the task of analysis is to identify how far the 'real world' departs from the pure theory, and to using legal mechanisms to realign the two. Selected institutional interventions can be deployed in such a way as to bring supply and demand for laws into equilibrium. Roger Van den Bergh[7] has described how this approach would work in the context of the European Union: it could be used, in principle, to justify a range of mechanisms, including the development by the European Court of Justice of its extensive case law on mutual recognition and non-discrimination. The *Cassis de Dijon*[8] principle can be seen as speeding up regulatory competition, since in requiring free movement of goods subject to a mutual recognition principle, it not only sets into competition producers from different countries, but does the same for the different regulatory regimes under which they were producing. The principle of freedom of movement for goods, regarded as a fundamental principle within the legal order of the EU and as foundation of the internal market, is also a means to the end of more efficient law making within the quasi-federal order.

The theory of competitive federalism could also be used to justify measures aimed at harmonization in clear cases of a negative externality arising from

imperfect competition. However, Van den Bergh argued that there should be a presumption against federal-level harmonizing legislation, because the negative effects of politically-motivated rent-seeking, that is to say, wealth-destroying conflicts over distribution. This was because there would be no equivalent, at federal level, to the inter-state competition which was going on at the lower levels and which would (according to this approach) restrain rent-seeking.[9]

Just as there is more than one model of competition in economics, so there is more than way of understanding regulatory competition. One alternative to competitive federalism has been called the model of *reflexive harmonization*.[10] This begins with the idea that competition is not so much a state of affairs in which welfare is maximized, but a process of discovery through which knowledge and resources are mobilized, the end point of which cannot necessarily be known. This type of competition depends on norms which establish a balance between 'particular' and 'general' mechanisms,[11] between, that is, the autonomy of local actors, and the effectiveness of mechanisms for learning based on experience and observation. One essential prerequisite is the preservation of local-level diversity, since without diversity, the stock of knowledge and experience on which the learning process depends is necessarily limited in scope.

The observation that 'hidden in the historical experience of economic integration, there is … a very important aspect of "system dynamics": international competition in the field of the welfare state serves as a kind of process of discovery to identify which welfare state package – for whatever reason – turns out to be economically viable in practice'[12] might seem to rule out substantial harmonising legislation, and, indeed, it was advanced with precisely this goal in mind, at a time when there was an active debate about extending labour law directives to avoid 'social dumping'. In the vein of a neo-Austrian or Hayekian economic analysis, intervention with the aim of curing so-called imperfections which prevents the market from arriving at an optimal allocation, if not simply beside the point, is actively harmful. These 'imperfections', which are simply the *differences* between systems, are the very basis on which learning can take place in a federal order. In this sense, diversity of national systems is an objective in its own right. It is only on the basis of diversity that a wide range of potential solutions to common regulatory problems can emerge.

One implication of this point of view is that to intervene with the aim of institutionalising a single 'best' solution, through harmonization, would be misguided. However, there is another implication, which is that federal level harmonization has a role in maintaining the appropriate relationship between

'particular' mechanisms operating at the sub-federal level, and the 'general' mechanisms by which learning across the federal unit as a whole takes place. The model of reflexive harmonization holds that the principal objectives of judicial intervention and legislative harmonization alike are two-fold: firstly, to protect the autonomy and diversity of national or local rule-making systems, while, secondly, seeking to 'steer' or channel the process of adaptation of rules at state level away from 'spontaneous' solutions which would lock in sub-optimal outcomes, such as a 'race to the bottom'.[13] In this model, 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 convergence around the 'evolutionary peak' or end-state envisaged by Tiebout's general equilibrium model. The idea of co-evolution, borrowed from the modern evolutionary synthesis in the biological sciences, argues that a variety of diverse systems can co-exist within an environment, with each one retaining its viability.[14] It thereby combines diversity and autonomy of systems with their interdependence within a single, overarching set of environmental parameters.

More generally, theories of reflexive law aim 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.[15] One of the problems with the competitive federalism model is that it appears to envisage just two forms of regulation: 'monopoly' control from the centre, and the complete absence of such formal controls, in favour of competitive forces. In practice, a range of options is available, some of which combine regulation and competition. Reflexive law theory maintains that it is possible for regulatory interventions to achieve their ends not by direct prescription, but by inducing 'second-order effects' on the part of social actors. Thus this approach aims to 'couple' external regulation with self-regulatory processes including those of the market. The 'procedural' orientation of reflexive finds expression in laws, for example, which underpin and encourage autonomous processes of adjustment, in particular by supporting mechanisms of group representation and participation, an approach also finds a concrete manifestation in legislation which seeks, in various ways, to devolve or confer rule-making powers to self-regulatory bodies. Thus laws which allow collective bargaining by trade unions and employers to make qualified exceptions to limits on working time or similar labour standards,[16] or which confer statutory authority on the rules drawn up by professional associations for the conduct of financial transactions,[17] are example of this effect.

In essence, the idea of reflexive *harmonization* takes this idea from reflexive law theory in general, and applies it to the level of transnational economic law

and the 'rules of the game' which govern regulatory competition. However, the distinction between competitive federalism, derived from general equilibrium economics and the economic analysis of law, and reflexive harmonization, derived from systems theory, is not simply an abstract or theoretical one; it is rooted in practice. In particular, as the next section explains, it reflects the different experience of regulatory competition in the USA and the European Union.

III. Regulatory competition and the evolution of the law governing the business enterprise in the USA and the EU

The case of Delaware is rightly seen as key to understanding the dynamics of regulatory competition in the USA. The state of Delaware is the principal site for the incorporation of larger US companies: over 40% of companies listed on the New York Stock Exchange, and over 50% of the top Fortune 500 companies are incorporated in that state. At the two extremes of the debate over the Delaware effect are two views: one holds that the Delaware legislature and courts attracted incorporations by diluting standards of shareholder protection, thereby engineering a 'race to the bottom';[18] the other maintains that Delaware has succeeded because its laws offer the best available set of solutions to the problem of agency costs arising between shareholders and managers.[19] Adherents of the race to the bottom hypothesis claim that, although the process of law making in Delaware is susceptible to the threat of disincorporation by companies, it is managers rather than shareholders who typically take decisions relating to the company's legal domicile. In the event of potential conflicts of interests between shareholders and managers, it is the interests of the latter which will tend to prevail. This can be seen in the willingness in the 1990s of the Delaware legislature, and to a certain extent of the courts, to adopt rules which can be construed as pro-management in the sense of allowing potential takeover targets to put defensive mechanisms in place against the threat of hostile takeover,[20] and in the passage in the 1990s of a law allowing companies to opt out of stringent standards of care in respect of directors' liability for negligence.[21] The idea that Delaware law represents a lowest common denominator has however been challenged by accounts which insist that any attempt by managers to downgrade shareholder interests would, over time, have led to a hostile response by the capital markets. Managers would have an incentive to incorporate under the law of a state which favoured shareholder interests and to shun states which harmed investors, thereby driving up the cost of capital.[22]

Despite the huge literature which this argument has produced,[23] it is unlikely that the debate over the optimality or otherwise of Delaware laws will ever be

clearly resolved, not least because Delaware's dominance of US corporate law makes it difficult to find meaningful benchmarks against which its own performance can be measured. At its best, the claim that Delaware's laws have been selected for their efficiency lends an air of ex-post rationalisation to a process which would have looked very different at most stages in its evolution. Delaware's preeminence is the result of a series of unexpected turns, but also of institutional steps which were taken in the nineteenth century which had the effect (which was not necessarily intended) of putting in place the conditions for inter-state competition over incorporations. These are often neglected in the debate.

Thus US regulatory competition rests upon the existence of a set of prior conditions, which provided the basis for freedom of companies to incorporate in the state of their choice. A nineteenth century US Supreme Court decision, *Paul* v. *Virginia* (1868),[24] established that states were not able to attach special requirements to corporations which had been chartered in other jurisdictions as a condition of allowing them to do business on their territory. This was later interpreted as meaning that states had to operate a rule of mutual recognition, according to which an incorporation which was effective in one state was acknowledged by the others.[25] This shift occurred in the final quarter of the nineteenth century, when New-York based corporations began to reincorporate in New Jersey to take advantage of a looser regulatory regime, designed by members of the New York corporate bar. In the 1890s and 1900s Delaware displaced New Jersey when the latter, under the influence of the Progressive political movement, introduced a number of regulatory constraints on large corporations including controls over the holding of shares in one company by another. The Delaware corporate regime had been initially designed to facilitate the operations of the Du Pont corporation, which, at that stage, was the only significant company which was registered in the state. The Delaware law had been 'drafted under the auspices of the Du Pont family to protect their managerial and shareholder interests', and 'appeared relatively favourable to manager-shareholders of other corporations as well'.[26] Since it obtained its initial advantage, a number of factors have served to consolidate Delaware's position. In particular, specialization means that Delaware now enjoys an advantage over other states in terms of the large body of case law which it has built up, the expertise of its courts and the speed with which they can deal with complex corporate litigation, and a concentration of professional legal and financial expertise with links to the state.[27]

There has been no tendency towards convergence in European company law to parallel that of the Delaware effect in the United States. This could be ascribed, straightforwardly enough, to the much shorter period of time during which

convergence could have taken place since the foundation of the European Community in the 1950s. Alternatively, the currently influential theory of legal origin could be invoked:[28] given the variety of legal systems, common law and civil law (French, German and Scandinavian) present in the European Union, by contrast to the overwhelmingly common law origin of the legal systems of the USA, convergence was not to be expected.

However, it is important, again, to avoid the reading history in a teleological fashion, so as to confer an overly functional explanation on outcomes which could well have turned out differently. The Treaty of Rome of 1957 contained far-reaching powers to introduce harmonizing measures in the field of company law. These were (and remain) essentially ancillary to the rights of freedom of establishment in Articles 43 (ex 52) and 48 (ex 58) of the EC Treaty. Some degree of parity or equivalence in the laws protecting shareholders and 'others' – the latter term could include a range of stakeholder groups[29] – 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. Moreover, during the early development of the Community's company law programme, an active case for harmonization was made which echoed the claims advanced at around the same time by the 'race to the bottom' school in the USA.[30] It was in this spirit of protective regulation that the early company law directives, the so-called first generation directives which were heavily prescriptive in their approach, were adopted.[31] However, this early emphasis on uniformity and prescription soon gave way to more flexible approaches which placed greater stress on member state autonomy. 'Second-generation' measures typically 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, while 'third' and 'fourth generation' directives opened up the harmonization process to the influence of norms generated outside the legal process by inter-professional and sectoral bodies.

Why, if harmonization has not resulted in uniformity, has the alternative of a market for incorporations emerged, so far at any rate, in the EU? This is in large part the consequence of the lack of a consistent approach on the part of the EU member states on the issue of the applicable law of corporate constitutions, which in turn is a function of legal diversity. 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, as in the United States, the applicable law is a matter of choice for managers of the company or, in the final analysis, for its shareholders (to the extent that they can mandate the board to take a particular view of this issue, which is by no means

always the case, or bring about the same outcome through a proxy fight to replace one set of directors with another) ; 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 have operated 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 a key 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 under the EC Treaty, most importantly as a result of the *Centros* decision of the European Court of Justice of 9 March 1999, and later cases in the same line, *Überseering* and *Inspire Art*.[32] In *Centros*, 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 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 minimize the risk of fraud. In ruling 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), the Court took a wide view of the market access

principle.[33] It is essential to note that at the time of the registration request, Centros Ltd. had never traded in the UK, nor was it intended to. Thus the issue in this case was not whether the founders of the company could have access to British company law – they could, had they wished to trade anywhere but Denmark – nor whether they could trade in Denmark – they could have done that too, by incorporating a company there. The issue was purely whether their inability to take advantage of UK company law was a sufficiently significant distortion of the 'competitive space' of the internal market to constitute an interference with freedom of establishment. In finding that it did, the Court was placing itself at the outer limits of free movement jurisprudence, since this was a case involving, at best, a de facto rather than a formal barrier to market access. Nor was this a clear case of discrimination on the grounds of nationality. In then going on to conclude that the Danish government had failed to show that the refusal to register was proportionate in the circumstances, it substituted its own view for that of the legislature on the far from straightforward question of how to control for the likely negative effects on third parties of liberalizing incorporation rules.[34]

The judgment of the ECJ in *Centros* does not necessarily signify the demise of the *siège reel* principle. Denmark was one of the states which operated under the incorporation rule, so the *siège reel* principle was not, strictly speaking, before the Court. Nevertheless, dicta in *Centros* suggest that the *siège reel* principle, as such, may well at some point be seen as contrary to the single market rules. The post-*Centros* case law suggests that this is the direction in which the Court is heading.[35] Thus *Centros* is likely to herald a move, sooner or later, towards greater jurisdictional competition in EU company law.[36] There is empirical evidence to the effect that this is already happening, as the number of start-ups from other EU member states which are incorporated in the United Kingdom has sharply increased since the early 2000s, while minimum capital requirements have been watered down in several countries.[37]

A market for incorporations would therefore empower shareholders, and possibly managers; it is less clear what its effects on other corporate constituencies, such as creditors and employees, would be. The *Centros* case itself illustrates how creditors might be negatively 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. A 'race to the bottom' could well result.[38]

In the same way, companies 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. The principle of territoriality tends to determine the application of most labour law rights, rather than the domicile of the company.[39] 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 organization 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. If that occurs, the type of distinctions drawn by the Court in the *Centros* case will begin to loom large for the future of social policy and not simply for corporate law.

If companies could outflank codetermination laws, for example, through reincorporation outside the jurisdiction, avoiding the principle of the territorial effect of labour laws, there would be little point in states retaining them. If legislators and policy makers begin to act in the way predicted by the theory of regulatory competition, they will repeal such mandatory laws with the aim of attracting more incorporations or retaining those which they already have. The implications for third parties excluded from the decision on incorporation will most likely be negative: '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'.[40] It seems highly possible, then, that a market for incorporations would lead to a reduction in mandatory employment and insolvency laws of all kinds. It is not even necessary for there to be large-scale corporate movements for this to occur; the threat might be sufficient.

The *siège réel* principle was not an historical accident; it was a manifestation of the organizational emphasis and stakeholder orientation of the company law systems of those member states which had long recognized it. As long as that principle remained in place, it was a significant obstacle to convergence of systems upon a shareholder-orientated model. In that sense it was also a significant guarantor of the diversity which the European Union systems demonstrated, and which distinguished the European model from the American one. If the *siège réel* principle is now fraying at the edges, the implications for the future of European corporate law are profound.

In the context of the case law on freedom of movement, *Centros* is an outlier, dependent upon what are arguably artificial notions of what constitutes an obstacle to market access.[41] In terms of its implications for the construction of the single market, it threatens to replace the distinctive approach to regulatory competition which has marked the European experience to date. It is not

difficult to believe that the Court has had an eye on the Delaware experience in developing its approach in the *Centros* line of cases. But if that is the case, it may well have overvalued the supposed benefits of the Delaware effect, and underestimated its drawbacks.

This difference between the US and Europe is not a straightforward distinction between a US solution which favours competitive solutions and a European one which favours regulation. US corporate law contains many highly regulative and rigid elements. The essence of the Delaware effect is a race neither to the top nor the bottom, but a *race to converge*. Delaware represents a race to converge through competition, and has arrived at the predictable result, for such unregulated competition, of a near-monopoly supplier.[42] But it is also important to bear in mind the role of the federal regulator. The recent adoption of the Sarbanes-Oxley Act a reminder that there are extensive federal powers to legislate in the field of corporate and securities law, and that Delaware's preeminence is to a large degree the consequence of the decision of the federal legislature not to intervene when it could do so. There is, indeed, a substantial track record of intervention by the federal legislature when inter-state competition is seen to have failed. Moreover, harmonization here tends to take a particularly rigid form which is largely absent from EU corporate and labour law: this is the solution of *federal preemption*. This is, perhaps, why critics of US federal regulation in such areas as company law and labour law argue so vociferously that it acts as a 'monopoly regulator', excluding all scope for state initiative.[43] The restriction of state initiative has occurred in relation both to securities regulation and the law governing collective bargaining. In each of these areas, the federal legislature intervened in the 1930s to cure what were seen as fundamental failings of state-level regulation. The courts subsequently applied the preemption doctrine to hold that these federal regulations 'occupied the field' in such a way as to prevent the states legislating in the area. This form of pre-emption contains a strong version of centrally-imposed uniformity: where it applies, states are not simply prevented from derogating from the standards set by the federal legislature; it is very often the case that they cannot improve on them either. The Securities Act of 1933, the Securities and Exchange Act 1934 and the National Labor Relations Act 1935 are still very largely in force today, notwithstanding long-standing criticisms from commentators on all sides of the policy debate who argue that a return to state autonomy would better serve the policy goals of intervention in these areas.

A core characteristic of US-style competitive federalism, then, is not simply the presence of a particular form of inter-state competition, but also the use of a certain type of centralized regulation as a way of achieving policy goals when inter-state competition breaks down. The description of a 'monopoly regulator'

which US critics use to attack federal intervention is entirely appropriate in a system which tends to react to extreme failures in the market for regulation by shutting down competition entirely. The criticisms may be justified, but the critics should also recognize that the counterpoint of unbridled competition versus monopoly regulation has a certain logic to it: it is precisely because the system of decentralized lawmaking so often led to extreme coordination failures, as in the case of the capital markets and labour markets of the 1930s, that the federal legislature, in its turn, came to intervene with the goal of shutting down inter-competition entirely in contexts where it was perceived to have failed.

A different logic underpins the transnational harmonization of laws in the European Community. Here, the purpose of harmonization is not to substitute for state-level regulation; hence, the transnational standard only rarely operates to 'occupy the field' in the manner of a 'monopoly regulator'. Rather, transnational standards in effect 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.[44] Directives in the areas of labour law offer a good example of this, since they are almost invariably interpreted as setting basic standards in the form of a 'floor of rights'. Although 'downwards' derogation is prohibited, member states are allowed, and implicitly encouraged, to improve on the standards set centrally.[45] Far from being a 'straitjacket', then, which restricts local autonomy, *central-level intervention is the precondition for continued local-level experimentation*.

Directives in the area of corporate law have also drawn on this philosophy. In particular, company law harmonization was influenced by the 'new approach' to harmonization 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 harmonization, where it established a principle that Community intervention should be limited to the harmonization of essential safety-related requirements. It also established the 'reference to standards' approach, under which it was presumed that a product which conformed to a standard set by a European-level body, or, failing that, with the relevant national standard, also complied with EC law.[46] In this context, the Twelfth Company Law Directive, on single-member private companies (1989),[47] 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. Later 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 organizations in the financial sector. The more recent Thirteenth Directive,[48] on takeover bids, 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 takeover panels, and in the specific provision which it makes for continued national-level divergence on matters such as takeover defences and the role of employee consultation.

In short, there is no one, all-embracing model of regulatory competition. The Delaware experience is the singular of a particular trajectory, possibly unique, and is unlikely to be repeated in the same form elsewhere. The European Union's different trajectory reflects the particular conditions under which the national systems evolved and under which the harmonisation programme developed. In both systems, it can be seen that the nature of regulatory competition is dependent on the particular institutional environment or 'framework' which defines the relevant relationships between the different levels of rule making. Systems which approximate to the model described above in terms of 'competitive federalism' tend to give rise to a *race to converge* which could be either a race to the top or to the bottom; an optimal outcome is not guaranteed. The solution to extreme market failures, which would otherwise lock in inefficient rules, is preemption, that is, federal intervention which occupies the field to the complete exclusion of local initiative; but this, too, risks locking in inefficiency. By contrast, in the model of 'reflexive harmonization', intervention has the goal of preserving diversity in order to make it possible for regulatory competition to operate as a process of discovery, based on mutual learning between states.

IV. Conclusion: the prospects for the European model of regulatory competition

This paper has argued that regulatory competition in corporate and labour law in Europe has taken a distinctive form, through which harmonization, far from limiting national diversity as some of its critics have feared, has served to maintain it. This is a feature of a particular regulatory style, referred to here as 'reflexive harmonisation', which developed to match the highly divergent regimes which operate within the EU for the regulation of the business enterprise. By contrast, the predominant regulatory style in the USA has been a 'race to converge' through, on the one hand, jurisdictional competition which has been unmediated by any harmonizing framework of basic rules and,

secondly, federal legislation which, where it applies, preempts state-level initiative. It was further suggested that the advantages of inter-state competition as a mode of regulatory inteaction should be thought of in terms of the learning process which it engenders, which presupposes the maintenance of diversity, rather than in terms of the convergence of systems on a supposedly single best model.

At a fundamental level, the debate between European and American approaches is one of the prevailing conception of the relationship between regulation and the market. The US literature, particularly the standard law and economics approach, views regulation as external interference in private ordering, to be justified only where a clear market failure can be demonstrated. By contrast, the predominant European approach has been to see regulation, and the legal system more generally, as constituting the market order, an approach which is compatible with the idea that regulatory and market forces will more often complement than oppose each other. It would be paradoxical, under these circumstances, for the European approach to mimic US practice, and seek to initiate a Delaware-style process of interstate competition in company law, or any other area for that matter. That may well be the direction to which EU policy is leaning. But when state laws are seen as a 'distortion' of competition in the otherwise empty 'space' of the single market, a reassessment of that policy is overdue.

Notes

[1] For a recent example, see the use of each of these terms in the context of the proposed EU Services Directive: Commission, *Proposal for a Directive of the European Parliament and of the Council on services in the internal market*, Brussels, 5.3.2004, COM(2004) 2 final/3; see further, below, section 4.

[2] See A. Supiot, 'The dogmatic foundations of the market' (2000) 29 *Industrial Law Journal* 321-345.

[3] On the distinction between utility maximization and wealth maximisation, and an argument in favour of using the latter as the normative criterion for the evaluation of laws, see R. Posner, *The Economics of Justice* (Cambridge, MA: Harvard University Press, 1981).

[4] See K. Polanyi, 'The economy as instituted process', in K. Polanyi, C. Arensberg and H. Pearson (eds.) *Trade and Market in the Early Empires* (Glencoe, IL.: Free Press, 1957)) 243-270; M. Harvey, 'Productive systems, market and competition as "instituted economic process"', in B. Burchell, S. Deakin, J. Michie and J. Rubery (eds.) *Systems of Production: Markets, Organisations and Performance* (London: Routledge, 2003), 40-59.

[5] There are nineteenth century antecedents to today's debates about competition between jurisdictions in the matter of company law. The UK company legislation of the 1950s, which saw the introduction of limited liability, may have been a response to the threat of companies registering in other jurisdictions. See J. Saville, 'Sleeping partnership and limited liability, 1850-1856' (1956) 8 *Economic History Review (NS)* 418-433.

[6] C. Tiebout, 'A pure theory of local expenditure' (1956) 64 *Journal of Political Economy* 416.

[7] R. Van den Bergh, 'The subsidiarity principle in European Community law: some insights from law and economics' (1994) 1 *Maastricht Journal of European and Comparative Law* 337.

[8] Case 120/78 *Rewe Zentrale v. Bundesmonopolverwaltung fur Branntwein ('Cassis de Dijon')* [1979] ECR 649.

[9] 'The subsidiarity principle', op. cit.

[10] S. Deakin, 'Two types of regulatory competition: competitive federalism versus reflexive harmonisation. A law and economics perspective on *Centros*' (1999) 2 *Cambridge Yearbook of European Legal Studies* 231-260; C. Barnard and S. Deakin, 'Market access and regulatory competition' in C. Barnard and J. Scott (eds.) *The Law of the Single Market: Unpacking the Premises* (Oxford: Hart, 2002).

[11] On the distinction between 'particular' and 'general' mechanisms in system theory, see R. Sugden, 'Spontaneous order' in P. Newman, *The New Palgrave Dictionary of Economics and the Law* (London: Macmillan, 1997), Vol. III, 485-495, at p. 487.

[12] K.-H. Paqué, 'Does Europe's Common Market need a social dimension? Some academic thoughts on a popular theme', in J.T. Addison and W.S. Siebert (eds.) *Labour Markets in Europe: Issues of Harmonisation and Regulation* (London: Dryden, 1997), at p. 109.

[13] Deakin, 'Two types of regulatory competition', op. cit.

[14] G. Teubner, *Law as an Autopoietic System* (Oxford: Blackwell, 1993), at p. 52.

[15] Teubner, ibid.; R. Rogowski and T. Wilthagen (eds.) *Reflexive Labour Law* (Deventer: Kluwer, 1994).

[16] S. Deakin and F. Wilkinson, ''Rights v. efficiency? The economic case for transnational labour standards' (1994) 23 *Industrial Law Journal* 289-310.

[17] J. Black, *Rules and Regulators* (Oxford: OUP, 1997).

[18] W. Cary, 'Federalism and corporate law: reflections upon Delaware" (1974) 83 *Yale Law Journal* 663.

[19] R. Winter, 'State law, shareholder protection and the theory of the corporation" (1977) 6 *Journal of Legal Studies* 251; D. Fischel, 'The "race to the bottom" revisited: reflections on recent developments in Delaware's corporation law" (1982) *Northwestern University Law Review* 913; F. Easterbrook 'The economics of federalism'(1983) 26 *Journal of Law and Economics* 23; F. Easterbrook and D. Fischel, 'Voting in corporate law' (1983) 26 *Journal of Law and Economics* 395; R. Romano, 'Law as a product: some pieces of the incorporation puzzle' (1985) 1 *Journal of Law, Economics and Organization* 225; F. Easterbook and D. Fishel, *The Economic Structure of Corporate Law* (Cambridge: MA, Harvard University Press) ch. 10.

[20] L. Bebchuk and A. Ferrell, 'Federalism and takeover law: the race to protect managers from takeovers' (1999) 99 *Columbia Law Review* 1168-99.

[21] D. Charny, 'Competition among jurisdictions in formulating corporate law rules: an American perspective on the "race to the bottom" in the European Communities', in S. Wheeler (ed.) *A Reader on the Law of the Business Enterprise* (Oxford: OUP, 1994), at pp. 372-3.

[22] Winter, 'State law', op. cit.; Easterbrook and Fischel, *Economic Structure*, op. cit.

[23] A number of recent studies are sceptical of the claim that Delaware law is optimally efficient: see L. Bebchuk, A. Cohen and A. Ferrell, 'Does the evidence favor state competition in corporate law?' (2002) 90 *California Law*

Review 1175-1821; G. Subramanian, 'The disappearing Delaware effect' Harvard Law and Economics Discussion Paper no. 391 (2002).

[24] 9 Wall 168.

[25] For an argument that *Paul* was not aimed at instigating competition for incorporations, and that its later use in this context was opportunistic and contingent, see F. Tung, 'Origins of the internal affairs doctrine' Loyola Law School (LA) Research Paper No. 2005-8, March 2005.

[26] Charny, 'Competition among jurisdictions', at p. 368.

[27] M. Roe, 'Takeover politics', in in M. Blair (ed.) *The Deal Decade* (Washington DC: Brookings Institution, 1993), and, by the same author, 'Delaware's politics' (2005) 118 *Harvard Law Review* 2493, providing a political-economy analysis of the relationship between Delaware corporate law and federal-level regulation.

[28] See E. Glaeser and A. Shleifer 'Legal origins' (2002) 117 *Quarterly Journal of Economics* 1193-1229.

[29] C.Villiers, *European Company Law: Towards Democracy*? (Aldershot: Dartmouth, 1998), at p. 19.

[30] C. Schmitthoff, 'The future of the European company law scene', in C. Schmitthoff (ed.) *The Harmonisation of European Company Law* (London: UKNCCL: 1973).

[31] Villiers, *European Company Law*, op. cit.; V. Edwards, *European Company Law* (Oxford: OUP, 1999).

[32] Case C- 208/00 *Überseering* v. *Construction Company Baumanagement GmbH (NCC)* [2002] ECR-I Case C-167/01 *Kamer van Koophandel en Fabrieken voor Amsterdam* v. *Inspire Art Ltd.* [2003] ECR-I 10115.

[33] See Barnard and Deakin, 'Market access', for a fuller account of the argument in this paragraph.

[34] Creditor protection laws of the kind at issue in *Centros* are open to attack by law and economics analyses on the grounds that they can easily be subverted and so do not provide substantive protection, a point raised in the *Centros* case itself. However, systems such as the UK which do not have minimum capital requirements for small, privately-held firms, use other means, such as the disqualification of directors, to regulate the activities of SMEs and protect creditors from the abuse of the right to incorporate. See Deakin, 'Two types of regulatory competition', op. cit.

[35] In addition to the *Überseeing* and *Inspire Art* cases, cited above, see Case C-411/03, *SEVIC Systems AG*, Judgment of 13 December 2005, OJ C 289, 29.11.2003, applying *Centros* to a case of a cross-border merger.

[36] See generally J. Armour, 'Who should make corporate law? EC legislation versus regulatory competition' (2005) 58 *Current Legal Problems* 369, pointing out that other recent changes to EC company law, such as the provisions of the Tenth Company Law Directive which will facilitate the movement of a company's registered office from one jurisdiction to another (Directive 2005/56/EC of the European Parliament and of the Council of 26 October 2005 on cross-border mergers of limited liability companies (OJ L 310, 25.11.2005, p. 1), and the regulations governing the applicability of national-level rules on codetermination in the case of the establishment of a Societas Europaea (Council Regulation (EC) No 2157/2001 of 8 October 2001 on the Statute for a European company (SE) (OJ L 294, 10.11.2001, p. 1)), may also encourage the emergence of regulatory competition.

[37] M. Becht, C. Mayer and H. Wagner, 'Corporate mobility comes to Europe: the evidence', paper prepared for the conference on international markets and corporate governance, Georgetown Sloan project/Anton Philips Fund, October 2005.

[38] Becht, Mayer and Wagner, op. cit. at p. 18, find evidence of a lower survival rate among what they call 'Centros-driven incorporations', and suggest that 'this race to the bottom in standards of corporate legislation may give rise to agency conflicts between investors and managers on the one hand and the public interest on the other'.

[39] See S. Deakin, 'Labour law as market regulation: the economic foundations of European social policy', in Davies, P., Lyon-Caen, A., Sciarra, S. and Simitis, S. (eds.) *Principles and Perspectives on EC Labour Law: Liber Amicorum for Lord Wedderburn* (Oxford: Oxford University Press, 1996), 63-93.

[40] L. Bebchuk, 'The desirable limits in state competition in corporate law' (1992) 105 *Harvard Law Review* 1435-1510, at p. 1441.

[41] See Barnard and Deakin, 'Market access', op. cit.

[42] On the role of the federal legislature an implicit competitor to and regulator of Delaware, see M. Roe, 'Delaware's politics', op. cit.

[43] R. Romano, 'The state competition debate in corporate law' (1987) 8 *Cardozo Law Review* 709.

[44] In this respect is it interesting that a 'reflexive' aspect to EU-level regulation should have emerged prior to the more recent vogue for 'deliberative' forms of intervention, based around the concept of the open method of coordination (on which see e.g. J. Cohen and C. Sabel, 'Directly-deliberative polyarchy' (1997) 3 *European Law Journal* 313-42).

[45] Deakin and Wilkinson, 'Rights versus efficiency?', op. cit.

[46] K. Armstrong and S. Bulmer, *The Governance of the European Single Market* (Manchester: Manchester University Press, 1998), at p. 152.

[47] Directive 89/667/EEC of 21 December 1989 on single-member private limited-liability companies (OJ L 395, 30.12.1989, p. 40).

[48] Directive 2004/25/EC of the European Parliament and of the Council of 21 April 2004 on takeover bids (OJ L 142. 30.4.2004, p. 12).

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