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Optional rather than Mandatory EU Company Law Framework and Specific Proposals

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Abstract

A significant debate rages within the EU about whether to give firms the choice to opt in or out of corporate law provisions. Both sides agree that more flexibility and adaptability of legal rules to business needs is crucial. Nevertheless, and not surprisingly, many still view EU mandatory harmonization efforts as an opportunity to upgrade Member State corporate law.

We argue that bringing options to the forefront of EU company law may significantly reduce costs for small and medium-sized firms and provide clear benefits to public companies. With respect to implementing such a regime, we advocate the step-by-step adoption of legal options, beginning with the implementation of a limited number of specific EU provisions that firms can select as an alternative to the corresponding Member State statutory or case law.

Keywords: company law, default rule, harmonization, legal options, menu provisions, opt-in, opt-out, regulatory competition.

JEL Classifications: F15, G38, K22, L22.

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Optional rather than Mandatory EU Company Law
Framework and Specific Proposals

Gerard Hertig* and Joseph A. McCahery**

I. Introduction

Legal options are not a new thing.[1] For many years, specific default (opt-out) and menu (opt-in) provisions have been available to corporations in a wide range of legal contexts. More recently, corporate lawmakers in many jurisdictions have scrambled to increase the range of corporate forms firms can choose from so as to best accommodate diversity in organization, capital structure, and lines of business.

There are a number of reasons why giving firms a choice is an attractive strategy for governments that want to appeal to different business parties' preferences. Firm owners and investors are especially keen to be able to select among a variety of corporate forms at the incorporation stage as this permits them to opt into the corporate framework that is best tailored to their needs. They are also generally interested in the availability of specific legal options as their terms are binding only if and as long as they correspond to the firm's needs. In addition, specific default provisions can reduce formation and operation costs for small and medium-sized firms since they provide off-the-shelf provisions that permit firms to avoid or reduce the costs of negotiating and drafting tailor-made articles of associations.

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[1] There is an extensive literature on "regulatory" legal options (the type of legal options this paper focuses upon) as well as on "real" legal options (calls and puts created by law). On the latter, see also Ian Ayres, OPTIONAL LAW: REAL OPTIONS IN THE STRUCTURE OF LEGAL ENTILEMENTS (University of Chicago Press 2005).

Economic theory has emphasized that providing firms with specific legal options (for example, on capital contributions, dividend rate, management remuneration and tenure) encourages efficient contracting. There is, however, some debate as to the extent to which a legal option approach to corporate law is superior to a mandatory one.

There may be some situations where a mandatory regime would reduce agency costs. Further, an option regime may prove inadequate in situations where firms face significant costs if they wish to opt out of default provisions or in situations where behavioral shortcomings make it difficult to properly design legal options. Thus, rather than enhancing shareholder welfare, legal options might prove costly and could even allow further entrenchment of incumbent management or controlling shareholders. Nevertheless, we expect the net effect of a legal option approach to be positive.

We therefore argue that the adoption of specific legal options by European Union (EU) corporate lawmakers is likely to have significant benefits given the limited regulatory alternatives currently available to EU firms. Indeed, insofar as available corporate forms are few and still characterized by pervasive mandatory provisions, expanded choice can be seen as contributing to secure best value for the firm.

Admittedly, the recent pro-regulatory competition stand taken by the European Court of justice (ECJ) provides incentives for Member States to adopt a less rigid approach and offer more choice among and within corporate forms. However, this may not necessarily result in efficient outcomes as evidenced by the U.S. experience. In addition, there is a distinct possibility that emerging regulatory competition among Member States will prove short lived given on-going European Commission (EC) efforts to push through a wide-spread and still mandate-oriented reform agenda.

We also argues that the adoption of a legal options approach would have two political economy advantages over the present approach. First, the use of options should permit the EC and Member States to limit the risk of disruptive ECJ intrusions in the company lawmaking process. Second, to the extent firms have a preference for

legal options, the approach will generate demonstrable support through increased use by companies across Europe.

That said, there are be good reasons for recommending a cautious approach to fostering the use of legal options as a EU law-making techniques. First, mandatory provisions cannot be eliminated altogether. For instance, there is evidence that mandatory disclosure has positive effects on capital allocation. Moreover, a well-defined mandatory approach to fiduciary duties can serve as an effective strategy to constrain opportunistic transactions by insiders. In addition, freedom of choice only has a meaning if mandatory decision-making procedures prevent managers or controlling shareholders from abusing opt-in or opt-out provisions. Second, there is a danger that putting too many reform items on the agenda may create the very same implementation delay and complexity problems than under the mandatory harmonization approach. Third, it is always preferable to adopt a step-by-step approach when introducing new regulatory mechanisms, especially when there is a risk of legal diversity becoming excessive.

This article will proceed as follows. Part II summarizes the flexible elements of EU company law. Part III develops the concept of a legal option approach and argues that it provides greater benefits to firms and shareholders than the currently mandate-oriented EU regime. In Part VI, we advocate a step-by-step approach focusing on a limited number of specific legal options to allow for the advantages of choice without the welfare reductions associated with too many choices. Part V concludes by discussing the future of the pro-choice approach in Europe.

II. Towards a Flexible Approach to EU Company Law

The EC has built a record of company law reform that enjoys a mixed reputation. Early legislation has been praised for quickly developing a company law infrastructure that facilitated cross-border trading by minimizing the risk of companies or their transactions being considered void in other Member States. Moreover, the adoption of accounting and capital maintenance rules aimed at protecting minority shareholders and creditors secured some enthusiasm for Commission-designed mechanisms for dealing with financial

assistance and disclosure.

In the past two decades, however, the situation has changed. A series of high profile legislative efforts by the European Commission, ranging from the regulation of takeover bids to establishing new corporate forms, ran into conflict with the European Parliament. This shift in EC policymaking authority reflected Member States' less favorable attitude towards harmonization and increased reluctance to mobilize resources to achieve compromises in the company law area.[2] The legislative influence of the European Commission was further threatened by European Court of justice decisions on freedom of establishment.[3] By challenging the core elements of the *siège réel* (real seat) doctrine, these decisions led to an increase in the cross-border mobility of start-up companies and, more generally, in the attractiveness of regulatory arbitrage.[4] This, in turn, provided incentives for various Member States to adopt a less rigid approach to corporate law and offer more choice among and within corporate forms, potentially increasing their opposition to harmonization.[5]

These disruptive features have induced EC policymakers to at least temporarily abandon their traditionally pro-mandate approach to corporate law in favor of less constraining legal option oriented proposals. In particular, the Commission proposed - in a radical departure from its previous proposals -, that Member States be

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[2] See also Mark A. Pollock, THE ENGINES OF EUROPEAN INTEGRATION, DELEGATION, AGENCY AND AGENDA SETTING IN THE EU (Oxford University Press 2003); Jan Wouters, *European Company Law: Quo Vadis*, 37 COMMON MARKET LAW REVIEW 257 (2000).

[3] Case C-212/97 Centros Ltd. v. Erthvers-og Selskabbsstyrelsen, [1999] ECR I-1459; Case C-208/00, Überseering BV v. Nordic Construction Company Baumanagement GmbH (NCC), [2002] ECR I-9919; and Case C-167/01, Kamer van Koophandel en Fabrieken voor Amsterdam v. Inspire Art Ltd (NL), [2003] ECR I-10155.

[4] Marco Becht, Colin Mayer, and Hannes Wagner, *Mobility Comes to Europe: The Evidence* (Working Paper 2005, available at ssrn.com).

[5] An ever-wider array of Member States, such as Ireland, Luxembourg, The Netherlands and the UK have prioritized the creation of corporate law provisions that are attractive for companies operating in other jurisdictions.

allowed to opt-out of Articles 9 (board neutrality) and 11 (break-through rule) of the Takeover Bids Directive. These amendments were received favorably by Member States and paved the way for adopting a Directive that had been engulfed in a regulatory deadlock for more than a decade.[6]

This shift from a mandate toward a legal option oriented approach probably reflects opportunistic considerations. The repeated failures in getting the Takeover Bids Directive adopted and the need to finally show some results (regardless of their substance) paved the way for what many observers considered a desperate one-off move. The EC probably also hoped to thus reignite support for (mandate-oriented) EU corporate law-making by those Member States likely to suffer from emerging regulatory arbitrage and competition.[7]

It would be mistaken, however, to conclude that the softer approach adopted for the Takeover Bids Directive is short lived. In view of the almost immediate results it generated, the EC certainly realized that it could prove politically advantageous to substitute a less binding Recommendation to its established Directive regulatory strategy. The move would not only greatly simplify EC lawmaking, but also provide Member States and firms with more time to adjust to reforms and, in turn, reduce opposition to harmonization. Indeed, standard public choice theory would explain the shift in terms of special interest groups persuading EC policymakers that the groups' preferences would serve the EC's own political interests and become useful in putting together a winning coalition.[8] This realization is clearly represented by the EC's recent Recommendations on

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[6] Directive 2004/25/EC, [2004] OJ L 142/12.

[7] France and Germany, in particular, have made it a specific objective to make reincorporations by their respective firms unpopular. See Klaus Heine, *Regulatory Competition Between Company Laws in the European Union: the Überseering Case*, 38 INTERECONOMICS 102 (2003); Erik P. M.Vermeulen, THE EVOLUTION OF LEGAL BUSINESS FORMS IN EUROPE AND THE UNITED STATES (Kluwer Law International 2003).

[8] See Avinash Dixit and John Londregan, *Ideology, Tactics, and Efficiency in Redistributive Politics*, 113 QUARTERLY JOURNAL OF ECONOMICS 497 (1998).

independent directors and director remuneration.[9]

The EC is also likely to have been influenced by the increasing popularity of legal options in EU as well as Member States law-making. A telling example is provided by the Directive on Privacy and Electronic Communication, which is nicknamed the "opt-in" Directive because it submits e-mail marketing to explicit consumer acceptance.[10] Closer to our topic, the Directive on Markets in Financial Instruments empowers Member States to let sophisticated investors choose among different levels of regulatory protection by opting in or out of information and best execution conduct of business rules.[11]

As noted above, legal options have also made inroads into EU corporate law. The Second Company Law Directive probably is the oldest example, inasmuch it provides capital maintenance bonding mechanisms for firms that opt for capital levels set above the prescribed minimum.[12] More recently, the Regulation on the Statute for a European Company allows firms to choose an EU rather than a Member State corporate form and gives them the possibility of opting out of specific Member State provisions.[13] This freedom of choice regime is significant as recently made clear when Allianz, an insurance company with registered offices in Germany, reincorporated as a European Company. Allianz took advantage of the Regulation allowing for the articles of association to determine the size of the board to reduce the number of supervisory board members from the previously mandatory 20 to 12. As a result, there now are only 6 employee representatives on the supervisory board, 2 of whom represent subsidiaries outside Germany – the net effect being that only 4 employee directors currently represent German members of

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[9] Recommendations 2005/162/EC, [2005] OJ L 52/51 and 2004/913/EC, [2004] OJ L 385/55.

[10] Directive 2002/58/EC, [2002] OJ L 201/37.

[11] Directive 2004/39/EC, [2004] OJ L 145/1.

[12] Directive 77/91/EEC, [1977] OJ L 26/1.

[13] Council Regulation 2157/2001, [2001] OJ L 294/1.

the Allianz group compared to 10 previously.[14]

We contend that the number of flexible EU corporate law provisions should be increased. Essentially, there are two advantages in doing so. First, the availability of additional EU corporate provisions that can be opted in or out of would increase firm choice in an environment that has been characterized by an inflexible approach towards regulatory competition.

Second, and possibly more importantly, the addition of legal options as a EU regulatory technique should make it easier to avoid the costs of relying on mandatory instruments. The expansion would allow the EC to choose among six regulatory strategies: 1) enact mandatory EU provisions (as was generally done in the past); 2) offer Member States a choice among a finite number of EU-defined options (an approach originally adopted in the Accounting Directives); 3) enact harmonized provisions, but empower Member States to opt-out of them (an approach adopted by the Takeover Bids Directive); 4) enable firms to opt out of applicable Member State provisions by providing substitutable EU provisions (as was also done in the Takeover Bids Directive); 5) adopt EU provisions that firms can opt-out of (which has not been tried yet, but is in line with the flexible approach adopted by the Takeover Bids Directive); and 6) abstain from legislating.[15]

III. Legal Options Framework

Corporate laws around the world provide firms with rules and standards that can be mandatory or simply enabling. Rules can be defined as rather specific prescriptions, whereas standards are more open and give courts more discretion in *ex post* determination of

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[14] See www.allianz.com.

[15] EC reformers could also combine approaches. For example, the Takeover Bids Directive allows Member States to opt-out of its board neutrality and prohibition of defensive measures provisions, while enabling firms incorporated in Member States that do so to opt into the EU regime. Or, to take another example, firms could be allowed to opt-out of their domestic regime not only to escape mandatory provisions, but also when EU law has a standardization advantage over Member State default provisions.

compliance.[16] Mandatory provisions must, by definition, be complied with, whereas enabling provisions can be opted out of (so-called defaults) or are only applicable if opted into (also referred to as menu provisions).

1. Incomplete Statutes and Articles of Association

Corporate law statutes are generally incomplete.[17] This is not merely because lawmakers cannot anticipate all future events or behaviors. Incompleteness may also be due to lawmakers being unable to pass statutory rules in some areas, relying on *ex post* judicial gap filling by adopting standards or simply leaving it to shareholders to incorporate in the articles of association the tailor-made provisions they may need.

Articles of associations and their equivalents (such as charters and by-laws) are incomplete too: some contingencies will be missing, some provisions will be drafted ambiguously. Here again, this is partly due to the inability to foresee and describe all future contingencies. But incompleteness may also reflect information asymmetries and strategic bargaining among the firm's stakeholders.[18]

Additional hindsight is provided by the theory of incomplete contracts.[19] The theory points out that articles of association being incomplete, they are not literally enforceable and thus cannot by themselves resolve disputes. It is therefore crucial to determine who

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[16] See Louis Kaplow, *Rules Versus Standards: An Economic Analysis*, 42 DUKE LAW REVIEW 557 (1992).

[17] See Katharina Pistor and Chenggang Xu, *Incomplete Law - A Conceptual and Analytical Framework and its Application to the Evolution of Financial Market Regulation*, 35 JOURNAL OF INTERNATIONAL LAW AND POLITICS 931 (2003).

[18] See Patrick Bolton and Mathias Dewatripont, CONTRACT THEORY (MIT Press 2005).

[19] See Oliver Hart and John Moore, *Foundations of Incomplete Contracts*, 66 REVIEW OF ECONOMIC STUDIES 115 (1999); Oliver Hart and John Moore, *Property Rights and the Nature of the Firm*, 98 JOURNAL OF POLITICAL ECONOMY 1119 (1990).

among the firm's stakeholders has the "residual right" to rule over issues not anticipated or not specified in full detail by the articles of association.

Corporate laws generally allocate residual rights to shareholders, probably because their marginal contribution to firm performance is harder to assess than for managers, employees, lenders or trade creditors.[20] Such allocation, however, opens other issues. One is that when shareholders have to renegotiate the articles of association to react to unforeseen contingencies, some of them may be able to act opportunistically and obtain more of the *ex post* return on investment. Another issue is managers' ability to opportunistically influence renegotiations and achieve an outcome that favors their rather than shareholders' interests.

Incomplete law and incomplete contract theories allow for a broader understanding of the legal mechanisms required for the optimal production and design of company law. Corporate law statutes can foster efficiency by providing two types of provisions, mandatory and enabling provisions. Mandatory provisions aim at dealing with issues which shareholders are unlikely to solve efficiently due to stakeholder opportunism. Optional provisions have a more enabling function and provide off-the-shelf-solutions for contingencies that 1) are difficult to foresee or 2) shareholders can only deal with through tailor-made articles of association if they are prepared to incur significant information, negotiation and other transaction costs.

It is, obviously, not easy for corporate lawmakers to design and produce the optimal mix of mandatory and optional provisions. Lawmakers are aware of this and generally let firms choose among various sets of corporate forms, each characterized by diverse combinations of mandates and legal options. Unfortunately, mere diversity does not mean that firms will get to pick the corporate form that best satisfies their needs.

Law and economics corporate scholars have devoted

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[20] See Bengt R. Holmstrom and Jean Tirole, *The Theory of the Firm*, in Richard Schmalensee and Robert D. Willig (eds.), HANDBOOK OF INDUSTRIAL ORGANIZATION 61 (Volume I, North-Holland 1989).

considerable attention to the optimal design and content of corporate law statutes. Those who favour a less interventionist, enabling approach, see corporate law as being essentially a set of standardized default provisions which business parties are free to opt out of, should they wish to draft their own set of arrangements. To minimize transaction costs, default provisions should, in most circumstances, reflect what a majority of business parties would have chosen had they considered the question. This "majoritarian" approach is deemed efficient in situations in which transaction costs are high (allowing for an opt-out is less costly than a mandate) as well as in an environment in which transaction costs are low (the majority of business parties does not have to incur the costs of negotiating the explicit default provisions).

The majoritarian approach has sparked intense debate. First, it has been argued that majoritarian defaults are not necessarily efficient as they do not take into account situations in which managers or controlling shareholders have an information advantage (so-called private information) that allows them to act opportunistically.[21] In other words, it would be preferable to supply default provisions that are biased in favour of less informed parties, thus forcing parties with private information to share it if they want to opt into tailor-made provisions they consider more efficient.[22] More specifically, it has been proposed to deal with managerial opportunism by adopting "penalty" default provisions, which err on the side of constraining managers whenever lawmakers are uncertain about which of several default arrangements is more efficient.[23]

Second, it has been claimed that it may be excessively costly to depart from default provisions when it is unusual for articles of

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[21] See Ian Ayres and Robert Gertner, *Strategic Contractual Inefficiency and the Optimal Choice of Legal Rules*, 101 YALE LAW JOURNAL 729 (1992).

[22] See Ian Ayres and Robert Gertner, *Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules*, 99 YALE LAW JOURNAL 87 (1989).

[23] See Lucian A. Bebchuk and Assaf Hamdani, *Optimal Defaults for Corporate Law*, 96 NORTHWESTERN UNIVERSITY LAW REVIEW 489 (2002).

association to include tailor-made opt-outs.[24] In particular, corporations may fear that stakeholders will suspect that an opt-out is hiding some unknown problem and must be regarded as a "trick".[25] Learning effects, network externalities and judicial unfamiliarity with alternatives may also contribute to make it prohibitive to depart from default provisions that are well entrenched.[26]

Third, cognitive distortions (also referred to as "bounded rationality") may contribute to the costs of efficient default. For example, laboratory experiments have shown that individuals may overestimate the advantages of default provisions due to their preferences for the status quo.[27] The validity of these conclusions in a corporate environment and their regulatory implications are not well understood.[28] On the other hand, it has been pointed out that it can be useful to take cognitive distortions into account when designing legal options, as this may permit to improve stakeholders choice or increase the value of the option.[29]

In sum, corporate scholars generally agree that any statutory corporate form should comprise legal options in addition to mandates

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[24] See Lisa Bernstein, *Social Norms and Default Rules Analysis*, 3 SOUTHERN CALIFORNIA INTERDISCIPLINARY LAW JOURNAL 59 (1993).

[25] See Omri Ben-Shahar and John Pottow, *On the Stickiness of Default Rules*, 33 FLORIDA STATE UNIVERSITY LAW REVIEW 651 (2006).

[26] See Marcel Kahan and Michael Klausner, *Standardization and Innovation in Corporate Contracting (or "The Economics of Boilerplate")*, 83 VANDERBILT LAW REVIEW 713 (1997).

[27] See Russel Korobkin, *The Status Quo Bias and Contract Default Rules*, 83 CORNELL LAW REVIEW 608 (1998).

[28] See Jennifer Arlen, Matthew Spitzer, and Eric Talley, *Endowment Effects Within Corporate Agency Relationships*, 31 JOURNAL OF LEGAL STUDIES 1 (2002); Russell Korobkin, *The Endowment Effect and Legal Analysis*, 97 NORTHWESTERN LAW REVIEW 1227 (2003).

[29] See Christine Jolls and Cass R. Sunstein, *Debiasing Through Law*, 35 JOURNAL OF LEGAL STUDIES 199 (2006); Oren Bar-Gill, *Pricing Legal Options: A Behavioral Perspective*, 1 REVIEW OF LAW AND ECONOMICS 205 (2005).

– a view that is supported by practitioners.[30] On the other hand, most commentators emphasize the potential costs of improperly designed default provisions. This conclusion is reinforced by recent empirical work on the impact of non-mandatory provisions in anti-takeover statutes enacted by US states.[31] It appears that those default provisions that favor management are considerably less likely to be opted out of than default provisions that favor investors.

Default provisions are, thus, tricky to devise and may have limited effects.[32] We will, therefore, adopt a cautious approach when it comes to proposing opt-outs – including the "comply or explain" provisions typical of many corporate governance legal regimes.

There is less concern about opt-in provisions. Their adoption requires a pro-active rather than reactive approach, which should reduce the risk of opportunistic use and cognitive distortion effects. In addition, they may reduce the costs of opting out of default provisions by providing a standardized alternative. It follows that we will adopt a more positive approach toward opt-ins.

2. Default and Menu Provisions in EU Company Law

As indicated above, legal options have made significant inroads in EC company law and there are good theoretical reasons for expanding their use given the ever-changing nature of the business environment.

An enabling approach has additional advantages in an EU environment characterized by excessive reliance on mandatory provisions due to a dogmatic approach to EU law-making and inflexible attitudes towards regulatory competition at the Member State level.

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30 See George S. Dallas and Hal S. Scott, MANDATING CORPORATE BEHAVIOR – CAN ONE SET OF RULES FIT ALL? (McGraw Hill 2006).

31 See Yair Listokin, *What Do Corporate Default Rules and Menus Do? An Empirical Examination* (Working Paper 2006, available at ssrn.com).

32 See also Cass R. Sunstein, *Switching the Default Rule*, 77 NEW YORK UNIVERSITY LAW REVIEW 106 (2002).

To begin with, making legal options a mainstream EU regulatory strategy is likely to diminish member government conflicts and increase the value of the EU company law regime. Up to recently, there was mainly one alternative to abstaining from law-making: adopting mandatory corporate law arrangements. As these arrangements were necessarily biased in favor of one set of Member States and did not give business parties the possibility to opt out, law-making was slow and unlikely to produce efficient results.[33] Adding opt-in and opt-out alternatives to the "mandate or abstain" regulatory dichotomy would increase the regulatory choices available to EU lawmakers and decrease the risk of deadlock and inefficient lawmaking.

Moreover, the availability of legal options at the EU level would provide a low cost regulatory mechanism for dealing with both (currently) insufficient and (potentially) excessive regulatory competition at the Member State level.[34] Firms could be given the benefit of directly opting into specific EU provisions, thus being able to opt-out from costly mandatory or sticky default Member State provisions without having to re-incorporate into a friendlier Member State company law regime.

To illustrate this point, EU lawmakers could allow firms to opt into provisions about shareholder standing to sue directors or shareholder ratification of self-dealing (procedural options) or to opt into provisions about director duty of care or shareholder appraisal rights in case of squeeze-outs (substantive options).

Actually, we expect the adoption of specific and directly applicable opt-ins (menu provisions) to become the EU's favored approach. They are less prone to inefficiencies than directly applicable opt-outs. They also are less subject to implementation delays and diversity than options subject to Member State

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[33] See also Erin A. O'Hara, *Opting Out of Regulation: A Public Choice Analysis of Contractual Choice of Law*, 53 VANDERBILT LAW REVIEW 1551 (2000).

[34] See already Lucian A. Bebchuk and Allan Ferrell, *A New Approach to Takeover Law and Regulatory Competition*, 87 VIRGINIA LAW REVIEW 111 (2001).

transposition. In addition, specific opt-ins have a political economy advantage over the enacting of EU corporate forms (in addition to the European Company form). Indeed, such an overall opt-in strategy would generate significant Member State opposition as it would not only produce large scale "vertical" regulatory competition but also facilitate re-incorporations that threaten their labor and tax powers.

To be sure, moving from a "mandate or abstain" to a multiple alternative regulatory approach may also increase (albeit probably only slightly) the chances of deadlock by preventing the emergence of clear Member State majorities. Moreover, as mentioned above, enhancing firm choice could make it more difficult and costly for business parties to ascertain and select the most appropriate provisions.

Finally, while the presumption is that stakeholders tend toward efficient outcomes, it may be necessary for lawmakers who care about efficiency to introduce the conditions which enable the parties to achieve the expected result.[35] In some cases, this will require the creation of stringent mandatory provisions, rather than defaults, in order to constrain opportunistic behavior. Lawmakers would also have to take into account that a legal option approach may result in opportunistic entry or exit.

What emerges from these arguments is the observation that policymakers must, when designing legal options, find the proper balance between mandatory and optional provisions and ensure that parties efficiently use the choices supplied. Table 1 provides an analytical overview of the type of decisions EU law-makers would have to make when designing specific and directly applicable opt-ins or opt-outs.

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[35] See also Ari Hyytinen and Tuomas Takalo, *Corporate Law and Small Business Finance: Mandatory v. Enabling Rules*, 6 EUROPEAN BUSINESS ORGANIZATION LAW REVIEW 449 (2005).

TABLE 1: Designing specific EU legal options

	Prototypical examples	Sample EU opt-in	Sample EU opt-out
Entry rules (Mandatory)	Shareholder decision making Judicial ratification	Proposed by any shareholder Approval by a majority of minority shareholders	Not pertinent as default provisions are applicable unless opted out of
Procedural options	Managerial or shareholder decision making Shareholder standing to sue	One-share-one-vote Shareholder ratification of major or related party transactions Standing to sue for any individual shareholder	
Substantive options	Legal capital Dividends	Minimum legal capital Limited liability for managers or auditors	
Exit rules (Mandatory)	Shareholder decision making Judicial ratification	Proposed by any shareholder Approval by a majority of minority shareholders Appraisal rights	

A few features of the table above are worth pointing out. First, the analytical framework in Table 1 provides good reasons for recommending a cautious approach to fostering the use of legal options within the EU law-making process. It is worth noting that the absence of disclosure options clearly demonstrates that mandatory provisions cannot be eliminated altogether. In addition, Table 1 makes it clear that freedom of choice only has a meaning if mandatory exit and entry provisions prevent managers or controlling shareholders from abusing opt-in or opt-out provisions.

Second, the large range of potential options emphasizes the need for a step-by-step approach to the adoption of new EU legal options. If EU lawmakers were to place substantially more opt-ins or opt-outs on the agenda than needed, they could create the very same

implementation delay and complexity issues than under the mandatory harmonization approach. Moreover, they would run the risk of adopting ill-designed provisions or ending up with excessive legal diversity.

Overall, we argue that adopting pro-choice provisions will prove advantageous to the interests of firms and investors. The opportunity to select specific provisions that firms prefer without having to reincorporate in another Member State is likely to lead to significant cost-savings. These savings are unlikely to be offset due to opportunistic behavior or excessive diversity. First, adopting mandatory entry/exit rules should prevent one constituency (managers, controlling shareholders, minorities) from acting opportunistically. Second, any increase in legal diversity should benefit most European firms as their needs tend to differ across classes. Some firms may suffer higher costs because of reduced standardization, but this should not prove sufficient to outweigh the benefits for other firms.[36] Third, and most importantly, adopting a step-by-step approach, under which a limited number of legal options are tested during an introductory phase, should limit the risk of regulatory inefficiencies or distortions.

IV. Step-by-Step Reform Recommendations

In this section, we develop a set of reform suggestions based on the investigations above. We examine the company law areas that are best suited to mandates and the areas that would benefit, in principle, from legal options. This will permit us to propose a step-by-step approach allowing for early adoption of a limited number of specific legal options. A trial introductory phase would permit benchmarking and testing of their use and potential impact.

1. Mandatory Requirements

As already noted, the introduction of legal options does not eliminate the need for mandatory requirements to address contracting problems

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[36] Erik Berglöf and Mike Burkart, *European Takeover Regulation*, 2003 ECONOMIC POLICY 171 (April 2003).

of firms. A good example is corporate disclosure, an area in which regulatory mandates have significant coordination and standardization advantages. It is also worth emphasizing again that legal options may have to be complemented by mandatory entry or exit rules. Hence, EU opt-in or opt-out provisions would make little sense as a governance mechanism in controlling shareholders environments, unless reinforced by mandatory approval requirements such as minority shareholder or judicial ratification.

In recent years, the EU has adopted a fair number of transparency requirements. Despite the demand for more disclosure and its importance for asset allocations, scholars have questioned the effectiveness of these reforms without the creation of an agency, such as a European SEC, to induce firms to make reliable and accurate disclosure of financial and non-financial information.[37] Since none of the crucial enforcement mechanisms or institutions are likely to be introduced in the short term, it may not make much sense to propose new corporate disclosure requirements that will end up increasing the cost to firms and provide little additional information to investors.

Still, it appears that the mechanism of disclosure is particularly crucial for investors, especially in light of the sequence of increasingly blatant misinformation by public companies (culminating with the Parmalat scandal), and the emphasis given by policymakers to it, despite the absence of effective enforcement bodies, is understandable. Hence, the EU has recently adopted new auditing standards as well as requirements to rotate auditors on a regular basis and to designate a single, fully responsible auditor for groups of companies.[38]

The investor protection value of some of these new reforms may be questioned. For example, even though Italy has been the first (and only) Member State to introduce auditor rotation requirements, it seems that this measure did little to prevent the Parmalat scandal – and may even have contributed to it. On the other hand, imposing

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[37] See Gerard Hertig and Ruben Lee, *Four Predictions about the Future of Securities Regulation*, 3 JOURNAL OF CORPORATE LAW STUDIES 359 (2003).

[38] See Directive 2006/43/EC, [2006] OJ L 157/87.

some level of gatekeeper supervision could reinforce investor confidence and prevent auditor liability from becoming prohibitive.[39] A case can thus be made for new auditing firm regulation that addresses some of the perceived technical shortcomings and the conflicts of interest problems that have contributed to costly governance failures.

Restoring investor confidence having particular appeal in the EU context, it also has led to calls for EU lawmakers to liberalize the barriers to private enforcement.[40] Given the importance of ensuring effective financial reporting and limiting opportunism, lawmakers could simply mandate that all shareholders of firms incorporated in the EU have the right to sue for breaches of shareholder voting rules and for violations of managerial or controlling shareholder fiduciary duties. At the same time, Member States could also be required to establish courts specializing in shareholder litigation, with the French *Tribunal de Commerce*, the German *Handelsgericht* or the Delaware Chancery Court as possible models. Finally, the EU could further introduce reforms leading to the adoption of pre-trial discovery procedures and mass litigation devices such as class actions and contingent fees. Such a shift would build on mechanisms that already exist (in law or in fact) in several Member States and would therefore appear to reinforce and extend upon the institutions that exist in these countries.

Yet there are a number of objections that could be advanced against such proposals. First, there is the view that EU policymakers should address only substantive law issues, leaving the enforcement of company law to Member State law-making. While the case can be made for such a delegation, it is not very persuasive in light of the level of harmful activity and the complexity of the regulatory task. In any event, the European Commission naturally assumes that the

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[39] See Pankaj K. Jain and Zabihollah Rezaee, *The Sarbanes-Oxley Act of 2002 and Security Market Behavior: Early Evidence* (forthcoming in CONTEMPORARY ACCOUNTING RESEARCH, available at ssrn.com); John C. Coffee, *Understanding Enron: "It's About the Gatekeepers, Stupid"*, 57 BUSINESS LAWYER 1403 (2002).

[40] See Gerard Hertig and Joseph A. McCahery, *Company and Takeover Law Reforms in Europe: Misguided Harmonization Efforts or Regulatory Competition*, 4 EUROPEAN BUSINESS ORGANIZATION LAW REVIEW 179 (2003).

need for effective enforcement is a high priority of the EU. Moreover, given the large number of Member State enforcement systems that clash with the fundamental objective of providing equivalent levels of substantive protection across the internal market, EU intervention can be considered compatible with the principle of subsidiarity.[41]

Another, more fundamental, objection is that facilitating private litigation is not necessarily effective or efficient means to curb internal governance abuses. This is a difficult topic to tackle, not least because the evidence is murky. For example, US class actions were much criticized in the early 1990s as the source of abusive law suits against auditors and civil procedure reforms were passed to curtail their effectiveness. Today, these reforms are listed among the top reasons why auditors undertook the more risky and conflicted activities that facilitated the occurrence of corporate scandals in recent years.[42] Or, to take another example, the jury system is often considered a crucial reason why damage awards are larger (and the level of litigation higher) in the US than in Europe. The empirical evidence, however, is mixed.[43] The effect of fees reforms on enforcement levels is still another area where there is no clear direction which could give guidance in the debate. For many years, the law and economics literature has suggested that contingent fees are the fuel that has powered US-type litigation. Conversely, a seemingly innocuous reduction of filing fees was apparently sufficient by itself to cause an impressive increase in shareholder litigation in Japan.[44]

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[41] See Directive 2004/48/EC on the enforcement of intellectual property rights, [2004] OJ L 195/16; Market Abuse Directive 2003/6/EC, [2003] OJ L 96/16.

[42] See Coffee, above footnote 39.

[43] Compare Theodore Eisenberg, Neil LaFountain, Brian Ostrom, David Rottman, and Martin T. Wells, J*uries, Judges, and Punitive Damages: An Empirical Study* 87 CORNELL LAW REVIEW 743 (2002); Joni Hersch and W. Kip Viscusi, *Punitive Damages: How Judges and Juries Perform*, 33 JOURNAL OF LEGAL STUDIES 1 (2004).

[44] Mark D. West, *Why Shareholder Sue: The Evidence from Japan*, 30 JOURNAL OF LEGAL STUDIES 351 (2001).

It would seem that these studies make it difficult to summarily dismiss the efficiency of an EU imposed reduction in enforcement barriers. On the other hand, it cannot be disputed that such a reform presupposes a sophisticated economic analysis of the costs and benefits of the proposed measures and their effect on other provisions as well. More importantly, mandatory enforcement reforms would face fierce opposition by Member States who challenge the facilitation of litigation on political, cultural or even protectionist grounds. In other words, any attempt to impose a reduction in enforcement barriers is likely to face considerable delay or even certain defeat. In short, it would make little sense to propose EU mandatory requirements in this area at this stage.

2. Finite Set of Competing Legal Options

A competing legal options approach of the kind previously adopted by the EC in the case of the accounting directives, permits Member States to choose among a finite set of more or less conservative standards as well as to exempt small to medium-size firms (SMEs) from specific requirements deemed to be too costly. Our analysis suggests that this approach has important beneficial effects. It makes it easier for firms to identify variations in the Member States' rules. There is some evidence, moreover, that enhanced choice will lead Member States to switch to a less demanding regime for SMEs and hence reduce the regulatory burden for this class of firms.

It is worth pointing out, however, that the experience with the accounting directives has been far from successful. Whilst there are a number of factors responsible, it seems likely that the problems may be primarily due to the options being designed to deal with regulatory concerns other than efficiency. More generally, the experience tends to confirms that it is generally a mistake to impose a fixed menu of options from the top. On the one hand, standardization benefits are significantly reduced, as there is no single set of EU provisions that firms and investors can rely upon. On the other hand, harmonization costs are likely to increase.

An additional key point is that adopting a finite set of competing legal options will reduce Member States willingness to compromise, as they have good reasons to hope that a hard stance will insure the

adoption of an option that is close to their own preferences. Unfortunately, the likely result will be a set of options which has few benefits and thus all the more difficult to justify. In addition, the existence of multiple options should increase the petrifaction effect, as amendments would have to be coordinated and should thus be more difficult to pass than when there is only one mandate or one legal option.

The potential weakness of the finite set of competing legal options approach suggest that it is not ideally suited to the current institutional and political environment and hence should not be considered an appropriate mechanism for first step company law reforms.

3. Opting-out of EU Provisions

It was argued earlier that an opting-out approach is more efficient than a mandates approach, particularly where there are significant variations in company law regimes across Member States. In such a situation, a single set of EU mandatory provisions would have a different impact in each Member State, with many firms incurring costs far in excess of standardization and other benefits. For example, differences in the use of the open corporate form by smaller firms and shareholder ownership regimes (dispersed or concentrated) can considerably affect the efficiency of director independence mandates.

By contrast, permitting Member States or firms to op out of EU provisions should eliminate most of the costs due to a "one-size-fits-all" approach. Unsurprisingly, this is particularly relevant in light of the debate on shareholder voting. The EC has recently announced plans to introduce legislation that would mandate one-share-one-vote. Most studies indicate that, within the EU, there are voting systems in which blockholders enjoy all or most of the private benefits as a consequence of their use of dual-class stock, non-voting ownership certificates, trust companies, and other cash-flow rights.[45] However, there are significant differences in voting systems and impact across

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[45] Joseph A. McCahery,, Luc Renneboog, Peer Ritter and Sascha Haller, THE ECONOMICS OF THE PROPOSED TAKEOVER BIDS DIRECTIVE (Centre for European Policy Studies 2003).

EU Member States.[46]

Given this diversity, an important question arises regarding whether shareholders would support a EU proposal where there is some uncertainty about its potential outcome. Indeed, there are intricate economic arguments in respect of the efficiency of the one-share-one-vote rule. On the one hand, deviations from the rule may decrease controlling shareholders' cost of capital and possibly increase takeover efficiency. On the other hand, the issuance of dual class voting shares may facilitate the transfer of resources from the company to a large shareholder and lead to the oppression of minority shareholders. Thus, shareholders have to take account of a large number of factors in determining what capital structure can be expected to produce the highest value. This is a complex firm-specific undertaking, and shareholders may prefer having a one-share-one vote regime that they can opt out of rather than having it imposed upon them.

This one-share-one-vote example is not meant to imply that opt-outs are costless. First, as indicated, stickiness may prevent firms from opting out of all but the most costly EU default provisions. Stickiness costs may, however, be reduced by adopting EU provisions that are tilted in favor of shareholders (so-called penalty defaults). Second, allowing opt-outs reduces the standardization advantage of EU law-making, especially when domestic corporate law regimes vary significantly. On the other hand, this is precisely the situation where Member States are likely to oppose or delay mandatory harmonization, but agree on opt-out provisions. Indeed, member government opposition to EU law-making should remain relatively light when they themselves are allowed to opt-out.[47] Naturally, opposition could be more significant when firms also have the right to opt-out, but this may be mitigated by combining Member State opt-out powers and firms' right to opt back into EU law.

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[46] Deminor Ratings, APPLICATION OF THE ONE-SHARE-ONE-VOTE PRINCIPLE IN EUROPE (2005).

[47] Opposition will not necessarily be inexistent, as some Member States may fear that the adoption of EU provisions may make opt-outs unsustainable in the long-term.

That said, many studies indicate that it would be efficient for the EU to adopt legal provisions with opting-out possibilities in various areas of company law. First, such an approach could enable Member States to opt-out of controversial provisions such as the Takeover Directive's equitable price, squeeze-out and sell-out provisions. Second, new firms could be subject to one-share-one-vote, no staggered boards, no voting caps, no pyramid structures requirements, but allowed to opt-out in favor of the regime of the Member State they are incorporated in – the latter limitation aiming at insuring some degree of uniformity and transparency. Third, shareholders of both new firms and firms established in new Member States could be recognized standing to sue for breaches of shareholder voting rules and violations of fiduciary duties, but allowed to opt-out in favor of the regime of the Member State in which they are incorporated. (By contrast, established firms in pre-2004 Member States could be permitted to opt into such a regime.)

At this stage, however, there are several cautions against the increased use of opt-out provisions in such a broad array of corporate law subjects. Adopting such measures in practice could place too many items on the reform agenda, thereby creating the very same delay in implementation that has arisen under the Commission's mandatory company law harmonization program. At the same time, as indicated, opt-outs can also be costly. From a step-by-step approach perspective, it is thus appears preferable to start testing the advantages of legal option by adopting opt-ins.

4. Opting into EU Provisions

EU intervention could also increase firms' choice while avoiding re-incorporation issues by supplying firms with selective opt-in provisions that allow them to opt out of specific Member State provisions – as opposed to the full opt-out brought by re-incorporation.

An EU opt-in regime can be cost-effective to the extent it provides firms with a small menu of provisions, lowering transaction costs and increasing the degree of standardization and, therefore, legal certainty. Firms may also be better served by opt-ins that credibly signal a commitment to comply with state-of-the-art

regulation. Another important factor is that opt-in provisions can be useful for companies that must address legal difficulties, such as workers' participation requirements.

The opt-in approach, however, may also be compelled by political expediency. Subjecting an EU opt-in proposal on related party transactions, for instance, to a shareholder vote would have no impact in terms of constraining controlling shareholder opportunism – but still looks better than forgoing any intervention. Member States may also favor opt-in provisions to prevent the adoption of more efficient opting-out provisions. A potential example is a proposal on dividend rights for minority shareholders. Likewise, Member States could support opt-in provisions because they deem them likely to increase legal diversity and either make it more difficult for investors to ascertain the costs of their domestic regime or increase their own corporate law's stickiness.

It follows that, under certain conditions, the adoption of opt-in provisions could prove to be less-cost-effective than expected. Overall, it seems likely that the benefits of an opt-in approach will generally exceed its costs in areas where Member States have adopted costly mandatory provisions that cannot be dismantled through mandatory or opt-out EU intervention. In addition, the opt-in approach should be an appropriate one in areas where Member State law is diverse, but standardization or "best practice" signaling is important for investors or stakeholders.

Opt-ins seem particularly suited for dealing with Member State mandatory provisions on employee participation structures, multiple voting and dividend rights, as well as on various takeover issues (board neutrality, mandatory bid thresholds and exit prices). As indicated, EU mandatory entry requirements might, in some cases, be required to complement such opt-in arrangements, both to prevent Member States from opposing their adoption and to minimize managerial and shareholder opportunism. Thus, opting into EU employee participation provisions could, for instance, be made subject to court ratification. Similarly, opting into EU multiple voting and dividend rights provisions or into EU mandatory bid thresholds and exit prices might be made subject to qualified majority or minority shareholder approval.

As far as standardization and signalization are concerned, new firms or firms incorporated in new Member States should benefit from opt-in provisions that establish simple and transparent procedures for the disclosure and approval of related party transactions (be it self-dealing, compensation agreements, or the appropriation of corporate opportunities).

Finally, the opt-in approach could serve a pro-enforcement function. Under this approach, existing firms in "old" Member States would be encouraged to choose litigation arrangements. To be sure, managers or controlling shareholders may resist such a move, fearing a reduction of their private benefits due to minority shareholder litigation. However, it may not even be necessary to give the majority of minority shareholders power to exercise the opt-in option for it to be effective. As recent events have shown, managers or controlling shareholders may endorse an opt-in measure, to the extent it provides a civil enforcement alternative to criminal investigations and sanctions.

V. Conclusion: The Future of the Pro-Choice Approach

The preceding discussion illustrates that it might be feasible in the near term for the EU to adopt a legal options approach to company law. On the other hand, the EU's experience with legal options could prove short lived if it cannot quickly develop a feasible role for them. Should options fail to meet their targets, one may envisage that the Commission may simply roll back the optional regime and revert to a mandatory approach – especially if the switch has the support of a law-making majority comprising Member States and members of the European Parliament opposed to regulatory arbitrage and competition.

In this case, however, it may be difficult for policymakers to limit the momentum of the pro-choice movement that has been opened-up by the ECJ's freedom of establishment judgments. First, it is well established that legislative attempts to counter major case law developments are usually unsuccessful.[48] Even if it is not unusual to

[48] Robert D. Cooter and Tom Ginsburg, *Comparative Judicial Discretion*, 16 INTERNATIONAL REVIEW OF LAW AND ECONOMICS 295 (1996).

see diverging positions gradually erode toward a common middle ground, this process is time-consuming and firms are unlikely to remain idle throughout the convergence process. Second, access to the pro-freedom path is now substantially controlled by the judiciary and pro-choice Member States, and is therefore largely outside the reach of a political alliance comprising the European Commission and anti-choice constituencies.

Moreover, it seems likely that Member States and interest groups opposed to regulatory arbitrage and competition may find it preferable to "guide" firms' legal regime strategies through pro-choice EU legislation rather than engage in less effective mandatory harmonization exercises. Indeed, given the mentioned history of slow legislative reaction to major case law developments and continued diversity of national governance regimes, one should expect years of intergovernmental negotiations on the possible terms of new mandatory measures. While generally accepted by parties in the past, this cumbersome process is unlikely to prove sustainable in the face of continuing regulatory arbitrage and competition.

While it is difficult to predict with certainty, it is foreseeable that the pro-choice approach will become a mainstream regulatory strategy, as such an approach provides the best mechanism for successfully adopting and implementing "essential" legislation. This prediction is reinforced by a variety of other considerations. A review of the legislative history of the Takeover Bids Directive suggest that the key institutional actors within the EU have already recognized that there is no longer one single approach to regulatory design in corporate law. Pro-choice arrangements are becoming a favored mechanism to secure benefits in unrelated areas (e.g. trading temporary workers legislation against takeover provisions), to target regulatory beneficiaries (e.g. by allowing sophisticated capital market players to opt out of investor protection provisions) or to facilitate the EU enlargement process (e.g. by permitting firms in new Member States to signal their commitment to "best practice" by opting into EU corporate law provisions). Thus, while options may not in themselves always create efficiency, they are crucial for parties to bargain to such conclusions and can play an important role in promoting the goals of economic integration.

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