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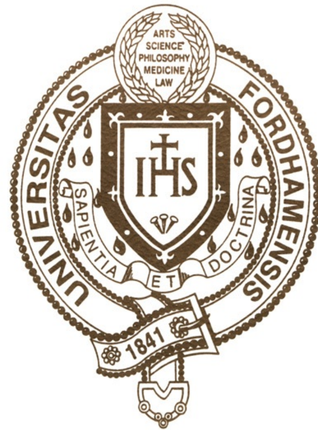

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"Tilting the Balance Between Capital and Labor? The Effects of Regulatory Arbitrage in European Corporate Law on Employees"

By

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Abstract

This Article examines the consequences of regulatory arbitrage in European corporate law on the position of employees. Two innovations of secondary EU law, namely the possibility to create a European Company ("SE") out of existing firms and the Directive on Cross-Border Mergers, have made regulatory arbitrage with respect to employee involvement in existing firms possible. While these instruments require the merging firms to negotiate with employees about their representation rights as a precondition to the merger, a closer analysis of the law and recent experience show that the protection accorded to existing employee participation systems is incomplete. There can be little doubt about some potential advantages of regulatory arbitrage, such as the possibility to avoid excessive regulation. However, the possibility of an "erosion" of employee participation systems (such as codetermination) undermines their economic function, which is to foster long-term commitment. This Article takes a broad view on the role of labor in corporate governance and also addresses other mechanisms affected by regulatory arbitrage opportunities that are potentially relevant for the position of employees, such as the degree to which management is directly or indirectly influenced by shareholders, and directors' duties in general and in takeovers in particular. It suggests that controlling shareholders, whose presence characterizes corporate governance structures in much of Europe, are in a good position to exploit arbitrage opportunities to the disadvantage of other groups, including labor.

Keywords: regulatory competition, codetermination, Centros, EU company law
JEL Classifications: G34, K22, K31, L23

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TILTING THE BALANCE BETWEEN CAPITAL AND LABOR? THE EFFECTS OF REGULATORY ARBITRAGE IN EUROPEAN CORPORATE LAW ON EMPLOYEES

*Martin Gelter**

INTRODUCTION

Ten years after the European Court of Justice's ("ECJ") seminal *Centros* decision,[1] which ushered in a series of cases that now allow firms to choose their country of registration regardless of the location of their business activities, regulatory competition in European corporate law has still not come of age. True, *Centros*, *Überseering*,[2] and *Inspire Art*[3] have collectively transformed European corporate law into a transnational field of research and triggered a debate about regulatory competition. Some scholars have optimistically argued that the ECJ has ushered in an era of a race to the top in the European Union ("EU"), meaning that the forces of competition will coerce member states to optimize their laws.[4] Others have, justifiably, expressed doubt as to whether there will be much, if any, regulatory competition.[5] Some have

* Associate Professor, Fordham University School of Law, and Research Associate, European Corporate Governance Institute. For comments and discussion of prior versions of this article I would like to thank Roger Goebel, Reinier Kraakman, Mark Roe, and Tobias Tröger.

1. Centros Ltd. v. Erhvervs-og Selskabsstyrelsen, Case C-212/97, [1999] E.C.R. I-1459.

2. Überseering BV v. Nordic Constr. Co. Baumanagement GmbH (NCC), Case C-208/00, [2002] E.C.R. I-9919.

3. Kamer van Koophandel en Fabrieken voor Amsterdam v. Inspire Art Ltd., Case C-167/01, [2003] E.C.R. I-10155.

4. *See, e.g.*, STEFANO LOMBARDO, REGULATORY COMPETITION IN COMPANY LAW IN THE EUROPEAN COMMUNITY: PREREQUESITES AND LIMITS (2002); John Armour, *Who Should Make Corporate Law? EU Legislation* versus *Regulatory Competition*, 58 CURRENT LEGAL PROBS. 369 (2005); Jens C. Dammann, *Freedom of Choice in European Corporate Law,* 29 YALE J. INT'L L. 477 (2004).

5. *See, e.g.*, Luca Enriques, *EC Company Law and the Fears of a European Delaware,* 15 EUR. BUS. L. REV. 1259 (2004).

taken mixed or skeptical positions.[6] At the very least, the notion that any member state could establish itself as a fully-fledged "European Delaware" is probably deemed unlikely by the majority of scholars.[7]

So far, the academic literature has focused mostly on the long-term consequences within the triangle between investors, large shareholders, and managers. In practice, legal issues relating to corporate creditors have been the main driver of regulatory arbitrage.[8] The incorporation of thousands of newly-founded firms in a particular jurisdiction, typically England, that intend to be active primarily in another one, in many cases Germany,[9] is said to undermine the capital maintenance and creditor protection systems in countries that import the corporate law of a more liberal corporate law.[10] Some recent reforms to legal capital and other policies intended to protect creditors have been identified as a form of "defensive" regulatory competition—measures attempting to prevent economic entities from incorporating elsewhere that are intended to do business in

6. *See, e.g.*, Martin Gelter, *The Structure of Regulatory Competition in European Corporate Law,* 5 J. CORP. L. STUD. 247 (2005); Tobias H. Tröger, *Choice of Jurisdiction in European Corporate Law: Perspectives of European Corporate Governance,* 6 EUR. BUS. ORG. L. REV. 3, 6 (2005).

7. *See, e.g.*, Enriques, *supra* note 5; *see also, e.g.*, Gelter, *supra* note 6, at 253–64; Tröger, *supra* note 6, at 5–6.

8. *See, e.g.*, Luca Enriques & Martin Gelter, *How the Old World Encountered the New One: Regulatory Competition and Cooperation in European Corporate and Bankruptcy Law,* 81 TUL. L. REV. 577, 612–13 (2007).

9. *See* Udo Kornblum, *Bundesweite Rechtstatsachen zum Unternehmens- und Gesellschaftsrecht, Stand 1.1.2008* [*Nationwide Facts on Business and Corporate Law, as of 1.1.2008*], 100 GMBH-RUNDSCHAU [GMBHR] 25, 31 (2009) (F.R.G.) (estimating roughly 15,000 limited liability companies in Germany as of year-end 2007). *See generally* Marco Becht et al., *Where Do Firms Incorporate? Deregulation and the Cost of Entry,* 14 J. CORP. FIN. 241 (2008) (providing empirical data on the basis of the residence of directors).

10. *Centros* and its progeny have triggered an intense academic debate about creditor protection rules, which are thought to be more important in Europe than in the United States. *See generally* LEGAL CAPITAL IN EUROPE. ECFR SPECIAL NO. 1 (Marcus Lutter ed., 2006); THE LAW AND ECONOMICS OF CREDITOR PROTECTION: A TRANSATLANTIC PERSPECTIVE (Horst Eidenmüller & Wolfgang Schön eds., 2008) (analyzing the merits of legal capital from various perspectives); Luca Enriques & Jonathan R. Macey, *Creditors Versus Capital Formation: The Case Against the European Legal Capital Rules*, 86 CORNELL L. REV. 1165 (2001) (criticizing legal capital as inefficient); Peter O. Mülbert & Max Birke, *Legal Capital – Is There a Case against the European Legal Capital Rules?*, 3 EUR. BUS. ORG. L. REV. 695 (2002) (same).

the member state where these legislative measures are taken.[11] However, these creditor protection mechanisms are usually an impediment only to the formation of new firms, which is why "defensive" regulatory competition primarily affects just these new businesses.[12]

This Article examines an issue of regulatory competition that seems to be of greater interest for the corporate governance of large, publicly traded firms: the position of employees. EU member states offer a wide spectrum of different systems of mandatory "employee participation," under which a firm's employees enjoy representation on a corporation's board of directors. The two recent innovations of secondary EU law that

11. A recent German reform can be clearly identified as motivated by regulatory competition. The Gesetz zur Modernisierung des GmbH-Rechts und zur Bekämpfung von Missbräuchen [Act to Modernize the GmbH Laws and Combat Abuse], Oct. 23, 2008, BGBl. I at 2026, takes various measures to facilitate the formation process for the limited liability company, or *Gesellschaft mit beschränkter Haftung* ("GmbH"), and introduces the entrepreneur corporation, or *Unternehmergesellschaft*, which is not subject to the minimum capital requirement, but does require all business entities taking this form to use the designation "*Unternehmergesellschaft (haftungsbeschränkt)*" or simply "*UG (haftungsbeschränkt)*" in its name. *See id.*, § 5(a). For a detailed description of the German reform, which does not take the final version into account, see William W. Bratton et al., *How Does Corporate Mobility Affect Lawmaking? A Comparative Analysis*, 57 AM. J. COMP. L. 347, 381–82 (2009). The protocols of the parliamentary debate clearly show, as do previous proposals for the law, that the motivation for the enactment of this reform was competition among jurisdictions and the influx of firms incorporated in England, notwithstanding their high rates of failure. *See* Erklärung von Sabine Zimmermann [Statement of Sabine Zimmermann], Deutscher Bundestag Drucksache [BTDrucks] 16/172, at 18196 (quoting Doctor Jürgen Gehb as stating that "we are standing in European competition, not only regarding the production of goods and services, but also with respect to legal systems and legal forms. We accept this competition. We want to and have to win it."); Entwurf eines Gesetzes zur Modernisierung des GmbH-Rechts und zur Bekämpfung von Missbräuchen (MoMiG) [Draft Act to Modernize the GmbH Laws and Combat Abuse (MoMiG)], BTDrucks 16/6140, at 56 (the original government draft explicitly stating that the "GmbH should remain internationally competitive"). Similarly spirited Dutch and Austrian projects are looming on the horizon. *See, e.g.*, Bratton et al., *supra*, at 31, 34–36 (discussing the planned Dutch reform); REPUBLIK ÖSTERREICH [REPUBLIC OF AUSTRIA], REGIERUNGSPROGRAMM [GOVERNMENT PROGRAM] 2008–2013, at 138–39 (2008), at http://www.austria.gv.at/DocView.axd?CobId=32965 (declaration by the Austrian government announcing, among many other things, that minimum capital will be reduced during the current legislative period).

12. The fact that new businesses have made use of the freedom of incorporation in some countries far more than in others also seems to be influenced by administrative burdens or even blatant ignorance of the European Court of Justice ("ECJ") case law that the authorities in some states impose on setting up a branch office. *See* Marco Becht et al., Centros *and the Cost of Branching*, 9 J. CORP. L. STUD. 171 (2009) (reporting on branching costs of several thousand Euros in Italy and a complete disregard of the *Centros* decision in Greece).

permit the formation of the European Company—*Societas Europaea* ("SE")—and the cross-border merger at first seem to limit the ability for corporate law arbitrage relating to this group by requiring the merging firms to negotiate with employees about their representation rights as a precondition to the merger. However, this Article emphasizes that this protection is incomplete, and that the structure imposed by these directives subverts the basic premises, and potential economic functionality, of employee participation systems. Specifically, the regulatory arbitrage[13] driven by controlling shareholders can have negative effects for employees going beyond employee participation systems in firms that have operated for decades.[14] The economic function of employee participation systems, to foster long-term commitment, is undermined by the inability of shareholders to commit to a particular regime. An analysis of the position of employees would not be complete if it were restricted to participation systems. This Article therefore also addresses other potentially relevant mechanisms affected by regulatory arbitrage opportunities, particularly the degree to which management is directly or indirectly influenced by shareholders. The Article suggests that controlling shareholders, whose presence characterizes corporate governance structures in much of Europe, are in a good position to exploit arbitrage opportunities to the disadvantage not only of minority investors, but also of employees.

The Article proceeds in three parts. Part I sets out the basic premise of the analysis by describing why employees may be

13. This Article prefers the terms regulatory choice and regulatory arbitrage over regulatory competition. This is because, as previously noted, the evidence for actual regulatory competition of member states actively seeking re-incorporation remains scarce. The most interesting national reaction to regulatory arbitrage so far is a recent proposal by a group of German law professors to allow German companies to negotiate with employees about the introduction of a flexible employee participation system comparable based on the same negotiation mechanism that is required for the formation of a European Company (*Societas Europaea* ("SE")) or a cross-border merger. *See* Arbeitskreis "Unternehmerische Mitbestimmung", *Entwurf einer Regelung zur Mitbestimmungsvereinbarung sowie zur Größe des mitbestimmten Aufsichtsrats* [*Draft Rules on Codetermination Agreement and the Size of the Supervisory Board Codetermination*], 2009 ZEITSCHRIFT FÜR WIRTSCHAFTSRECHT [ZIP] 885 (F.R.G.). For purposes of this Article, regulatory arbitrage will mean that the involved parties make deliberated choices about the law.

14. *See* Daniel Komo & Charlotte Villiers, *Are Trends in European Company Law Threatening Industrial Democracy?*, 34 EUR. L. REV. 175, 192–93 (2009) (discussing the effects of incorporation choice of small firms on employee involvement).

relevant to the corporate governance structure. This Part will briefly draw on economic theory to explain why, at least under certain circumstances, it can be beneficial to create an institutional structure that facilitates long-term commitment between firms and their employees. Part II identifies aspects of European corporate law that are relevant to labor and corporate law arbitrage opportunities. After delineating the scope of regulatory arbitrage, this Part describes the three main issues that surround regulatory arbitrage. The most important of these are employee participation systems, which give employee representatives a say in corporate governance. The second issue relates to the controversial issue of directors' duties, with special attention to the extent that directors may defend against hostile takeovers. A third and often overlooked issue is the degree to which directors are independent from shareholder intervention. Finally, Part III presents the core of the analysis by describing the economic consequences of ex ante and ex post regulatory choice. Regulatory arbitrage provides the advantages of increased flexibility and possibilities to avoid some obviously inefficient regulation. On the other hand, mechanisms that may help to foster long-term commitment of firm employees are undermined by ex post arbitrage opportunities because of shareholders inability to permanently commit to a particular system. This Article argues that employee participation systems are at risk, in spite of the arbitrage limitations set by secondary EU law.

I. *WHY BOTHER ABOUT EMPLOYEES IN CORPORATE LAW?*

It is tempting to argue that employees play an insignificant role in corporate law arbitrage. After all, the contractarian approach, which predominates in academic analysis of corporate law, presumes that nonshareholder constituencies of the firm have their rights specified by contract, which is why they are said to not bear a risk comparable to that of shareholders.[15] However,

15. *See* FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 11 (1991) (describing shareholders as the bearers of the greatest risk); Lyman Johnson, *Corporate Law Professors as Gatekeepers*, 6 U. ST. THOMAS L.J. 447, 449 (2009) (identifying shareholder wealth maximization as the goal of corporate law according to the majority of scholars). Creditors are sometimes considered an exception to this theory, even by those that endorse the shareholder primacy view. *See, e.g.*, Henry Hansmann & Reinier Kraakman, *The End of History for Corporate Law*, 89 GEO. L.J. 439, 443 (2001). The rationale behind this exception is that creditors suffer the downside

much of the literature on the theory of the firm now considers the assumption of complete contracts to be an oversimplification that carries with it analytical limitations;[16] other firm constituencies may also be exposed to risk because of firm-specific investment by these groups. Most important to this Article, workers often make such an investment by acquiring skills that are only useful within their current employment relationship.[17] This type of investment may initially be costly to acquire, but it allows employees to gain quasi rents in the course of the relationship with the firm. As a result, the productive process of the firm may sometimes improve, thus increasing the total corporate "pie," either because of productivity increases or because skilled workers can be motivated to take on the job (for instance, due to moving costs).[18]

The traditional agency view of corporate law assumes employee investment to be fully protected by contract, which is

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risk when the company approaches insolvency. *See* Stewart C. Myers, *Determinants of Corporate Borrowing*, 5 J. FIN. ECON. 147, 164–70 (1977). Both U.K. and U.S. law has therefore developed doctrines suggesting that directors have duties towards creditors in the vicinity of insolvency. *See, e.g.*, Geyer v. Ingersoll Publ'n Co., 621 A.2d 784 (Del. Ch. 1992); Credit Lyonnais Bank Neth., N.V. v. Pathe Commc'n Corp., Civ. A. No. 12150, 1991 WL 277613, at 34 n.55 (Del. Ch. Dec. 30, 1991); W. Mercia Safetywear Ltd. v. Dodd, [1988] B.C.L.C. 250 (Eng.). *But see* N. Am. Catholic Educ. Programming Found., Inc. v. Gheewalla, 930 A.2d 92 (Del. 2007) (denying *direct* fiduciary claims against directors by creditors and limiting these duties to situations where the firm is already insolvent).

16. *See, e.g.*, Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247, 249–50 (1999).

17. *See, e.g.*, HENRY HANSMANN, THE OWNERSHIP OF ENTERPRISE 26 (1996); John Armour & Simon Deakin, *Insolvency and Employment Protection: The Mixed Effects of the Acquired Rights Directive*, 22 INT'L REV. L. & ECON. 443, 445–46 (2002); Larry Fauver & Michael E. Fuerst, *Does Good Corporate Governance Include Employee Representation? Evidence from German Corporate Boards*, 82 J. FIN. ECON. 673, 679 (2006); Gavin Kelly & John Parkinson, *The Conceptual Foundations of the Company: A Pluralist Approach*, *in* THE POLITICAL ECONOMY OF THE COMPANY 113, 123–27 (John Parkinson et al. eds., 2000); David Kershaw, *No End in Sight for the History of Corporate Law: The Case of Employee Participation in Corporate Governance*, 2 J. CORP. L. STUD. 34, 42–46 (2002); *see also* James M. Malcomson, *Individual Employment Contracts*, *in* 3B HANDBOOK OF LABOR ECONOMICS 2291, 2330–33 (Orley Aschenfelter & David Card eds., 1999) (reviewing the labor economics literature on contractual protection of specific investment).

18. *See, e.g.*, EIRIK G. FURUBOTN & RUDOLF RICHTER, INSTITUTIONS AND ECONOMIC THEORY 232 (2d ed. 2005); *see also* ANNALEE SAXENIAN, REGIONAL ADVANTAGE: CULTURE AND COMPETITION IN SILICON VALLEY AND ROUTE 128, at 135 (1994) (quoting a Texas engineer as describing career mobility as the norm following the advent of Silicon Valley).

why many describe employees as avoiding residual risk.[19] However, real-life contracts are not normally "complete contingent" agreements.[20] The transaction cost necessary to anticipate every improbable state of the world would exceed the potential welfare gains from incorporating such provisions into the contract. Being subject to bounded rationality, parties might be unable to foresee possible contingencies and to process the information they receive because of cognitive limitations.[21] More specifically, economic theory suggests that it is in many cases impossible to make human capital investment a condition of an enforceable contract, because courts will often be unable to determine whether an employee has made the specified amount of relationship-specific investments.[22] It follows that employees whose future gains from the continued employment relationship are not protected against opportunism from other corporate constituencies (particularly controlling shareholders, who typically hold an ex post interest to maximize stock value) will avoid making specific investment in the first place. Even in corporate finance, the "purely financial" view of corporate governance no longer dominates entirely. In the latest edition of their leading textbook, Brealey, Myers, and Allen note that "managers and employees of a firm are investors, too . . . . If you give financial capital too much power, the human capital doesn't show up—or if it does show up, it won't be properly motivated."[23] By going public, stockholders can commit "not to interfere if managers and employees capture private benefits when the firm is successful."[24] In other words, one economic function of the

19. *See, e.g.*, EASTERBROOK & FISCHEL, *supra* note 15, at 10–11.

20. A complete contingent contract would require stipulations for payoffs to all parties under every single possible state of the world, however unlikely. *See, e.g.*, Alan Schwartz, *Incomplete Contracts*, *in* 2 THE NEW PALGRAVE DICTIONARY OF ECONOMICS AND THE LAW 277, 277 (Peter K. Newman ed., 1999).

21. The idea of "bounded rationality" is attributed to Herbert Simon. *See* Herbert Simon, *A Behavioral Model of Rational Choice*, 69 Q.J. ECON. 99, 104 (1955); *see also* OLIVER HART, FIRMS, CONTRACTS AND FINANCIAL STRUCTURE 81 (1995); OLIVER E. WILLIAMSON, THE ECONOMIC INSTITUTIONS OF CAPITALISM 45–46 (1985); Christine Jolls, Cass R. Sunstein & Richard Thaler, *A Behavioral Approach to Law and Economics*, 50 STAN. L. REV. 1471, 1477 (1998).

22. *Cf.* FURUBOTN & RICHTER, *supra* note 18, at 233 (defining the terms "verifiable" and "observable"); HART, *supra* note 21, at 37–38 n.15 (same).

23. RICHARD A. BREALEY, STEWART C. MYERS & FRANKLIN ALLEN, PRINCIPLES OF CORPORATE FINANCE 949 (8th ed. 2006).

24. *Id.* at 949 n.36.

publicly traded firm may be to serve as a nexus for specific investment.

It is unnecessary to address the issue of what degree of specific human capital investment is important in particular corporate governance systems. Nevertheless, the various aspects of corporate law discussed in Part II are likely to influence whether employees have incentive to invest. Moreover, the impact of regulatory arbitrage opportunities on the shareholder–employee relationship are of interest even if one does not follow the specific-asset theory of human capital because the utility derived from employees may be of interest from a distributive perspective.[25] A particular corporate governance structure in any given country is likely to be an equilibrium result of bargaining on the political level and the outcome of historical path dependence. As such, it may, in any given society, gain wide acceptance as a balanced solution tolerable to the relevant interest groups.[26] Regulatory arbitrage creates possibilities to modify this outcome without universal assent or at least an open debate that probably most would prefer to have about such an important issue of social and economic governance.

II. *CORPORATE LAW ARBITRAGE OPPORTUNITIES AFFECTING EMPLOYEES*

In order to analyze regulatory arbitrage opportunities, it is necessary to delineate the extent to which corporate law affects the relationship between a firm and its employees. Part II.A identifies issues that are potentially subject to regulatory arbitrage, and Part II.B will study the effects that these issues are likely to have on employees.

25. *Cf.* Luigi Zingales, *Corporate Governance*, *in* 1 THE NEW PALGRAVE DICTIONARY OF ECONOMICS AND THE LAW, *supra* note 20, at 497, 498 (defining corporate governance "as the complex set of constraints that shape the ex-post bargaining over the quasi-rents generated by the firm").

26. *See generally* Mark J. Roe, *Backlash*, 98 COLUM. L. REV. 217 (1998) (arguing that economically efficient policy choices may not be sustainable because of political backlash); MARK J. ROE, POLITICAL DETERMINANTS OF CORPORATE GOVERNANCE (2003) (developing a theory of comparative corporate governance focusing on the role of past political choices that may have been economically inefficient, but necessary to achieve social peace).

A. *Delineating the Scope of Employee-Related Regulatory Competition*

The primary fields of law governing the employee-firm relationship would seem to be employment and labor law, which are not objects of regulatory competition in corporate law. Under the new European regulation on the law applicable to contractual obligations, colloquially known as the Rome I Regulation, employment contracts are normally governed by the law of the jurisdiction where the employee "habitually carries out his work in performance of the contract", even "if he is temporarily employed in another country."[27] If no such country can be identified, the contract is governed "by the law of the country where the place of business through which the employee was engaged is situated."[28] Other laws apply only when it can be shown that "the contract is more closely connected with" another country.[29] While the Regulation allows for choice of law,[30] the latter may not deprive the employee of mandatory protection accorded to him under the otherwise applicable default law.[31] Rights collectively held by employees, such as the right to establish works councils, and the specification of their rights and competences, typically depend on the location of the business establishment.[32] In fact, EU law requires large transnational firms with a cross-border scope of activities to permit the establishment

27. Council Regulation on the Law Applicable to Contractual Obligations (Rome I), No. 593/2008, art. 8(2), 2008 O.J. L 177/6.

28. *Id.* art. 8(3).

29. *Id.* art. 8(4).

30. *See id.* art. 3.

31. *See id.* art. 8(1). For a more detailed discussion of the equivalent predecessor provisions of these rules in the former Rome I convention, see SIR PETER NORTH & J.J. FAWCETT, CHESHIRE AND NORTH'S PRIVATE INTERNATIONAL LAW 208–10 (13th ed. 2004). *See also* Sebastian Krebber, *Conflict of Laws in Employment in Europe*, 21 COMP. LAB. L. & POL'Y J. 501, 522–29 (2000).

32. *See* Krebber, *supra* note 31, at 538–39. For a German perspective, see Rolf Birk, *in* 1 MÜNCHENER HANDBUCH ZUM ARBEITSRECHT [MUNICH HANDBOOK ON EMPLOYMENT AND LABOR LAW] § 22 , cmts. 5–6 (Reinhard Richardi & Otfried Wlotzke eds., 2d ed. 2000) (F.R.G.) (explaining the principle of territoriality), and Dieter Martiny, *in* 10 MÜNCHENER KOMMENTAR ZUM BÜRGERLICHEN GESETZBUCH [MUNICH COMMENTARY ON THE CIVIL CODE] EBGBG art. 30, cmts. 129–36 (Kurt Rebmann et al. eds., 4th ed. 2006) (F.R.G.) (same). For a French perspective, see PIERRE MAYER & VINCENT HEUZÉ, DROIT INTERNATIONAL PRIVÉ [PRIVATE INTERNATIONAL LAW] 553–54 (9th ed. 2007) (Fr.) (pointing out that collective rights of employees necessarily depend on territoriality and mentioning a case where an international firm had to permit a works council in its French operations).

of a European Works Council.[33] A 2002 directive further requires member states to implement information and consultation systems for employee representatives in other firms that exceed a minimum size, while leaving to national law the question regarding how employees should be represented.[34] Any regulatory arbitrage regarding these rules will therefore be only an element of competition for businesses in general—employment law may influence the decision where to locate a plant, but as a factor in regulatory competition it will be strongly confounded with other aspects pertinent to its physical location, including taxation.

B. *Employee Participation Systems and Codetermination*

While at least some of the issues outlined above are no doubt important, in particular the requirement to consult with works councils and other employee representatives, these rules are not subject to corporate law regulatory arbitrage opportunities. However, some corporate law issues are of considerable importance to employees as well, which is discussed below in more detail. At present, member states that favor codetermination and other employee participation systems do not even attempt to apply their employee participation statutes to foreign firms.[35]

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33. Council Directive on the Establishment of a European Works Council or a Procedure in Community-Scale Undertakings and Community-Scale Group Undertakings for the Purposes of Informing and Consulting Employees, No. 94/45, art. 1(2), 1994 O.J. L 254/64, amended by 1998 O.J. L 10/22 (extending the original directive to the United Kingdom); *see also* CATHERINE BARNARD, EC EMPLOYMENT LAW 707–20 (3d ed. 2006) (providing a detailed discussion of this directive). Collective bargaining agreements are governed by the law of the country where the employment relationship is executed or the law of the employment contract. *See* Krebber, *supra* note 31, at 537.

34. Council Directive Establishing a General Framework for Informing and Consulting Employees in the European Community, No. 2002/14, 2002 O.J. L 80/29; *see also* BARNARD, *supra* note 33, at 732–39 (explaining the objectives of the directive).

35. On Germany, see, for example, CLEMENS JUST, DIE ENGLISCHE LIMITED IN DER PRAXIS [THE ENGLISH LIMITED LIABILITY COMPANY IN PRACTICE] 199–202 (2d ed. 2006) (F.R.G.), Marcus Kamp, *Die unternehmerische Mitbestimmung nach „Überseering" und „Inspire Art"* [*Codetermination After „Überseering" and „Inspire Art"*], 59 BETRIEBS-BERATER 1496, 1498–1499 (2004) (F.R.G.), Klaus J. Müller, *Die englische Limited in Deutschland—für welche Unternehmen ist sie tatsächlich geeignet?* [*The English Limited Liability Company in Germany—For Which Businesses is it Useful in Practice?*], 61 BETRIEBS-BERATER 837, 840 (2006) (F.R.G.), Bernd Gach, *in* 3 MÜNCHENER KOMMENTAR ZUM AKTIENGESETZ [MUNICH COMMENTARY ON THE STOCK CORPORATION ACT] § 1 MitbestG cmt. 6 (Bruno

1. The Prevalence and Significance of Employee Participation Systems

The system of codetermination in Germany assigns half of the seats on the supervisory board of German companies to employees[36] and is one of the issues that has received the most attention in the comparative corporate governance literature.[37] The system of codetermination occupies one end of the regulatory spectrum, the other being no employee participation at all.[38]

Codetermination in the strictest sense of the word requires the election of half of the members of the firm's supervisory board by employees[39] in firms with more than 2000 employees.[40]

Kropff & Johannes Semler eds., 2d ed. 2004) (F.R.G.), Christoph Teichmann, *Restructuring Companies in Europe: A German Perspective*, 2004 EUR. BUS. L. REV. 1325, 1334, and Martin Veit & Joachim Wichert, *Unternehmerische Mitbestimmung bei europäischen Kapitalgesellschaften mit Verwaltungssitz in Deutschland nach „Überseering" und „Inspire Art"* [*Codetermination in European Corporations with Headquarters in Germany After „Überseering" and „Inspire Art"*], 50 DIE AKTIENGESELLSCHAFT 14, 16–17 (2004) (F.R.G.). For possible future "outreach" statutes applying employee participation systems to foreign firms, see *infra* notes 133–137 and accompanying text.

36. *See* Mitbestimmungsgesetz [MitbestG] [Co-Determination Act], May 4, 1976, BGBl. I at 1153, § 7, last amended by Gesetz, July 30, 2009, BGBl. I at 2479, 2491, § 1(1) (F.R.G), *translated in* D. HOFFMAN, THE GERMAN CO-DETERMINATION ACT, 1976 (MITBESTIMMUNGSGESETZ 1976) (1976). The law is applicable to all companies outside of the coal, mining, and steel industries. *Id.* § 1(2). These industries are governed by an even stricter statute, the Montan-Mitbestimmungsgesetz [MontanMitbestG] [Montane Co-Determination Act], May 21, 1951, BGBl. I at 347, last amended by Gesetz, October 31, 2006, BGBl. I at 2407, 2434 (F.R.G.).

37. *See, e.g.*, Luca Enriques et al., *The Basic Governance Structure: Minority Shareholders and Non-Shareholder Constituencies*, *in* THE ANATOMY OF CORPORATE LAW 90, 100–02 (Reinier Kraakman et al. eds., 2d. ed. 2009); Mark J. Roe, *German Codetermination and German Securities Markets*, 1998 COLUM. BUS. L. REV. 167.

38. Slovenia, for instance, initially adopted the German version of codetermination after gaining independence, but subsequently abandoned it after its constitutional court declared the system unconstitutional. *See* THOMAS RAISER, UNTERNEHMENSMITBESTIMMUNG VOR DEM HINTERGRUND EUROPARECHTLICHER ENTWICKLUNGEN, GUTACHTEN B FÜR DEN 66. DEUTSCHEN JURISTENTAG [WORKER BOARD-LEVEL PARTICIPATION AGAINST THE BACKDROP OF EUROPEAN DEVELOPMENT, REPORT B FOR THE 66TH MEETING OF THE ASSOCIATION OF GERMAN JURISTS], B 42–B 43 (2006) (F.R.G.); Rado Bohinc & Stephan M. Bainbridge, *Corporate Governance in Post-Privatized Slovenia*, 49 AM. J. COMP. L. 49, 58–60 (2001).

39. *See* MitbestG § 10. German law and the laws of various other countries in the European Union ("EU") require stock corporations to have dual board system comprised of a management board, or *Vorstand*, whose members are the senior managers of the firm, and a supervisory board, or A*ufsichtsrat*, whose members are outside directors. *See* Aktiengesetz [AktG] [Stock Corporation Act], Sept. 6, 1965, BGBl. I at 1089, §§ 76–116, last amended by Gesetz, July 31, 2009, BGBl. I at 2509 (F.R.G.),

The applicable law specifies the precise number of directors that will comprise the supervisory board according to the size of the firm.[41] A minority among these directors are not employees of the firm, but representatives of unions.[42] In the case of a tied vote, the vote of the president of the board, a shareholder representative, is decisive, putting the representatives of capital at an advantage.[43] Nevertheless, codetermination strengthens the position of labor by facilitating access to information and the possibility to grant and withhold assent to important corporate decisions, most of all regarding the composition of the management board.[44] A more moderate employee participation scheme applies in firms with 500 to 2000 employees, in which employee representatives fill only one third of the board seats.[45]

The German system of codetermination is far from unique in the European Union. Although Britain, perhaps the most shareholder-centric European corporate jurisdiction today, famously rejected what it touted as "industrial democracy" in the 1970s,[46] employee participation systems giving one third of the seats on the board to employees exist in countries such as Austria,[47] Denmark,[48] Finland,[49] Luxemburg,[50] and Sweden,[51] as

translated in THE GERMAN STOCK CORPORATION ACT (Hannes Schneider & Martin Heidenhain trans., 2d ed. Kluwer Law Int'l 2000).

40. *See* MitbestG §1(1), ¶2.

41. *See id.* § 7(1).

42. *See id.* § 7(2).

43. *See id.* § 29.

44. Enriques et al., *surpa* note 37, at 101.

45. *See* Drittelbeteiligungsgesetz [One-Third Employee Representation Act], May 18, 2004, BGBl. I at 974, last amended by Gesetz, July 30, 2009, BGBl. I. at 2479, § 1 (F.R.G.).

46. A codetermination system comparable to the German one was recommended in the "Bullock Report." REPORT OF THE COMMITTEE OF INQUIRY ON INDUSTRIAL DEMOCRACY, 1977, Cmnd. 6706 (U.K.). For the reasons on why it was rejected, see, for example, HERMAN KNUDSEN, EMPLOYEE PARTICIPATION IN EUROPE 53 (1995), and David Marsh & Gareth Locksley, *Capital in Britain: Its Structural Power and Influence over Policy*, 6 WEST EUR. POL. 36, 49–50 (1983).

47. *See* Arbeitsverfassungsgesetz [ArbVG] [Labor Constitution Act], Bundesgesetzblatt Teil I [BGB1 I] No. 22/1974, § 110 (Austria).

48. RAISER, *supra* note 38, at B 43–B 44. Regarding the Danish system, see KNUDSEN, *supra* note 46, at 81–95, and Jesper Lau Hansen, *The Danish Green Paper on Company Law Reform – Modernising Company Law in the 21st Century*, 10 EUR. BUS. ORG. L. REV. 73, 89–90 (2009).

49. *See* Laki yhteistoiminnasta yrityksissä [Act on Cooperation with Undertakings] (1978:725) (Fin.). A unofficial translation by the Finnish government is electronically available at http://www.finlex.fi/pdf/saadkaan/E9780725.pdf.

well as in post-Communist states such as the Czech Republic, Slovenia, Slovakia, and Hungary.[52] Many of these states reserve one-third of the seats on the board to employees.[53] Notably, Denmark, Finland, Luxemburg, and Sweden have one-tier board systems with varying proportions of seats being assigned to employees.[54] Large Dutch firms are subject to the structure regime known as *structuurregime*,[55] in which one-third of the shareholder-elected supervisory board is nominated by the works council.[56] Until statutory reform in 2004, Dutch board members were appointed under a system of "controlled co-optation."[57]

The overall efficiency of employee participation is contested. While some scholars have found that it depresses shareholder value (which may not necessarily mean that the system is inefficient overall),[58] other studies have suggested that

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50. *See* Law of May 6, 1974, Mémorial du Grand-Duché de Luxembourg [Official Gazette of Luxembourg], A-No. 35, May 10, 1974, at 620 (Lux.).

51. *See* 32 § Lag om Medbestämmande i arbetslivet [Act on Codetermination in the Workplace] (Svensk författningssamling [SFS] 1976:580) (Swed.), *translated in* FOLKE SCHMIDT, LAW AND INDUSTRIAL RELATIONS IN SWEDEN (1977).

52. *See* RAISER, *supra* note 38, at B 42. The idea likely spread to these post-communist countries because their legal tradition has historically been influenced by Germany. *See* Holger Spamann, *Contemporary Legal Transplants—Legal Families and the Diffusion of (Corporate) Law*, 2009 B.Y.U. L. REV. 1813, 1867.

53. *See* RAISER, *supra* note 38, at B 42.

54. *See id.* at B 43–B 44.

55. *See* Abe de Jong & Alisa Roëll, *Financing and Control in the Netherlands: A Historical Perspective*, *in* A HISTORY OF CORPORATE GOVERNANCE AROUND THE WORLD 467, 473 (Randall K. Morck ed., 2005) (discussing the aim of *structurregime* and its drawbacks). *See generally* STEVEN R. SCHUIT ET AL., CORPORATE LAW AND PRACTICE OF THE NETHERLANDS 111–14 (2d ed. 2002) (describing the corporate structure of "large" Dutch corporations); Edo Groenewald, *Corporate Governance in the Netherlands: From the Verdam Report of 1964 to the Tabaksblat Code of 2003*, 6 EUR. BUS. ORG. L. REV. 291, 294 (2005) (providing a breakdown of the statutory two-tier regime). To qualify as a "large" company, a firm must meet three criteria: (1) an equity capital of at least €13,000,000; (2) the corporation or a dependent company must have established a Works Council (as required by law); and (3) a regular workforce of 100 or more persons in the Netherlands (together with dependent companies). *See* Burgerlijk Wetboek [BW2] [Civil Code] bk. 2, tit. 5, arts. 153(2), 263(2) (Neth.). There are several exemptions to this definition. For example, a dependent firm with a parent company that fulfills the requirements is exempt. *See* SCHUIT ET AL., *supra*, at 115–17.

56. *See* BW2 [Civil Code] bk. 2, tit. 5, art. 158(6). A rejection of the nominees of the works council is only possible for a limited number of reasons. *See* Groenewald, *supra* note 55, at 295 (describing the grounds for the shareholders to object to a nominee of the works council).

57. Groenewald, *supra* note 55, at 297.

58. *See, e.g.*, Gary Gorton & Frank A. Schmid, *Capital, Labor and the Firm: A Study of German Codetermination*, 2 J. EUR. ECON. ASS'N 863, 885–86 (2004).

moderate forms have a beneficial effect on Tobin's q[59] in certain industries[60] or that its introduction is correlated with gains in productivity.[61] The conclusions of these studies are limited by their use of a measure of shareholder wealth as a dependent variable, while possible rents to employees—which are difficult to quantify—should in principle figure into the efficiency calculus.[62] Furthermore, it is quite possible that codetermination and other employee participation systems contribute to the maintenance of social peace and good employment relations.[63] Consequently, employee participation models, like the system of codetermination, may therefore have an indirect benefit for firms that are not captured by econometric studies. As noted earlier, even if the potential efficiency benefits are unconvincing, it seems clear that employee representation has important distributive consequences, as it will at least enhance the bargaining power of employees and thus entail a marginal increase in rents accruing to labor.

2. Negotiations About Employee Representation

In order to subject a company to the law of a member state other than the one under which it was originally founded, shareholders in practice must avail themselves of specific instruments of EU law that impose restrictions on ex post changes to employee participation systems. The main instrument for reincorporation is the cross-border merger as contemplated

59. Tobin's q, as it is referred, is the ratio between the firm's market value and the replacement value of its assets. *See, e.g.*, James Tobin & William C. Brainard, *Asset Markets and the Cost of Capital*, *in* ECONOMIC PROGRESS, PRIVATE VALUES, AND PUBLIC POLICY 235 (William Fellner et al. eds., 2d ed. 1977). It is frequently used to measure how much wealth a firm generates for its shareholders compared to other firms.

60. *See* Fauver & Fuerst, *supra* note 17, at 675. These results do not hold when the employee representatives do not actually work in the firm, but are sent by unions. *See id.* at 710.

61. *See generally* Felix FitzRoy & Kornelius Kraft, *Co-determination, Efficiency, and Productivity*, 43 BRIT. J. INDUS. REL. 233, 242–44 (2005).

62. Conceivably, there could be other consequences, such as helping society to become more egalitarian, which are even more difficult to assess from the perspective of utility-maximization. *See* RAISER, *supra* note 38, at 49–50 (criticizing econometric studies for leaving these aspects aside).

63. *See* MARK J. ROE, STRONG MANAGERS, WEAK OWNERS 214 (1994) ("[C]odetermination affects corporate governance in the supervisory board, impeding intermediaries from pushing for rapid organizational change that would disrupt employment.").

by the Council Directive on Cross-Border Mergers.[64] Under this instrument, a shell subsidiary is set up in the target member state, followed by a merger between the original and the new entity.

Another potential path to a different member state's law is the creation of an SE through a merger under the SE Statute.[65] While the SE is a corporation governed by EU law, the SE Statute provides a rather shallow regulatory framework;[66] gaps are filled by special national legislation governing SEs with their registered office in the respective member state, and failing that, by national provisions applicable to public limited liability companies.[67] As a result, there are a number of British, Czech, French, Swedish, and other SEs that are all to a large extent governed by the respective national law.[68] Since article 8 of the SE Statute explicitly allows the transfer of the SE's registered office without initiating a winding up of the firm,[69] national obstacles to reincorporations can be overcome with relative ease.[70] However, for a previously existing purely national firm, the route to a foreign type of SE is, again, to create a shell company in the target member state and then merge with it, in this case under the SE Statute.

The Directive on the Involvement of Employees in the SE[71] sets up a negotiating procedure that must be followed before the SE can be registered.[72] Employees from both companies merging into the new SE must elect or appoint a "special negotiating body" ("SNB") to settle employee representation rights in the

64. Council Directive on Cross-Border Mergers of Limited Liability Companies, No. 2005/56, 2005 O.J. L 310/1.

65. Council Regulation on the Statute for a European Company, No. 2157/2001, arts. 17–31, 2001 O.J. L 294/1, at 7–10. *See generally* Luca Enriques, *Silence is Golden: The European Company as a Catalyst for Company Law Arbitrage*, 4 J. CORP. L. STUD. 77 (2004) (discussing how the *Societas Europaea* ("SE") can be used for company law arbitrage).

66. *See* Enriques, *supra* note 65, at 77 (noting that the statute is limited in scope).

67. Council Regulation on the Statute for a European Company, No. 2157/2001, art. 9, 2001 O.J. L 294/1, at 6.

68. A recent study found a total of 213 of these companies. *See* Horst Eidenmüller et al., *Incorporating Under European Law: The Societas Europaea as a Vehicle for Legal Arbitrage*, 10 EUR. BUS. ORG. L. REV. 1, 20 (2009).

69. Council Regulation on the Statute for a European Company, No. 2157/2001, art. 8, 2001 O.J. L 294/1, at 5–6.

70. *See* Enriques, *supra* note 65, at 81–82.

71. Council Directive Supplementing the Statute for a European Company with Regard to the Involvement of Employees, No. 2001/86, 2001 O.J. L 294/22.

72. For a detailed description of this directive, see BARNARD, *supra* note 33, at 723–32.

future SE with the competent bodies of the merging companies.[73] Negotiations should normally be concluded within six months, but the parties may agree to extend this period to a year.[74] National legislatures are required to establish standard rules in the event that negotiations break down.[75] In the case of an SE created by a cross-border merger, this provision applies by operation of law when at least twenty-five percent of the employees of the merging firms participated in some type of employee representation system.[76] However, they also apply when a smaller number of employees were subject to such a system, and when the SNB passes a resolution to that effect.[77] The standard rules must conform to a "highest level" principle, meaning that the proportion of employees on the board must correspond to the "most advanced" system before the merger.[78] Even employees previously not covered by an employee participation system at all must have this level of participation rights after the conclusion of the merger.[79]

While the applicable law is that of the state in which the SE is registered, all member states (including those without mandatory employee representation rules for purely national companies) are required to develop a default employee participation system for SEs.[80] These rules must stipulate that the highest proportion of employee participation of any of the participating firms applies to the SE resulting from the merger.[81]

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73. *See* Council Directive Supplementing the Statute for a European Company with Regard to the Involvement of Employees, No. 2001/86, arts. 3–4, 2001 O.J. L 294/22, at 24–26. Article 4(2) sets out the issues the agreement must cover, such as the allocation of seats and the powers of the representative body. *Id.* art. 4(2).

74. *See id*, art. 5, 2001 O.J. L 294/22, at 27.

75. *See id.* annex (setting out the fundamental principles of these rules).

76. *See id.* annex, pt. 3(b); *see also* BARNARD, *supra* note 33, at 730; Paul L. Davies, *Workers on the Board of the European Company?* 32 INDUS. L.J. 75, 85–87 (2003) (explaining the "highest level" requirement).

77. *See* Council Directive Supplementing the Statute for a European Company with Regard to the Involvement of Employees, No. 2001/86, art. 7(2)(b), 2001 O.J. L 294/22, at 27.

78. *See id.* art. 7.

79. BARNARD, *supra* note 33, at 730.

80. *See* Council Directive Supplementing the Statute for a European Company with Regard to the Involvement of Employees, No. 2001/86, pmbl. ¶¶ 3–4, 2001 O.J. L 294/22, at 22.

81. *See id.* annex, pt. 3(b). According to article 7(3), member states may provide that the default provisions do not apply if the SE is formed by merger. *Id.* art. 7(3). This provision was introduced in order to secure Spain's approval of the directive. According

Slightly modified rules apply under the Directive on Cross-Border Mergers. As a general principle, the law applicable at the registered office of the entity resulting from the merger governs employee participation.[82] However, there are three exceptions: first, negotiations are mandatory when one of the merging companies has an employee participation system and more than 500 employees; second, when national law applicable after the merger does not provide the same level of employee representation to employees that were previously subject to such a regime; and third, when the postmerger law discriminates against employees employed in another member state by not granting equivalent representation rights.[83]

Regarding cases of mandatory negotiations, the Cross-Border Mergers Directive refers to the respective provisions of the SE Regulation and SE Employees Directive.[84] However, the threshold for automatic application of the "standard rules" in this case is thirty-three percent and one third.[85] Furthermore, employee representation in a one-tier board may be limited to one third of the positions, even if the merged firm previously applied parity codetermination on the supervisory board.[86]

to the predominant interpretation of the provision, an SE cannot be formed in the absence of an agreement with the SNB if the member state refused to adopt the default provisions in the formation of an SE through merger. *See* Paul Davies, *Employee Involvement in the European Company*, *in* THE EUROPEAN COMPANY: DEVELOPING A COMMUNITY LAW OF CORPORATIONS 67, 67 n.2 (Jonathan Rickford ed., 2003); Jonathan Rickford, *Inaugural Lecture – The European Company*, *in* THE EUROPEAN COMPANY, *supra*, 13, 28 n.56; Ger van der Sangen, *The European Company and the Involvement of Employees*, *in* THE EUROPEAN COMPANY: CORPORATE GOVERNANCE AND CROSS-BORDER REORGANISATIONS FROM A LEGAL AND TAX PERSPECTIVE 169, 199 (S.H.M.A. Dumoulin et al. eds., 2005). The United Kingdom did not elect to use this option, but instead provides that the standard rules apply in the case of a merger. *See* European Public Limited-Liability Company Regulations, 2004, S.I. 2004/2326, c. 6, § 33(3) (U.K.).

82. *See* Council Directive on Cross-Border Mergers of Limited Liability Companies, No. 2005/56, art. 16(1), 2005 O.J. L 310/1, at 7.

83. *See id.* art. 16(2); *see also* Arianna Ugliano, *The New Cross-Border Merger Directive: Harmonisation of European Company Law and Free Movement*, 2007 EUR. BUS. L. REV. 585, 609.

84. *See* Council Directive on Cross-Border Mergers of Limited Liability Companies, No. 2005/56, art. 16(3), 2005 O.J. L 310/1, at 8.

85. *See id.* art. 16(3)(e).

86. *See id.* art. 16(4)(c). The rationale seems to be that employee influence on a one-tier board is thought to be more significant than on a supervisory board, which is less directly involved in the firm's decision-making processes. *See* Mathias Habersack, *Grundsatzfragen der Mitbestimmung in SE und SCE sowie bei grenzüberschreitender Verschmelzung* [*Fundamental Issues of Codetermination in the European Company and the*

The European Union has debated the introduction of a directive on the cross-border transfer of a firm's registered office (the "14th Directive") for many years, but the project has been shelved since late 2007, at least for the time being.[87] The ECJ determined in the recently decided *Cartesio* case that a member state may prohibit companies governed by its law from relocating the firm's real seat to another member state while retaining its character as a company under the laws of the origin state. However, a member state may not prevent a company from converting into a company governed by the law of another state as long as the latter will accept the firm.[88] Without a directive, however, a change of the national law applicable to the firm is wrought with great difficulty.[89] It is usually thought that if the 14th Directive is ever passed, it will include comparable provisions regarding employee representation.[90] Since a transfer of seat involves only a single company, the codetermination

European Cooperative, as well as After a Cross-border Merger], 171 ZEITSCHRIFT FÜR DAS GESAMTE HANDELS- UND WIRTSCHAFTSRECHT 613, 626 (2007) (F.R.G.); Olaf Kisker, *Unternehmerische Mitbestimmung in der Europäischen Gesellschaft, der Europäischen Genossenschaft und bei grenzüberschreitender Verschmelzung im Vergleich* [*Codetermination in the European Company, the European Cooperative, and after Cross-Border Mergers in Comparison*], 59 RECHT DER ARBEIT 206, 210 (2006) (F.R.G.).

87. *See* Stephan Rammeloo, *The 14th EC Company Law Directive on the Cross-Border Transfer of the Registered Office of Limited Liability Companies – Now or Never?*, 15 MAASTRICHT J. EUR. & COMP. L. 359, 372–73 (2008).

88. Cartesio Oktató és Szolgáltató bt, Case C-210/06, [2008] ECR I-9641, ¶¶ 110–13; *see also* Gert-Jan Vossestein, *Cross-Border Transfer of Seat and Conversion of Companies under the EC Treaty Provisions on Freedom of Establishment*, 6 EUR. COMPANY L. 115, 120 (2009). In other words, member states may voluntarily take their own laws out of the market for corporations, but must not inhibit competitive actions by other states. *See* Rammeloo, *supra* note 87, at 368–71.

89. It is very plausible that provisions of the SE Regulation on the transfer of seat would apply by analogy, which might require negotiations about employee participation. *See* Georg Eckert, *Sitzverlegung von Gesellschaften nach der Cartesio-Entscheidung des EuGH [Transfer of a Company's Real Seat Under the Cartesio Decision of the ECJ]*, 2009 DER GESELLSCHAFTER 139, 149–53 (Austria).

90. *See, e.g.*, Maureen Johnson, *Does Europe Still Need a Fourteenth Company Law Directive*, 3 HERTFORDSHIRE L.J. 18, 38 (2005) (noting that a new company law directive, if adopted, will provide for employee participation); *see also* Federico M. Mucciarelli, *Corporate 'Emigration' and EC Freedom of Establishment:* Daily Mail *Revisited*, 9 EUR. BUS. ORG. L. REV. 267, 300 (2008) (suggesting that a "corporate mobility" directive should have similar safeguards as the cross-border mergers directive); Marco Ventoruzzo, *"Cost-Based" and "Rules-Based" Regulatory Competition: Markets for Corporate Charters in the U.S. and the E.U.,* 3 N.Y.U. J.L. & BUS. 91, 149 (2006) (same); Eddy Wymeersch, *Is a Directive on Corporate Mobility Needed?*, 8 EUR. BUS. ORG. L. REV. 161, 168 (2007) (same);.

regime of the state of origin would most likely apply unless the SNB agrees to reduce employee participation.[91]

3. Codetermination Arbitrage Opportunities

The rules governing employee participation in the SE and Cross-Border Mergers directives are complex, and, in theory, rely on a "before-after" principle that is intended to maintain previous codetermination structures unless the SNB agrees to a reduction or complete elimination in the percentage of labor-appointed board members. Because of these rules, some commentators have concluded that employee participation systems are still entrenched following the introduction of the transnational merger mechanisms under secondary EU law.[92] Furthermore, the requirement to negotiate with employees has been said to shield codetermination regimes against regulatory competition because the prospect of including English employees in the codetermination process can act as a deterrent against transnational mergers involving larger English firms (presumably because English managers would not like it).[93] This latter concern does not pose an obstacle in the case of a true reincorporation, where an English firm is set up as a target firm for a merger with its German parent or sister, because a merger into a newly created English firm could be used to eliminate codetermination after the expiration of three years, as specified under English law.[94]

In fact, there are various ways how controlling shareholders can use the opportunities provided by cross-border mergers and SEs to restructure labor representation on the board in

91. *See* Andrew Johnston, *EC Freedom of Establishment, Employee Participation in Corporate Governance and Regulatory Competition*, 7 J. CORP. L. STUD. 71, 107 (2006).

92. *See, e.g.*, *id.* 106–07.

93. *See id.* at 109.

94. *See* The Companies (Cross-Border Mergers) Regulations, 2007, S.I. 2007/2974, art. 40, ¶ 1 (U.K.) (providing that subsequent domestic mergers must not affect employee participation rights before the end of a period of three years after the cross-border merger took effect); *see also* Georg Eckert & Matthias Schimka, *Die Arbeitnehmermitbestimmung bei grenzüberschreitenden Verschmelzungen nach dem EU-VerschG* [*Employee Participation Folllowing Cross-border Mergers According to the Cross-Border-Mergers Act*], 22 WIRTSCHAFTSRECHTLICHE BLÄTTER 201, 210 (2008) (Austria) (pointing out that subsequent mergers of the company resulting from the initial cross-border merger with a new entity of the same nationality are governed by that country's law); Habersack, *supra* note 86, at 637 (same).

idiosyncratic ways. This is illustrated by the proposed takeover of Volkswagen AG ("VW") by Porsche SE that seemed imminent in late 2008. While the bid stalled in spring 2009, when Porsche became starved for cash due to the world financial crisis,[95] Porsche's original plans illustrate interesting codetermination arbitrage possibilities. VW was shielded from takeover offers by the *VW-Gesetz* (VW Act), which set out a twenty percent voting cap and gave the right to appoint directors to the Federal Republic of Germany and the State of Lower Saxony as long as they held a single share.[96] In 2007, the ECJ ruled that this act violated the EU freedom of movement of capital.[97] As a result of the decision, the way was paved for Porsche to acquire a controlling share in the company.[98] Porsche had recently created Porsche Automobil Holding SE, which held 100% of the operative Porsche AG.[99] Under the parity codetermination regime negotiated with Porsche employees when the firm was transformed into an SE, three members would have represented Porsche employees, and three would have represented VW employees on the Porsche SE board after a takeover.[100]

95. *See, e.g.*, Carter Dougherty, *Tables Turn in Porsche's Pursuit of VW*, N.Y. TIMES, June 19, 2009, at B1; *Porsche Aids VW Merger By Selling Stake to Qatar*, N.Y. TIMES, Aug. 15, 2009, at B2.

96. Gesetz über die Überführung der Anteilsrechte an der Volkswagenwerk Gesellschaft mit beschränkter Haftung in Private Hand [Law Concerning the Privatization of Shares in the Volkswagen Limited Liability Company], July 21, 1960, BGBl I at 585, last amended by Gesetz, July 31, 1970, BGBl. I at 1149 (F.R.G.). The state of Lower Saxony continues to hold shares in VW, while the Federal Republic of German does not.

97. *See* Commission v. Germany, C-112/05 [2007] E.C.R. I-8995 [hereinafter *Volkswagen*]; *see also* Peer Zumbansen & Daniel Saam, *The ECJ,* Volkswagen *and European Corporate Law: Reshaping the European Varieties of Capitalism*, 8 GERMAN L.J. 1027, 1034–42 (2007) (discussing the *Volkswagen* case); Jonathan Rickford, *Free Movement of Capital and Protectionism After* Volkswagen *and* Viking Line, *in* PERSPECTIVES IN COMPANY LAW AND FINANCIAL REGULATION 61, 76–83 (Michel Tison et al. eds., 2009) (examining the effects of *Volkswagen*). The court rejected Germany's argument that the law could be justified by invoking the interests of employees. *See Volkswagen*, [2007] E.C.R. I-8995, ¶ 70; *see also* Erik Werlauff, *Safeguards against Takeover after* Volkswagen – *On the Lawfulness of Such Safeguards under Company Law After the European Court's Decision in* "Volkswagen," 2009 EUR. BUS. L. REV. 101, 108.

98. *See* Zumbansen & Saam, *supra* note 97, at 1047.

99. *See* Press Release, Porsche AG, Porsche Enters the Future with a New Corporate Structure (June 26, 2007), http://www.porsche.com/usa/aboutporsche/pressreleases/pag/archive2007/quarter2/?pool=international-de&id=2007-06-26_02 (announcing the approval of a holding structure in the form of a parent SE entity).

100. *See* Press Release, Porsche AG, Parity Representation on Supervisory Board of Porsche Automobil Holding SE (June 26, 2007), http://www.porsche.com/usa/

Unsurprisingly, VW employee representatives strongly opposed the agreement, given that its workforce of 324,000 dwarfed Porsche's mere 12,000 employees.[101] VW employee representatives sought to block the registration of Porsche SE,[102] but the competent German court in Stuttgart refused to issue a preliminary injunction in fall 2007.[103] The same court subsequently ruled in spring 2008 that the there was no legal ground for VW's works council to request a rescission of the agreement between Porsche and its employee representatives, partly because Porsche had not yet acquired control of VW.[104]

As a consequence of the unexpected outcome in this matter, courts did not have the opportunity to resolve the lingering question of whether a renegotiation of the employee participation agreement would be required. Recital 18 of the preamble to the SE Directive establishes the "before and after" principle, which is intended to guarantee employee rights not only in the case of the formation of an SE, but also in the case of later "structural changes."[105] However, in the case of the acquisition of a subsidiary, renegotiations are not required either by the Directive or under German law,[106] and it is not clear how

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aboutporsche/pressreleases/pag/archive2007/quarter2/?pool=international-de&id=2007-06-26_03 (outlining the details of the employee participation agreement in the new SE entity); *see also* Press Release, Porsche Automobil Holding SE, Porsche Automobil Holding SE Sets the First Benchmark (July 25, 2007), http://www.porsche.com/usa/aboutporsche/pressreleases/pag/archive2007/quarter3/?pool=international-de&id=2007-07-25 (listing the members of Porsche SE's supervisory board).

101. *See, e.g.*, Mark Landler, *Porsche to Wait Until Holidays End to Take Over Volkswagen*, N.Y. TIMES, Nov. 28, 2007, at C3.

102. *See id.*

103. Arbeitsgericht Stuttgart [Stuttgart Labor Court], Oct. 24, 2007, No. 12 BVGa 4/07 (F.R.G.), *available at* http://www.arbg-stuttgart.de/servlet/PB/show/1213597/12-BVGa-4-07; *see also* Zumbansen & Saam, *supra* note 97, at 1049–51 (providing detailed background information surrounding the case).

104. Arbeitsgericht Stuttgart, April 29, 2008, No. 12 BV 109/07 (F.R.G.), *available at* http://www.jum.baden-wuerttemberg.de/servlet/PB/show/1222314/12-BV-109-07.pdf.

105. Council Directive Supplementing the Statute for a European Company with Regard to the Involvement of Employees, No. 2001/86, pmbl. ¶ 18, 2001 O.J. L 294/22, at 23.

106. German law allows the management of an SE or its works council to request renegotiations in the case of a planned structural change that may result in the reduction of employee's participation rights, but without providing a definition, examples, or mentioning the acquisition of new subsidiaries, the consequence of which is to deprive employees of the *subsidiary* of codetermination in the controlling entity. *See*

German courts would deal with reorganization of ownership structures.[107] Naturally, Porsche's employee representatives saw little reason to negotiate on behalf of workers from another firm that was expected to become part of the Porsche group.

The case illustrates that controlling shareholders might use arbitrage opportunities by playing different labor groups against each other—by reducing the rights of powerful groups of employees to the benefit of more manageable ones. Other German publicly traded firms have managed to substantially alter codetermination by creating an SE. For example, the Allianz insurance group reduced the size of the supervisory board by merging with an Italian subsidiary.[108] BASF also managed to change its employee participation system by transforming into an SE, although one of the professed motives in this case was apparently to assure better representation of employees outside Germany.[109]

There are further possibilities of reducing the participation regime for particular employee groups without their assent that can be used to install a weaker employee participation system. The formation of an SE makes the result of the negotiations permanent for the duration of the entity's existence unless national law requires renegotiation.[110] Moreover, since national rules on employee participation are overruled by the

Gesetz über die Beteiligung der Arbeitnehmer in einer Europäischen Gesellschaft [SE-BG] [SE Participation Law], Dec. 22, 2004, BGBl. I at 3686 § 18(3) (F.R.G.). *But see* ArbVG, BGB1 I No. 22/1974, § 228(2) (Austria); (recognizing a change in the number of employees, including subsidiaries, as a legal ground for renegotiation); Code du Travail [C. TRAV.] [Labor Code] art. L. 2354-4 (Fr.), *translated in* THE FRENCH COMMERCIAL CODE IN ENGLISH (Philip Raworth trans., rev. ed. 2009) (same, but without reference to subsidiary entities). U.K. law lacks an equivalent provision. *See* European Public Limited-Liability Company Regulations, 2004, S.I. 2004/2326, c. 6, § 33(3) (U.K.).

107. *See, e.g.*, Habersack, *supra* note 86, 641–42 (pointing out that the purchase of sale of a subsidiary or business establishment does not result in a revitalization of the negotiation procedure).

108. *See* CURTIS MILHAUPT & KATHARINA PISTOR, LAW AND CAPITALISM 85 (2008); Enriques et al., *supra* note 36, at 55, 70. In *Allianz*, the motivation to create an SE primarily seems to have been the desire to merge with its Italian subsidiary, with changes to governance structure as a byproduct. *See* ALLIANZ GROUP, ALLIANZ GROUP ANNUAL REPORT 2006, at 91 (2006), http://annualreport.allianz.com/ar06/en/pdf/AZ_GB_e_088-099.pdf.

109. *See* Jochem Reichert, *Experience with the SE in Germany*, 4 UTRECHT L. REV. 22, 27 (2008).

110. *See supra* note 106 and accompanying text.

participation agreement, additional requirements that are contingent on changes to the structure of the corporation no longer apply. For example, a German firm that crosses the threshold of 2000 employees is not required to increase the number of employee members on its supervisory board from one third to one half (as it would otherwise be).[111] SEs can also be created as joint parent firms, or through cleverly structured mergers, and altogether avoid the necessity to negotiate with employees.[112]

Notably, article 11 of the SE Employees Directive requires states to take appropriate measures against the misuse of the SE corporate form for the purpose of depriving employees of rights to employee involvement.[113] However, the directive neither defines the term "misuse" nor explains appropriate measures. Most likely, these measures will also be subject the four-factor test set out by the ECJ in *Gebhard*.[114] Certain reorganizations that ultimately reduce or eliminate employee participation may well be considered a legitimate use of the freedom of establishment by the ECJ.[115] Some authors have even suggested that a market for "shelf SEs" without employee participation might develop, which would be ready for use in a merger with a firm governed by the law of a codetermination-friendly country.[116] Before the

111. Markus Rehberg, *Die missbräuchliche Verkürzung der unternehmerischen Mitbestimmung durch die Societas Europaea* [*The Abusive Reduction of Employee Participation by the Societas Europaea*], 34 ZEITSCHRIFT FÜR UNTERNEHMENS- UND GESELLSCHAFTSRECHT 859, 861 (2005) (F.R.G.).

112. *See id.* at 861–62 (providing a number of possibilities).

113. Council Directive Supplementing the Statute for a European Company with Regard to the Involvement of Employees, No. 2001/86, art. 11, 2001 O.J. L 294/22, at 28.

114. *See* Reinhard Gebhard v. Consiglio dell'Ordine degli Avvocati e Procuratori di Milano, Case C-55/94, [1995] E.C.R. I-4165, ¶ 37 (requiring that national measures hindering the exercise of the freedoms "must be applied in a non-discriminatory manner; they must be justified by imperative requirements in the general interest; they must be suitable for securing the attainment of the objective which they pursue; and they must not go beyond what is necessary in order to attain it"). Thus, broad-sweeping laws that restrict companies solely on the basis that they incorporate in another member state are impermissible. *See* Rehberg, *supra* note 111, at 876.

115. *See, e.g.*, Bodo Riegger, *Centros – Überseering – Inspire Art: Folgen für die Praxis* [*Centros – Überseering – Inspire Art: Practical Implications*], 33 ZEITSCHRIFT FÜR UNTERNEHMENS-UND GESELLSCHAFTSRECHT 510, 521 (2004) (F.R.G.).

116. *See* Rehberg, *supra* note 111, at 863; Paul Storm, *Cross-Border Mergers, the Rule of Reason and Employee Participation*, 3 EUR. COMPANY L. 130, 135 (2006); *see also* Bratton et al., *supra* note 11, at 365 (finding that twenty-seven percent of SEs are shelf companies).

ECJ has the opportunity to breathe life into article 11, its interpretation will largely be left to national legislators. Given that the law of the "target country" applies to the new SE, shareholders may use the creation process to make sure that the newly founded SE is subject to the law of a member state that is relatively hostile to employee participation. As seen in the case of VW and Porsche, not even German law appears to provide comprehensive protection against such a process.

The most important factor ultimately permitting a downscaling or even elimination of employee participation seems to be future structural changes to a firm. The SE Regulation allows SEs to be converted into a public limited-liability company governed by the law of the state of registration two years after its formation.[117] A German corporation might, for example, transform into an SE by merging with its British subsidiary, and convert into a traditional British company without any employee participation after two years. Such a conversion would most likely not be considered a "misuse." Even if the German authorities believed that it did, they would be unable to act on that belief because British law would apply to the company at that time.[118]

Moreover, it is not clear whether the two-year waiting period for a *conversion* would also apply to *mergers* or other structural changes involving a corporation governed by national law.[119] Austrian, German, and U.K. lawmakers did not assume that it would be, given that the laws of these countries presume misuse only for structural change taking place within one year after the formation of the SE.[120] Irrespective of when a merger within one member state with a "fresh" company is permissible, article 11 is

117. Council Regulation on the Statute for a European Company, No. 2157/2001, art 66(1), 2001 O.J. L 294/1, at 17.

118. *See* Friedrich Kübler, *Mitbestimmungsfeindlicher Missbrauch der Societas Europaea?* [*Abuse of the Societas Europaea that is hostile to codetermination?*], *in* FESTSCHRIFT FÜR THOMAS RAISER ZUM 70. GEBURTSTAG AM 20. FEBRUAR 2005 247, 254 (Reinhard Damm et al. eds., 2005) (F.R.G.); Kisker, *supra* note 86, at 208.

119. *See* Carsten Schäfer, *VO (EWG) 2157/2001 Art. 66, comment 14*, *in* 9/2 MÜNCHENER KOMMENTAR ZUM AKTIENGESETZ 764, 766 (Bruno Kropff & Johannes Semler eds., 2d ed. 2006) (F.R.G.) (arguing that article 66(1) should apply by analogy, but citing other authors that do not share this view).

120. *See* ArbVG, BGB1 I No. 22/1974, § 229(1) (Austria); SE-BG, Dec. 22, 2004, BGBl. I at 3686, § 43 (F.R.G.); European Public Limited-Liability Company Regulations 2004, S.I. 2004/2326, c. 6, § 35(2) (U.K.); *see also* Storm, *supra* note 116, at 135 (reporting that seven member states had implemented this rule).

not likely to preempt employees from being deprived of participation rights. As in the case of a conversion, it is up to the state where the SE is registered to implement and interpret the prohibition against misuse, and to decide whether new negotiations or other measure are necessary to protect them.[121] While a number of countries have introduced criminal sanctions for "misuses,"[122] the more fundamental issue is the interpretation of the term. While the final arbiter—both for its interpretation[123] and whether a member state has introduced appropriate measures against it—is of course the ECJ, some member states are likely to assess potential misuses more favorably than others in the short-term.

The Directive on Cross-Border Mergers requires member states to protect employee participation rights in the event of subsequent domestic mergers for a period of three years.[124] While some commentators have suggested that the directive requires a resumption of negotiations in such instances,[125] both German and Austrian law provide that the agreement reached in the original negotiations applies to firms resulting from subsequent mergers unless the respective national participation regime would be stricter.[126] Since the firm resulting from a subsequent domestic merger is a creature of the state of incorporation, it is effectively up to the law of the "target state" to shield negotiated employee participation from subsequent opportunism. While French, German, and U.K. law retain the three-year period

121. *See* Adam Sagan, *The Misuse of a European Company according to Article 11 of the Directive 2001/86/EC*, 2010 EUR. BUS. L. REV. 15, 37.

122. In Germany, a "misuse" can even be penalized with a prison sentence of up to two years. *See* SE-BG, Dec. 22, 2004, BGBl. I at 3686, § 45(1), ¶ 2 (F.R.G.); *see also* Rehberg, *supra* note 111, at 890 (criticizing these criminal sanctions as constitutionally problematic in light of the term's vagueness); Sagan, *supra* note 121, at 35 (listing eleven countries in which misuse is subject to criminal sanctions).

123. *See* Sagan, *supra* note 121, at 28–35 (providing some guidance for the interpretation of the term).

124. *See* Council Directive on Cross-Border Mergers of Limited Liability Companies, No. 2005/56, art. 16(7), 2005 O.J. L 310/1, at 8; *see also* Edward Rock et al., *Fundamental Changes*, *in* THE ANATOMY OF CORPORATE LAW, *supra* note 36, at 183, 217–18.

125. Habersack, *supra* note 86, at 637–38.

126. *See* Gesetz über die Mitbestimmung der Arbeitnehmer bei einer grenzüberschreitenden Verschmelzung [MgVG] [Law on the Participation of Employees in a Cross-Border Merger], Dec. 21, 2006, BGBl. I at 3332, last amended by Gesetz, July 30, 2009, BGBl. I at 2479, § 30 (F.R.G.); ArbVG, BGB1 I No. 22/1974, § 262 (Austria).

contemplated by the Directive, Austrian law mandates a five-year window.[127] However, EU law does not explicitly preclude member states from allowing firms to eradicate the negotiated result by means of a simple merger with a "fresh" corporate entity not subject to employee participation after the expiry of the three-year period.[128]

The SE Regulation adopts a "real seat" approach by requiring the registered office to be in the same member state as the head office.[129] A company that transfers its registered office to another state (thus changing the applicable national law) must relocate its head office as well or risk severe sanctions, including liquidation.[130] By contrast, the Directive on Cross-Border Mergers offers better legal arbitrage opportunities because it applies to "regular" companies governed by national law,[131] which, according to the ECJ, must be permitted to convert into a company governed by the law of another member state without losing their identity if the state into which they seek to "immigrate" allows it.[132] As a consequence, the member states must allow firms to emigrate, even if they are void of any employee participation as a result of a series of mergers.

There is some corresponding speculation as to whether EU law would permit member states to implement "outreach statutes" that apply national codetermination systems to foreign firms with a significant presence or with their "real seat" in the local jurisdiction. Such a statute would then also theoretically apply to companies emerging from cross-border mergers. Politically, the enactment of such a statute does not presently seem very likely even in Germany.[133] Moreover, such a statute

127. *Compare* C. TRAV. art. L. 2374-2 (Fr.) (three years), *and* MgVG § 30 (F.R.G.) (same), *and* The Companies (Cross-Border Mergers) Regulations 2007, 2007 S.I. 2007/2974, s. 40 (U.K.) (same), *with* ArbVG § 262 (Austria) (five years).

128. The ECJ would most likely consider a prohibition of subsequent mergers by national law as a violation of the principle of freedom of establishment. It is doubtful whether the court would allow a member state to impose an employee participation system on "pseudo-foreign" companies for public policy reasons.

129. *See* Council Regulation on the Statute for a European Company, No. 2157/2001, pmbl. ¶ 27, art. 7, 2001 O.J. L 294/1, at 3–4.

130. *See id.* art. 64, 2001 O.J. L 294/1, at 16.

131. Council Directive on Cross-Border Mergers of Limited Liability Companies, No. 2005/56, pmbl. ¶¶ 2–3, 2005 O.J. L 310/1, at 1.

132. Cartesio Oktató és Szolgáltató bt, Case C-210/06, [2008] ECR I-9641, ¶ 112.

133. Teichmann, *supra* note 35, at 1334.

would have to pass the four-factor *Gebhard* test.[134] Given the ECJ's assessment of creditor protection mechanisms in *Inspire Art*,[135] it seems doubtful that employee participation systems would pass the court's strict scrutiny.[136] Most analysts seem skeptical that the court would consider employee protection goals to be an "imperative requirement in the public interest", and that employee participation is a necessary means to attain that goal.[137]

134. *See supra* note 114 and accompanying text.

135. Kamer van Koophandel en Fabrieken voor Amsterdam v. Inspire Art Ltd., Case C-167/01, [2003] E.C.R. I-10155, ¶¶ 136–42.

136. *Cf.* Kübler, *supra* note 118, at 256–57 (arguing that in light of *Centros* and *Inspire Art* the mere use of a more favorable foreign law cannot be considered a misuse by German courts); Sagan, *supra* note 121, at 30–31 (arguing that the creation of an SE as such cannot constitute an abuse by virtue of depriving employees of their right to representation).

137. *See, e.g.*, Alexander Franz, *Internationales Gesellschaftsrecht und deutsche Kapitalgesellschaften im In- bzw. Ausland* [*Conflict of Laws Relating to Corporations and German Corporations in Germany or Abroad*], 64 BETRIEBS-BERATER 1250, 1253–54 (2009) (F.R.G.); Horst Hammen, *Zweigniederlassungsfreiheit europäischer Gesellschaften und Mitbestimmung der Arbeitnehmer auf Unternehmensebene* [*Freedom of Branch Establishment of European Companies and Company-level Participation by Employees*], 53 WERTPAPIER-MITTEILUNGEN 2487, 2495 (1999) (F.R.G.); Riegger, supra note 115, at 521; Veit & Wichert, supra note 35, at 16–17; *see also* Friedemann Eberspächer, *Unternehmerische Mitbestimmung in zugezogenen Auslandsgesellschaften: Regelungsmöglichkeiten des deutschen Gesetzgebers* [*Codetermination in Foreign Companies Moving into Germany: Regulatory Options for the German Legislature*] 29 ZEITSCHRIFT FÜR WIRTSCHAFTSRECHT 1951, 1956 (2008) (F.R.G.) (considering it possible to impose employee participation in an advisory board); Müller, *supra* note 35, at 841 (arguing that codetermination cannot be considered an essential element of *ordre public* in Germany); Daniel Zimmer, *Neue Formen der unternehmerischen Mitbestimmung bei In- und Auslandsgesellschaften* [*New Forms of Codetermination in Domestic and Foreign Firms*], *in* EUROPÄISCHE AUSLANDSGESELLSCHAFTEN IN DEUTSCHLAND 365, 369–377 (Marcus Lutter ed. 2005) (F.R.G.) (doubting that it would be feasible to impose codetermination on foreign firms as a matter of legislative technique); Wolfgang Zöllner, *Konkurrenz für inländische Kapitalgesellschaften durch ausländische Rechtsträger, insbesondere die englische Private Limited Company* [*Competition for Domestic Companies from Foreign Entities, Particularly the English Private Limited Company*], 97 GMBH-RUNDSCHAU 1, 10 (2006) (F.R.G.) (pointing out that German codetermination has always remained exclusive to particular legal forms, which is why employee protection can hardly be assessed as requiring such a system or as German ordre publique). *But see* Jens Dammann, Note, *The Future of Codetermination after* Centros*: Will German Corporate Law Move Closer to the U.S. Model?*, 8 FORDHAM J. CORP. & FIN. L. 607, 632–85 (2003) (arguing that Germany could modify its statute to apply to foreign firms); Manfred Weiss & Achim Seifert, *Der europarechtliche Rahmen für ein „Mitbestimmungserstreckungsgesetz"* [*The EU Law Framework for a Codetermination Extension Act*], 38 ZEITSCHRIFT FÜR UNTERNEHMENS- UND GESELLSCHAFTSRECHT 542, 547 (2009) (F.R.G.) (suggesting that a limited expansion would be permissible). Another recently proposed option that is more likely to pass muster with the ECJ is the commencement of negotiation about employee participation systems, as they are required by EU law in the SE statute and the cross-border mergers directive. Such a statute might apply to all

C. *Duties of Directors in General and in Takeovers*

Besides employee participation systems, there are several other important issues that are potentially relevant for employee interests. First are the goals that directors and managers have to pursue under the applicable law. Second are the interests that managers are required to take into account in takeovers, a situation where shareholder and employee interests are often pitted against each other.

1. The Corporate Objective

In many countries, corporate law typically exhorts directors to pursue a certain overarching goal of corporate law and the corporation. In theory, the possible regulatory options range from relentless maximization of shareholder value to reconciling the interests of various groups, including shareholders and employees.

While the law falls between these two extremes, the conventional wisdom is that Anglo-Saxon jurisdictions give greater weight to shareholder value than others. In reality, the distinction is not clear-cut. True, U.K. law now seems to favor shareholders after the Companies Act of 2006,[138] which endorses an "enlightened shareholder value" approach.[139] Directors are required to have regard to the interests of an enumerative list of stakeholders (including employees), but only "to promote the success of the company for the benefit of its members as a whole."[140] In other words, employee interests are relevant only to

companies with their real seat in Germany (including German firms). *See* Christoph Teichmann, *Verhandelte Mitbestimmung für Auslandsgesellschaften* [*Negotiated Participation for Foreign Companies*], 30 ZEITSCHRIFT FÜR WIRTSCHAFTSRECHT 1787, 1787–88 (2009) (F.R.G.). *But see* Thomas Müller-Bonnani, *Unternehmensmitbestimmung nach „Überseering" und „Inspire Art"* [*Codetermination After „Überseering" and „Inspire Art"*], 94 GMBH-RUNDSCHAU 1235, 1238 (2003) (F.R.G.) (arguing that it would be difficult to apply this mechanism to such firms).

138. Companies Act, 2006, c. 46.

139. *See generally* Andrew Keay, *Tackling the Issue of the Corporate Objective: An Analysis of the United Kingdom's 'Enlightened Shareholder Value Approach'*, 29 SYDNEY L. REV. 577 (2007) (contrasting the approach contained in section 172(1) of the 2006 Companies Act to the pure shareholder value approach).

140. Companies Act, 2006, § 172, sched. 1.

the extent that they are instrumental to shareholder value.[141] However, the former Companies Acts of 1980 and 1985 required directors to have regard to "the interests of the company's employees in general, as well as the interests of its members,"[142] which—while without a doubt suffering from a lack of enforceability—could be interpreted as a "pluralist" corporate objective approach.[143] U.S. law is maybe even less clearly shareholder-centric. In spite of the famous "shareholder primacy" norm of *Dodge v. Ford Motor Co.*,[144] the case law has remained inconclusive,[145] leading some legal scholars to question whether the shareholder primacy principle actually applies as a matter of legal doctrine.[146] The American Law Institute's Principles of Corporate Governance in principle suggest that "corporate profit and shareholder gain" should be the objective of corporate activity, but also go on to permit deviations from

141. *See, e.g.*, PAUL L. DAVIES, GOWER AND DAVIES' PRINCIPLES OF MODERN COMPANY LAW 507–09 (8th ed. 2008); BRENDA HANNIGAN & DAN PRENTICE, THE COMPANIES ACT 2006 – A COMMENTARY 31 (2007). The Department of Trade and Industry's White Paper explains that the concept of enlightened shareholder value "is most likely to drive long-term company performance and maximise overall competitiveness and wealth and welfare for all." DEPARTMENT OF TRADE AND INDUSTRY, COMPANY LAW REFORM, 2005, Cm. 6456, at 20–21 (U.K.).

142. Companies Act, 1985, c. 6, § 309(1); Companies Act 1980, 1980, c. 22, § 46(1); *see also* NIGEL SAVAGE, THE COMPANIES ACT 1980: A NEW BUSINESS CODE (1980).

143. *See, e.g.*, Paul Davies, *Shareholder Value, Company Law, and Securities Markets Law: A British View*, *in* CAPITAL MARKETS AND COMPANY LAW 261, 270 (Klaus J. Hopt & Eddy Wymeersch eds., 2003) (highlighting directors' competing duties to both shareholders and stakeholders, including employees and creditors, under the previous Companies Acts); Ross Grantham, *The Doctrinal Basis of the Rights of Company Shareholders,* 57 CAMBRIDGE L.J. 554, 569–570 (1998) (discussing the directors' duties created by the Companies Acts of 1980 and 1985 as including the interests of shareholders, employees, and creditors); Lord Wedderburn of Charlton, *Companies and Employees: Common Law or Social Dimension?*, 109 L.Q. REV. 220, 235 (1993) (discussing the controversy over the "pluralist" corporate objective standard created by the Companies Acts of 1980 and 1985).

144. Dodge v. Ford Motor Co., 170 N.W. 668, 684 (Mich. 1919) ("A business corporation is organized and carried on primarily for the profit of the stockholders. The powers of the directors are to be employed for that end.").

145. *See, e.g.*, Shlensky v Wrigley, 237 N.E. 2d 776, 180–81 (Ill. App. Ct. 1968) (applying the business judgment rule to director's decision to forego lighting installation at a professional baseball diamond despite its potential to increase profits).

146. *See* Johnson, *supra* note 15, at 450 (suggesting that, outside the narrow scope of *Revlon* duties, there is no doctrinal basis for shareholder wealth maximization). *See generally* D. Gordon Smith, *The Shareholder Primacy Norm*, 23 J. CORP. L. 277 (1998) (arguing that the case should be understood as addressing majority-minority conflicts); Lynn A. Stout, *Why We Should Stop Teaching* Dodge v Ford*,* 3 VA. L. & BUS. REV. 163 (2008) (arguing that *Dodge* is no longer good law).

that objective for ethical, humanitarian, or philanthropic reasons.[147] Even continental laws are not clear-cut because pluralist interpretations of the overarching goal of corporate law are not in fact required by statute. While this was the case in Germany between 1937 and 1965,[148] the French *intérêt social*[149] and the Italian *interesse sociale*[150] are pure products of interpretation in their respective pluralist understanding.

147. AM. LAW INST., PRINCIPLES OF CORP. GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 2.01 (1994).

148. *See* AktG, Jan. 30, 1937, RGBl. I at 107, § 70 (F.R.G.) (requiring directors "to manage the corporation as the good of the enterprise and its retinue and the common weal [sic] of folk and realm demand"). Such a requirement continues to exist in section 70 of Austria's corporation statute with a less politically loaded wording. AktG, BGB1 No. 98/1965, § 70 (Austria). In Germany, the section was removed in the 1965 act, the legislative materials to which stated that it was self-evident that managers would also have to take employee and public interests into account. For the official reasoning for the proposal, see BRUNO KROPFF, AKTIENGESETZ 97 (1965). For an overview of the development of the rule, see Vagts, *supra*, at 38–43. *Cf.* Hans-Joachim Mertens, *in* 2 KÖLNER KOMMENTAR ZUM AKTIENGESETZ § 76 cmt. 16 (Wolfgang Zöllner et al. eds., 2d ed. 1996) (F.R.G.) (stating that the language of the 1937 act was still relevant). The German law's Austrian counterpart includes to this day a rule under which the management board is required manage the company as required by the good of the enterprise with regard to the interests of stockholders, employees and the public interest. AktG § 70 (Austria).

149. *See* Christiane Alcouffe, *Judges and CEOs: French Aspects of Corporate Governance*, 9 EUR. J. L. & ECON. 127, 133–35 (2000); Philippe Bissara, *L'intérêt social* [*The Social Interest*], 117 REVUE DES SOCIETES 5, 14 (1999); Didier Danet, *Crony capitalism et gouvernement d'entreprise* [*Crony Capitalism and Corporate Governance*], 14 REVUE INTERNATIONALE DE DROIT ÉCONOMIQUE 247, 273 (2000); Jacques Delga, *Éthique, éthique d'entreprise, éthique du gouvernement d'entreprise* [*Ethics, Business Ethics, and Corporate Governance Ethics*], 1999 LE DALLOZ, chronique 397; Claude Ducouloux-Favard, *Trente Années d'influence du droit communautaire sûr le droit français des sociétés* [*Thirty Years of Community Law to Influence the Course of French Law Firms*], 113 REVUE DES SOCIETES 649, 657 (1995); Jean Paillusseau, *La modernisation du droit des sociétés commerciales* [*The Modernization of Commercial Law*], 1996 Recueil Dalloz Sirey, chronique 287, 289; Jean Paillusseau, *Entreprise, société, actionnaires, salariés, quels rapports?* [*Business, Society, Shareholders, Employees, What Reports ?*], 1999 RECUEIL DALLOZ, chronique 157, 164–65; Joëlle Simon, *L'évolution du gouvernement d'entreprise en France* [*The Evolution of Corporate Governance in France*], 77 REVUE DE DROIT INTERNATIONAL ET DE DROIT COMPARE 368, 373 (2000); Didier Poracchia, *La rôle de l'intérêt social dans la société par actions simplifiée* [*The Role of the Social Interest in the Joint Stock Company*], 118 REVUE DES SOCIETES 223, 224 (2000). *But see* Dominique Schmidt, *De l'intérêt social* [*On the Social Interest*], LA SEMAINE JURIDIQUE [J.C.P.] I, No. 488 (1995).

150. *See, e.g.*, PIER GIUSTO JAEGER, L'INTERESSE SOCIALE (1964) (Italy) (providing a thorough review of the Italian system). For more recent assessments, see, for example, LUCA ENRIQUES, IL CONFLITTO D'INTERESSI DEGLI AMMINISTRATORI DI SOCIETÀ PER AZIONI 159–83 (2000) (Italy), and Pier Giusto Jaeger, *L'interesse sociale rivisitato (quarant'anni dopo)* [*The Social Interest Revisited (Forty Years Later)*], 27 GIURISPRUDENZA COMMERCIALE I, 795 (2000) (Italy).

In spite of extensive debates in each of these countries, it is doubtful whether the orientation of these norms, which might be considered the ideological attitude toward the corporate law system, is relevant for purposes of regulatory arbitrage. While it may be too pessimistic to consider them completely irrelevant, their significance is most likely an indirect one that manifests itself in subtle differences in the attitude that jurists develop in the course of interpreting the law, often even without directly referring to such overarching ideals. General principles of corporate law influence the interpretation of other rules; courts refer to them as guidelines for interpretation, much like the German Federal Supreme Court did in the recent *Mannesmann* case regarding executive compensation.[151] However, it seems doubtful that arbitrage gains from this type of rule will be large enough to drive reincorporation decisions. In particular, with the exception of the marginal cases that are dealt with by the courts, important business decisions will usually be taken upon the instigation and with the assent of large shareholders, whose interests typically "overrule" corporate objective norms for practical purposes.[152]

2. Directors' Duties in Hostile Takeovers

The most interesting aspect of directors' duties emerges in hostile takeovers, a situation where the interests of shareholder

151. Bundesgerichtshof [BGH] [Federal Court of Justice] Dec. 21, 2005, 50 Entscheidungen des Bundesgerichtshofes in Strafsachen [BGHSt] 331 (F.R.G.), *translated in* FRANKLIN A. GEVURTZ, GLOBAL ISSUES OF CORPORATE LAW 97 (2006). The court explicitly grounded its decision in the concept of *Unternehmensinteresse*, or interest of the business, which is traditionally understood as going beyond the mere interests of shareholders. *See, e.g.*, MILHAUPT & PISTOR, *supra* note 108, at 83–84. However, in this particular case the reference to the doctrine was unnecessary to achieve the court's conclusion.

152. In the United Kingdom, any pluralist inclinations directors may have developed as a result of section 309(1) of the 1985 Companies Act were, for practical purposes, most likely overruled by the market for corporate control and the risk of hostile takeovers under the regime created by the City Code on Takeovers and Mergers. *See* Companies Act, 1985, c. 6, § 309(1) (Eng.); Lucian A. Bebchuk, *The Myth of the Shareholder Franchise*, 93 Va. L. Rev. 675 (2007) ("U.K. law facilitates the removal of directors by shareholders . . . which operate[s] to make boards more accountable and more attentive to shareholder interests."). Apparently the courts never explored how the Code related to § 309. *Cf.* Dawson Int'l plc v Coats Patons plc 1988 S.L.T. 854, 859 (Sess.) (Scot.) (deciding that directors may agree to have a third party recommend a bid to shareholders without violating fiduciary duties and stating that the code does not contradict this conclusion).

value maximization and employees often clash.[153] While hostile takeovers have long been of little relevance in continental Europe because of concentrated ownership, it is remarkable how the principal Anglo-Saxon countries have long occupied opposing ends on the regulatory spectrum in this regard. In the United States, the threat of hostile takeovers fuelled the enactment of laws permitting or requiring managers to take nonshareholder constituencies into account in order to justify defensive measures against hostile takeovers.[154] In more than half of all U.S. states, a statute explicitly allows or requires directors to take the interests of other constituencies into account, including those of shareholders, employees, creditors, bondholders, suppliers, and communities.[155]. In some states, constituency statutes are mandatory, whereas in others they are optional or require a charter provision.[156] Delaware is the most prominent absentee, but the state supreme court has found that "the impact on 'constituencies' other than shareholders (i.e., creditors, customers, employees, and perhaps even the community generally)" is among the concerns the board may take into account.[157] Subsequent case law effectively gave directors a "just

153. *See, e.g.*, Andrei Shleifer & Lawrence Summers, *Breach of Trust in Hostile Takeovers*, *in* CORPORATE TAKEOVERS: CAUSES AND CONSEQUENCES 34 (Alan J. Auerbach ed., 1988) (describing how hostile takeovers may allow shareholders to breach an implicit agreement with employees).

154. Bebchuk and Ferrell argue that U.S. regulatory competition has resulted in a race to protect managers from takeovers. Lucian Bebchuk & Allen Ferrell, *Federalism and Corporate Law: The Race to Protect Managers from Takeovers*, 99 COLUM. L. REV. 1168, 1177 (1999).

155. *See* Jonathan D. Springer, *Corporate Constituency Statutes: Hollow Hopes and False Fears,* 1999 ANN. SURV. AM. L. 85, 125–28 (listing a total of thirty-two statutes that allow directors to consider the corporation's continued independence as optimally serving the interest of the corporation and its shareholders); John C. Coates IV, *Note: State Takeover Statutes and Corporate Theory: The Revival of an Old Debate*, 64 N.Y.U. L. REV. 806, 855 (1989) (discussing the laws that require or allow directors to take constituencies other than the shareholders into consideration during the prospective takeover even though those laws may not give the non-shareholder constituents a voice in the takeover considerations); *see, e.g.*, CONN. GEN. STAT. §§ 33-756(d)(3)–(4) (1997) (requiring directors to consider stakeholder interests). Of the thirty-two statutes, Nebraska's was repealed in 1995. *See* Springer, *supra*, at 95.

156. *See* Springer, *supra* note 155, at 101–02.

157. Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 955 (Del. 1985).

say no" defense[158] and the ability to effectively shield the firm against takeovers.[159]

By contrast, the British City Code on Takeovers and Mergers requires the board to maintain strict neutrality regarding hostile bids. It may not "take any action which may result in any offer or bona fide possible offer being frustrated or in shareholders being denied the opportunity to decide on its merits."[160] According to Paul Davies, "the directors of the target are thrown back on their powers of persuasion."[161] While this difference may not be specific to takeover law, and instead a reflection of a different general attitude of corporate law towards centralized management,[162] it is probably the most significant aspect. Several commentators have pointed out that U.K. takeover regulations give directors "a greater incentive to focus on returns to shareholders."[163]

158. *See, e.g.*, Jeffrey N. Gordon, *"Just Say Never?": Poison Pills, Deadhand Pills, and Shareholder-Adopted Bylaws: An Essay for Warren Buffet*, 19 CARDOZO L. REV. 511, 516 (1997).

159. *See* Lucian A. Bebchuk et al., *The Powerful Antitakeover Force of Staggered Boards: Theory, Evidence, and Policy*, 54 STAN. L. REV. 887 (2002) (arguing that the "law of staggered boards" has given directors the ability to effectively shield the company against hostile takeovers).

160. PANEL ON TAKEOVERS AND MERGERS, THE CITY CODE ON TAKEOVERS AND MERGERS R. 21.1(a) (9th ed. 2009), *available at* http://www.thetakeoverpanel.org.uk/wp-content/uploads/2008/11/code.pdf [hereinafter U.K. TAKEOVER CODE]. Before the 2006 amendments to the Code, this general clause was not part of rule 21, but rather found in general principle 7 of the Code. For a discussion of these amendments, see Geoffrey K. Morse, *Proposed Amendments to the Takeovers Code to Implement the 13th EC Directive*, 2006 J. BUS. L. 242. Before the amendments, the Takeover Code required directors to consider not only shareholders' interests, but also those of employees of directors under general principle 9. *See* PANEL ON TAKEOVERS AND MERGERS, THE CITY CODE ON TAKEOVERS AND MERGERS AND THE RULES GOVERNING SUBSTANTIAL ACQUISITIONS OF SHARES (7th ed. 2002). Moreover, rule 24.1 still requires the bidder to disclose its long-term plans and intentions with regard to the firm's employees. U.K. TAKEOVER CODE, *supra*, R. 24.1. However, as Deakin et al. point out, "these provisions do little to counter-balance the specific duties of disclosure owed to shareholders under the Code." Simon Deakin et al., *Implicit Contracts, Takeovers and Corporate Governance: In the Shadow of the City Code*, *in* IMPLICIT DIMENSIONS OF CONTRACTS: DISCRETE, RELATIONAL AND NETWORK CONTRACTS 289, 299 (David Campbell et al. eds., 2003).

161. DAVIES, *supra* note 141, at 987.

162. *See* Paul Davies & Klaus Hopt, *Control Transactions*, *in* THE ANATOMY OF CORPORATE LAW, *supra* note 36, at 225, 269.

163. John Armour & David A. Skeel, Jr., *Who Writes the Rules for Hostile Takeovers, and Why? - The Peculiar Divergence of U.S. and U.K. Takeover Regulation*, 95 GEO. L.J. 1727, 1739 (2007); SIMON DEAKIN & FRANK WILKINSON, THE LAW OF THE LABOUR MARKET: INDUSTRIALIZATION, EMPLOYMENT AND LEGAL EVOLUTION 337 (2005).

While many U.S. scholars are skeptical about whether constituency statutes actually help employees very much,[164] particularly because of the lack of an enforcement mechanism,[165] others have pointed out that, without the threat of hostile takeovers, directors lack incentives to relentlessly pursue shareholder interests.[166] During the takeover wave of the 1980s, unions were instrumental in blocking several hostile takeovers, and they typically were part of coalitions, which induced many states, to introduce antitakeover statutes.[167] A certain degree of insulation from shareholder influence is likely beneficial to other employees.[168] While the interests of directors and employees are clearly not uniformly aligned, they are certainly allies with regard to some issues.

The overall efficiency of hostile takeovers is of course controversial. Surely, not each takeover will be beneficial from a shareholder-value perspective, as some may indeed be driven more by CEO megalomania more than by anything else.[169] But, by and large, takeovers are likely to exert a disciplining force on managers and reduce agency cost. However, they may also help to drive them into a shareholder-value frenzy that impedes long-term bonding with stakeholders, thus increasing holdup cost. Irrespective of what one thinks about the efficiency implications, it is clear that this trade-off involves a conflict of interest between shareholders and employees.

164. *See* Stephen M. Bainbridge, *Interpreting Nonshareholder Constituency Statutes*, 19 PEPP. L. REV. 971, 1012 (1992) (pointing out that directors lobbying for constituency statutes equally lobby against plant closing and worker protection laws); Gary von Stange, Note, *Corporate Social Responsibility Through Constituency Statutes: Legend or Lie?*, 11 HOFSTRA LAB. L.J. 461, 489 (1994) (challenging the efficacy of constituency statutes). *See generally* William J. Carney, *Does Defining Constituencies Matter?*, 59 U. CIN. L. REV. 385, 418, 420–24 (1990) (highlighting the problems that result from considering the interests of other constituencies).

165. *See* Coates, *supra* note 155, at 855; Springer, *supra* note 155, at 108, 121. As noted earlier, most statutes only allow directors to take stakeholder interests into account, but do not require them to do so. *See supra* note 156 and accompanying text.

166. *See, e.g.*, Springer, *supra* note 135, at 122.

167. *See, e.g.*, Roberta Romano, *The Political Economy of Takeover Statutes*, 73 VA. L. REV. 111, 120–22 (1987).

168. *See* Brett H. McDonnell, *Corporate Constituency Statutes and Employee Governance*, 30 WM. MITCHELL L. REV. 1227, 1244–53 (2004) (modeling the implications of takeovers for employees).

169. *See, e.g.*, Gary Hamel, *When Dinosaurs Mate*, WALL ST. J., Jan. 22, 2004, at A12 (suggesting that large mergers often destroy shareholder wealth).

3. The EU Takeover Directive

The EU Takeover Directive was passed in 2004,[170] following the recommendation of the High Level Group of Company Law Experts.[171] At first glance, it seems to implement a system of board neutrality and free choice of shareholders modeled on the British system. According to article 9(2), the board of the target firm must, between the time when the board learns about the bid and the time when the result of the bid is made public or lapses, obtain authorization from shareholders before taking any action that might frustrate the bid other than seeking alternative bids.[172] Article 11 also sets forth the "breakthrough" rule. Under article 11(2), restrictions on the transfer of securities (either as set out in the firm's charter or by contractual stipulation) do not apply vis-à-vis the bidder.[173] Similarly, restrictions on voting rights do not apply in shareholder meetings that are convened to decide on defensive measures, and multiple-voting shares (if permitted by the applicable national law) carry only one vote.[174] Article 11(4) provides for a permanent removal of these restrictions if the bidder manages to obtain seventy-five percent of the capital carrying voting rights.[175]

While the primary stance taken by these provisions and the directive in general therefore appears to be shareholder primacy by allowing shareholders to make decisions that can affect the success of the bid,[176] they are in fact less consequential than they

170. Council Directive on Takeover Bids, No. 2004/25, 2004 O.J. L 142/12. Regarding the historical background and impediments to its enactment, see Joëlle Simon, *Adoption of the European Directive on Takeover Bids; an On-again, Off-again Story*, *in* PERSPECTIVES IN COMPANY LAW AND FINANCIAL REGULATION, *supra* note 97, at 345.

171. THE HIGH LEVEL GROUP OF COMPANY LAW EXPERTS, REPORT ON A MODERN REGULATORY FRAMEWORK FOR COMPANY LAW IN EUROPE (2002), *available at* http://ec.europa.eu/internal_market/company/docs/takeoverbids/2002-01-hlg-report_en.pdf.

172. Council Directive on Takeover Bids, No. 2004/25, art. 9(2), 2004 O.J. L 142/12, at 19.

173. *Id.* art. 11(2), 2004 O.J. L 142/12, at 20.

174. *Id.* art. 11(3).

175. *Id.* art 11(4). Furthermore, extraordinary rights of shareholders to appoint directors no longer apply, and multiple-voting securities are treated as normal shares in the first meeting convened after the bid to appoint new board members.

176. *See, e.g.*, Steef M. Bartman, *The EC Directive on Takeover Bids: Opting in as a Token of Good Corporate Governance*, *in* EUROPEAN COMPANY LAW IN ACCELERATED PROGRESS 1, 3 (Steef M. Bartman ed., 2006) ("[T]he eventual power of decision making on a takeover bid lies with the shareholders . . . ."). The "interests" of the company as a

appear to be at first glance. Article 12(1) stipulates that "Member States may reserve the right not to require companies" to apply the provisions outlined above—board neutrality and the breakthrough rule thus remain optional.[177] However, member states are required to allow firms to voluntarily submit to the rules in their articles of association.[178] While the neutrality rule is now compulsory under the law of most member states, only the three Baltic states have imposed the breakthrough rule on their firms.[179] A firm might want to apply them voluntarily because of the reciprocity rule of article 12(3) that permits member states to exempt a firm that normally applies these rules when the bidder is a firm that does not apply them.[180] Whether a firm will opt into these rules will most likely depend on what probabilities the decision-makers assign to being the bidder or the target of a hostile takeover.

The issues relating to the board's duties when confronted with a hostile takeover prevented the directive from passing for a long time, whose first draft dates back to 1989.[181] With these important options left to member states in compromise, regulatory arbitrage gains are possible. The choice of law rules of the Takeover Directive offer split competencies between the laws

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whole referred to in article 3(1)(c) of the EU directive seems to be more ambivalent. *See* BEATE SJÅFJELL, TOWARDS A SUSTAINABLE EUROPEAN COMPANY LAW 346–51 (2009); Theo Raaijmakers, *Takeover Regulation in Europe and America: The Need for Functional Convergence*, *in* CORPORATE GOVERNANCE REGIMES: CONVERGENCE AND DIVERSITY 205, 210–11 (Joseph A. McCahery et al. eds., 2003) (suggesting that the directive includes "stakeholder" elements).

177. Council Directive on Takeover Bids, No. 2004/25, art. 9(2), 2004 O.J. L 142/12., at 19.

178. *Id.* art 12(2), 2004 O.J. L 142/12, at 21.

179. Commission of the European Communities, Report on the Implementation of the Directive on Takeover Bids 6–8, 12, SEC (2007) 268 (Feb. 21, 2007) [hereinafter Commission Report on the Takeover Directive].

180. Council Directive on Takeover Bids, No. 2004/25, art. 12(3), 2004 O.J. L 142/12, at 21. For an analysis, see Marco Becht, *Reciprocity in Takeovers*, *in* REFORMING COMPANY AND TAKEOVER LAW IN EUROPE 647 (Guido Ferrarini et al. eds., 2004).

181. *See* Vanessa Edwards, *The Directive on Takeover Bids – Not Worth the Paper It's Written On?*, 1 EUR. COMP. & FIN. L. REV. 416, 417–31 (2004); Luca Enriques, *EC Company Law Directives and Regulations: How Trivial Are They?*, 27 U. PA. J. INT'L ECON. L. 1, 24 (2006); Jette Steen Knudsen, *Is the Single European Market an Illusion? Obstacles to Reform of EU Takeover Regulation*, 11 EUR. L.J. 507 (2005); Marco Ventoruzzo, *Europe's Thirteenth Directive and U.S. Takeover Regulation: Regulatory Means and Political and Economic Ends*, 41 TEX. INT'L L.J. 171, 203–05 (2006).

of the involved member states.[182] However, rules that are typically classified as corporate law, such as those regarding the board's duties, which are crucial for defending against hostile takeovers, are invariably tied to the firm's registered office.[183] Admittedly, some rules that depend on the place of listing, such as those relating to the consideration for a mandatory bid, may also influence the incidence of takeovers, but the main impediment—the permissibility of defensive measures—is determined by the applicable corporate law.[184] As previously stated, the costs and benefits of hostile takeovers are beyond the scope of this Article; however, an impact on employees is possible, particularly in firms with dispersed ownership.

4. Large Blockholders, "Golden Shares" and the Breakthrough Rule

In contrast to the many firms with dispersed ownership in the United States and the United Kingdom, board neutrality seems of relatively little, if any, importance for takeovers in publicly traded firms in continental Europe, where concentrated ownership dominates the corporate landscape.[185] For the disciplinary force of hostile takeovers to create incentives, the replacement of managers must be a likely outcome, which is ruled out when management is effectively controlled by a large blockholder. Incumbent blockholders may fear the possibility of other stockholders increasing their share and outpacing them, possibly by breaking other blockholders out of the governing

182. If a company's shares are traded on a regulated market not of the member state where its registered office is located, the supervisory authority of the market state is considered competent with regard to the firm. Council Directive on Takeover Bids, No. 2004/25, art. 4(2)(b), 2004 O.J. L 142/12, at 16. When shares are traded on several markets, the markets where it was first traded is decisive. *See id.* art. 4(2)(c). The same law governs issues that can be considered capital markets law, such as the bid price and procedural issues relating to the offer. *See id.*

183. *See id.* art. 4(2)(e).

184. *See* Luca Enriques & Tobias Tröger, *Issuer Choice in Europe*, 67 CAMBRIDGE L.J. 521, 531 (2008).

185. *Cf.* Lucian Bebchuk & Assaf Hamdani, *The Elusive Quest for Global Corporate Governance Standards*, 157 U. PA. L. REV. 1263, 1287 (2009) ("[T]he arrangements governing control contests are largely irrelevant to [controlling shareholder] companies[.]"). There are clearly some dispersed ownership firms in continental Europe, but concentrated ownership is by far the majority structure.

coalition. However, this type of threat will most likely only create an incentive to entrench the controlling position.[186]

There is a current trend on the EU level to remove such entrenchments. This is particularly manifest in the ECJ case law on "golden shares."[187] In these cases, government entities attempted to retain control for purported public policy reasons after privatization, either by means of charter provisions, or by special laws attaching a veto right to the owner of a specific share.[188] While the various governments did not claim to be concerned with employee welfare in their defense of these measures before the court, golden shares may have indirectly benefited employees by deterring takeovers.[189]

While private actors are not subject to this case law,[190] this debate elucidates important differences between takeover defenses under dispersed and concentrated ownership. The primary concern in the United States is to entrench the board, as

186. One is tempted to speculate that the relative unimportance of the neutrality rule explains why it was nearly universally adopted in Europe after the passing of the Takeover Directive, while the breakthrough rule has only been made mandatory by the three Baltic states. *See* Commission Report on the Takeover Directive, *supra* note 179.

187. *See* Federconsumatori v. Comune di Milano, Joined Cases C-463 & 464/04, [2007] E.C.R. I-10419; Commission v. Netherlands, Joined Cases C-282 & 283/04, [2006] E.C.R. I-9141; Commission v. Italy, Case C-174/04, [2005] E.C.R. 4933; Comm'n v. United Kingdom, Case C-98/01, [2003] E.C.R. I-4641; Commission v. Spain, Case C-463/00, [2003] E.C.R. I-4581; Commission v. Belgium, Case C-503/99, [2002] E.C.R. I-4809; Commission v. France, Case C-483/99, [2002] E.C.R. I-4781; Commission v. Portugal, Case C-367/98, [2002] E.C.R. I-4731;. For an overview of all but the three most recent cases, see Anne Looijestijn-Claerie, *All That Glitters is Not Gold: European Court of Justice Strikes Down Golden Shares in Two Dutch Companies*, 8 EUR. BUS. ORG. L. REV. 429, 431–32 (2007). The *Volkswagen* case, described above, *see supra* note 97, which triggered a dispute about employee participation rights, is closely related to this line of cases.

188. More precisely, the execution of certain important decisions required the approval of that shareholder.

189. Some member states, however, have not yet been deterred from enacting such regulation by the ECJ. On October 8, 2007, Hungary passed the "Lex MOL" to prevent partly government-owned Austrian OMV AG from taking control of the Hungarian national champion in the oil industry, MOL. *See, e.g.*, Economic Intelligence Unit, *Hungary Regulations: The Controversial "Lex Mol"*, EIU VIEWSWIRE HUNGARY, Nov. 12, 2007. OMV's bid for MOL ultimately failed for antitrust reasons. *See* Haig Simonian, *Brussels Blamed as OMV Ends Mol Chase*, FIN. TIMES (London), Aug. 6, 2008, at 17.

190. *See* Looijestijn-Claerie, *supra* note 187, at 442–45. Notably, however, the prohibition against golden shares applies when the state acts as a private market participant, for instance by introducing golden shares in the articles of association. *See id.*

is apparent in the use of devices such as the poison pill.[191] In continental Europe, however, the main issue concerns blockholders preventing other large shareholder from collecting a bigger share of the firm's votes, as is apparent though the use of devices such as voting caps, dual-class share structures, or multiple-voting shares.[192] U.S.-style poison pills would hardly be helpful for this purpose. The duties of the board in hostile takeovers are of much smaller importance in corporate governance systems with concentrated ownership than they are in the United States or the United Kingdom, since large shareholders are more often able to mold the outcome of a bid. Frequently, a bidder is forced to negotiate a deal with a number of large shareholders. The breakthrough rule might be more interesting for regulatory arbitrage in the continental context.

Consequently, regulatory arbitrage opportunities with respect to takeovers are unlikely to have significant effects on employees in firms with concentrated ownership, as incumbent and employee interests will normally coincide with respect to the firm's contestability.[193] Moreover, incumbent controlling shareholders will normally not have to avail themselves of corporate law arbitrage opportunities. They can either opt into provisions that make the firm more contestable or they can opt out of these provisions (where they are mandatory) by forming pyramid structures.[194]

D. *Shareholder Involvement Versus Independence of the Board*

The discussion of antitakeover measures illustrates the broader issue regarding how corporate governance matters to employees. Different corporate laws vary remarkably in the

191. John C. Coates IV, *Ownership, Takeovers and EU Law: How Contestable Should EU Corporation Law Be?*, *in* REFORMING COMPANY AND TAKEOVER LAW IN EUROPE 678, 698–702 (Guido Ferrarini et al. eds., 2004) (discussing the ways in which U.S. companies can avoid takeovers).

192. *Cf.* Komo & Villiers, *supra* note 14, at 202 (pointing out that the effect of the *Volkswagen* decision was to entrench Porsche as a large blockholder).

193. The case of Italy, which originally implemented both rules but reverted that decision in 2008 shows that the lobbying power of incumbents is at least sometimes strong enough to shield firms against takeovers on the political level. *See* Rock et al., *supra* note 124, at 272.

194. Coates IV, *supra* note 191, at 689–90 (discussing cross-holding and pyramid structures that allow companies going public to shield themselves from takeovers).

extent to which they give shareholders (as a group) power to influence business decisions taken by directors and senior managers.

If the firm's senior managers were completely insulated from shareholder involvement and not held accountable at all, it is clear that they would have no reason to favor shareholder interests over those of any other group. Sometimes their intrinsic interests will correspond to those of shareholders, and sometimes they will be more aligned with those of employees. Adherents of the "team production" theory of corporate law go further and posit that the relatively unconstrained position of the board of directors allows its members to balance the interests of different corporate constituencies, which in turn encourages firm-specific investment by stakeholder groups such as employees.[195]

Obviously, releasing managers from any accountability to shareholders is likely to increase agency cost, as they will primarily attempt to use the firm for their own personal ends. Thus, constraining them may not only benefit shareholders, but also other nonshareholder constituencies.[196] However, it is important to distinguish self-interested behavior from what could be called legitimate business judgment, which roughly traces the boundaries between the common law duties of loyalty and care.[197] While courts typically apply a stringent standard to situations where directors, managers, and controlling shareholders misappropriate corporate assets or opportunities to their own personal benefit,[198] judicial review of nonconflicted

195. *See* Blair & Stout, *supra* note 16, 288–89 (1999) ("[P]ublic corporation law encourages directors to serve the joint interests of all stakeholders who comprise the corporate 'team' by generally insulating them from the demands of any single stakeholder group, including the shareholders."); *see also* Bruno Frey & Margit Osterloh, *Yes, Managers Should Be Paid Like Bureaucrats*, 14 J. MGMT. INQ. 96, 99–102 (2005) (advocating that a common pool approach, which incorporates the "team production" theory, encourages a more conscientious management); Martin Gelter, *The Dark Side of Shareholder Influence: Managerial Autonomy and Stakeholder Orientation in Comparative Corporate Governance*, 50 HARV. INT'L L.J. 129, 136–43 (2009) (arguing that a comparatively greater insulation of managers from shareholder influence may result in more firm-specific investment in human capital by employees).

196. *See, e.g.*, Bebchuk, *supra* note 152, at 731.

197. Regarding U.S. law, see ROBERT C. CLARK, CORPORATE LAW 123–25, 142–50 (1986), and WILLIAM T. ALLEN, REINIER KRAAKMAN & GUHAN SUBRAMANIAN, COMMENTARIES AND CASES ON THE LAW OF BUSINESS ORGANIZATIONS 239 (3d ed. 2009).

198. Margaret M. Blair & Lynn A. Stout, *Director Accountability and the Mediating Role of the Corporate Board*, 79 Wash. U. L.Q. 403, 427 (2001) ("[C]ourts tend to hold

managerial decision-making provides a very loose constraint, if any, in most jurisdictions.[199] Decisions that redistribute wealth between shareholders and employees typically fall into the latter group.[200]

For the debate about the effects of regulatory arbitrage on employees, it is important to emphasize the distinction between these two different aspects of corporate governance. Shareholders and employees have a joint interest in impeding managerial self-dealing: shareholders because their financial claims are diluted, and employees because their jobs are less secure and their advancement opportunities are eliminated. While regulatory competition is likely to have effects on such issues,[201] they are not the ones of primary relevance for this Article.

directors liable *only* in egregious situations involving a significant pecuniary benefit to the director or loss to the firm, and in which the offending director or directors failed to subject the self-dealing transaction to an informed vote . . . ." (emphasis added)).

199. The U.S. business judgment rule protects directors from judicial review unless they fail to gather relevant information before acting, act in good faith, and stay clear of self-interest. *See* PRINCIPLES OF CORPORATE GOVERNANCE § 4.01(c) (1992). Regarding the United Kingdom, see DAVIES, *supra* note 141, at 493–94, and Brian Cheffins & Bernard S. Black, *Outside Director Liability Across Countries*, 84 TEX. L. REV. 1385, 1401 (2006) (pointing out that judges are unlikely to second-guess business decisions even in the absence of a formal business judgment rule). Regarding France, see YVES GUYON, 1 DROIT DES AFFAIRES [BUSINESS LAW] 502–03 (12th ed. 2001) (Fr.). Regarding Italy, see Giuseppe Campana, *La responsabilità civile degli amministratori delle società di capitali* [*Civil Liability of Directors of Corporations*], 2 LA NUOVA GIURISPRUDENZA CIVILE COMMENTATA 215, 224–226 (2000) (discussing Italian equivalents to the business judgment rule), and Antonio Rossi, *Art. 2392 (Responsabilità verso la società)* [*Art. 2392 (Liability to the Corporation)*], *in* IL NUOVO DIRITTO DELLE SOCIETÀ 790, 796–803 (Alberto Maffei Alberti ed., 2005). German law even adopted a provision modeled on the U.S. business judgment rule in 2005, AktG, Sept. 6, 1965, BGBl. I at 1089, § 93, last amended Gesetz zur Unternehmensintegrität und Modernisierung des Anfechtungsrechts (UMAG) [Act Regarding Business Integrity and the Modernization of Nullification Suits] , Sept. 22, 2005, BGBl I, at 2802, but only after broad managerial latitude was already recognized in the case law. *See* BGH April 21, 1997, 135 Entscheidungen des Bundesgerichtshofes in Zivilsachen [BGHZ] 244 (F.R.G.), *translated in* GEVURTZ, *supra* note 151, at 80; *see also* Erich Schanze*, Directors' Duties in Germany*, 3 CO. FIN. & INSOLVENCY L. REV. 286, 291 (1999).

200. *See* Blair & Stout, *supra* note 198, at 428 (listing board decisions that can be classified as business judgments as including its ability to "unilaterally raise retirees' pension benefits, refuse to adopt a corporate strategy that would increase profits but harm the local community, and fend off a hostile takeover bid at a premium"); Gelter, *supra* note 195, at 146–47 (discussing the broad discretion provided to managers under the business judgment rule).

201. *See, e.g.*, Gelter, *supra* note 7, at 273–75.

By contrast, employees share an interest with managers regarding issues that do not involve what could be described as theft or conflicted decision-making, but simply fundamental business decisions. For example, it is crucial for them whether managers threaten to close a plant, to reduce the workforce, or just drive a hard bargain in collective negotiations with unions. Tautologically, shareholders have a financial interest in shareholder value maximization, which may require such actions. As long as managers' decisions are not dictated by a controlling shareholder or forced by pro-shareholder incentives set by executive compensation or the market for corporate control, this principle does not necessarily apply to them with equal force. Behavioral theory suggests that managers, unless they are tightly constrained, do not try to maximize profits, but instead engage in the practice of "profit-satisficing" by determining what payoff would be acceptable for providers of equity.[202] Profits, however, may be hard to verify by outside shareholders.[203] Econometric research suggests that that managers prefer a "quiet life" and would rather avoid closing down plants[204] instead of eagerly engaging in firm reorganizations that are usually associated with job cuts and angry unions. The U.S. debate on hostile takeovers

202. *See* JESSE H. CHOPER, JOHN C. COFFEE, JR. & RONALD J. GILSON, CASES AND MATERIALS ON CORPORATIONS 29–30 (6th ed. 2004); John C. Coffee, Jr., *Shareholders Versus Managers: The Strain in the Corporate Web*, 85 MICH. L. REV. 1, 29 (1986) ("'[B]ehaviroal' theory of the firm postulates that managers do not profit-maximize, but rather 'profit-satsfice'—that is, they seek that level of profits that will suffice to prevent external interventions by dissatisfied creditors or stockholders."); Einer Elhauge, *Sacrificing Corporate Profits in the Public Interest,* 80 N.Y.U. L. REV. 733, 804 (2005) (describing profit-satisficing as achieving "the level of profits necessary to avoid interference with [managerial] discretion but otherwise run the firm to advance other aims); Christoph Engel, *The Behavior of Corporate Actors: A Survey of the Empirical Literature* 3 (2008) (Max Planck Institute for Research on Collective Goods, Paper No. 2008/23) ("Empirical work has shown early on that firms are often satisficers, not utility maximisers."), *available at* http://www.coll.mpg.de/pdf_dat/2008_23online.pdf. The theory of "satisficing" can be traced to Simon, *supra* note 21. *See also* Julius Margolis, *The Analysis of the Firm: Rationalism, Conventionalism, and Behavioralism*, 31 J. BUS. 187, 190 (1958) (arguing that, the objective of the firm is to achieving "satisfactory" profits, rather than profit maximize, due to imperfect knowledge).

203. *See, e.g.*, M. Pagano & P.F. Volpin, *Managers, Workers, and Corporate Control*, 40 J. FIN. 841, 842 (2005).

204. Marianne Bertrand & Sendhil Mullianathan, *Enjoying the Quiet Life? Corporate Governance and Managerial Preferences*, 111 J. POL. ECON. 1043, 1066–67 (2003).

suggests that employees and top management are often natural allies.[205]

Besides takeover law, the other issue of corporate law that matters for shareholder-employee conflicts in managerial business decisions is the degree to which management is shielded from shareholder involvement.[206] The team production theory of U.S. corporate law claims that nonshareholder constituencies benefit to some degree from the U.S. corporate and securities law that tie shareholders' hands.[207] Given the absence of influence by shareholders, the primary beneficiary of potential opportunism against employees, the latter may have better incentives to make specific investment.[208] The theory implicitly rests on the variable of dispersed ownership that itself impedes direct shareholder involvement in managerial decision. While this theory seems to be a good fit for an important subset of U.S. publicly traded firms, it is hardly compatible with the corporate governance structures of firms in continental Europe, where large shareholders continue to exert considerable control over management even in firms comparable in size to their largest U.S. counterparts,[209] unless they find some way of committing not

205. *See, e.g.*, Pagano & Volpin, *supra* note 203, at 864 ("[M]anagers and workers are natural allies against a takeover threat."); *see also* Romano, *supra* note 167, at 120–22 (explaining that managers natural align themselves with corporate groups outside the shareholder nexus when making certain decisions); Jordi Surroca & Josep A. Tribó, *Managerial Entrenchment and Corporate Social Performance*, 36 J. BUS. FIN. & ACCT. 748 (2008) (positing that shareholders and stakeholders are "natural allies").

206. As mentioned in Part II.A, there are other aspects of the law that matter, such as employment protection laws and the requirement to consult with works councils, but these are not part of the body of pure "corporate law" and therefore not subject to the type of regulatory arbitrage studied here.

207. *See* Blair & Stout, *supra* note 16, at 253 (noting that the team production model suggests that the legal requirement of board supervision may have evolved to encourage firm-specific investment by "all the members of the corporate 'team,' including shareholders, managers, rank and file employees, and possibly other groups, such as creditors").

208. *See* Shleifer & Summers, *supra* note 153, at 40.

209. *See, e.g.*, ROE, *supra* note 26, at 49–56; Marco Becht & Alisa Röell, *Blockholdings in Europe: An International Comparison*, 43 EUR. ECON. REV. 1049 (1999) (conducting an empirical study that finds that the degree of concentration of shareholder voting power is considerably higher in continental Europe than in the United States or the United Kingdom); Mara Faccio & Larry H.P. Lang, *The Ultimate Ownership of Western European Corporations*, 65 J. FIN. ECON. 365 (2002) (finding that 44.29% of the companies in a study comprising 5,232 companies from Western European are family controlled); Rafael La Porta et al., *Corporate Ownership Around the World*, 44 J. FIN. 471 (1999) (generally discussing the control structure of corporations in twenty seven wealthy

to "expropriate" stakeholders.[210] The theory's applicability to firms with dispersed ownership can, however, be undermined setting when managers have a strong incentive to maximize shareholder wealth. This seems to be the case in the United Kingdom to a larger degree than in the United States primarily because of U.K. takeover law.[211]

For purposes of this Article, it suffices to emphasize the possible benefits from insulated management for employees. In the case of an upcoming decision clearly within the scope of legitimate managerial business judgment, for instance whether to open a new plant, a controlling shareholder or a coalition of blockholders will typically be in the position to influence management to favor the collective financial interest of shareholders. Corporate law rules determining the powers and independence of the board of directors from shareholders influence the degree of managerial insulation, and thus, at least marginally, also the position of employees.

In fact, some European laws were purposefully designed to insulate managers from shareholders. Germany provides a useful example. Ever since the 1937 reform of German corporate law, the management board is appointed and dismissed by the supervisory board, and cause is required to revoke the management board members' appointment prematurely.[212] Supervisory board members can only be dismissed prematurely by a supermajority of three quarters in the shareholder meeting.[213] Shareholders can legally only involve themselves in management decisions when a decision is submitted for a vote by

economies); *see also* Ronald J. Gilson, *Controlling Shareholders and Corporate Governance: Complicating the Corporate Taxonomy*, 119 HARV. L. REV. 1641, 1645 (2006) (summarizing the empirical evidence). *But see* Clifford G. Holderness, *The Myth of Diffuse Ownership in the United States*, 22 REV. FIN. STUD. 1377 (2009) (arguing that, contrary to the conventional wisdom and most other empirical evidence, dispersed ownership is not more prevalent in the United States than elsewhere).

210. *See* Gelter, *supra* note 195 , at 154–76.

211. For a comparison of the two regimes, see Armour & Skeel, *supra* note 163, at 1738. For a discussion in the light of the theory outlined here, see Gelter, *supra* note 195, at 188–89.

212. AktG, Sept. 6, 1965, BGBl. I at 1089, last amended by Gesetz, July 31, 2009, BGBl. I at 2509, § 84(3). However, a shareholder vote of no confidence that is not obviously frivolous may constitute cause. With the exception of the United States, multiyear appointments are both permitted by the law and common.

213. *Id.* § 103(1).

management[214] The prevailing Nazi ideology of the *Führerprinzip* certainly dictated strong leadership,[215] but the policy of insulation was at least in part the consequence of a longstanding debate in German economic and legal theory during the previous decades, in which a left-wing current in the literature sought to restrain the influence of capital and, arguably, to protect firms from changing majorities and coalitions in the shareholder meeting.[216]

The German model affected other countries as well, such as Austria and France. In Austria, the German model was clearly followed when the *Aktiengesetz* was introduced in 1938.[217] In France, the position of the *Président Directeur-General* ("PDG"), which combined the functions of the president of the board and the CEO, was introduced in the hastily enacted reforms of 1940[218] and 1943[219] and remained mandatory until 2001.[220]

214. *Id.* § 119(2). The law of course requires shareholder votes for structural changes such as mergers, which go beyond mere management decisions, and the courts have additionally required shareholder votes in the case of certain other transactions of high significance. BGH, Feb. 25, 1982, 174 BGHZ 80 (requiring a vote on the contribution of 80% of the firm's assets to a wholly-owned subsidiary in a case popularly known as *Holzmüller*). *But see* BGH April 26, 2004, 155 BGHZ 02 (clarifying that *Holzmüller* duties only apply in exceptional cases). For a description of the development of the case law see, Marc Löbbe, *Corporate Groups: Competences of the Shareholders' Meeting and Minority Protection – the German Federal Court of Justice' Recent* Gelatine *and* Macotron *Cases Redefine the* Holzmüller *Doctrine*, 5 GERMAN L.J. 1057 (2004).

215. *See* Jan von Hein, *Vom Vorstandvorsitzenden zum CEO?* [*From Chief Executive Officer to CEO?*], 166 ZEITSCHRIFT FÜR DAS GESAMTE HANDELS- UND WIRTSCHAFTSRECHT 464, 475 (2002).

216. Important writers include: WALTHER RATHENAU, VOM AKTIENWESEN. EINE GESCHÄFTLICHE BETRACHTUNG (1917); and Oskar Netter, *Zur aktienrechtlichen Theorie des „Unternehmens an sich", in* FESTSCHRIFT HERRN RECHTSANWALT UND NOTAR JUSTIZRAT DR.JUR.H.C. ALBERT PINNER ZU SEINEM 75 GEBURTSTAG 507 (Deutscher Anwaltsverein et al., eds., 1932). *But see* FRITZ HAUSSMANN, VOM AKTIENWESEN UND VOM AKTIENRECHT (1928) (criticizing Rathenau's theory of the institutional interest of the corporation).

217. The 1938 promulgation of *Aktiengesetz* was introduced for newly founded corporations on April 11, 1938 by Erste Verordnung zur Einführung handelsrechtlicher Vorschriften im Lande Österreich [First Regulation to Introduce Commercial Law Provisions in the Land of Austria], RGBl No. 385/1938, and for existing firms as of January 1, 1939, by Zweite Verordnung zur Einführung handelsrechtlicher Vorschriften im Lande Österreich [Second Regulation to Introduce Commercial Law Provisions in the Land of Austria] RGBl No. 982/1938.

218. Law of Nov. 16, 1940, Journal Officiel de la République Française [J.O.] [Official Gazette of France], Nov. 16, 1940, p. 5828. This law replaced the prior Law of September 18, 1940, before it could come into force. *See* Paul Cordonnier, *Loi du 16 novembre 1940*, *in* 1941 DALLOZ RECUEIL CRITIQUE 1, 1–2 (1941).

Contemporary writers sometimes attributed this development to a "transposition of the German theory of the *Führerprinzip*" in France (although the issue is, unsurprisingly, controversial).[221] French law, however, always retained the rule that directors could be removed by a shareholder resolution at any time, which counteracted the independence of the PDG.[222] Even the United Kingdom, which is usually thought of as the most pro-shareholder European jurisdiction, once had a statute requiring directors to have regard to the interests of employees.[223] The Companies Act of 2006 has, however, changed the law to the effect of requiring a concern to "enlightened shareholder value."[224]

Concentrated ownership structures persisted in spite of these rules, and large shareholders usually remain able to impose their will on corporations, even in Germany.[225] However, the extent to which directors and managers are able to assert their independence from large shareholders depends on a complex set of factors, including personal authority and corporate culture. But in the case of any individual firm, the applicable law is still a major determinant of shareholder influence of major and minor

219. Law of Mar. 4, 1943, J.O., Mar. 6, 1943, p. 642 (Fr.); *see also* MICHEL GERMAIN & LOUIS VOGEL, 1:2 TRAITÉ DE DROIT COMMERCIAL 400, 442–45 (G. Ripert & R. Roblot eds., 18th ed. 2001).

220. Law No. 2001-420 of Mar. 15, 2001, J.O., May 16, 2001, p. 7776 (Fr.).

221. *See, e.g.*, JEAN PAILLUSSEAU, LA SOCIÉTÉ ANONYME, TECHNIQUE D'ORGANISATION DE L'ENTREPRISE 154–55 (1967) (Fr.) (providing various references).

222. *See* GERMAIN & VOGEL, *supra* note 219, at 453; Claude Ducouloux-Favard, *Les déviances de la gestion dans nos grandes entreprises* [*The Deviations of Management in Our Largest Businesses*], 1996 RECUEIL DALLOZ SIREY, chronique 190, 191 (describing the possibility of removal *at nutum* as being at odds with the prevailing institutional theory of the firm); Enriques et al., *supra* note 36, at 61 (noting the nonwaivable right in French law to remove directors midterm).

223. *See supra* notes 142–143.

224. *See supra* note 141.

225. Supervisory board members, who decide about the removal of management board members, are typically close confidants of large shareholders, and the requirement of a 75% supermajority is not insurmountable. *See, e.g.*, Peter Doralt, *Die Unabhängigkeit des Vorstands nach österreichischem und deutschen Aktienrecht – Schein und Wirklichkeit* [*The Independence of the Board Under Austrian and German Company Law – Appearance and Reality*], *in* DIE GESTALTUNG DER ORGANISATIONSDYNAMIK. FESTSCHRIFT FÜR OSKAR GRÜN 31, 47–48 (Werner H. Hoffmann ed., 2003); *see also* Reinhard H. Schmidt, *Corporate Governance in Germany: An Economic Perspective*, *in* THE GERMAN FINANCIAL SYSTEM 386, 393 (Jan Pieter Krahnen & Reinhard H. Schmidt eds., 2004) (reporting that blockholders and banks are represented on the supervisory board besides employees).

business decisions. This factor could therefore be the subject of regulatory arbitrage.

III. *CONSEQUENCES OF REGULATORY ARBITRAGE IN THE NEXUS BETWEEN SHAREHOLDERS AND EMPLOYEES*

Having identified legal mechanisms that could potentially serve as targets for regulatory arbitrage, this Part will now analyze possible consequences of ex ante and ex post corporate law choices in corporate law. As a result of the ECJ's *Centros* and *Überseering* cases, codetermination and other aspects of corporate law relevant to employees are no longer mandatory at the formation stage of the firm, at least in those member states that do not counteract EC law by setting up further hurdles for setting up a branch office.[226] The only limitation is the necessity to select the entire bundle of a particular law.

A. *Ex Ante Choice of Law*

At the formation stage, the incorporation decision is often taken by a group of founders who will typically take on the role of shareholders and managers concurrently; minority investors, employees, and other stakeholders only enter the picture later. In other cases, employee participation systems may already be important at the beginning, for example when a joint subsidiary comprising some existing business is set up by two firms from different countries. Obviously, regulatory arbitrage can have a beneficial impact: founders will be able to choose the bundle most appropriate in light of the firm's business environment. This applies also to the firm's relationship with its employees:[227] If the mechanisms described in the previous section indeed protect employees' specific investment, firms operating in an industry where specific investment is a competitive advantage will

226. *See* Überseering BV v. Nordic Constr. Co. Baumanagement GmbH (NCC), Case C-208/00, [2002] E.C.R. I-9919; Centros Ltd. v. Erhvervs-og Selskabsstyrelsen, Case C-212/97, [1999] E.C.R. I-1459. *But see* Becht et al., *supra* note 12 (describing differences in costs among member states and even citing blatant disregard of ECJ case law in some).

227. *Cf.* Stefano Lombardo, *Conflict of Law Rules in Company Law after* Überseering*: An Economic and Comparative Analysis of the Allocation of Policy Competence in the European Union*, 4 EUR. BUS. ORG. L. REV. 301, 322–30 (2003) (making a similar argument regarding creditors).

be able to choose the preferable legal system by committing to a beneficial legal framework in the formation stage. Firms choosing a suboptimal regime would—in the long run—be eliminated by competition in product markets. The result would be, more or less, efficient choice.[228]

In practice, however, pro-employee laws, particularly employee participation systems, appear not to be selected voluntarily on a regular basis. To the contrary, it currently seems that some firms are trying to escape or mitigate German codetermination through regulatory arbitrage.[229] Of course, one reason could be that these are simply inefficient and therefore not chosen by firms.[230] However, there are other possibilities. The primary corporate law issue driving regulatory arbitrage at the formation stage seems to be minimum capital and related creditor protection doctrines, which have also been the only issue addressed by legislative reactions to corporate law arbitrage. At the founding stage, employee participation systems are hardly any concern, since it is not known whether they will ever grow big enough to support a substantial workforce. With employee participation systems typically "bundled" with minimum capital in one regulatory package, they simply are not important enough to influence the incorporation decision.

Even a choice influenced by long-term prospects of the firm may not be uniformly efficient. The most frequently cited arguments in the literature regarding why such regimes are not chosen voluntarily appears to be adverse selection: laws increasing the bargaining position may reduce the wage differential between senior management and workers, which is why the best managers might avoid these firms; furthermore, since the least able workers are likely to have the strongest preference for job security, firms committing to consider employee interests may also attract the least effective workers.[231]

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228. *See, e.g.*, Michael C. Jensen & William H. Meckling, *Rights and Production Functions: An Application to Labor-managed Firms and Codetermination*, 52 J. BUS. 469, 472–75 (1979) (arguing that the burden of proof lies with the proponents of codetermination).

229. *See supra* notes 108–109 and accompanying text.

230. *See* Jensen & Meckling, *supra* note 228, at 472–75.

231. *See* Fauver & Fuerst, *supra* note 17, at 679. For similar arguments regarding the voluntary introduction of provisions equivalent to employment protection laws, see Armour & Deakin, *supra* note 17, at 447–4;, David I. Levine, *Just-Cause Employment Policies*

Furthermore, for individual employees it may be irrational to bargain for job protection as it may signal the absence of a commitment to work hard.[232]

The analysis so far has assumed that employees are able to look after their own interests by penalizing an unfavorable corporate law regime with a discount, in a similar way as creditors may impose higher interest rates, or simply by avoiding specific investment and always expecting the looming possibility of a job change in the near future. In reality, this assumption may not always hold, with some employees being unable to adjust their firm-specific investment to a level commensurate with the risk. This mirrors the debate about corporate creditors, which distinguishes between "adjusting creditors" on one side, and "non-adjusting" or only "partially adjusting" creditors on the other.[233] Only adjusting creditors react to risk by requiring higher interest rates, by stipulating that the entire loan will fall due in the case of events that increase risk, or simply by not trading at all. Analogously, non-adjusting workers might put too much trust in their relationship with the firm and therefore overinvest compared to what would be optimal from their individual perspective.

While it is hard to assess whether a substantial group of such workers exists, regulatory arbitrage would then become largely a fairness issue. If workers always specifically invest, the legal arrangement is irrelevant for purposes of a firm's competitiveness. Still, the issue can be relevant for distributive policy reasons. In order to maximize social welfare[234] one would then need to have context-specific information about the marginal utility of wealth of workers and stockholders.

Even when workers adjust, one likely problem for the voluntary provision of pro-employee rules is that crucial aspects

in the Presence of Worker Adverse Selection, 9 J. LAB. ECON. 293 (1991); and Cass R. Sunstein, *Human Behavior and the Law of Work*, 87 VA. L. REV. 205, 225–26 (2001). *But see* J. Hoult Verkerke, *An Empirical Perspective on Indefinite Term Employment Contracts: Resolving the Just Cause Debate*, 1995 WIS. L. REV. 837, 902–05 (describing the adverse selection argument and possible objections).

232. *See, e.g.*, Sunstein, *supra* note 231, at 225–26; Verkerke, *supra* note 231, at 903.

233. *See, e.g.*, John Armour, *Legal Capital: An Outdated Concept?*, 7 EUR. BUS. ORG. L. REV. 5, 10–11 (2006); Lucian Arye Bebchuk & Jesse M. Fried, *The Uneasy Case for the Priority of Secured Claims in Bankruptcy*, 105 YALE L.J. 857, 864–65 (1996).

234. *See generally* LOUIS KAPLOW & STEVEN SHAVELL, FAIRNESS VERSUS WELFARE (2002) (discussing total social welfare as the maxim and of economic and legal analysis).

of corporate law favoring employees, such as codetermination, pertain to the entire firm. Such mechanisms could then not develop as the result of bargaining within the individual employment relationship. In fact, one of the major mechanisms protecting workers is collective bargaining, where either unions or elected representatives act as the agents of workers.[235]

B. *Ex Post Opportunism: The Clash Between Shareholder, Manager, and Employee Interests in Corporate Law Arbitrage*

1. Benefits and Risks of Flexibility

Ex post choice, like ex ante choice, has important advantages, the most obvious being flexibility. Employee participation systems could be designed to operate efficiently and adapted to the changing needs of the firm, for instance those regarding the size of the supervisory board or the degree of employee involvement, which of course might depend on the industry and market of the firm.

The downside of employee participation systems is often their inflexibility. German codetermination law rigidly stipulates a mandatory size of the board depending on the size of the firm[236] and has thus long been criticized for making the supervisory board cumbersome and ineffective.[237] Comparable provisions neither exist in some other member states with codetermination systems, nor for SEs or firms that undergo a cross-border merger.[238] Firms might therefore avail themselves of a less intrusive system where these disadvantages are less serious.

The downside of flexibility is always the risk of not meeting someone's expectations. In this case, employees might form expectations about the stability of the work environment. If a

235. *Cf.* Armour & Deakin, *supra* note 17, at 445 (suggesting that specific collective rights of employees may protect firm-specific human capital).

236. *See supra* note 41 and accompanying text.

237. *See, e.g.*, ROE, *supra* note 26, at 73; Katharina Pistor, *Codetermination: A Sociopolitical Model with Governance Externalities*, *in* EMPLOYEES AND CORPORATE GOVERNANCE 163, 178–79 (Margaret M. Blair & Mark J. Roe eds., 1999).

238. For analysis of these rules, see Habersack, *supra* note 86, at 632–34. It is disputed whether the total number of members must be agreed upon during negotiations or whether it can be set in the corporate charter (meaning that the result of negotiations would have to be the share of seats on the board allocated to employees).

reincorporation coupled with a reduction in participation rights is possible, these expectations might not be fulfilled because employees' formal or informal power has been reduced. As a result, the possibility of reincorporation could therefore marginally influence the incidence of specific investment.

2. Reasons for Mandatory Corporate Law and the Importance of Ownership Structure

Ex post opportunism is often brought as a rationale why corporate law should be mandatory. In the United States, Lucian Bebchuk argues that management is able to accomplish charter amendments that are detrimental to shareholders and advantageous to management, given the powerful position of the board in U.S. firms and collective action problems of shareholders.[239] Correspondingly, amendments that are beneficial to shareholders, but detrimental to managers, will not happen. Mandatory constraints might therefore be beneficial.[240]

As a first step, it is necessary to ask who decides about reincorporations in practice, since this power ultimately determines the ability to use arbitrage opportunities. Employees as a driving force can be ruled out, given that they cannot induce firms to reincorporate.[241] While it is clear that the initial incorporation decision is taken by the founders of the firm, the question becomes more complicated when the company is up and running, and when different interest groups and coalitions have formed. If regulatory arbitrage is driven by shareholder interest, employees may suffer from shareholder opportunism. However, the situation is more complicated because managers may also play a role. Given the triangle of possible coalitions, regulatory competition might lead to different results depending on which coalition's form is able to prevail.

As previously noted, a variable that fundamentally alters the equation in the theory of regulatory competition is the presence of controlling shareholders in continental Europe and the

239. *See* Lucian A. Bebchuk, *Limiting Contractual Freedom in Corporate Law: The Desirable Limits of Constraints on Charter Amendments*, 102 HARV. L. REV. 1820, 1835–1847 (1989).

240. *See* Jeffrey N. Gordon, *The Mandatory Structure of Corporate Law*, 89 COLUM. L. REV. 1549, 1573–85 (1989).

241. *See* Dammann, *supra* note 4, 515–16.

tendency to see dispersed ownership in U.S. firms.[242] In the U.S. context, Lucian Bebchuk has pointed out that it is necessary to have both the board of directors and the majority of shareholders agree to a reincorporation.[243] Thus, reincorporations typically will not purely favor either managers or shareholders, but there must be something in it for both groups for a firm to subject itself to the law of a new state. In spite of possible pressures from the capital markets to incorporate in a state with "optimal" corporate law, agency problems will never be fully resolved because of the board veto.[244] At the same time, regulatory competition will also not be fully pro-managerial because of the necessity of a shareholder vote.[245] In the United States, the requirement to submit a reincorporation proposal to a shareholder vote provides at least some degree of a check on managerial opportunism in deciding on reincorporations according to Bebchuk's modern "race to the bottom" school of thought.[246]

However, concentrated ownership implies that the relevant agency problem is not the one between managers and shareholders, but between majority and minority shareholders. Majority shareholders will typically decide on the issue of reincorporation alone, which may allow them to capture the regulatory competition process, or at least to use regulatory arbitrage possibilities.[247] As described in another article, large shareholders effectively control reincorporation in continental Europe.[248] Unlike managers in the United States, who need a shareholder vote for a reincorporation that increases agency cost, managers in continental Europe do not need to seek the approval of the minority for their actions. This argument applies analogously with regard to non-shareholder constituencies. It has already been suggested that creditors of European firms might find themselves in a similar situation with their expectations

242. *See supra* note 209 and accompanying text.

243. *See* Lucian A. Bebchuk, *Federalism and the Corporation: The Desirable Limits on State Competition in Corporate Law*, 105 HARV. L. REV. 1437, 1460–61 (1992).

244. *See id.* at 1470.

245. *See id.*

246. *See id.* at 1471–75. In fact, Bebchuk's view can be classified as intermediate because he seeks to identify criteria for which a race to the top or bottom is likely.

247. *See* Gelter, *supra* note 7, at 269–75. For a similar analysis see also Birkmose, *supra* note 7, at 47–54.

248. *See* Gelter, *supra* note 7, at 269–75.

being negatively affected, because shareholders, particularly large blockholders, control the incorporation process.[249] Equivalently, if reincorporation is ex post beneficial to shareholders, but harmful to employees, it is very likely that such a redistributive reincorporation will take place when shareholder benefits exceed the (possibly substantial) costs of reincorporation. In the case of a true shareholder-stakeholder conflict, large blockholders will even be able to typically obtain the support of minority shareholders.

Thus, ownership structure plays an important role. However, in individual cases it will depend on what coalitions are formed. For example, in a dispersed ownership company, employees and shareholders might share an interest in strong enforcement of the directors' duty of loyalty, while they would probably share managers' interests regarding hostile takeovers and the prospect of confrontation with the board. In other words, with respect to issues where managers and employees share similar objectives, employees might gain by free-riding on managerial opportunism because managers succeed in committing the firm to a legal system not hospitable to takeovers and resisting shareholders' attempts to change the applicable regime. In a concentrated ownership environment, however, managers are immediately subject to the wishes of the controlling shareholder and will be unable to resist their advances.

True, ex ante there may be an incentive to commit to a corporate law system favorable to employees in order to ensure their goodwill and long-term cooperation. However, an ex ante decision is only helpful if it is coupled with a previous commitment. Shareholders may sometimes benefit from an ex post change of the applicable regime to the detriment of employees, in which case there will be little incentive for shareholders or managers to take the interests of nonshareholder constituencies into account in ex post reincorporation decisions.[250] If a reincorporation is easy, any ex ante choice is simply preliminary, which is why it cannot have any desirable incentive effects.

249. Enriques & Gelter, *supra* note 8, at 617–18.
250. *Cf.* Bebchuk, *supra* note 243, at 1485.

3. Dispersed Ownership and Employees

Next, consider firms with dispersed ownership, which predominate in Europe only among listed firms in the United Kingdom. As suggested by the U.S. discussion, the objective sought by self-interested managers seems to be increased independence from shareholders.[251] All three of the issues identified earlier as relevant for employees[252] may play a role here—reducing direct possibilities by shareholders to influence managerial conduct may widen the possibilities for managers to obtain rents and classical private benefits of control. In other words, it may affect agency cost. By contrast, team production advocates emphasize that shielding managers from shareholders allows insulated managers to avoid the exploitation of the quasi-rents of nonshareholder constituencies.[253]

Part III.D of this Article describes the potential conflicts of interest where managers and employees will be on one side, and shareholders on the other. While I have argued elsewhere that the influence of dispersed shareholders on managerial decision-making is greater in the United Kingdom than in the United States (among other things, because of a higher incidence of hostile takeovers),[254] it does not seem likely that managers might use it as an opportunity to secure independence from shareholders. To be sure, the issues identified above might serve this purpose. In a dispersed ownership firm, employees on the board might be faithful allies of management against "intrusion" by shareholder activists or outside board members seeking to maximize shareholder wealth. Directors' duties using a pluralist objective may sometimes help directors to justify their actions when seeking re-election, as they could say that a new management team would not be in the position to do anything else. And, of course, it might help them to construct a shield against the occasional liability suit. Likewise, a reduced risk of hostile takeovers may increase managers' freedom to act. Here, it

251. *See* Bebchuk, *supra* note 243, at 1462–68 (describing the value-decreasing rules that managers may seek when determining whether to reincorporate).

252. *See supra* Part II.B–D.

253. *See* Blair & Stout, *supra* note 16; *see also* Coffee, *supra* note 202, at 70–71, 73–81 (discussing breaches of implicit agreements as a result of hostile takeovers); Shleifer & Summers, *supra* note 153, at 42 (same).

254. Gelter, *supra* note 195, at 186–93.

is the duties of managers (or their freedom to defend against takeovers) that may be important also for employees. The U.S. experience provides a good example: firms all but threatened to migrate out of Delaware when it was suggested that managers would be forced to let hostile takeovers go through.[255]

Among these three options, it is probably safe to say that employee participation systems are likely to be the least popular among managers. Even as potential allies, employee board representatives are difficult to keep under control and will typically seek to promote their own agenda.[256] It is sometimes argued that German codetermination undermines the functioning of the supervisory board because employee representatives cannot sometimes be trusted with confidential information.[257] While this argument is usually made before the backdrop of German concentrated ownership, it applies irrespective of ownership structure: employee participation may help managers when employee and managerial interests coincide, but it may hurt them greatly when they do not.[258] In dispersed-ownership firms, managers will therefore rather seek a coalition with shareholders against employees with regard to codetermination. Although the European legal framework puts

255. The notorious "Wachtell Lipton Memo" was disseminated by one of the leading U.S. corporate law firms after the Delaware Chancery Court's decision in *City Capital Assoc. v. Interco Inc.*, 551 A.2d. 787 (Del. Ch. 1988), which would have greatly reduced managers ability to defend against hostile bids. *See* Jeffrey N. Gordon, *Corporations, Markets, and Courts*, 91 COLUM. L. REV. 1931, 1959 n.95 (1991) (quoting Memorandum from Wachtell, Lipton, Rosen, & Katz to clients, The Interco Case (Nov. 3, 1988)). The decision was subsequently rejected by the Delaware Supreme Court. *See* Paramount Communications, Inc. v. Time, Inc., 571 A.2d. 1140 (Del. 1990).

256. *See, e.g.*, Klaus J. Hopt, *The German Two-Tier Board: Experience, Theories, Reforms*, *in* COMPARATIVE CORPORATE GOVERNANCE: THE STATE OF THE ART AND EMERGING RESEARCH 227, 247 (Klaus J. Hopt et al. eds., 1998) (describing how labor interests predominate the discussion on German boards).

257. *See, e.g.*, Jean J. Du Plessis & Otto Sandrock, *The Rise and Fall of Supervisory Board Codetermination in Germany*, 16 INT'L COMPANY & COM. L. REV. 67, 74–75 (2005); FitzRoy & Kraft, *supra* note 61, at 236 (citing studies revealing a deliberate restriction of information in some firms); Roe, *supra* note 37, at 171–75.

258. *See supra* notes 198–203 (contrasting when employee and manager interests coincide and when they do not). An example would be managerial private benefits of control or self-dealing, which is typically not in line with employee interests. However, it may sometimes be possible to bribe employee representatives on the board, which is not a novel practice. The most prominent case is the Volkswagen corruption affair. *See* Mark Landler, *Sentences in Volkswagen Scandal*, N.Y. TIMES, Feb. 23, 2008, at C3. From the perspective of a potential managerial self-dealer it will be preferable if there is no employee representative they would have to bribe.

some breaks on the erosion of employee participation systems, codetermination arbitrage may be a factor to reckon with even in continental dispersed-ownership firms, whose number has increased during the past decade.[259]

Reduced exposure to takeovers and attenuated influence of shareholders on the firm may be of broader interest for both employees and managers. One might, for example, expect managers to seek opportunistic movements away from member states that implement the neutrality rule. In fact, regulatory competition is usually considered to be the reason for the pro-manager slant in U.S. takeover law.[260] However, as a general matter, it seems relatively unlikely that shareholders in European firms that already have dispersed ownership would agree to a reincorporation into a less takeover-friendly jurisdiction, particularly if such a move was motivated by pro-employee concerns. Most of all, a shareholder vote would seem to be a particularly strong obstacle for British companies. True, U.S. shareholders have often approved staggered boards in the past, which is one of the elements that makes a company takeover-proof, but this has stopped since about 1990.[261] Institutional investors in Britain are also known to be more proactive than their U.S. counterparts; while normally acting cautiously, they are known to take action in situations where the alarm bells in a particular firm ring.[262] A reincorporation into another member state from Britain, and the (partial) attempt to escape from the financial culture of the City of London would seem to be a more significant event than a mere reincorporation from one U.S. state to another. Arguably, the recent EU Shareholder Rights Directive[263] will strengthen the position of institutional

259. *See generally* Julian Franks et al., *The Life Cycle of Family Ownership: A Comparative Study of France, Germany, Italy and the U.K.* (Working Paper Series 2009), *available at* http://ssrn.com/abstract=1102475.

260. *See e.g.*, Bebchuk & Ferrell, *supra* note 154.

261. Bebchuk et al., *supra* note 159, at 900 (describing how staggered boards were frequently approved before 1990, but not afterwards).

262. *See, e.g.*, G. P. STAPLEDON, INSTITUTIONAL SHAREHOLDERS AND CORPORATE GOVERNANCE 122–29 (1996); John Armour et al., *Corporate Ownership Structure and the Evolution of Bankruptcy Law: Lessons from the United Kingdom*, 55 VAND. L. REV. 1699, 1751–54, 1752 (2002); Bernard S. Black & John C. Coffee, Jr., *Hail Britannia?: Institutional Investor Behavior under Limited Regulation*, 92 MICH. L. REV. 1997, 2036–37, 2053 (1994).

263. Council Directive on the Exercise of Certain Rights of Shareholders in Listed Companies, No. 2007/36, 2007 O.J. L 184/17.

investors—often based in the United States or the United Kingdom—also in other member states.[264] Thus, the argument would seem to apply by analogy also in continental dispersed ownership firms.

4. Concentrated Ownership and Employees

The more pressing issue seems to be whether firms with concentrated ownership might avail themselves of corporate law arbitrage opportunities that are relevant to employees. Here, the triangular relationship between shareholders, managers, and employees is transformed into one involving large shareholders, small investors, and employees. This changes the situation dramatically, since powerful managers are essentially eliminated from the picture as another independent force framing issues of corporate policy. Large blockholders, either acting single-handedly or in coalition, can easily initiate a reincorporation if they can garner the required supermajority.[265] Large shareholders are also in a position to exploit holdup possibilities with respect to employees by means of their continued control over management; if, for some reason, they are unwilling or unable to do so, they may voluntarily sell control to someone else who will, and thus share part of the profits arising from opportunistic behavior towards employees. In the issues identified above as potential shareholder-stakeholder conflicts, minority and large shareholders share an ex post interest in large financial gains. While I have elsewhere argued that large shareholders are in a position to exploit the minority by means of regulatory arbitrage,[266] they are equally well-positioned to exploit holdup possibilities to the detriment of employees.

This argument is in line with U.S. varieties of stakeholder theories of corporate law, particularly the team production

264. *See* Arthur R. Pinto, *The European Union's Shareholder Voting Rights Directive from an American Perspective: Some Comparisons and Observations*, 32 FORDHAM INT'L L.J. 587, 617–19 (2009).

265. Amendments to a firm's charter in European states, including the United Kingdom, typically require a supermajority. *See, e.g.*, AktG, Sept. 6, 1965, BGBl. I at 1089, § 179(2), last amended by Gesetz, July 31, 2009, BGBl. I at 2509 (F.R.G.) (requiring a majority vote of three-quarters for reincorporation); C. TRAV. art. L. 225-96 (Fr.) (requiring two-thirds); Companies Act 2006, 2006, c.46, §§ 21(1), 283(1) (U.K.) (requiring three-quarters).

266. Gelter, *supra* note 7, at 269–75.

theory,[267] which emphasizes that stakeholders will benefit from the insulation of the board from shareholders. In the comparative corporate governance debate, some authors seem to share this position.[268] Others have suggested that employees could rely on the long-term position of large shareholders within the firm, who might have a greater stake in securing the long-term cooperation of stakeholders.[269] The second view would seem to rule out opportunistic reincorporations to the detriment of labor and rather indicate that controlling shareholders might seek alliances with labor against small investors. The literature seems not yet to have made much progress towards a synthesis of these two opposing views, which would require a closer investigation of what factors determine the stance towards stakeholders taken by either managers or controlling shareholders.[270] For purposes of regulatory arbitrage, it is important to emphasize that the effects on employees may largely depend on the identity of the controlling shareholder, as that person may refrain from opportunism for idiosyncratic reasons. Employees can be protected from takeovers because of nonpecuniary benefits received by the controller of a firm.[271]

267. *See, e.g.*, Blair & Stout, *supra* note 195, at 418–22.

268. *See, e.g.*, Gérard Charreaux & Philippe Desbrières, *Corporate Governance: Stakeholder Value versus Shareholder Value*, 5 J. MGMT. & GOVERNANCE 107, 116 (2001); Andrei Shleifer & Robert W. Vishny, *A Survey of Corporate Governance,* 52 J. FIN. 737, 758 (1997); *see also* Michel A. Habib, *Monitoring, Implicit Contracting, and the Lack of Permanence of Leveraged Buyouts*, 1 EUR. FIN. REV. 139 (1997) (mathematical model in the LBO context); Pagano & Volpin, *supra* note 203, at 841 (providing a model in which managers have an incentive to provide employees with strong protection to make the firm unattractive as a target of takeovers; however, this incentive rests on managers having only a small stake in equity).

269. *See* William W. Bratton & Joseph A. McCahery, *Comparative Corporate Governance and Barriers to Global Cross Reference*, *in* CORPORATE GOVERNANCE REGIMES: CONVERGENCE AND DIVERSITY 23, *supra* note 176, at 27; Julian Franks & Colin Mayer, *Ownership and Control in Europe*, *in* 2 THE NEW PALGRAVE DICTIONARY OF ECONOMICS AND THE LAW, *supra* note 20, at 722, 728–29; Ruth V. Aguilera & Gregory Jackson, *The Cross-National Diversity of Corporate Governance: Dimensions and Determinants*, 28 ACAD. MGMT. REV. 447, 451 (2003).

270. For an attempt to provide a formal model addressing the issue see Giulio Ecchia, Martin Gelter & Piero Pasotti, *Corporate Governance, Corporate and Employment Law, and the Costs of Expropriation*, (European Corporate Governance Institute, Working Paper No. 128, 2009), *available at* http//ssrn.com/abstract=1430623.

271. *See* Gilson, *supra* note 209, at 1663–64 (defining nonpecuniary benefits as "forms of psychic and other benefits that, without more, involve no transfer of real company resources and do not disproportionately dilute the company's stock to a diversified investor").

This could be, for example, the personal satisfaction that a member of an entrepreneurial family may derive from his or her privileged position as a controlling shareholder,[272] or political benefits if the controlling shareholder is a government entity. Those controlling shareholders that are in a position to initiate reincorporations therefore have a shared interest with employees and are unlikely to reincorporate in an environment where their position is less secure. However, regulatory arbitrage could be a possible road to go down once the nonpecuniary benefit has subsided—such as when a family firm is passed on by the founding generation. As far as aspects of corporate law actually help to foster long-term commitment, regulatory arbitrage gains can easily obtained by the controlling shareholder once such a change occurs.

Assuming constant ownership structures, are any of the relevant corporate law issues likely to trigger anti-employee arbitrage, or sufficiently significant to help support a decision to reincorporate? Board-centric takeover defenses are largely irrelevant for firms with concentrated ownership; blockholders' cooperation is often needed for a change of control over the firm. The neutrality rule is irrelevant. The breakthrough rule may be significant, given that it removes some entrenchment possibilities of large shareholders.[273] For employees, its relevance is limited to those where the incumbent controller (such as an entrepreneurial family) takes a friendly attitude towards them to foster long-term investment, whereas the challenger (such as a hedge fund), takes a different position.

In some cases, the reciprocity rule of the Takeover Directive may create incentives to opt into board neutrality and the breakthrough rule. Since other firms normally applying these rules may opt out of them vis-à-vis firms that do not apply them, the reciprocity rule facilitates taking over firms. Firms (through their controlling shareholders) expecting to be bidders and not targets might avail themselves of this possibility, but potential

272. *See* Mike Burkart et al., *Family Firms*, 58 J. FIN. 2167, 2168 (2003) ("A founder may derive pleasure from having his child run the company that bears the family name."); *cf.* Gilson, *supra* note 209, at 1666 (describing social and political benefits that accompany being a member of the fifteen wealthiest families in Sweden).

273. *See* Joseph A. McCahery et al., *The Economics of the Proposed European Takeover Directive*, *in* REFORMING COMPANY AND TAKEOVER LAW IN EUROPE 575, 623–36 (Guido Ferrarini et al. eds,. 2004).

targets will not. Firms are more likely to be targets if there are either inefficiencies, potential private benefits of control for the bidder,[274] or rents that can be expropriated from employees.[275]

Opting out of the neutrality or breakthrough rule in order to avoid being an open target may be a potential corporate law arbitrage strategy, and typically one that employees will appreciate. By contrast, opting into either of these rules will not work in their favor. However, an opt-in does not necessarily require corporate law arbitrage because member states must permit firms to do so in their charter.[276]

Thus, the one major employee-relevant issue where one might expect significant corporate law arbitrage is employee participation. Controlling shareholders are not likely to be in favor of it, in substance for the same reason as powerful managers in a Berle-Means firm. While employee directors might sometimes turn out to be useful allies for managers,[277] their propensity to develop their own agenda, and the frequent suspicion that they cannot be trusted with certain sensitive information relevant for their constituencies,[278] will most likely be a deterrent against codetermination. As a result of an increased involvement of international institutional investors precipitated by developments such as the Shareholder Rights Directive,[279] even relatively employee-friendly controlling shareholders might feel compelled to put greater weight on the concerns of small shareholders with issues that are as visible as employee participation.[280] It seems safe to conjecture that corporate law arbitrage would in most cases disfavor employee participation.

274. *See generally* Lucian A. Bebchuk, *Efficient and Inefficient Sales of Corporate Control*, 109 Q.J. ECON. 957 (1994) (providing an analysis how various factors, including private benefits of control of controlling shareholders, determine what kind of takeover law is best suited for a particular corporate governance system).

275. Shleifer & Summers, *supra* note 153, at 34.

276. *See supra* note 178 and accompanying text.

277. *See supra* note 203 and accompanying text.

278. *See supra* notes 256–257 and accompanying text.

279. Council Directive on the Exercise of Certain Rights of Shareholders in Listed Companies, No. 2007/36, 2007 O.J. L 184/17.

280. *Cf.* Pinto, *supra* 264, at 621 (postulating that the Shareholder Rights Directive might reconfigure the power balance between various players in the corporate structure).

Some scholars have suggested that regulatory competition could precipitate changes in corporate governance structures. Most of all, the U.K. takeover regime might draw continental firms seeking a stock exchange listing, ultimately aiming for dispersed ownership.[281] In addition to the other benefits, this could entail an increase due to gains from employees if the firm becomes more contestable.[282] However, making use of transnational regulatory possibilities may not even be necessary. Although member states are not required to implement the neutrality and breakthrough rules as mandatory law, they are required to allow firms to apply them voluntarily.[283] Unless the British Takeover Panel possesses significant institutional advantages over its counterparts in other EU member states, a choice within one legal system (and simply making the respective choice in the charter) will suffice. Firms can still seek an exchange listing in the United Kingdom, in which case they will be subject to those aspects of U.K. takeover law that hinge on the exchange listing. Most other issues of takeover law, besides board duties, are not dependent on where the firm has its registered office.[284]

5. Erosion of Codetermination?

The rather theoretical reflections of the preceding sections aside, the one practical issue where we already seem to be seeing regulatory arbitrage is employee participation. Ex post changes of the applicable codetermination regime could be used for opportunistic purposes by controlling shareholders, as the assent of employees is not required. At first glance, the negotiation mechanism regarding employee participation applicable to cross-border mergers and the creation of an SE would seem to greatly mitigate the effects of such a move. Even when using the less "employee-friendly" rules of the Directive on Cross-Border Mergers, the highest level of employee participation prevails when a third of the merged firm's employees were previously subject to any participation system; and even where a single

281. *See* Armour, *supra* note 4, at 390–91; Armour & Skeel, *supra* note 163, at 1789–90.

282. *See supra* Part II.C.3.

283. *See supra* note 178 and accompanying text.

284. *See* Enriques & Tröger, *supra* note 184, at 531–32.

employee was previously subject to such a mechanism, the SNB may decide which participation system applies.

One might therefore conclude that the SNB has a strong bargaining position, as the default rule awards the entire prize to their constituency.[285] Some commentators have concluded that codetermination effectively insulates employee participation systems from regulatory competition.[286] If the analysis stopped here, the only situation where the expectations of employees in one member state with regard to a particular level of participation would be disappointed might be one where shareholders and managers succeed in pitting employee groups from different states against each other.[287] Significantly, the default rules do not apply in newly merged entities where previously fewer than twenty-five percent (SE Directive) or thirty-three percent (Cross-Border Merger Directive) of employers were subject to an employee participation system.[288] The rationale for this threshold is apparently to avoid forcing boardroom participation on reluctant employees.[289]

However, the impression that codetermination is completely protected is deceptive. An SE can indeed be used to escape codetermination by converting into a legal form of national law.[290] A conversion into a corporation governed by national law is permitted two years after the registration of the SE, and after that period, it will not normally be considered "misuse."[291] As already pointed out, a merger with a legal form of national law may even be possible before the end of the two-year period.[292] Whether an employee participation system must be "transferred" to the acquiring firm is essentially up to the member state.

285. Furthermore, it can delay the registration of an SE by six months, which is the default maximum duration of negotiations. *See supra* note 74 and accompanying text. This creates additional bargaining power for the employee side. *See* Rickford, *supra* note 81, at 27 n.50.

286. *See, e.g.*, Johnston, *supra* note 91, at 109.

287. *See* discussion *supra* note Part II.B.3.

288. *See supra* notes 76, 85 and accompanying text.

289. *See* Rickford, *supra* note 81, at 28 n.56. For example, British unions were historically skeptical about employee participation. *See, e.g.*, KNUDSEN, *supra* note 46, at 52.

290. *See supra* notes 117–122 and accompanying text.

291. *Supra* notes 117–118 and accompanying text; *see also* Kisker, *surpa* note 86, at 208 (suggesting that a transformation after more than two years will not be a "misuse").

292. *See supra* note 119 and accompanying text.

Likewise, after a period of least three years (unless member state law prescribes a longer period), a firm formed by a cross-border merger can be merged with a "clean slate" firm that is not subject to a negotiated employee participation agreement.[293] In both cases, it is largely left to the member state where the firm is incorporated to decide how the negotiated employee participation system is dealt with in such cases. True, some companies may be deterred from setting up an SE or merging by the lengthy negotiation process.[294] However, companies may elect to submit to the applicable default participation rules voluntarily in a cross-border merger and thus avoid lengthy negotiations.[295] Whether "outreach statutes" applying national employee participation systems to "pseudo-foreign" firms incorporated in other member states will be politically feasible and legally possible under EU law remains to be seen.[296]

While transformations into the SE form have so far not yet become a mass phenomenon, they are growing in popularity. In June 2008, there were 213 SEs in Europe.[297] So far there is no systematic data on the exact motivation to transform a firm into an SE, but anecdotal evidence indicates that board structure plays an important role. While some observers point out that the legally mandated size of the German supervisory board is often considered detrimental by firms,[298] at least in some cases, SEs appear to have been used to avoid the future possibility of codetermination or of a stronger form of it once the firm exceeds the required size threshold.[299] Some observers predict that a large proportion of large publicly traded German firms may become SEs in the future.[300] Given that only a handful of the

293. *See supra* note 124.

294. *See* Joseph McCahery & Erik Vermeulen, *Does the European Company Prevent the 'Delaware Effect'?*, 11 EUR. L.J. 785, 799 (2005); Rock et al., *supra* note 124, at 218.

295. *See supra* notes 82–83.

296. *See supra* notes 133–137 and accompanying text.

297. Eidenmüller et al., *supra* note 68, at 20.

298. *See id.* at 25 (reporting that several German publicly traded firms reduced the number of board members).

299. *See* Ingrid Herden & Reinhard Kowalewsky, *Das neue Drohpotenzial: Europa-AG* [*The New Potential Threat: Europe-AG*], CAPITAL, Mar. 19, 2008, at 192 (citing a representative of Klöckner SE saying that there will never be board codetermination after the firm has been transformed); *see also supra* note 108 (describing how the creation of an SE reduced the size of the Allianz supervisory board).

300. *See* Herden & Kowalewsky, *supra* note 299, at 192 (quoting German corporate governance experts and politicians that a large number of firms will transform into SEs).

existing SEs are truly large firms, this assessment may be premature.[301] Furthermore, the evidence compiled by Eidenmüller et al. suggests that SEs are more popular in countries with employee participation systems, such as Austria, the Czech Republic, Germany, or the Netherlands, than in others such as France, Italy Spain, or the United Kingdom, where SEs are rare relative to population size, or do not exist at all thus far.[302]

Ultimately, whatever bargaining victory the SNB achieves, it may be a pyrrhic one since shareholders are unable to commit to retaining the results after a subsequent merger. It seems also unlikely that a court would consider a subsequent merger abusive in the case of a time lag of several years. The assessment that European corporate law legislation could result in an "erosion" of German codetermination[303] may therefore well turn out right.

CONCLUSION

The possibilities of regulatory arbitrage put employees at a disadvantage compared to the traditional "protected" national systems of corporate law. Previous articles have pointed out that differences in ownership structure between Europe and the United States are likely to result in stronger risks in the European context due to the relatively unchecked power of controlling shareholders on the European continent. Due to differences in ownership structure, the results of regulatory arbitrage opportunities are likely to be very different from the United States, where regulatory competition seems to have largely reinforced the pre-eminence of managers over shareholder power. U.S. shareholders have traditionally been prevented by political forces (that have influenced securities law and financial regulation) from gaining an intrusive influence on firms.[304] True,

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301. *See* Eidenmüller et al., *supra* note 68, at 22–23 (reporting on the conversion of only four firms with more than 10,000 employees, those being Allianz, Porsche, Strabag, and Elcoteq).

302. *See id.* at 20 (reporting numbers of SEs by population). This is my own interpretation of their evidence. In fact there are many reasons why the SE form may be chosen, including tax advantages.

303. *See, e.g.*, Habersack, *supra* note 86, at 643; Teichmann, *supra* note 137, at 1787; *see also* MILHAUPT & PISTOR, *supra* note 108, at 85 ("[T]he mandatory codetermination regime can be softened considerably.").

304. *See generally* ROE, *supra* note 26.

no state in the United States has implemented an employee participation system. Still, employees have often figured prominently in the debate on hostile takeovers, in which managers asserted their independence and insulation. U.S. managers' assertion of their independence has probably shielded employees from takeovers to some extent—where employee and managerial interests overlap, it has most likely done so even without employees having a formal influence on decisions whether or not to reincorporate.

In continental Europe, by contrast, blockholders dominate corporate governance. Controlling shareholders are not only in a position to use their influence to the detriment of other stakeholders, but they are also the likely beneficiaries. Their position has been strengthened further by the regulatory arbitrage opportunities created by EU law that can undermine pro-employee institutions of national corporate governance systems. Employee participation systems are the main issue that could become a target of regulatory arbitrage. While EU law sets certain limits to arbitrage by requiring negotiations, there are techniques that can allow patient shareholders to erode codetermination. The negotiation mechanism implemented by the SE Employees Directive and the Directive on Cross-Border Mergers does not provide complete protection, and even allows controlling shareholders to escape employee participation systems. Possible incentives in long-term commitment and firm-specific investment are mitigated or eliminated because controlling shareholders can renege on a prior commitment to a particular law.

Free choice of the corporate law regime regarding employees implies that shareholders cannot permanently commit. The reason why such mechanisms may sometimes be beneficial for firm-specific investment is precisely because they are likely to foster long-term commitment and trust. Regulatory arbitrage rules out a permanent commitment to codetermination or similar systems. Decisions on reincorporations are taken exclusively by shareholders, who cannot stipulate against mergers or the creation of an SE. The limits of "codetermination arbitrage" under European law remain tentative. Thus, even if an efficient ex ante choice is possible, specific investment by employees may not occur or be adjusted in anticipation of

opportunism. While employee participation systems used to be shielded from markets in the past, they no longer have a fair chance to prove themselves in the market, as regulatory arbitrage possibilities undermine the possible reason for their very existence. Given the new corporate law arbitrage possibilities, employees are likely to learn that their position is less safe (at least on the margins) and adjust their specific investment downward. Some scholars employing a "varieties of capitalism" approach have already identified developments in European law that affect the economic and political balance within national corporate governance systems.[305] The regulatory arbitrage opportunities relating to employee participation will add to the changes that are already underway.

305. *See* MILHAUPT & PISTOR, *supra* note 108, at 84–85; Zumbansen & Saam, *supra* note 97, at 1043–49; Komo & Villiers, *supra* note 14.

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