

# INSTITUTE FOR LAW AND FINANCE

DAVID C. DONALD

APPROACHING COMPARATIVE COMPANY LAW



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David C. Donald\*

## Abstract

This paper identifies some common errors that occur in comparative law, offers some guidelines to help avoid such errors, and provides a framework for entering into studies of the company laws of three major jurisdictions. The first section illustrates why a conscious approach to comparative company law is useful. Part I discusses some of the problems that can arise in comparative law and offers a few points of caution that can be useful for practical, theoretical and legislative comparative law. Part II discusses some relatively famous examples of comparative analysis gone astray in order to demonstrate the utility of heeding the outlined points of caution. The second section offers a framework for approaching comparative company law. Part III provides an example of using functional definition to demarcate the topic "company law", offering an "effects" test to determine whether a given provision of law should be considered as functionally part of the rules that govern the core characteristics of companies. It does this by presenting the relevant company law statutes and related topical laws of Germany, the United Kingdom and the United States, using Delaware as a proxy for the 50 states. On the basis of this definition, Part IV analyzes the system of legal functions that comprises "company law" in the United States and the European Union. It selects as the predominant factor for consideration the jurisdictions, sub-jurisdictions and rule-making entities that have legislative or rule-making competence in the relevant territorial unit, analyzes the extent of their power, presents the type of law (rules) they enact (issue), and discusses the concrete manner in which the laws and rules of the jurisdictions and sub-jurisdictions can legally interact. Part V looks at the way these jurisdictions do interact on the temporal axis of history, that is, their actual influence on each other, which in the relevant jurisdictions currently takes the form of regulatory competition and legislative harmonization. The method of the approach outlined in this paper borrows much from system theory. The analysis attempts to be detailed without losing track of the overall jurisdictional framework in the countries studied.

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## I. INTRODUCTION

The disciplines of "comparative law" in general and "comparative company law" in particular are natural companions to the globalization of social, political and economic activity. The course of economic and political developments in recent decades has thus increased the amount of comparative law taking place at every level, whether it be that of fact-oriented practitioners, result-seeking legislators and development agencies, or theory-focused academics. Each of these activities has its own interests, priorities, and goals. Nevertheless, there are certain approach coordinates that mark the path for all their comparative studies. This paper outlines these approach coordinates for the comparison of the laws that govern public companies in the United States, the United Kingdom and Germany.

Just as the merchants who engaged in the earliest forms of international trade developed a commercial law that was trans-jurisdictional,<sup>1</sup> so today are merchants and their counsel often at the forefront of comparative legal activity. When a transaction spans international borders, the persons responsible for structuring it must of necessity become comparatists. As Professor Klaus Hopt has observed, lawyers and legal counsel "are the real experts in both conflict of company laws and of

<sup>1</sup> See e.g., JOHN HENRY MERRYMAN & ROGELIO PÉREZ-PERDOMO, *THE CIVIL LAW TRADITION* 13 (3<sup>rd</sup> ed. 2007).

foreign company laws. . . . Working out the best company and tax law structures for international mergers, and forming and doing legal work for groups and tax haven operations, is a high, creative art."<sup>2</sup> Legal counsel's repeated choices of a given structure or law can gradually crystallize into a "best practice," which independently or under the auspices of professional associations<sup>3</sup> can lead to many jurisdictions adopting the practice and converging toward a perceived optimal rule. In this way the practical choices of lawyers eventually collect into recognized legal norms. Comparative scholars like Professor Philip R. Wood, whose numerous books focus on the practical details of the financial laws and instruments in many countries,<sup>4</sup> give internationally active lawyers the information they need to approach transnational problems. His is a comparative law that focuses on providing detailed and accurate information about disparate legal systems rather than either reflecting on the policy goals of legislation or seeking the overall coherence of a given system's solution to a specific problem.<sup>5</sup>

Comparative activity with great practical impact also occurs at venues quite removed from commercial transactions. The unprecedented level of international cooperation occurring on the regulatory side of globalization creates systematic comparative studies that have dramatically accelerated legal understanding and convergence. Any project to harmonize national laws or draft a convention to govern an area of law among nations will likewise of necessity compare laws to find the best, or at least the most mutually acceptable, solution. Institutions such as the European Union,<sup>6</sup> the United Nations,<sup>7</sup> the International Institute for the Unification of Private Law (UNIDROIT)<sup>8</sup> and the

<sup>2</sup> Klaus Hopt, *Comparative Company Law*, in THE OXFORD HANDBOOK OF COMPARATIVE LAW 1169 (Mathias Reimann & Reinhard Zimmermann, eds., 2006) (hereinafter "HANDBOOK").

<sup>3</sup> Such "associations" can range from the International Chamber of Commerce and their "Incoterms" for international sales transactions, to the International Bar Association and their numerous practice guides, to the voluntarily adopted master framework agreements created by organizations like the International Swaps and Derivatives Association, Inc.

<sup>4</sup> See e.g., PHILIP WOOD, *COMPARATIVE LAW OF SECURITY INTERESTS AND TITLE FINANCE* (2<sup>nd</sup> ed. 2007) and *COMPARATIVE FINANCIAL LAW* (2000).

<sup>5</sup> The method used, as is appropriate for the goal of the comparative study, centers around the practitioner's desire to use the law: "There are three broad steps in this type of measurement: (1) the legal rules; (2) the weighting of the importance of the legal rules in practice; and (3) actual implementation or compliance by the jurisdiction concerned." WOOD, *COMPARATIVE SECURITY INTERESTS*, *supra* note 4, at 16.

<sup>6</sup> As it developed from an initial six to its current 27 member states over a 50 year period, the European Economic Community (then European Union) harmonized a core of minimum standards in many areas, followed this up with mutual recognition of member state law while restricting harmonization to health and safety, and introduced a parallel movement of European standardization. See PAUL CRAIG & GRÁINNE DE BÚRCA, *EU LAW: TEXT, CASES AND MATERIALS* 620 *et seq.* (4<sup>th</sup> ed. 2008). This combination of legislative strategies allowed mandatory harmonization to pave an initial uniformity, making home rule and voluntary convergence acceptable, which in turn led to greater harmonization becoming unproblematic, so that the laws of the separate member states – particularly the late entries, which were forced to adopt packages of introductory laws – became ever more tightly matched to each other.

<sup>7</sup> In particular the Commission on International Trade Law (UNCITRAL) and the Office of Legal Affairs, Codification Division's Codification of International Law. See <http://www.un.org/law>.

Hague Conference on Private International Law<sup>9</sup> engage in comparative law on a grand scale in order to produce their directives, regulations and conventions. This activity falls under the rubric of "legislative comparative law" in the descriptive schema offered by Professors Konrad Zweigert and Hein Kötz, and has historically been one of comparative law's most solid domains.<sup>10</sup> If legislative efforts seek to achieve a specific result, like economic prosperity, stable government, or investor protection,<sup>11</sup> then a second level problem arises: the legislator must correctly ascertain a real, causal connection between the chosen law or legal system and the desired social or economic effect. The latter type of project falls squarely within the mission of institutions such as the World Bank, which seeks to "help developing countries and their people . . . [by] building the climate for investment, jobs and sustainable growth . . . ."<sup>12</sup> In addition to the studies prepared by their own staffs and experts, much of the academic comparative law produced in universities also supports the activities of legislators and development agencies.

The increasingly high stakes of correctly understanding foreign law for the success of commercial transactions and of the comparing, choosing and implementing of laws carried out by international organizations have naturally drawn an increasing amount of academic attention to comparative law. Although the steady growth actually began in the 19<sup>th</sup> Century, with the major codifications in Continental Europe,<sup>13</sup> the increase was dramatic as efforts to develop the economies of the former Soviet Union, Eastern Europe and China took off in the 1990's. This activity has been particularly intense in the area of comparative company law, specifically addressing questions of "comparative corporate governance", comparative "investor protection"<sup>14</sup> and, within the European Union itself, comparative methods of "creditor protection".<sup>15</sup> Major events in this "academic comparative law" were the publication in 2006 of a collection of theoretical essays on the activity of

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<sup>8</sup> UNIDROIT "is an independent intergovernmental organisation . . . [whose] purpose is to study needs and methods for modernising, harmonising and co-ordinating private and, in particular, commercial law as between States and groups of States." See <http://www.unidroit.org>.

<sup>9</sup> "Since 1893, the Hague Conference on Private International Law, a melting pot of different legal traditions, develops and services Conventions which respond to global needs . . . ." See <http://www.hcch.net>.

<sup>10</sup> KONRAD ZWEIGERT & HEIN KÖTZ, AN INTRODUCTION TO COMPARATIVE LAW 51 (3rd ed., trans. Tony Weir, 1998). Also see Charles Donahue, *Comparative Law Before the Code Napoleon*, in HANDBOOK, *supra* note 2, at 3 ("Modern comparative lawyers . . . tend to date the foundation of their discipline to the nineteenth century and to the promulgation of the great European codes.")

<sup>11</sup> Zweigert & Kötz call this "applied comparative law." *Id.* at 11.

<sup>12</sup> See the "Challenge" of the World Bank at <http://web.worldbank.org>.

<sup>13</sup> See ZWEIGERT & KÖTZ, *supra* note 10, at 51.

<sup>14</sup> See Part II.B and C.

<sup>15</sup> See e.g., Vol. 7, EUROPEAN BUSINESS ORGANIZATION LAW REVIEW (2006) on creditor protection and Special Vol. 1, EUROPEAN COMPANY AND FINANCIAL LAW REVIEW (2006) on legal capital in Europe.

comparative law in the *Oxford Handbook to Comparative Law*<sup>16</sup> and, with particular regard to comparative company law, the teaming up of seven leading corporate law scholars from different jurisdictions to produce in 2004 a high-level comparison of the company law of the United States, Europe and Japan.<sup>17</sup>

Comparative company law is thus expanding quickly at various levels of abstraction and practice. Each level has its own focus and its own tasks. While practical comparatists might concern themselves with the type of document filed or lodged in order to perfect a security interest, the legislative comparatists could focus on whether a specific regime for collateral could stimulate desired commercial activity, and the theoretically oriented academic comparatists might well be occupied with whether practical comparatist's understanding of both "filings" and "creditor possession" as two forms "publicity"<sup>18</sup> is a tenable functional analysis or displays unacceptable levels of an Aristotelian teleological essentialism.<sup>19</sup> All three levels of activity occur separately but are closely related, and many works, like that of Wood, tend to cross the line from practice to theory and back again. Like any other theoretical activity, academic comparative law examines the steps taken in the practical activity of comparison in an attempt to make its methods more transparent and conscious and its results more objective and accurate. This includes, at a minimum, scrutiny of the perspective from which foreign legal systems are investigated and understood, the scope and content of such investigation, the conceptual tools that are used to compare and evaluate laws, and the basis on which causal links between law and a desired social or economic result are posited.<sup>20</sup>

One of the best methodological analyses of comparative law, that of Zweigert and Kötz, proposes a flexible, inductive process of preliminary hypotheses, investigation of functional values, checking of preliminary results, and reformulation of hypotheses.<sup>21</sup> Although Professor Ralf Michaels, in his excellent analysis of the functional method in comparative law, finds that this approach "has an irrational ring to it" that would distance comparison from "scientific aspirations,"<sup>22</sup> it is certainly comparable to what Michaels at another point in his article praises in the work of Ernst Cassirer: "it is not necessary to recognize some essence of a particular element; it is sufficient to

<sup>16</sup> HANDBOOK *supra* note 2.

<sup>17</sup> REINIER R. KRAAKMAN, PAUL DAVIES, HENRY HANSMANN, GÉRARD HERTIG, KLAUS J. HOPT, HIDEKI KANDA, AND EDWARD B. ROCK, *THE ANATOMY OF CORPORATE LAW A COMPARATIVE AND FUNCTIONAL APPROACH* (2004) (hereinafter "ANATOMY").

<sup>18</sup> See WOOD, *COMPARATIVE SECURITY INTERESTS*, *supra* note 4, at 140 *et. seq.*

<sup>19</sup> Ralf Michaels, *The Functional Method of Comparative Law*, in HANDBOOK, *supra* note 2, 339 at 345 *et seq.*

<sup>20</sup> See ZWEIGERT & KÖTZ, *supra* note 10, at 34 *et seq.*

<sup>21</sup> See ZWEIGERT & KÖTZ, *supra* note 10, at 46.

<sup>22</sup> See Michaels, *supra* note 19, at 360.



understand the element as variable result of a functional connection with another variable element."<sup>23</sup> Seen against this background, the method proposed by Zweigert and Kötz, which moves back and forth between functional parts understood in a hypothetical whole and adjustments to the initial understanding of that whole based on new information gained from an analysis of the parts, is not irrational at all, but phenomenological; it roughly resembles a key method of one of Cassirer's more famous contemporaries, Martin Heidegger. In the "hermeneutic circle" which is central to Heidegger's ontology, a higher-level, presupposed concept necessarily encompasses the relational values of the individually existing, lower-level items, and an understanding of the latter then helps better to understand the true nature of the presupposed, higher-level concept, and so on; this circle is not "irrational" or tautological, but a methodological tool used to grasp relational values.<sup>24</sup> While these values for Heidegger are to be understood as essential and true, for the comparatist they are one solution to a given problem.<sup>25</sup>

Although cautions within this circular method of using an assumed whole to determine the function of the parts and a deepened understanding of the various parts' complementary functions to reformulate the model of the whole cannot be reduced to a simple checklist, they would include at least the following approach coordinates against certain, predictable mistakes. At the most basic level, it is important that accurate information about the respective legal systems be procured and only comparable items indeed be compared, so as to avoid creating useless or misleading comparisons. Next, it must be remembered that, unlike discrete objects (e.g., apples and oranges), legal rights, duties and forms cannot be accurately compared in isolation. Rights and duties exist within legal systems and tend to serve relative (i.e., not transcendently essential) functions within their overall framework.<sup>26</sup>

<sup>23</sup> See Michaels, *supra* note 19, at 355.

<sup>24</sup> See MARTIN HEIDEGGER, *SEIN UND ZEIT 7 et seq.*, 148 *et seq.* (1928). In another context, Michaels accepts the hermeneutic circle as comparable to the "way in which mathematicians recognize functions." Michaels, *supra* note 19, at 369.

<sup>25</sup> Michaels critique on the *ends* of this method, on the other hand, appears to be both correct and a significant contribution to comparative law. He observes that for Zweigert: "In stitutions are contingent while problems are universal, the function can serve as *tertium comparationis*, different legal systems find similar solutions by different means, so universal principles of law can be found and formulated." Michaels, *supra* note 19, at 346. By contrast a more sophisticated functionalism would recognize the irregularities in systems: laws have both "manifest" and "latent" functions, societies are sometimes dysfunctional rather than functionally symmetric, and elements of a society can even be non- or anti-functional. Michaels, *supra* note 19, at 352. All this suggests that the search for the perfect social response to a universal problem is ill placed in comparative law.

<sup>26</sup> Ralf Michaels finds "equivalence functionalism" to bear promise for comparative law. As he explains: "Functional equivalence means that similar problems may lead to different solutions; the solutions are similar only in their relation to the specific function under which they are regarded. . . . Equivalence functionalism by contrast explains an institution as a possible but not necessary response to a problem, as one contingent solution amongst several possibilities. As a consequence, the specificity of a system in the presence of (certain) universal problem lies in its decision for one against all other (functionally

The functions of a given right, duty or organizational form might also complement other functions within the same system, so the functions create an almost organic network of interdependence within the legal system. In order better to understand what is strictly considered "law", comparatists must also remember that legal systems exist within societies, and both receive and exercise influence vis-à-vis such societies. Societies further exist in history, and develop and change in relation to historical events, which means that the comparatist must often be aware of the historical position of the legal system being studied. Finally, since at least one leg of a legal comparison will include a law or legal system of a foreign state or country or from a distant time, accurate comparison will require an acute awareness of the distorting tendencies of one's own perspective in time, nation and culture. The foregoing indicates that comparatists should exercise caution with regard to at least the following points of approach:

1. Obtain accurate information and compare only comparable items;
2. Examine the functional values of system components, also within the context of the society as a whole;
3. Duly consider history's impact on the legal system; and
4. Be aware of the natural distorting tendencies of one's own perspective.

It might seem that the utility of such a list would be limited to an introductory text on comparative law, and need not be addressed to professionals actually engaging in comparative or applied comparative law. However, as Part II of this paper will make clear, examples of highly skilled professionals ignoring these approach coordinates are not difficult to find.

The purpose of this paper is to outline a feasible approach to comparative company law that takes into account at least these methodological cautions, which are straightforward enough for practitioners yet contain much of the theoretical insight offered by academic comparative law. Each of the four points will be fleshed out with a well-known case from the comparative law literature. Thereafter, the paper will sketch out a possible frame of reference for a comparison of three major systems of company law: the German, as found primarily in the Stock Corporation Act (*Aktiengesetz* or "AktG"),<sup>27</sup> the British, as found primarily in the Companies Act 2006 (Companies Act 2006 or "CA

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equivalent) solutions. Legal developments are thus no longer necessary but only possible, not predetermined but contingent. This method in turn requires an understanding of society (and its subsystems, including law) as a system constituted by the relation of its elements, rather than set up by elements that are independent of each other." *Id.* at 358 *et seq.*

<sup>27</sup> Law of September 6, 1965, as last amended on January 5, 2007, Federal Law Reporter (Bundesgesetzblatt – BGBl), vol. I, p. 20.

2006"),<sup>28</sup> and the U.S., as found primarily in a state corporate law, represented here by the Delaware General Corporation Law ("DGCL" or "Title 8, Del. Code").<sup>29</sup> This frame will attempt to make clear what is comparable, the systemic boundaries within which respective functions can be sought and compared, and certain prejudices that the differences between these three jurisdictions can evoke at this point in history. The paper will thus be organized as follows: Part II will look at examples of comparisons that fail to heed the points of caution summarized above. Part III will define the term "company law" by examining the topical laws that could reasonably be included in a study of company law, thus addressing the caution expressed in point 1, above. Part IV will examine the law- and rulemaking bodies responsible for creating such topical laws in Germany, the United Kingdom and the United States, and Part V will look at how the various levels of legislation interact in these three jurisdictions, thus creating the framework necessary for points 2 and 3. Part VI will then offer conclusions.

## II. FIVE POINTS OF CAUTION WHEN APPROACHING COMPARATIVE COMPANY LAW

### A. Obtain Accurate Information about the Legal System and Compare Only Comparables

Perhaps the most immediate danger faced by comparative lawyers is the risk of basing an analysis on incomplete or incorrect information about the legal systems being studied, especially because good information may be far away and written in a foreign language. This explains the utility of the numerous texts that present translations or summary analyses of the laws of various countries in English, usually in completely separate chapters, with little or no attempt to draw comparative conclusions about the laws of the separate jurisdictions.<sup>30</sup> The problem of incomplete or incorrect information can arise in even the best comparative legal scholarship and even regarding law that is very close to home. Take, for example, one of today's most influential schools of comparative company law, led by finance theorists such as Professors Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer, and Robert Vishny (hereinafter the "Origin Theorists"). This group of scholars is best known for its argument that legal systems originating from common law lead to effective investor protection – and consequently to the development of stock markets and prosperity – while those originating from the civil law do not.<sup>31</sup> The Origin Theorists summarize one of their key findings as follows: "Common law countries have the strongest protection of outside investors – both shareholders and creditors – whereas French civil law countries have the weakest protection. German civil law and

<sup>28</sup> Companies Act 2006, Chapter 46, 8th November 2006.

<sup>29</sup> Delaware Code Annotated, title 8.

<sup>30</sup> See e.g., *SECURITIES TRANSACTIONS IN EUROPE* (Sweet & Maxwell, 2004), which contains separate, detailed chapters on the major European jurisdictions for securities transactions written by leading corporate and financial law firms in the respective jurisdiction.

<sup>31</sup> See e.g., Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer, & Robert Vishny, *Investor Protection and Corporate Governance*, 58 *Journal of Financial Economics* 3 (2000).

Scandinavian countries fall in between, although comparatively speaking they have stronger protection of creditors, especially secured creditors.<sup>32</sup> Roughly put, the method used to obtain this result is to create a list of countries sorted by their lineage of legal origin, gather data on the existence of certain shareholder rights in each country, and rank the countries by their score on a governance index based on such rights.<sup>33</sup> From the perspective of corporate law, this method is problematic not only because it assumes that certain rights are universal keys to investor protection while others are not,<sup>34</sup> and that the rights on the books can in fact be effectively exercised in the jurisdictions the Origin Theorists favor,<sup>35</sup> but primarily because it fails to use accurate information on the nature of the law in the jurisdictions it discusses.

The Origin Theorists see civil law countries as "interventionist" and "bureaucratic",<sup>36</sup> while they understand common law countries to use flexible standards like "fiduciary duty" or "fairness" to protect private property.<sup>37</sup> As Professor Mark Roe has rightly pointed out, however: "State presence in common law systems today exceeds its historical presence in civil law nations. . . . The United States began moving away from judge-made law, and even away from legislatively made but judicially enforced law, well over a century ago when Congress set up the Interstate Commerce Commission and chose to have regulators, not judges, make law."<sup>38</sup> At least until 2003, the rules of the U.S. Securities and Exchange Commission (SEC) created a web of regulations more pervasive than those found in

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<sup>32</sup> *Id.* at 8.

<sup>33</sup> *See Id.* at 8 *et seq.*

<sup>34</sup> "[I]ndices are constructed so as to treat all component governance mechanisms as complements, when the data suggest that several such mechanisms are actually substitutes for, and not complements to, each other and the relation appears to vary across firm characteristics and industry sectors. In short, one size does not fit all. Good governance is therefore best understood as highly context-specific, something that even the best-constructed index simply cannot capture and convey." Sanjai Bhagat, Brian Bolton & Roberta Romano, "The Promise and Peril of Corporate Governance Indices," 67 *et seq.* (October 2007), ECGI - Law Working Paper No. 89/2007, Available at SSRN: <http://ssrn.com/abstract=1019921>.

<sup>35</sup> Professor Lucian Bebchuk has explained repeatedly in many contexts how the guarantees bestowed on shareholders by corporate statutes are not as effective in practice as they might seem on paper. For example, "shareholders' veto power over charter amendments and reincorporations [is] ineffective at securing value-increasing changes" because it is a mere right to react, not to act, and "management's agenda-setting power under existing arrangements also enables it to obtain shareholder approval for changes that, by themselves, reduce shareholder value" by bundling the proposal to an attractive transaction up for shareholder vote. Lucian Arye Bebchuk, *The Case for Increasing Shareholder Power*, 118 Harv. L. Rev. 833, 864 (2005).

<sup>36</sup> La Porta, Lopez-de-Silanes, Shleifer, & Vishny, *supra* note 31, at 12.

<sup>37</sup> *Id.* at 9.

<sup>38</sup> Mark J. Roe, *Legal Origins, Politics and Modern Stock Markets*, 120 Harv. L. Rev. 460, 484 (2006). On the levels of regulatory enforcement in common and civil law countries and their correlation to market volume, *see* Howell E. Jackson & Mark J. Roe, "Public Enforcement of Securities Laws: Preliminary Evidence" (August 8, 2007), 2nd Annual Conference on Empirical Legal Studies Paper Available at SSRN: <http://ssrn.com/abstract=1000086>, which shows a higher staffing of regulatory agencies in common as compared to civil law countries.

any European country, whether of civil or common law origin. As discussed in Part IV.A.2-4 of this paper, the European Commission has all but eliminated this imbalance with a cluster of directives and regulations on securities regulation, some of which track recommendations from the International Organization of Securities Commissions (IOSCO),<sup>39</sup> in which the United States plays a leading role. Perhaps it is a point of American pride to think of the US markets as lean and unbureaucratic. This is belied, however, by the fact that foreign issuers have historically found the cost of falling under the SEC's extensive regulatory regime to outweigh the costs of excluding US investors from their offerings<sup>40</sup> and US journalists from their road shows<sup>41</sup> until the SEC issued safe harbors rules like Regulation S<sup>42</sup> and Rule 134e,<sup>43</sup> in effect promising that when the safe harbor conditions are met, it will not reach out extraterritorially to cast its heavy regulatory net over such foreign activities. As is discussed in Section C of this Part II, countries in Continental Europe may indeed have legislatively disfavored capital markets, but this was part of a political choice to favor labour over capital, and did not result from their law being less judicial or more pervasive. A comparison of national political and economic policies would be the appropriate tool to prove this point, not a common law/civil law comparison. To present US securities regulation as slim, flexible and judicially oriented while the capital markets regulation of civil law countries is pervasive, rigid and regulatory is simply an inaccurate description of the law.

On the other hand, the Origin Theorists also depend on the rather aged argument that judges in civil law jurisdictions, rather than adjust law analogically to the case at hand, mechanically compare

<sup>39</sup> For example, IOSCO released its report "International Disclosure Standards for Cross-Border Offerings and Initial Listings by Foreign Issuers" in 1998, which the SEC carried almost without change into an amended Form 20-F in 2000 (*see* International Disclosure Standards, Release Nos. 33-7745; 34-41936, 64 *Fed. Reg.* 5390 (Oct. 5, 1999)) and the European Union incorporated into its Prospective Directive in 2003 (*see* Directive 2003/71/EC of the European Parliament and of the Council of 4 November 2003 on the prospectus to be published when securities are offered to the public or admitted to trading and amending Directive 2001/34/EC, 2004 O.J. (L 345) 64). The result is substantially identical, annual disclosure for listed issuers in the United States and the European Union.

<sup>40</sup> "[T]he significant increase in offshore offerings of securities, as well as the significant participation by U.S. investors in foreign markets, present numerous questions. . . . The Regulation adopted today is based on a territorial approach . . . . The registration of securities is intended to protect the U.S. capital markets and investors purchasing in the U.S. market . . . . Principles of comity and the reasonable expectations of participants in the global markets justify reliance on laws applicable in jurisdictions outside the United States . . . ." Offshore Offers and Sales, Release Nos. 33-6863 and 34-27942, 55 *Fed. Reg.* 18306 (May 2, 1990).

<sup>41</sup> "U.S. journalists are being excluded on a regular basis from the offshore press activities of foreign issuers. . . . The purpose of this rulemaking is to eliminate this unintended and undesirable consequence of the Commission's rules governing offering publicity." Offshore Press Conferences, Meetings with Company Representatives Conducted Offshore and Press-Related Materials Released Offshore, Release Nos. 33-7470 and 34-39227, 62 *Fed. Reg.* 38948, 38949 (Oct. 17, 1997).

<sup>42</sup> *See* 17 CFR §230.901 *et seq.*

<sup>43</sup> *See* 17 CFR §230.135e.

facts to rigid rules: "The vague fiduciary duty principles of the common law are more protective of investors than the bright line rules of the civil law, which can often be circumvented by sufficiently imaginative insiders."<sup>44</sup> However, in 1982, nearly twenty years before the article on investor protection under discussion was published, the German High Federal Court issued its landmark *Holz Müller* decision,<sup>45</sup> in which it judicially created a right for shareholders to vote on a management decision to spin off a substantial portion of the company's assets into a subsidiary. In its opinion, the Court explained:

The express provisions of the Stock Corporation Act offer the shareholders of the parent company insufficient protection against such encroachments. . . . At least in this case, it is certainly necessary to protect these shareholders from the danger that, by making fundamental decisions in the subsidiary, the management board will exploit the structure it has created through its power of representation to further diminish those shareholder rights that have already been weakened by the spin-off. . . . This is a real gap in the Stock Corporation Act that should be closed in accordance with the Act's systematic design and policy aims. It would unduly restrict a necessary extension of the law through judicial precedent (*Rechtsfortbildung*) to ask the damaged shareholders to wait for a future legislative amendment or further clarification in the legal scholarship . . . .<sup>46</sup>

Such judicial flexibility is widely practiced in civil law countries. For example, because much of the Code Napoleon still remains in its original form from 1804, French judges have through a large and growing body of judicial decisions over the last 200 years adapted the statutory rules to the changing nature and problems of society.<sup>47</sup>

In the presence of a known socio-political difference like the postwar Continental European political tendency to prefer the protection of labour over the promotion of capital investment, a comparatist might be tempted not only to argue that the difference is caused by diverging legal origins, as do the Origin Theorists, but also to seek support for the difference in sloppy comparisons – such as comparing diverging laws that also have diverging functions. Such errors can easily occur because use of the functional method means one must detach laws from their "literal" meaning and derive a "functional" purpose based on one's understanding of the legal system in question (for example, Prof.

<sup>44</sup> La Porta, Lopez-de-Silanes, Shleifer, & Vishny, *supra* note 31, at 9.

<sup>45</sup> German High Federal Court, 2<sup>nd</sup> Civil Division, February 25, 1982, Doc. No. 174/80 (*In re Holz Müller*).

<sup>46</sup> *Id.*, author's translation. This decision is merely one of the better known cases of judicially crafted doctrine, but is by no means an isolated occurrence. Another landmark decision is the German High Federal Court's adoption of the "entity theory" over the "aggregate theory" for general (civil law) partnerships in 2000 (*see* German Federal Law Reporter on Civil Cases (BGHZ) vol. 146, p. 341), something which in the United States the courts were not able to push through alone, and that was achieved by *statute* in the Revised Uniform Partnership Act (1997). This clear reversal of the antiquated characterization of flexible, judicially made common law and rigid, statutory civil law further calls the position of the Origin Theorists into question.

<sup>47</sup> *See* the discussion of judicial development of the Code Napoleon in ZWEIGERT & KÖTZ, *supra* note 10, at 90 *et seq.*

Douglas Baird has shown that US rules on "fraudulent conveyance," the literal purpose of which is to protect bankruptcy creditors, actually function like European "capital maintenance" rules<sup>48</sup>). The "functional" method used in comparative law, like functional analysis in sociology,<sup>49</sup> and the "structural" method employed in anthropology<sup>50</sup> and literary criticism,<sup>51</sup> splits the studied object into the two levels of "name" or "essence" on the one hand and relative "function" on the other. The use of function instead of name or essence dislodges the object of comparison from its linguistic or conceptual moorings and opens up the risk that the comparatist will abuse the elasticity of the "function" concept. A well-informed legal scholar's interpretation of function will usually be accurate, even if no particular comparative methodology is self-consciously applied. For example, the cases of "functional convergence" in corporate governance that Professor John C. Coffee argued to exist even in the face of clear "formal divergence,"<sup>52</sup> have generally been seen as valid interpretations of comparable functions despite different formal provisions of law.<sup>53</sup>

However, when comparisons are performed deductively on the basis of well known difference rather than inductively on the actual basis of laws or their functions rigorously seen, there is a risk of the comparison becoming merely "anecdotal" rather than actually yielding knowledge. Take, for

<sup>48</sup> See Douglas G. Baird, *Legal Approaches to Restricting Distributions to Shareholders: The Role of Fraudulent Transfer Law*, 7 EBOR 199 (2006).

<sup>49</sup> With respect to functional analysis in sociology, Ralf Michaels has succinctly explained Émile Durkheim's contribution: "First, he separated functions from origins and established functions as relations between, not qualities of, elements. Second, he emphasized that the goals of individuals were contingent and therefore not the valid material of scientific endeavors . . . . As long as the ends or goals of an institution had been its inherent elements, any explanation had to be teleological, and an analysis would have to focus either on the will of a transcendent creator or on the inherent nature of things. If institutions were defined by the purpose defined by their creators, a systematic analysis had to be impossible . . . . The emphasis on objective functions . . . distinct from both origin and purpose, allowed the search for general laws, the goal of all sciences." Michaels, *supra* note 19, at 349 *et seq.*

<sup>50</sup> A memorable functional analysis in anthropology is Claude Lévi-Strauss' comparison of mythical thought, characterized as "*bricolage*", to scientific thought, stating that both are merely constructive activities, the primary difference being that the *bricoleur* improvises on the basis of an existing repertoire while the engineer subordinates each task performed to the availability of certain materials. See CLAUDE LEVI-STRAUSS, *THE SAVAGE MIND* 17 (trans. John & Doreen Weightman, 1966).

<sup>51</sup> The functional method in literary criticism can be traced back to the 1928 work of VLADIMIR PROPP, *MORPHOLOGY OF THE FOLK TALE* (trans. Laurence Scott, 1968). The school of thought that developed out of Propp's work became known as "Structuralism". See e.g., WINFRIED NÖTH, *HANDBOOK OF SEMIOTICS* 298 (1990).

<sup>52</sup> "Although this Article agrees with the path dependency perspective that formal convergence faces too many obstacles to be predicted, it argues that functional convergence can be facilitated . . . ." John C. Coffee, Jr., *The Future as History: The Prospects for Global Convergence in Corporate Governance and Its Implications*, 93 Nw. U.L. Rev. 641, 650 (1999). Coffee focuses on how the participants in international mergers and listings can find ways functionally to bridge formally different legal rules.

<sup>53</sup> See e.g., Ronald J. Gilson, *Globalizing Corporate Governance: Convergence of Form or Function*, 49 Am. J. Comp. L. 329, 349 *et seq.* (2001). Although Coffee and Gilson are to a certain extent relying on each other's work in these articles, the validity of functional analysis in comparative company law is firmly established. See e.g., ANATOMY, *supra* note 17, at 4.

example, the debate on executive compensation that followed the disclosure of the exorbitant sums granted former General Electric CEO Jack Welch and former New York Stock Exchange CEO Richard Grasso, as well as the publication of a celebrated book on the subject by Lucian Bebchuk and Jesse Fried.<sup>54</sup> As is well known from studies such as those written by Roe,<sup>55</sup> Germany is, or at least was,<sup>56</sup> a "social democracy" in which the profit principle is to a certain extent subordinated to the general good, and in particular the good of employees, pursuant to a generally recognized national policy. In addition, German stock corporations are managed by a board of managing directors that by law must act as a "collegial" body, and this means that the leadership of one man or woman is deemphasized.<sup>57</sup> In 2006, the average compensation of the persons filling a role that came closest to a CEO in 29 major German corporations was just under €5 million. This average was drawn upward by Deutsche Bank's chief managing director, Josef Ackermann, earning over €13 million,<sup>58</sup> a figure considerably lower than the \$ 25 million taken home by Charles Prince of Citicorp in the same year.<sup>59</sup> Nevertheless, this state of affairs prompted German politicians across the political spectrum to react. While Oskar Lafontaine, leader of the Leftist Party, advocated restricting CEO compensation to a multiple of 20 times that of the company's lowest paid employee, Renate Künast, a Green Party cabinet member flatly stated that salaries running into the millions are "immoral", and Wolfgang Schäuble, a Christian Democratic Union cabinet member, is reported as saying that leading citizens must set good moral examples, and if they fail to restrict their own excessive salary then the state may step in to do so.<sup>60</sup> All evidence indicates a significant difference between how executive compensation is viewed in Germany and in the United States. This is an undisputed social and legal phenomenon.

In an article presenting an anecdotal analysis of decisions regarding executive compensation in German and US courts, a leading US corporate law scholar compared the German judiciary's decision regarding a "golden handshake" paid out to the former CEO of Mannesmann AG, Dr. Klaus Esser,

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<sup>54</sup> LUCIEN A. BEBCHUK & JESSE FRIED, *PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION* (2004).

<sup>55</sup> See e.g., MARK ROE, *POLITICAL DETERMINANTS OF CORPORATE GOVERNANCE* 29 *et. seq.* (2003)

<sup>56</sup> For a more recent and a rather more "German" opinion on the German economic structure, see Peer Zumbansen, *The Parallel Worlds of Corporate Governance and Labor Law*, 13 *Ind. J. Glob. Leg. Stud.* 261, [♦] *et seq.* (2006).

<sup>57</sup> See § 77(1) AktG ("If the management board is composed of more than one person, all members are authorized only collectively for executive management. The articles or the by-laws may provide otherwise; they may not provide, however, that one or more members make disputed decisions against the position held by the majority of the board." Author's translation).

<sup>58</sup> Catherine Hoffmann, *Warum verdienen Manager so viel Geld?*, FRANKFURTER ALLGEMEINE SONNTAGSZEITUNG, July 22, 2007, at 44.

<sup>59</sup> See THE WSJ/MERCER 2006 CEO COMPENSATION SURVEY (2007).

<sup>60</sup> Manfred Schäfers, *Was darf ein Manager verdienen?*, FRANKFURTER ALLGEMEINE ZEITUNG, November 27, 2007, at 15.



following the company's takeover by Vodafone plc, with the Delaware judiciary's decision on a very large severance payment to Disney Inc.'s short-lived, former President, Michael Ovitz. As the article explains:

Delaware courts exonerated directors of The Walt Disney Company from liability for damages - despite the directors having paid Michael Ovitz around \$ 130 million in exchange for a year accomplishing little as the number two executive at Disney. At about the same time, the German Federal Supreme Court held that directors of the German company, Mannesmann AG, breached their duty to the company when they awarded a bonus of approximately \$17 million to the outgoing CEO - whose actions apparently played an important role in gaining over \$ 50 billion for the Mannesmann shareholders.<sup>61</sup>

This comparison would seem to illustrate that German courts, in line with the social and political differences discussed above, are much tougher on executive compensation than are those in Delaware. What the comparison fails clearly to state is that the Delaware decision was made on the basis of *corporate* law whilst the German decision was made on the basis of *criminal* law, bodies of law with very different functions, and which receive different treatment from the courts.<sup>62</sup> Moreover, the payment to Ovitz was made on the basis of a negotiated contract, and most of the court's decision went to analyzing the adequacy of the negotiation and approval process for this agreement.<sup>63</sup> However, as the German court stressed,<sup>64</sup> the payment to the outgoing CEO of Mannesmann, Klaus Esser, was awarded on a wholly gratuitous basis for past performance after Esser's exit was decided and agreed, and independently from his negotiated bonus package – a scenario that Delaware courts have found to constitute waste of corporate assets.<sup>65</sup> Further, the Delaware court that issued the relevant decision in the Disney litigation was the Court of Chancery, a court of equity and perhaps the

<sup>61</sup> Franklin A. Gevurtz, *Disney in a Comparative Light*, 55 Am. J. Comp. L. 453 (2007).

<sup>62</sup> Whereas civil remedies like those found in corporate law are primarily remedial or coercive, criminal penalties have the primary purpose of punishing and deterring wrongful conduct. *See e.g., In re American Biomaterials Corp.*, 954 F.2d 919 (3<sup>rd</sup> Cir. 1992); *U.S. v. Twentieth Century Fox Film Corp.*, 882 F.2d 656 (2<sup>nd</sup> Cir. 1989); *Allied Capital Corp. v. GC-Sun Holdings, L.P.*, 910 A.2d 1020 (Del. Ch. 2006). As one would expect, this is a position also held in Germany. With regard to German position on the distinction between criminal and civil law, *see* CLAUS ROXIN, STRAFRECHT vol. 1, § 1, margin no. 2 (4<sup>th</sup> ed. 2006) ("A provision does not belong to the criminal law because it regulates against violations of prescriptions or prohibitions – many provisions of civil and administrative law also do that – but because such violations are sanctioned by rules on punishment or deterrence." Author's translation).

<sup>63</sup> *See In re The Walt Disney Company Derivative Litigation*, 2005 WL 2056651, at 133 *et seq.* (Del. Ch. 2005).

<sup>64</sup> German Federal High Court (*Bundesgerichtshof*), Docket No. 470/04 (Dec. 21, 2005), margin no. 27.

<sup>65</sup> *In re The Walt Disney Company*, at 32. Earlier decisions of the Delaware courts also indicate that award for past services are often treated as lacking consideration and thus invalid as a waste of corporate assets. *See Fidanque v. Am. Maracaibo*, 92 A.2d 311 (Del. Ch. 1952) and *Lewis v. Hett*, C.A. No. 6752 (Del. Ch. Sept. 4, 1984), as well as *In re Walt Disney*, at 32.

nation's most famously business savvy court,<sup>66</sup> whilst the division of the German High Federal Court that heard the Mannesmann appeal was the Criminal Division (not the 2<sup>nd</sup> Civil Division, which deals with corporate law matters and handed down, for example, the *Holz Müller* decision discussed above), which is not accustomed to balancing business interests in the corporate area. A criminal court applying criminal law has no reason whatsoever to consider the exigencies of corporate business operations.

These very meaningful differences render the two decisions themselves beyond any useful comparison. A specialized business court's decision under corporate law evaluating whether the negotiation and approval of a compensation contract was grossly negligent simply has very little in common with a criminal court's decision under criminal law evaluating whether a gratuitous payment made to an exiting director was an abuse of trust. What could remain, however, would be the possibility that these cases each *function* as the procedural remedy of choice in their respective jurisdiction for the discipline of such management actions. Indeed the author asks whether "the difference is coincidental, or symptomatic of the way in which the two jurisdictions are likely to react to cases of this nature."<sup>67</sup> The answer he provides is that *because* shareholder suits are more difficult to bring in Germany, the public prosecutor filed the criminal complaint against the Mannesmann directors,<sup>68</sup> which indicates shareholder remedies in Germany taking a different route from like cases in Delaware. This is also an interesting idea, but finds little basis in the facts.

Whilst the Delaware courts do regularly hear shareholder challenges to the award of director compensation,<sup>69</sup> on the other side of the Atlantic, the Mannesmann decision was major news in Germany exactly because a case of this type had never been tried<sup>70</sup> – hardly a "standard remedy" of the German legal system. Moreover, unlike the position of Delaware courts applying the demand

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<sup>66</sup> See e.g. R. FRANKLIN BALOTTI & JESSE A. FINKELSTEIN, *THE DELAWARE LAW OF CORPORATIONS AND BUSINESS ORGANIZATIONS* § 20.11 (2002) ("In particular, the Delaware Court of Chancery, which has a long tradition of resolving complex business disputes in a timely, efficient and fair manner . . . .") and Franklin A. Gevurtz, *The Business Judgment Rule: Meaningless Verbiage or Misguided Notion*, 67 S. CAL. L. REV. 287, 323 (1994) (" . . . judges (at least in Delaware) have some expertise in providing legal advice to corporate boards.").

<sup>67</sup> See Gevurtz, *supra* note 61, at 485 *et seq.*

<sup>68</sup> See *id.* at 490 (" . . . the criminal prosecution in Mannesmann illustrates what can happen in a high profile transaction, perceived by the public as outrageous, in the absence of a viable opportunity for civil adjudication . . . .").

<sup>69</sup> See the cases discussed in BALOTTI & FINKELSTEIN, *supra* note 66, at § 4.19.

<sup>70</sup> German legal scholarship is led by highly respected, multivolume commentaries on individual laws and codes. An examination of the lengthy comments on § 266 of the German Criminal Code (*Strafgesetzbuch*) reveals no case comparable to Mannesmann AG. See THOMAS FISCHER, *BECK'SCHE KURZKOMMENTAR ZUM STRAFGESETZBUCH*, vol. 10 margin no. 54 (55<sup>th</sup> ed. 2008); KRISTIAN KÜHL, *LACKNER & KÜHL STGB § 266* (27<sup>th</sup> ed. 2007).

requirement in Delaware,<sup>71</sup> German courts have specifically refused to grant protection of the business judgement rule to supervisory board decisions refusing to pursue an action against a board member, explaining that evaluating the merits of a legal claim is – far from a business judgment – what courts themselves do and thus courts are competent to evaluate the claim *de novo*.<sup>72</sup> Thus an action regarding compensation would have far less chance of being stopped by the board in Germany than in Delaware, and in fact the demand requirement led to the Disney shareholders' action in 1996 bouncing back and forth between the courts for nearly 10 years until it finally reached its conclusion in the 2006 decision discussed above.<sup>73</sup> Moreover, unlike the Delaware law, the German Stock Corporation Act specifically provides a standard against which the adequacy of executive compensation must be measured,<sup>74</sup> which is another reason why compensation cases could take a corporate rather than a criminal route. Consequentially, although it is well known that the United States is far friendlier to shareholders litigation than is Germany, this is not reflected in the two court decisions. In addition, even though the broader topic the author seeks to highlight, i.e., that socially democratic Germany is much less sanguine on high executive compensation than the economically utilitarian United States, is certainly true, the comparison of two decisions with very different fact patterns on the basis of laws with different functions by courts with different purposes and tenors does nothing to support it. Comparisons of "incomparables" used to draw systematic conclusions could potentially distract attention away from comparative work that focuses on the actual causes of the diverging treatment of compensation. As Zweigert & Kötz note, "[i]ncomparables cannot usefully be compared, and in law the only things which are comparable are those which fulfil the same function."<sup>75</sup>

<sup>71</sup> See *Aronson v. Lewis*, 473 A.2d 805 (1984).

<sup>72</sup> See *ARAG v. Garmenbeck*, German Federal Law Reporter on Civil Cases (BGHZ), vol. 135, p. 244 (1997) ("the supervisory board may not invoke a 'decision-making prerogative' to restrict the scope of the court's review with regard to this part of its decision-making. In examining whether a claim for damages exists and the merits thereof, the supervisory board does nothing other than anyone else who evaluates – for himself or for another – whether a claim exists and whether it may be successfully prosecuted in court. The substance and correctness of such an evaluation of the merits of judicial prosecution of a claim may, in cases of a dispute, generally be fully tested in a court, given that such an evaluation does not regard business dealings but rather solely regards an area of knowledge for which we may always consider positing a limited freedom for discretion." Author's translation).

<sup>73</sup> The Disney proceedings began in 1996 with the shareholders filing a complaint directly with the court rather than requesting that the directors pursue the action. In the first round of action, the directors then sued to dismiss the case, and the Court of Chancery complied, following which the Supreme Court reversed in part and remanded to the Court of Chancery for further determinations. As a sampling of the 10 decisions in this long procedural history, see *In re The Walt Disney Co. Deriv. Litig.*, 11, Del. Ch., C.A. No. 15452, (Mar. 13, 1997); *In re The Walt Disney Co. Deriv. Litig.*, 731 A.2d 342 (Del. Ch. 1998); *In re The Walt Disney Co. Deriv. Litig.*, 825 A.2d 275 (Del. Ch. 2003).

<sup>74</sup> The overall compensation of a managing director must be "in an appropriate relationship to the duties of the director and the state of the company." § 87(1) AktG.

<sup>75</sup> ZWEIFERT & KÖTZ, *supra* note 10, at 34.

## B. Recognize Functions and Relationships within Systems

It is the rare case that seeks to compare two elements of a legal system that are both formally and functionally different. However, it is quite common that the comparatist does not cast her analytical net wide enough, and thus fails to understand all functional elements that interact with a law or right in a foreign legal system. This is one of the problems that has plagued development law and led to developing countries rejecting incompatible "transplants" from foreign legal systems. As Professors Daniel Berkowitz, Katharina Pistor and Jean-Francois Richard explain: "Extensive comparative research prior to the adoption of a foreign legal system is indicative for an informed choice."<sup>76</sup>

Such extensive comparative research would reveal "a system of functional constellations; its concepts [would] denote the tasks that a given life situation assigns law – indeed, assigns all laws resting on the same social and economic conditions."<sup>77</sup> The research would from the outset renounce the conviction that certain legal institutions are essentially necessary, and instead employ an "anti-metaphysical focus . . . [that] understand[s] institutions through their relation to problems."<sup>78</sup> The relationship between the problems posed by similar underlying conditions and the solutions devised to address them is central to the analysis. In *The Anatomy of Corporate Law*, Kraakman and his colleagues observe that, "[i]t would perhaps be more accurate to call our approach 'economic' rather than 'functional' . . . the exigencies of commercial activity and organization present practical problems that have a rough similarity in developed market economies throughout the world . . . corporate law everywhere must necessarily address these problems . . . forces of logic, competition, interest group pressure, imitation, and compatibility tend to lead different jurisdictions to choose roughly similar solutions to these problems."<sup>79</sup> However, not only the legal provisions themselves, but also the means of enforcing them are included in such comparative research. In analyzing governance under the company law of a given jurisdiction, Professors Lucian Arye Bebchuk and Mark J. Roe argue that "[w]hat counts are all elements of a corporate legal system that bear on corporate decisions and the distribution of value: not just general principles, but also all the particular rules implementing them; not just substantive rules, but also procedural rules, judicial practices, institutional and procedural infrastructure, and enforcement capabilities."<sup>80</sup> The foregoing quotations from leading

<sup>76</sup> Daniel Berkowitz, Katharina Pistor and Jean-Francois Richard, *The Transplant Effect*, 51 AM. J. COMP. L. 163, 180 (2003).

<sup>77</sup> ZWEIGERT & KÖTZ, *supra* note 10, at 46, defining the method of comparative law.

<sup>78</sup> Michaels, *supra* note 19, at 360.

<sup>79</sup> ANATOMY, *supra* note 17, at 4, discussing their approach to the "anatomy of corporate law."

<sup>80</sup> Lucian Arye Bebchuk & Mark J. Roe, *A Theory of Path Dependence in Corporate Ownership and Governance*, 52 Stan. L. Rev. 127, 155 (1999), describing what they include in their analysis of legal systems.

corporate law comparatists display a general agreement that in comparative law, the relative functions of a given rule or structure must be understood in the complete context of the legal system and broader societal framework as solutions to problems that may well arise also in other jurisdictions. Although the functional approach of comparative law is not without its dangers,<sup>81</sup> it is generally accepted.

Berkowitz, Pistor and Richard explain how law development projects have had little success since the 19<sup>th</sup> Century in large part because of a failure to perform extensive comparative research on the constellation of values and functions within the recipient society before transplanting a foreign legal tool. Using the term "demand" as shorthand for the desire of a recipient society to actually enforce a transplanted rule, they explain:

[C]ountries that receive their formal legal order from another country have to come to grips with what was often a substantial mismatch between the preexisting and the imported legal order. They may be unfamiliar with dispute settlement through adversarial litigation rather than mediation and negotiation, or with the rigidity of legal rights independent of kinship relations or norms of social obligations. Moreover, the social, economic and institutional context often differs remarkably between origin and transplant country, creating fundamentally different conditions for effectuating the imported legal order in the latter.<sup>82</sup>

Our basic argument is that for law to be effective, a demand for law must exist so that the law on the books will actually be used in practice and legal intermediaries responsible for developing the law are responsive to this demand. If the transplant adapted the law to local conditions . . . then we would expect that the law would be used. Because the law would be used, a strong public demand for institutions to enforce this law would follow. . . However, if the law was not adapted to local conditions . . . then we would expect that initial demand for using these laws to be weak. . . . Countries that receive the law in this fashion are thus subject to the "transplant effect": their legal order would function less effectively than origins or transplants that either adapted the law to local conditions and/or had a population that was familiar with the transplanted law.<sup>83</sup>

Understanding the law in context is a prerequisite to transplanting laws. Because the "donor" countries fail to perform sufficient comparative analyses on either their own legal systems or those of the recipient countries, the transplant fails. That efforts at transplanting legal systems from the colonization of the 19<sup>th</sup> Century to contemporary development law projects have yielded very poor results shows that the comparative analyses, where performed, were not exhaustive enough. As

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<sup>81</sup> With referenced to the use, critique and eventual rejection of functionalism in Sociology, Michaels' explains that functions should not be understood to express an essential *telos*, whether understood as the intention of a transcendent creator (Aristotle) or a necessary evolution (Compte) (*see* Michaels, *supra* note 19, at 345 *et seq.*), for not every function within a social system should be understood as indispensable, given that living societies contain contingent, antiquated and unnecessary elements (Robert Merton) (*Id.* at 352 *et seq.*). All these dangers point to the fact that the functional method is strongest when used to understand, compare and critique laws and legal systems, but "is not only a bad tool for legal unification, but even provides powerful arguments for maintaining differences" (*Id.* at 377).

<sup>82</sup> Berkowitz, Pistor and Richard, *supra* note 76, at 170 *et seq.*

<sup>83</sup> *Id.* at 167 *et seq.*

indicated above, these analyzes must examine a great number of components of the legal system and of society and attempt to grasp at least the primary ways in which the functions of these components interact with and complement each other. The complex and changing nature of this web of functional relationships tends to evoke organic metaphors like "transplant". Employing another organic metaphor, yet blaming the recipient rather than the foreign element being introduced (inappropriate earth for a healthy crop rather than inappropriate organ for the healthy body), Professors Bernard Black, Reinier Kraakman, and Anna Tarassova reflect on the lack of sufficient background study that went into recommending mass privatizations for Russia in the 1990's:

We have learned that Western-style capitalism is more fragile than we thought. It will not emerge - certainly not quickly, perhaps not at all - if seeds are simply scattered widely through mass privatization, to grow in the thin soil of an institutionally impoverished country. Instead, the institutions that control theft in its myriad forms, especially self-dealing by managers and controlling shareholders, are an essential fertilizer. The task of creating fertile soil in which privatized companies can take root is not a simple one. . . . Russia needs a serious, top-down effort to control corruption, organized crime, and self-dealing; adopt a rational tax system; reduce the broad administrative discretion that invites corruption; shrink the bloated bureaucracy; enforce existing rules that limit self-dealing; remove the principal loopholes in those rules; and improve financial reporting by major firms . . . . No one of these steps is sufficient by itself, but each will help and progress on any one can reinforce progress on others.<sup>84</sup>

A comparative analysis must therefore grasp not only the immediate function of rights, laws, and organizational forms within the specific legal system, but also the manner in which the legal system interacts with the society, its habits and mores. The affinity between comparative law and sociology thus goes not only to the use of the functional method of analysis, but also to the interdependence of the two objects of study.

### **C. Understand the Historical Setting of the Legal System**

To this breadth of systematic and social analysis must be added a temporal axis of comparative study. Accurate knowledge of historical facts and trends influencing a legal system and its operation are very often crucial to a comparison. Major events such as wars, revolutions, and economic booms or collapses are not "legal" in nature but have an impact on the development of economies and legal systems. The number of historical and political influences that go into a major change in the law is often so great that even a detailed historical analysis of the process can only be a summary.<sup>85</sup> The

<sup>84</sup> Bernard Black, Reinier Kraakman, and Anna Tarassova, *Russian Privatization and Corporate Governance: What Went Wrong?*, 52 STAN. L. REV. 1731, 1797 *et seq.* (2000).

<sup>85</sup> See e.g., JOEL SELIGMAN, *THE TRANSFORMATION OF WALL STREET: A HISTORY OF THE SECURITIES AND EXCHANGE COMMISSION AND MODERN FINANCE 1 et seq.* (3<sup>rd</sup> ed. 2003) and Roberta Romano, *The Sarbanes-Oxley Act and the Making of Quack Corporate Governance*, 114 YALE L. J. 1521 (2004) for unusually detailed and insightful analyses of the relationship between historical events and the creation of law.

Origin Theorists have come under criticism from a number of scholars exactly for failing to factor history into their analytical equations. Roe, for example, has subjected the argument of the Origin Theorists that civil law stunted the development of stock markets in Continental Europe while common law stimulated such development in the United States and the United Kingdom to a criticism that is, or approaches, a complete refutation. Berkowitz, Pistor and Richard also show how historical causes have had a more meaningful impact on the success of legal systems than has the origin of a given system in the common law. Both of these critiques, which are discussed in following, demonstrate how history must be factored into any comparative analysis of a legal system or the latter's effects on social development.

Berkowitz, Pistor and Richard challenge the link between legal origin and successful legal systems by demonstrating that legal institutions forced on countries through colonial conquest or uninformed development assistance have a high probability of failure regardless of their origin.<sup>86</sup> On the other hand, systems that a country itself develops and the complementary elements of which the culture appreciates have a high probability of success regardless of their origin.<sup>87</sup> The suitability of the transplanted law thus has a greater impact on its future development than does a fragile and diluted link to Justinian's *Corpus Juris Civilis*. Among developing countries, any difference in the rate of success between those with common law and those with civil law colonial backgrounds could be traced to the differing policies of colonial management. The British, influenced perhaps by their less rationalist approach to culture or perhaps by the unpleasant experience in North America, attempted to leave space for local customs and institutions,<sup>88</sup> while the French, perhaps following their more rationalist cultural heritage or riding the wave of enthusiasm for social engineering that carried them during the Revolution, sought to remake conquered societies by introducing their own customs and institutions, including French law, quite pervasively.<sup>89</sup> This difference was unlikely to be a common law/civil law divergence, as the civil law country of Holland applied its own law only to its own citizens in its colonies, and left the natives to their own customs.<sup>90</sup>

<sup>86</sup> "We provide statistical evidence showing that the 'transplant effect' is a more important predictor of effective legal institutions than the supply of a particular legal family." Berkowitz, Pistor and Richard, *supra* note 76, at 168 *et seq.*

<sup>87</sup> "Internal development can take advantage of new solutions economic agents develop in response to new challenges and existing constraints. Lawmakers can build on domestic knowledge and expertise and can take full advantage of complementarities between new and old institutional arrangements. This is most explicit for case law, where new legal rules are generated from litigated cases. But legislatures can also take advantage of social knowledge about perceived problems and possible solutions through survey instruments or law commissions staffed with experts." *Id.* at 170 *et seq.*

<sup>88</sup> See ZWEIGERT & KÖTZ, *supra* note 10, at 220.

<sup>89</sup> See ZWEIGERT & KÖTZ, *supra* note 10, at 113.

<sup>90</sup> Berkowitz, Pistor and Richard, *supra* note 76, at 176.

Roe focuses on the assertion that common law countries have developed more active capital markets than civil law countries due to the superior investor protection that derives from common law courts. The Origin Theorists attribute this argument to a statement by Professor John C. Coffee, Jr. that courts can flexibly apply rules to situations that are difficult to foresee in advance.<sup>91</sup> It should be noted, however, that in another context Coffee explains that investment bankers began to sit as "independent" directors on the boards of US companies, and effective shareholder monitoring thus began, exactly because US courts could be bribed and European investors needed assurances against the extraction of rents by management.<sup>92</sup> Thus a dogmatic application of common law as the source of effective investor protection can in no way be attributed to Coffee. Roe's critique of the Origin Theorists focuses on the highly industrialized countries that currently have active capital markets, and looks at the development of their markets during the 20<sup>th</sup> Century against the backdrop of the political events they experienced. Among the other evidence he offers, Roe shows that the percentage of GDP represented by stock markets was high in Continental Europe in 1913 (Belgium = 99%, France = 78% and Germany = 44%, compared to the United States = 39%), plummeted through World Wars I and II and their aftermath (Belgium = 32%, France = 28% and Germany = 35%, compared to the United States = 61% in 1960), and gradually returned to or exceeded its pre-1914 level by 1999, one decade after the end of the Cold War (Belgium = 82%, France = 117% and Germany = 67%, compared to the United States = 152%).<sup>93</sup> As Roe explains, the political events of the 20<sup>th</sup> Century, which were most intensely experienced in Continental Europe, disproportionately affected countries in that area, which were primarily countries of "civil law origin":

The first political economy channel has military occupation weakening institutions overall. When it came time to rebuild, the polity rebuilt human institutions in early

<sup>91</sup> La Porta, Lopez-de-Silanes, Shleifer, & Vishny, *supra* note 31, at 9 ("In the area of investor expropriation, also known as self-dealing, the judges apply what Coffee calls a 'smell test,' and try to sniff out whether even unprecedented conduct by the insiders is unfair to outside investors. The expansion of legal precedents to additional violations of fiduciary duty, and the fear of such expansion, limit the expropriation by the insiders in common law countries.").

<sup>92</sup> "[T]he derivative suit had been recognized by the Supreme Court as a legal mechanism to protect minority shareholders, and the law of fiduciary duties generally required any corporate official who engaged in a self-dealing transaction with his firm to prove its "intrinsic fairness." But once the investor had committed his capital, he might discover that the corporation had migrated to another, more permissive jurisdiction . . . . Or, a judge would simply be bribed to accept some pretext for clearly predatory misbehavior. . . . Litigation was simply not the answer for the foreign investor. . . . One means to this end was pioneered by J.P. Morgan & Co., namely, placing a partner of the firm on the client's board." John C. Coffee, Jr., *The Rise of Dispersed Ownership: The Roles of Law and the State in the Separation of Ownership and Control*, 111 YALE L.J. 1, 28 *et seq.* (2001). This is a technique that has historically been used in Germany. See JEREMY EDWARDS AND KLAUS FISCHER, *BANKS, FINANCE AND INVESTMENTS IN GERMANY* 199 *et seq.* (1994). For example, as following pages of data on the topic, the authors observe, "on average, bank representatives accounted for 20% of the total supervisory board membership of the 75 AGs among the largest 100 on which banks had seats." *Id.* at 210.

<sup>93</sup> Roe, *supra* note 38, at 488, Table 3.



decades, waiting until later to rebuild stock markets. The second channel ties destruction to postwar domestic politics. Stunned voters were averse to risk, labor was powerful, and savings were meager. Those background political conditions were not market-friendly. The third channel is postwar international politics. The program in many nations was fighting communism, inducing most Western European and East Asian governments to befriend international communism's most likely domestic allies. A fourth channel is that destroyed nations do not immediately need large pools of capital from financial markets. Banks are adept at allocating capital to known technologies, while securities markets are more adept at allocating capital to new and untried technologies. After World War II, reconstruction was largely a known task for which banks were well suited, perhaps better suited than volatile equity markets, and which fit with a polity that preferred steady and low-risk reconstruction.<sup>94</sup>

Countries in Continental Europe were occupied and partially destroyed by invading armies during the two World Wars, their surviving populations lost some or all of their property, and understandably became risk averse. The aftermath demanded investment in the conservative activity of reconstruction rather than speculative investments, and the main political aim was to keep Communism at bay, which meant appeasing labour and not ostensibly favouring capital. As Roe observes, banks were well suited to allocating capital to the kind of projects that rose out of these historical events, and as law permitted "universal banking",<sup>95</sup> these institutions were not only able to accompany their customers into more normal times with financing, but also to take equity stakes in them and seat outside "financial directors" on their supervisory boards, exercising a significant influence<sup>96</sup> that could have guided them towards further bank financing. Although the absence of a Glass-Steagall Act did mean that law facilitated this arrangement, but it was not the "origin" that counted but the content. Beyond these historical arguments, when one adds that Switzerland and Luxembourg, both civil law countries, host two of the world's most active stock markets,<sup>97</sup> the legal origin argument appears quite weak. In addition, capital flight from a troubled Europe in the 1930's not only weakened Continental markets, but strengthened those in the United States.<sup>98</sup>

Roe, Berkowitz, Pistor and Richard make it very clear that comparative law must understand and factor in the historical events and developments that affect the legal systems being studied. Moreover, a recent response by the Origin Theorists shows just how deep an understanding of culture

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<sup>94</sup> Roe, *supra* note 38, at 502.

<sup>95</sup> See EDWARDS & FISCHER, *supra* note 92, at 97 *et seq.*

<sup>96</sup> See *id.* at 213 *et seq.*

<sup>97</sup> Roe, *supra* note 38, at 488, Table 3; Luxembourg's domestic market capitalization of about €60 billion is substantially more than double its GDP, making its capital market a much more active segment of the economy than in the United States. See Luxembourg Stock Exchange, Fact Book 2007, p. 65 and Organization for Economic Co-Operation and Development, Statistics on Luxembourg.

<sup>98</sup> ERIC HELLEINE, STATES AND THE REEMERGENCE OF GLOBAL FINANCE: FROM BRETTON WOODS TO THE 1990s 39 (1996).

and history is necessary. In a 2007 paper, the Origin Theorists adjusted their argument to assert that "common law" and "civil law" work in a culture to promote planning or laissez faire:

In this paper, we adopt a broad conception of legal origin as a style of social control of economic life (and maybe of other aspects of life as well). In strong form (later to be supplemented by a variety of caveats), we argue that common law stands for the strategy of social control that seeks to support private market outcomes, whereas civil law seeks to replace such outcomes with state-desired allocations. In words of one legal scholar, civil law is "policy implementing", while common law is "dispute resolving". . . . These broad ideas and strategies were incorporated into specific legal rules, but also into the organization of the legal system, as well as the human capital and beliefs of its participants. When common and civil law were transplanted into much of the world through conquest and colonization, the rules, but also human capital and legal ideologies, were transplanted as well.<sup>99</sup>

This attempt to co-opt the socio-political criticism offered by Roe and others would go to the extent of compressing the significant differences in historical development between French and British thought into the type of legal system used by each. Along these lines, the difference between, say, the rationalism of René Descartes and the empiricism of Thomas Hobbes would have been the result of their respective legal systems,<sup>100</sup> or at least would have been transmitted to French and British colonies only through the transplant of such legal systems. While law is important, and some cultures have been better known for their law than for their philosophy, art or scientific and military accomplishments, it would be a rare thing for a civilization to be summed up in the origin of its law. Here, again, the hands-off domestic policies of (civil law) Switzerland's local democracy and the minimalist colonial management of (civil law) Holland, as well as the economic micro-management of (common law) Britain's post war economy<sup>101</sup> do not fit well into the Origin Theorists' mould. The gaps in the arguments and adjusted arguments of the Origin Theorists show just how necessary it is to investigate a jurisdiction's history and social composition before formulating theories of causality.

<sup>99</sup> Rafael La Porta, Florencio Lopez-de-Silanes, and Andrei Shleifer, "The Economic Consequences of Legal Origins" 3 *et seq.* (November 2007), available at SSRN: <http://ssrn.com/abstract=1028081>.

<sup>100</sup> The peculiarity of reversing the causal relationship in such manner is displayed in the solid method of the eminent intellectual historian, Prof. Peter Gay, who analyzes the *legal* writings of Montesquieu for the tension between influences from the *philosophical* positions of rationalism and empiricism rather than taking the reverse path proposed by the Origin Theorists. See PETER GAY, *THE ENLIGHTENMENT: THE SCIENCE OF FREEDOM* 326 (1996).

<sup>101</sup> See TONY JUDT, *POSTWAR: A HISTORY OF EUROPE SINCE 1945* 367 (2005) (" . . . the British Labour movement, whose core doctrine and program ever since 1918 rested on an in eradicable faith in the virtues of state ownership . . . . The example of the UK's British Motor Corporation, a helpless guinea pig for government experiments in centralized resource allocation . . . .").

#### D. Be Aware of and Counter Prejudicial Perspectives

Zweigert & Kötz argue that the negative side of the functional method is that the comparatist must radically free herself from her own legal and doctrinal prejudices.<sup>102</sup> Perhaps because no one can ever completely free himself of prejudices, writings evidencing harsh judgements on foreign law are not hard to find in comparative law literature. One of America's classic texts on comparative law sneers so obviously at the "civil law tradition" that it can make even the US reader uncomfortable. Take, for example, the following passages analysing the work of legal scholars in civil law countries:

"The assumption of legal science that it scientifically derives concepts and classes from the study of natural legal data on the one hand, and the generally authoritarian and uncritical nature of the process of legal education on the other, tends to produce the attitude that definitions of concepts and classes express scientific truth. A definition is not seen as something conventional . . . it becomes a truth, the embodiment of reality. . . . Legal scientists are more interested in developing and elaborating a theoretical scientific structure than they are in solving concrete problems. . . . Nor is the legal scientist interested in the ends of law, in such ultimate values as justice. . . they built ideologically loaded concepts into a systematic conceptual legal structure that is still taught in the faculties of law . . . . In this way European systematic jurisprudence embodies and perpetuates nineteenth-century liberalism, locking in a selected set of assumptions and values and locking out all others."<sup>103</sup>

This depiction of the bookish civil law professor building sky castles while ignoring justice seems, at some points, to refer just to the 19<sup>th</sup> Century Pandectics, whom many Germans of the period also found to be overly abstract and socially conservative.<sup>104</sup> However, in addition to the statement that the system of legal science is "still taught in the faculties of law," the analysis moves on in the next chapter to deconstruct the introduction of a current, elementary textbook in Civil Law. The analysis teases out inexactness in the introductory simplifications<sup>105</sup> and points to statements that contain an ideological perspective,<sup>106</sup> as if to show that the ideological tunnel vision of civil law scholars is still closing young minds off from the truth.<sup>107</sup> In fact, the explicatory criticism is so harsh that Merryman and Pérez-Perdomo seek to spare the author of the civil law book the embarrassment of having her

<sup>102</sup> ZWEIGERT & KÖTZ, *supra* note 10, at 35.

<sup>103</sup> MERRYMAN & PÉREZ-PERDOMO, *supra* note 1, at 63 *et seq.*

<sup>104</sup> See ZWEIGERT & KÖTZ, *supra* note 10, at 142.

<sup>105</sup> For example, in this introduction to the nature of law, a first year law student would read: "The legal norm . . . is . . . a command addressed to the individual by which a determined conduct . . . is imposed on him," but the comparatists beg to differ, explaining: "Actually, not all norms command; the text is inaccurate." MERRYMAN & PÉREZ-PERDOMO, *supra* note 1, at 70.

<sup>106</sup> The first year law student of civil law would read "subjective right is the power of the individual that is derived from the norm," but the comparatists find this is an "ideologically loaded fundamental notion," as "In private law, this is the foundation of a legal system in which private, individual rights . . . exist." *Id.*

<sup>107</sup> See *Id.* at 69 *et seq.*

name mentioned, referring to the text only as "a respected elementary work (which shall remain anonymous) on private law."<sup>108</sup>

This *exposé* of civil law scholarship shows strong cultural prejudice, and displays the kinds of contradictions that prejudice tends to bring with it. For example, the text explains that civil law scholars are not interested "in solving concrete problems," but 35 pages later states that because they "are not paid enough for [their academic work] to live well," "aspirants to academic positions customarily embark on an additional legal career."<sup>109</sup> A positive spin on this state of affairs would be that the legal scholar, who may also be a partner in a law firm, an arbitrator, or a director in a corporation, can bring his practical skills to bear in the classroom. However, for these authors, the civil law scholar is both divorced from reality and an odd-jobber moonlighting from his poorly paid post. The assertion that civil legal scholars are not interested in "such ultimate values as justice" is also troublesome, as it would seem to be refuted by the civil law origins of the concept of unconscionability in contracts,<sup>110</sup> as well as by the sociological projects of legal scholars like Niklaus Luhmann.<sup>111</sup> Indeed, the very existence of "equity", from which notions resembling unconscionability first developed in the common law, give evidence of the overly formalistic nature of an early common law that was more interested in formal perfection of the writs than in achieving equitable justice.<sup>112</sup> Coming from a legal tradition in which decisions like *Lochner v. New York*<sup>113</sup> prohibited most "paternalistic" interference with unequal bargaining power right up until the Executive Branch declared its preparations for war on the Judiciary in 1937,<sup>114</sup> the description of civil law as perpetuating 19<sup>th</sup> Century liberalism also seems more than a little one-sided. A comparative analysis of such liberalism stressing its uniform grip on *both* the common and the civil law, with an analysis of the diverging ideological approaches used to adapt law to an evolving understanding of the contracting subject would seem more appropriate in a sophisticated, comparative study.

Interestingly enough, the Origin Theorists also address 19<sup>th</sup> Century civil law development with the diametrically opposed assertion that civil law sought to manage and control economic activity rather than perpetuate a conservative, *laissez-faire* liberalism. They argue: "In England . . . common

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<sup>108</sup> See *Id.* at 69.

<sup>109</sup> See *Id.* at 108 *et seq.*

<sup>110</sup> In times when a common law court would refuse to inquire into the adequacy of consideration (*Sturlyn v. Albany*, 78 Eng. Rep. 327 (K.B. 1587)), the Austrian Civil Code of 1811 allowed dissolution of a contract if the consideration promised by the two parties was substantially disproportional. See ZWEIGERT & KÖTZ, *supra* note 10, at 320.

<sup>111</sup> See e.g., NIKLAS LUHMANN, *DAS RECHT DER GESELLSCHAFT* (1994).

<sup>112</sup> See JILL E. MARTIN, *HANBURY & MARTIN MODERN EQUITY* 5 *et. seq.* (17<sup>th</sup> ed. 2005).

<sup>113</sup> *Lochner v. New York*, 198 U.S. 45 (1905).

<sup>114</sup> See DAVID M. KENNEDY, *FREEDOM FROM FEAR* 325 *et seq.* (1999).

law evolved to protect private property against the crown. . . . In France and Germany, by contrast, parliamentary power was weaker. Commercial Codes were adopted only in the nineteenth century by the two great state builders, Napoleon and Bismarck, to enable the state to better regulate economic activity.<sup>115</sup> The historical assertions made in this statement are problematic, and they also seem to display a particular Anglo-American prejudice that was common in the 1990's following the victory in the Cold War. First, historical research by Professors Daniel Klerman and Paul Mahoney tends to refute the asserted role of common law courts as comparatively strong guardians of property.<sup>116</sup> Second, the argument that the French and German commercial codes were 19<sup>th</sup> Century tools of state control is weak, and ideologically about one century in advance. France's 1807 Commercial Code was only a partial amendment of royal decrees on commerce dating back to the late 17<sup>th</sup> century,<sup>117</sup> which were essentially codifications of much the same common mercantile customs that were used in Britain, both having derived from the law developed by European merchants during the Middle Ages.<sup>118</sup> The authors may have intended to refer to the French *civil* code, but as discussed above, far from being a tool of state socialism, this Code Napoleon enacted a 19<sup>th</sup> Century *laissez-faire* liberalism with individualistic notions of property and contract.<sup>119</sup> The German Commercial Code, while also promoting the same freedom of individual property and contract, was primarily designed to harmonize the local laws and codes pre-existing in various German states, principalities and dukedoms in order to facilitate trade in the newly unifying Germany.<sup>120</sup> If harmonization of commercial law is seen as state control, then the Uniform Commercial Code and UNITRAL are both projects seeking such control.

What then, is the authors' prejudicial perspective? Their comparison was written in the United States in 2000, at the close of the decade following the fall of Communism in Eastern Europe. That victory is seen as one of free enterprise and faith in markets, as expressed in the policies of leaders like

<sup>115</sup> La Porta, Lopez-de-Silanes, Shleifer, & Vishny, 58 *Journal of Financial Economics* 2 (2000).

<sup>116</sup> "By the early modern era, French judges probably enjoyed greater independence than their English counterparts because a French judgeship was considered a form of heritable property. Normally, French kings neither chose their judges nor had the power to remove them. In contrast, English judges served at the pleasure of the crown, although the power to remove was seldom used." Daniel Klerman and Paul Mahoney, "Legal Origin?", USC Legal Studies Research Paper No. 07-3, at 4 *et seq.*, available from SSRN at <http://ssrn.com/abstract=968706>. *See also* MERRYMAN & PÉREZ-PERDOMO, *supra* note 1, at 16 ("Before the French Revolution, judicial offices were regarded as property . . . judges were an aristocratic group who supported the landed aristocracy . . .").

<sup>117</sup> CH. LYON-CAEN & L. RENAULT, *DROIT COMMERCIAL* 7 *et seq.* (3rd ed. 1922).

<sup>118</sup> *Id.* at 5 *et seq.* For a brief discussion of how the medieval law merchant was used by British merchants, *see e.g.*, Paul Mahoney, *Contract or Concession? An Essay on the History of Corporate Law*, 34 *Ga. L. Rev.* 873, 880 *et seq.* (2000).

<sup>119</sup> MERRYMAN & PÉREZ-PERDOMO, *supra* note 1, at 93; ZWEIGERT & KÖTZ, *supra* note 10, at 92.

<sup>120</sup> As in the United States, this process started with a uniform law on negotiable instruments, and gradually spread to a uniform commercial code. *See* NORBERT HORN, *HANDELSGESETZBUCH*, Introduction VI, margin nos. 22 *et seq.* (2<sup>nd</sup> ed. 1995).

Ronald Reagan and Margret Thatcher, over state planning and domination of the economy, as expressed in the monolithic structure of the Soviet Union. The market was seen to create a much more efficient allocation of resources than the Continental European *dirigisme* championed most strongly by France. Professor Tony Judt has epigraphically captured the difference between the free market English style and the French statist style during this period: "In contrast to Mrs. Thatcher and her heirs . . . the French were cautious about selling off public utilities . . . . In markets as in gardens, the French were suspicious of unplanned growth. They preferred to retain a certain capacity to intervene."<sup>121</sup> At the time the Origin Theorists authored their comparison, the dichotomy between a private and flexible Anglo-American world and a statist and rigid Continental Europe had a significant amount of truth to it. However, their references to the timing, nature and purposes of the French and German commercial codes are inaccurate, and the distortions seem to display a projection of positions held at the close of the 20<sup>th</sup> Century backward into the 19<sup>th</sup> Century.

In following, this paper will try to offer a framework for an analysis of company law in Germany, the United Kingdom and the United States that can help avoid the pitfalls discussed above.

### III. COMPARE ONLY COMPARABLES: WHAT IS "COMPANY LAW"?

#### A. Defining Company Law Functionally

"Company law" or "corporate law"<sup>122</sup> in all jurisdictions is generally understood as a body of law enabling the creation of an entity with "five core structural characteristics": "(1) legal personality, (2) limited liability, (3) transferable shares, (4) centralized management under a board structure, and (5) shared ownership by contributors of capital."<sup>123</sup> If a law other than a "company" law were to

<sup>121</sup> JUDT, *supra* note 101, at 554.

<sup>122</sup> This paper uses the terms "company" law and "corporate" law indistinguishably. On the one hand, "corporate law" is a US term and "company" law is the preferred term in the United Kingdom, as well as in the English language versions of EU legislation. From a German perspective, the term "corporate" law might be more accurate for this paper, as the object of study is stock corporations that may well be large enough to be listed on a stock exchange, an area of study that German scholars might call "law of capital collecting companies" (*Kapitalgesellschaftsrecht*), as opposed to "company law" (*Gesellschaftsrecht*), which would likely include various forms of partnerships and limited liability companies (*Gesellschaften mit beschränkter Haftung*), as well as stock corporations (*Aktiengesellschaften*). The German understanding of the term "company law" might be rendered as "corporations and other business organizations." Here, both "company law" and "corporate law" will refer to the law governing entities with the five, listed characteristics.

<sup>123</sup> ANATOMY, *supra* note 17, at 5 (2004). These characteristics are not a recent invention. For similar lists of core characteristics, at least with respect to US law, see ROBERT C. CLARK, *CORPORATE LAW* 2 (1986) and HENRY WINTHROP BALLANTINE, *BALLANTINE ON CORPORATIONS* 1 (1946). For an historical discussion of the development of these characteristics, see Mahoney, *supra* note 118 (focusing on legal personality and limited liability); Franklin A. Gevurtz, *The Historical and Political Origins of the Corporate Board of Directors*, 33 *HOFSTRA L. REV.* 89 (2004) (focusing on central management under a board), and Ron Harris, "The Formation of the East India Company as a Deal between Entrepreneurs and Outside," Working Paper, Boalt Hall School of Law, UC Berkeley (July 2004) (discussing the early operation of shareholders meetings in the owner/investor governance of the company). Although limited

regulate one of these "core characteristics" of the corporate entity, it would require treatment in a study of company law. This is unproblematic when another law is expressly linked to the company law. Labour co-determination in Germany provides a good example. The sections of the *Aktiengesetz* that refer to number, qualifications and appointment of members of the supervisory board expressly refer to the provisions of the various laws providing for co-determination in Germany.<sup>124</sup> The inclusion of co-determination laws in any study of German company law is thus beyond question.

Difficulties arise, however, when a law's function closely complements the corporation law in the jurisdiction in question, but the law is not expressly linked to the company law. If such laws are excluded from treatment, any picture of the system of regulation will be incomplete. If different mixes of topical laws govern the same area in different jurisdictions, a comparison that does not take this difference into account could be distorted. For example, if we compared the German company law rule requiring disclosure of an interest in a stock corporation that exceeds 25 % of its capital, expressed in § 20(1) of the *Aktiengesetz*, exclusively with the DGCL and the case law related to that statute, which states no such requirement, we would have to conclude that German company law creates greater transparency. However, if we add to the mix a US federal law, the Securities Exchange Act of 1934 (the "Exchange Act"),<sup>125</sup> particularly § 13(d) thereof and the rules issued under it requiring disclosure of any holding exceeding 5 % of the capital of a "registered" company,<sup>126</sup> we tend

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liability is considered to be one of the most valuable characteristics of a corporation, it should be noted that both Germany and the UK offer companies with unlimited liability. The German limited partnership by shares (*Kommanditgesellschaft auf Aktien* – KGA) and the English "unlimited company" both offer the possibility of an entity that issues shares to investors but leaves at least one of their owners with unlimited liability.

<sup>124</sup> See §§ 95–104 AktG. Co-determination in German companies is regulated by three major laws, one of which – the Law on Co-Determination of Employees in the Supervisory Boards and Management Boards of Enterprises Engaged in the Mining Iron and Steel Industries of 21 May 1951 (*Montan-Mitbestimmungsgesetz*) – is no longer relevant. The most important law today is the Co-Determination Act of 1976 (*Mitbestimmungsgesetz*, or "MitbestG"), which applies to all GmbHs and AGs with more than 2,000 employees (see § 1 MitbestG), and requires that one-half of the supervisory board comprise representatives of the employees and their unions (see § 7 MitbestG). See Johannes Semler, in MÜNCHNER KOMMENTAR ZUM AKTIENGESETZ § 96, margin no. 9 *et seq.* (Bruno Kropff & Johannes Semler, eds., 2<sup>nd</sup> ed. 2000). Another important piece of legislation, the Works Constitution Act of 1952 (*Betriebsverfassungsgesetz*), requires that a company have a supervisory board and that one-third of the board members be appointed by employees if the corporation employs more than 500 persons.

<sup>125</sup> The Securities Exchange Act of 1934, 15 U.S.C.A. §§ 78m(a) (2000).

<sup>126</sup> Rule 13d-1 under the Exchange Act requires that any person who acquires directly or indirectly more than 5 % of either the "voting power" or the "investment power" of any class of equity security registered under § 12 Exchange Act must file details on such acquisition (on a form called a "Schedule 13D") with the SEC within 10 days after the acquisition. 17 C.F.R. § 240.13d-1(a). Securities must be registered under § 12 of the Exchange Act if either (i) they are listed on a national securities exchange (§ 12(a) Exchange Act) or (ii) the issuer of the securities has more than 500 shareholders and total assets exceeding \$ 10 million (§ 12(g) Exchange Act in connection with Exchange Act Rule 12g-1, 17 C.F.R. § 240.12g-1). In addition to securities registered under § 12 Exchange Act, Rule 13d-1 also applies to "any equity security of any insurance company which would have been required to be so registered except

to reach the opposite conclusion, and German law appears less extensive. Yet when the requirements of § 21 of the German Securities Trading Act (*Wertpapierhandelsgesetz*, or "WpHG"), which applies to listed companies, are also added to the comparison,<sup>127</sup> we see that the obligations of Delaware and German public companies are quite similar in this respect. Because the rules governing companies may be differently distributed in different topical laws within different countries, knowledge of the applicable topical laws, including their nature and the range of their application, is necessary.

Moreover, each of the five "core" characteristics listed above may be closely tied to other areas of law. One purpose of legal personality and limited liability is to demarcate the assets to which creditors may take recourse in collecting debts of the corporation,<sup>128</sup> and this position is integrally tied to the rights creditors hold in insolvency proceedings over the company's assets. The inclusion of bankruptcy law in the study of company law is, however, still debated. Professors Henry Hansmann and Reinier R. Kraakman have argued that "bodies of law *designed to serve* objectives that are largely unrelated to the core characteristics of the corporate form . . . do not fall within the scope of corporate law."<sup>129</sup> Following this view, the lawmakers legislative purpose would determine whether a given law be included within a study of corporate law. However, as discussed above, the functional method of comparative law should not limit itself to intention, but rather to the systemic role played by the given law within the legal system and the society. The intentional design of the topical law considered for inclusion would then not be the best criterion for decision. For example, German labour laws express a legislative *intention* to have employees treated fairly by corporations, but as one means to this end the law serves the *function* of assigning employee representatives to the supervisory board. US securities laws express a legislative intention to protect investors regardless of who or what is selling the relevant securities, but as one means to this end such laws have the *function* of, *inter alia*, regulating the information a corporation offering securities to the public must disclose. The principles of agency law that are central to any discussion of corporate governance were also in no way devised with the intention of regulating the centralized management of a corporation.

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for the exemption contained in section 12(g)(2)(G) of the Act, or any equity security issued by a closed-end investment company registered under the Investment Company Act of 1940." 17 C.F.R. § 240.13d-1(i).

<sup>127</sup> § 21(1) of the Securities Trading Act (*Wertpapierhandelsgesetz*) published on September 9, 1998 Federal Law Reporter (Bundesgesetzblatt – BGBl) vol. I p. 2708), as last amended by Art. 1 of the Law of July 16, 2007, BGBl vol. I p. 1330, requires that any person who through acquisition, disposal, or in another manner reaches, exceeds or falls below one of the thresholds of 3%, 5%, 10%, 25%, 30%, 50% or 75% of the voting rights of a listed company must within four calendar days provide written notice of this to the issuer and to the Federal Agency for the Supervision of Financial Services.

<sup>128</sup> ANATOMY, *supra* note 17, at 9, and Hansman & Kraakman (2000), at 393.

<sup>129</sup> ANATOMY, *supra* note 17, at 17 (emphasis added).



In a different context, Professor John Armour has asked whether EU member states could successfully use their bankruptcy laws to control the flow of regulatory competition opened by the decisions of the European Court of Justice (ECJ) following *Centros*.<sup>130</sup> He argues convincingly that "[c]orporate insolvency law supplies rules which govern companies experiencing financial distress, and so it is appropriate to consider it as being within the scope of a functional account of 'company law'. In particular, there may be complementarities between insolvency law and other aspects of a country's corporate governance regime."<sup>131</sup> Viewed from the perspective that Armour is considering, that of a corporate promoter or incorporator, complementarities would exist between a corporate law statute and an insolvency law if the latter would have a material impact on the choice of jurisdiction in which to incorporate. Such an "effects" test is essentially a functionality test seen from a practical rather than a theoretical vantage point. It would demand that provisions of other laws be considered together with the jurisdiction's company law – regardless of whether the legislative purpose of such law focuses on corporations – if the law affects or functionally complements the corporate law statute. Slightly reformulating Hansmann's and Kraakman's criterion, all rules, laws and organizational forms that have the function of regulating the corporation, its activities, and the rights of persons vis-à-vis the corporation with a close relation to the core characteristics of the corporate form would be potential candidates for inclusion in a company law analysis.

Along these lines, tax law, which is one of the most important considerations when planning the incorporation of a company or subsidiary, would not come within a study of company law because it does not have a close relation to a core characteristic of companies. On the other hand, rules on fraudulent conveyances would be part of "company law", as they serve a capital maintenance function (closely related to the limited liability and investor ownership characteristics of corporations) in the United States while the same function is served by the legal capital rules of German and UK company law. As this example makes clear, it can reasonably be assumed that the topical laws seen as having corporate law functions and thus included in a functional definition of company law will not be identical in each jurisdiction.

## **B. Germany**

In Germany, the *Aktiengesetz* provides a comprehensive regulation of stock corporations that is mandatory unless provided otherwise.<sup>132</sup> Tracking the core characteristics of the stock corporation listed above, the *Aktiengesetz* provides for the creation of an entity with legal personality, limited

<sup>130</sup> See Part IV.B.2, *infra*.

<sup>131</sup> John Armour, "Who Should Make Corporate Law? EU Legislation versus Regulatory Competition," ESRC Centre for Business Research, University of Cambridge Working Paper No. 307 (June 2005), at 38.

<sup>132</sup> § 23(5) AktG, discussed in detail in Part III.B.3.

liability and transferable shares,<sup>133</sup> having a centralized management under a two-tier board structure<sup>134</sup> that is subject in certain respects to the shareholders.<sup>135</sup> The *Aktiengesetz* also incorporates by reference provisions of the Commercial Code (*Handelsgesetzbuch* – "HGB") on the preparation of the annual financial statements, including the specification of reserves and distributable profits,<sup>136</sup> provides a right to demand a special audit,<sup>137</sup> and requires the financial statements to be made available to the shareholders for their approval.<sup>138</sup> Going well beyond the range of coverage that would be expected by an American lawyer, the *Aktiengesetz* contains provisions on the disclosure of equity holdings,<sup>139</sup> and on the solicitation of proxies by banks holding shares in custody,<sup>140</sup> incorporates the Co-Determination Act to place labour representatives on the supervisory board,<sup>141</sup> specifies the rights, duties and required financial statements of companies operating in corporate groups,<sup>142</sup> and requires listed companies to adopt a governance code on a "comply or explain" basis.<sup>143</sup> As will be discussed in Part IV, many of these special provisions come from EU directives that were incorporated into the *Aktiengesetz* over the years. Regardless of its jurisdictional origin, however, the resulting law is broad, comprehensive and mandatory.

German courts have also created doctrine beyond the statutory law through a significant body of decisions on topics such as pre-incorporation liability, equitable subordination of loans made by shareholders to the company and fiduciary duties of management.<sup>144</sup> Some of these decisions were actually handed down with reference to the Limited Liability Companies Act (*Gesetz betreffend die Gesellschaften mit beschränkter Haftung* – GmbHG) rather than the *Aktiengesetz* and are applied to

<sup>133</sup> See §§ 1-53a AktG.

<sup>134</sup> See §§ 76-116 AktG. Under the *Aktiengesetz*, a stock corporation has a two-tier board. The two levels are the supervisory board (*Aufsichtsrat*), provided for in §§ 95-116 AktG, and the management board (*Vorstand*), provided for in §§ 76-94 AktG. The shareholders elect all or some (if co-determination applies) of the supervisory directors (§ 101(1) AktG), and the supervisory board in turn appoints the managing directors (§ 84(1) AktG), who have direct responsibility for managing the company (§ 76(1) AktG). For discussions of this structure, see Theodore Baums, "Company Law Reform in Germany," Johann Wolfgang Goethe-Universität, Institute for Banking Law, Working Paper No. 100 (2002), available at <http://www.jura.uni-frankfurt.de/baums/>, and Klaus Hopt, *The German Two-Tier Board (Aufsichtsrat): A German View on Corporate Governance*, in *COMPARATIVE CORPORATE GOVERNANCE* 3 (Klaus Hopt & Eddy Wymeersch, eds., 1997).

<sup>135</sup> See §§ 118-147.

<sup>136</sup> § 150 AktG.

<sup>137</sup> §§ 142-146.

<sup>138</sup> § 175 AktG.

<sup>139</sup> § 20 AktG.

<sup>140</sup> § 128 AktG.

<sup>141</sup> § 101 AktG.

<sup>142</sup> See §§ 291-328 AktG.

<sup>143</sup> § 161 AktG.

<sup>144</sup> See e.g., the High Federal Court's creation of a German business judgment rule in the *ARAG v. Garmenbeck* *supra* note 72.

stock corporations by analogy. One exception to the inclusive tendency of the *Aktiengesetz* is the hiving off of rules on mergers between stock corporations in a special law, the "Transformation (or Reorganization) Act" (*Umwandlungsgesetz* – UmwG).<sup>145</sup> Like Delaware law, but unlike the UK Companies Act, the *Aktiengesetz* does not contain extensive provisions on accounting, which were moved to the Commercial Code in 1985.<sup>146</sup>

Although the *Aktiengesetz* itself includes provisions that other jurisdictions might attribute to areas outside of corporate law proper – such as on the disclosure of holdings and the behavior of custodian banks in the proxy solicitation process – most studies of German company law would also include, in addition to the MitbestG and the UmwG, a number of rules from the Securities Trading Act (*Wertpapierhandelsgesetz* – WpHG)<sup>147</sup> and the Takeover Act (*Wertpapiererwerbs- und Übernahmegesetz* – WpÜG)<sup>148</sup> in any comprehensive treatment of company law proper, especially when discussing listed companies. As the converse of the principle *lex specialis derogat legi generali*, a German court will also look to the more general rules on company forms contained in the Limited Liability Companies Act, the Commercial Code and the Civil Code (*Bürgerliches Gesetzbuch* – BGB) if a given situation is not expressly governed in the specifically applicable *Aktiengesetz*.<sup>149</sup> As companies listed on the Frankfurt Stock Exchange would be governed by the exchange rules, such rules might also be taken into account, although they tend to be less detailed and extensive than their counterparts in London or New York. One reason the Frankfurt listing rules tend to be light is the applicability of the German Corporate Governance Code (*Deutscher Corporate Governance Kodex*),<sup>150</sup> which the *Aktiengesetz* does not require listed companies to adopt, but rather to declare in the notes to their financial statements whether they have adopted the code, and if they have not, to explain their decision.<sup>151</sup>

<sup>145</sup> *Umwandlungsgesetz* (UmwG) of October 28, 1994, as last amended by the Law of April 19, 2007, Federal Law Reporter (Bundesgesetzblatt – BGBl) vol. I, p. 542.

<sup>146</sup> This was done in the context of implementing three EC directives on individual and group accounts. See The Law of 19 December 1985, BGBl. Vol. I, p. 2355.

<sup>147</sup> See, e.g., Semler, *supra* note 124, at Intro. margin no. 3, and KARSTEN SCHMIDT, *GESELLSCHAFTSRECHT* 32 (4<sup>th</sup> ed 2002).

<sup>148</sup> See e.g., FRIEDRICH KÜBLER & HEINZ-DIETER ASSMANN, *GESELLSCHAFTSRECHT* 506 *et seq.* (6th ed. 2006).

<sup>149</sup> For example, most of the rules on pre-incorporation liability for an AG are derived from cases regarding GmbH's, which in turn may depend on general principles of company membership found in the BGB's provisions on civil law companies (partnerships). See KÜBLER & ASSMANN, *supra* note 148, at 376 *et seq.*

<sup>150</sup> The Kodex is currently updated to June 2007, and is available at <http://www.corporate-governance-code.de/index-e.html>.

<sup>151</sup> See § 161 AktG.

Thus, the complete picture of what we understand as "company law" in Germany is rather broad, but easily defined. It includes a central, detailed statute and a number of laws specifically incorporated by reference to cover accounting, mergers and co-determination, laws and rules on takeovers and securities regulation, as well as applicable exchange rules and a Governance Code.

### C. The United States

In the United States, corporate law statutes are state law. The statute of the state in which a company is incorporated governs its existence and its "internal affairs,"<sup>152</sup> and US states generally allow corporations incorporated in other states to do business in their state as "foreign" corporations subject to minimal requirements, such as designating an agent for service of process.<sup>153</sup> Today, most major US corporations, including more than half of publicly listed companies, are incorporated under the law of the State of Delaware.<sup>154</sup> This paper will therefore use Delaware law as a proxy for the 50 corporation statutes of the US states.

The DGCL provides for each of the five, core characteristics of a business corporation. It provides for the creation of an entity with legal personality,<sup>155</sup> limited liability,<sup>156</sup> management by a centralized board<sup>157</sup> and transferable shares.<sup>158</sup> The aspect of shared ownership by investors is implicit in the company's existence as an entity that must issue stock,<sup>159</sup> which must be paid for,<sup>160</sup> and which represents a property interest in the corporation in the form of a "chase in action."<sup>161</sup> Although shareholders rarely use this power, § 141 DGCL also gives shareholders the right to eliminate centralized management by vesting executive control in a body other than the board of directors, such as a council including all shareholders.<sup>162</sup> The greatest difference between the DGCL and the *Aktiengesetz* is that the Delaware law is almost completely composed of optional, default terms that

<sup>152</sup> See EUGENE F. SCOLES et al., *CONFLICTS OF LAWS* § 23.2 (3<sup>rd</sup> ed. 2000). See Part III.C.1 for a detailed definition of "internal affairs."

<sup>153</sup> See FRANKLIN A. GEVURTZ, *CORPORATION LAW* 36 (2000) Although states do not require local incorporation as a requisite for doing business, the US Supreme Court has held that such a request would not impermissibly burden the interstate commerce whose regulation lies solely within the jurisdiction of the federal government. See *Railway Express Agency, Inc. v. Virginia*, 282 U.S. 440 (1931).

<sup>154</sup> According to the 2006 Annual Report of the State of Delaware's Division of Corporations, "Delaware is the corporate home to 61 percent of the Fortune 500 companies and half of all U.S. firms traded on the New York Stock Exchange and NASDAQ."

<sup>155</sup> See Del. Code Ann. tit. 8, § 108.

<sup>156</sup> See Del. Code Ann. tit. 8, § 102(b)(6).

<sup>157</sup> See Del. Code Ann. tit. 8, § 141.

<sup>158</sup> See Del. Code Ann. tit. 8, §§ 201-202.

<sup>159</sup> Del. Code Ann. tit. 8, § 102(a)(4).

<sup>160</sup> Del. Code Ann. tit. 8, § 152.

<sup>161</sup> See *Equitable Trust Co. v. Gallagher*, 67 A.2d 50, 54 (Del.Ch. 1949).

<sup>162</sup> Del. Code Ann. tit. 8, § 141(a): "The . . . corporation . . . shall be managed by or under the direction of a board . . . except as may be provided otherwise in this chapter or in its certificate of incorporation."

shareholders may modify, supplement or eliminate in the company's certificate of incorporation.<sup>163</sup> On this point it resembles the UK Companies Act. Delaware corporate law also comprises a large body of decisions by the Delaware Supreme Court and Court of Chancery on such matters as fiduciary duties, which are not specified in the statute.<sup>164</sup> The regulation of corporate groups, for example, which the *Aktiengesetz* expressly regulates, would be governed by fiduciary duties imposed on majority shareholders.<sup>165</sup>

The Delaware statute contains no provisions on disclosure, accounting or audits, but does have rules to govern mergers<sup>166</sup> and takeovers.<sup>167</sup> Given the thin and relatively optional character of the DGCL, it is not surprising that corporate law is generally considered to include substantial elements of securities regulation.<sup>168</sup> As will be discussed in more detail in Part IV of this paper, including "securities regulation" means looking to the requirements of some or all of the federal laws grouped under Title 15 of the US Code, which includes not only the Exchange Act, but also the Securities Act of 1933 (the "Securities Act")<sup>169</sup> and the Trust Indenture Act of 1939 (the "Trust Indenture Act"),<sup>170</sup> among others. Beyond these securities laws and the extensive body of rules that the SEC has issued under the authority they delegate, a listed company would also have to comply with the rules of the relevant exchange, which can be quite extensive. As mentioned above, it is also common to include basic principles of revocable or fraudulent transfers from bankruptcy law in studies of US corporate

<sup>163</sup> See Katharina Pistor, "Legal Ground Rules in Coordinated and Liberal Market Economies," Working Paper N° 30/2005, ECGI Working Paper Series in Law 9 (March 2005).

<sup>164</sup> For the two-year 1999 and 2000, Robert B. Thompson and Randall Thomas found that approximately 78 % of Delaware Chancery Court cases addressed fiduciary duty issues. See Robert B. Thompson & Randall S. Thomas, *The New Look of Shareholder Litigation: Acquisition-Oriented Class Actions*, 57 VAND. L. REV. 133, 165 (2004). It should also be noted that the use of cases as weighty authority is one area in which Common Law and Civil Law are certainly on a convergence path in many European countries. In conversations and experience during the period between 1992 and 2005, the author has received confirmation again and again that case precedent is the soundest authority used in Italy and Germany to discern the meaning of a given statutory provision.

<sup>165</sup> For example, see *Sinclair Oil Corp. v. Levien*, 280 A.2d 717 (Del. 1971). An excellent discussion of the fiduciary duties of controlling shareholders is Ronald J. Gilson & Jeffrey N. Gordon, *Controlling Controlling Shareholders*, 152 U. Pa. L. Rev. 785 (2005).

<sup>166</sup> See Del. Code Ann. tit. 8, §§ 251-266.

<sup>167</sup> See Del. Code Ann. tit. 8, § 203.

<sup>168</sup> See e.g., BALLANTINE, *supra* note 123, at 858-886; CLARK, *supra* note 123, at 293-340 and 719-749, and GEVURTZ, *supra* note 123, at 537-629. Gevurtz notes that "federal securities laws have become a significant component of corporation law." *Id.* at 39. It should also be noted that the US securities laws apply not only to companies whose securities (including debt securities) are listed on a stock exchange, but also to large companies with more than 500 shareholders. See *supra* note 126.

<sup>169</sup> The Securities Act of 1933, 15 U.S.C.A §§ 77a-77aa (2000).

<sup>170</sup> The Trust Indenture Act of 1939, 15 U.S.C.A §§ 77aaa-77bbbb (2000).

law.<sup>171</sup> The latter serve to supplement very permissive capital maintenance rules found in the DGCL and all other US company law statutes.

The enabling nature of the DGCL, which is composed of non-mandatory "default" rules, would allow a company, in its certificate of incorporation, to comprehensively govern every imaginable right, duty and circumstance, making the range of "company law" rather limited. However, once the company is large enough to trigger application of the securities laws, such laws begin to regulate annual meetings and accounting practices, among other things. When the company is listed, both the securities laws and the relevant set of exchange rules would impose yet another layer of mandatory regulation, governing the composition of the board of directors and the type of securities that may be issued. The composition of the concept "company law" in the United States thus changes dramatically depending on the proximity of a corporation to the capital markets.

#### **D. The United Kingdom**

As a jurisdiction with a common law system that has significantly influenced US law, and as a member state of the European Union that, like Germany, must implement EU directives and obey EU regulations and ECJ decisions, the company law of the United Kingdom takes a middle position between Delaware and Germany. The United Kingdom, which had some of the oldest rules on corporations, dating back to the 17<sup>th</sup> Century, now has the newest company law of the three jurisdictions examined. Both the core statute and many of the outlying rules serving a corporate law function were substantially amended in 2006. The Companies Act 2006 substantially amended the 1985 version of that law and restated a significant body of case law on the duties of directors into the statute itself,<sup>172</sup> thus providing norms that Delaware and German law primarily express through judicial decisions.<sup>173</sup> The Companies Act 2006 provides for the creation of all types of companies (public or private limited by shares or by guarantee, as well as unlimited)<sup>174</sup> and offers rules for a corporate entity with the five, core characteristics discussed in our functional definition of "company

<sup>171</sup> See MELVIN ARON EISENBERG, CORPORATIONS AND OTHER BUSINESS ORGANIZATIONS: CASES AND MATERIALS 858 *et seq.* (Concise 9<sup>th</sup> ed. 2005), and CLARK, *supra* note 123, at 40-52. Dean Clark also includes bankruptcy provisions on equitable subordination of creditor claims in his treatment of corporate law. See *Id.*, at 52-71.

<sup>172</sup> See Chapter 2 Companies Act 2006, generally. Sec. 170(3) Companies Act provides that: "The general duties are based on certain common law rules and equitable principles as they apply in relation to directors and have effect in place of those rules and principles as regards the duties owed to a company by a director."

<sup>173</sup> As discussed above, the *Aktiengesetz* does provide a standard of care for managing and supervisory directors (§§ 93 and 116 AktG), prohibits managing directors from competing with the company (§ 88 AktG), and imposes a duty of confidentiality on all directors (§§ 93 and 116 AktG), but the detailed parameters of the duty of loyalty (*Treupflicht*) have been worked out by the courts.

<sup>174</sup> See secs. 3 *et seq.* Companies Act 2006.

law". A company limited by shares is a "body corporate",<sup>175</sup> with limited liability,<sup>176</sup> transferable shares,<sup>177</sup> centralized management under a board,<sup>178</sup> and shared ownership by contributors of capital.<sup>179</sup>

The 2006 Act removed a number of rules, such as regarding the mandatory disclosure of significant shareholdings<sup>180</sup> and share dealings by directors<sup>181</sup> from the Companies Act and placed them in newly issued rules of the UK Financial Services Authority (FSA). This resembles earlier decisions to hive out rules from the Act, such as when insolvency rules were removed from a pre-1985 version of the Act and placed in the Insolvency Act 1986.<sup>182</sup> As mentioned, other matters, such as detailed rules on director's duties, were added to the Act, and it remains the largest and most detailed of the three laws being examined here. Like the *Aktiengesetz*, the Companies Act provides detailed rules on the constitution and maintenance of capital<sup>183</sup> and mandatory disclosure<sup>184</sup> (both from EU law), but like the DGCL the Companies Act is flexible, and allows such matters as the method of appointing directors<sup>185</sup> and the operation of the board<sup>186</sup> to be freely structured in the company's articles. In contrast to the other laws, the Companies Act provides extensive and detailed rules on accounting,<sup>187</sup> and contains annexed Model Articles that govern a significant extent of a company's internal management affairs.<sup>188</sup> The Model Articles are prescribed by the Secretary of State,<sup>189</sup> and drafted by the Department for Business, Enterprise & Regulatory Reform (previously the Department of Trade and Industry) (BERR).<sup>190</sup>

Beyond the Companies Act and its related statutory instruments, company law in the United Kingdom contains basically the same capital market elements as in Germany, given that they both derive from EU directives, plus the insider dealing provisions of the Criminal Justice Act 1993. The fact that rules on company insolvency, directors' dealings, and shareholder disclosures were originally located in the Companies Act argues for including such laws and rules under the rubric "company

<sup>175</sup> Sec. 16(2) Companies Act 2006.

<sup>176</sup> Sec. 9(2)(c) Companies Act 2006.

<sup>177</sup> Secs. 10, 544 Companies Act 2006.

<sup>178</sup> Sec. 154(2) Companies Act 2006.

<sup>179</sup> Sec. 8 Companies Act 2006.

<sup>180</sup> Previously secs. 198 *et seq.* Companies Act 1985.

<sup>181</sup> Previously secs. 323 *et seq.* Companies Act 1985.

<sup>182</sup> See PAUL L. DAVIES, GOWER AND DAVIES' PRINCIPLES OF MODERN COMPANY LAW 47 (7<sup>th</sup> ed. 2003).

<sup>183</sup> See e.g., Parts 17 & 18 Companies Act 2006.

<sup>184</sup> See e.g., secs. 414 *et seq.* Companies Act 2006.

<sup>185</sup> See sec. 19 Draft Model Articles for Public Companies (DTI 2007).

<sup>186</sup> See secs. 6 *et seq.* Draft Model Articles for Public Companies (DTI 2007).

<sup>187</sup> See e.g., Part 15 Companies Act 2006.

<sup>188</sup> See Companies Act 2006, Schedule 3, Draft Model Articles for Public Companies.

<sup>189</sup> Sec. 19(1) Companies Act 2006.

<sup>190</sup> The draft Model Articles are posted on the BERR website, <http://www.berr.gov.uk/index.html>.

law". The FSA's Disclosure and Transparency Rules thus constitute a central element of UK company law.<sup>191</sup> The FSA's Listing Rules also contain substantial elements of company law for listed companies, such as requirements that shareholders approve significant transactions and mandatory restrictions on directors' dealings in their company's securities.<sup>192</sup> Insider trading is disciplined by certain provisions of the Criminal Justice Act of 1993,<sup>193</sup> which should thus also be considered a functional component of company law. Unlike either the United States or Germany, takeovers involving listed companies in the United Kingdom are regulated by a code adopted by a private panel endowed with regulatory authority.<sup>194</sup> As mentioned above, UK company law should be understood to contain certain elements of the Insolvency Act 1986, particularly the doctrine of "wrongful trading,"<sup>195</sup> which can serve as an additional tool for capital maintenance.<sup>196</sup>

Leaving aside the very significant area of accounting rules (which are within the Companies Act 2006 and incorporated by reference into the *Aktiengesetz*), consider the laws falling under the rubric "company law" in Germany, the United Kingdom and the United States (represented by Delaware) to be those in the table below:

### Functional Components of Company Law

	Germany	United Kingdom	Delaware
<i>Main statute</i>	<i>Aktiengesetz</i>	Companies Act 2006	General Corporation Law
<i>Linked statute</i>	Co-Determination Act		
<i>Linked statute</i>	Transformation Act		
<i>Upper-level regulations</i>	Applicable EU regulations	Applicable EU regulations	Exchange Act and Rules (federal)
<i>Related area</i>	Takeover Act and Regulation	Takeover Code (linked rules)	(as above)
<i>Related area</i>	Securities Trading Act and Rules	FSA Disclosure and Transparency Rules under FSMA	(as above)
<i>Individual rules</i>		Criminal Justice Act 1993	
<i>Individual rules</i>		Insolvency Act 1986	Fraudulent Conveyance Rules (state) Bankruptcy Rules (federal)
<i>Related area</i>	Listing Rules	Listing Rules	Listing Rules
<i>Related area</i>	EU Regulations & Advice	EU Regulations & Advice	

<sup>191</sup> See FSA, Disclosure and Transparency Rules (Jan. 2008).

<sup>192</sup> See FSA, Listing Rules, LR 9 (The Model Code, nos. 3 *et seq.*) and LR 10 (Jan. 2008).

<sup>193</sup> See Part V, Criminal Justice Act 1993.

<sup>194</sup> See secs. 942 *et seq.* Companies Act 2006 and The Panel on Takeovers and Mergers, The Takeover Code (8<sup>th</sup> ed., updated to Jan. 2008).

<sup>195</sup> See Chapter X, Insolvency Act 1986.

<sup>196</sup> See ANATOMY, *supra* note 17, at 17; Armour, *supra* note 131, at 44.



#### IV. KNOW SYSTEMIC FUNCTIONS AND RELATIONSHIPS: THE JURISDICTIONAL INTERACTION OF COMPANY LAW

##### A. The Whole and Its Parts

Functions are by nature relational,<sup>197</sup> and a correct understanding of legal functions thus requires that the entire system of relationships from which their relational value derives be taken into account. This Part will examine the most salient systemic relationships for legal functions: the jurisdictions that issue legal rules, the areas they address and their respective powers. Part V will build on this analysis by examining how the systemic unity of these jurisdictions acts as an environment of causal interaction to shape law's development over time.<sup>198</sup> Phrased in a different way, this Part looks at the system components and the legal rules of their interaction, while Part V will examine the actual force that these components have exercised on each other in recent history.

Each of the three jurisdictions examined in this paper is a subunit of a larger jurisdiction. Germany and the United Kingdom belong to the European Union and Delaware belongs to the United States.<sup>199</sup> Because both the upper- and the lower-tier jurisdictions enact legislation that is or functions as company law, it is necessary to understand the nature of the rules coming from each jurisdiction and their respective standing vis-à-vis each other. The rule giving bodies<sup>200</sup> affecting the governance of public companies in each of our jurisdictions are found at the primary, nation or state level (i.e., Germany or Delaware), at an upper, supranational or national level (i.e., the European Union or the United States), and at the level of a private or quasi-public organization (e.g., the New York Stock Exchange or the UK Takeover Panel). There are also a growing number of cooperative plans between the securities regulators of the European Union and the United States, such as on the recognition of accounting principles<sup>201</sup> and the regulation of derivatives,<sup>202</sup> which could eventually lead to treaty or treaty-like obligations creating yet another layer of jurisdictional interaction.

This Part will restrict itself to defining the legal relationships of the relevant jurisdictions to each other and analyzing the specific content of the rules issued by each. As discussed in Part II,

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<sup>197</sup> See NIKLAS LUHMANN, *ZWECKBEGRIFF UND SYSTEMRATIONALITÄT* 349 (1968).

<sup>198</sup> *Id.* at 194.

<sup>199</sup> Although Germany itself is a federation of states and the United Kingdom unites England, Wales, Scotland and Northern Ireland, this aspect is much less important because with very few exceptions company law is uniform at the national level.

<sup>200</sup> The word "jurisdiction" would be used here very loosely, as it would also include securities exchanges. The agreement between an issuer and the securities exchange on which its shares are listed is a contract, and the exchange has "regulatory" power only over a very narrow group of persons, particularly its members and participants and its listed companies.

<sup>201</sup> See Press Release, "Developing Cross-Atlantic financial markets: CESR and the SEC launch a work plan focused on financial reporting" (Aug. 2, 2006).

<sup>202</sup> See CESR-CFTC Common Work Program to Facilitate Transatlantic Derivatives Business (June 28, 2005), available at [www.cesr.eu](http://www.cesr.eu).

socio-political and cultural factors are also important elements of the functional system comprising German, UK and US company law. Although this paper will make occasional reference to existing histories and socio-economic analyses of these factors it offers an *approach* to comparing these company laws, not a full comparison. Because each of the jurisdictions here discussed is a highly developed, Western culture with comparable social values and structures,<sup>203</sup> the real differences that may exist at the present time – other than cultural attitudes towards executives and labour – currently have less of an impact on the shape of the law than do constitutional and treaty relationships between jurisdictions and the arrangement of rules in mandatory norms or default options. Given the ample discussion in the economic and legal literature of the effects of an economy having corporate ownership rights dispersed among many small shareholders or concentrated in the hands of blockholders,<sup>204</sup> this paper will revisit that issue.

## B. The European Union and Its Member States

### 1. Pursuant to the EC Treaty

Germany was a founding member of the European Economic Community (EEC) in 1957,<sup>205</sup> and the United Kingdom joined the EEC in 1973.<sup>206</sup> Through the Treaty on European Union signed in Maastricht, Denmark in 1992, the EEC and the other connected European communities were transformed into the European Union.<sup>207</sup> Even though this paper will use the term "EU law" following convention,<sup>208</sup> it is perhaps useful to note that because the European Community is the lawmaking portion of the European Union,<sup>209</sup> the *Community's* relationship to the member states is most relevant

<sup>203</sup> On this point, greatly differing social and moral structures could make a significant difference with regard to the nature of securities regulation. For example, *see* footnote 84 and the accompanying text for lamentations of dishonesty in Russia following the collapse of the Soviet police state. On the other extreme, a contemporary society with certain types of religious principles might well condemn securities trading, as did British and American society in the 17<sup>th</sup> and 18<sup>th</sup> Centuries. *See* STUART BANNER, *ANGLO-AMERICAN SECURITIES REGULATION: CULTURAL AND POLITICAL ROOTS, 1690-1860* (1998) at 14 *et seq.* (Britain) and 122 *et seq.* (United States).

<sup>204</sup> *See e.g.*, Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer, *Corporate Ownership Around the World*, 54 *THE JOURNAL OF FINANCE* 471 (1999); FABRIZIO BARCA & MARCO BECHT, *THE CONTROL OF CORPORATE EUROPE* (2001); and John C. Coffee, *Dispersed Ownership*, *supra* note 92, at 34 *et seq.*

<sup>205</sup> JUDT, *supra* note 101, at 303

<sup>206</sup> *Id.* at 308.

<sup>207</sup> CRAIG & DE BÚRCA, *supra* note 6, at 15.

<sup>208</sup> It is common to use the term "EU Law" even when "EC Law" is more legally accurate. As Prof. Eilís Ferran explains when making this observation with reference to the directives adopted in the area of securities regulation, "[t]he strict technical position is that securities laws are made within the legal framework of the European Community (EC, formerly European Economic Community or EEC), which is a Community within the common structure of the European Union. The EU, as such, has a limited role." EILÍS FERRAN, *BUILDING AN EU SECURITIES MARKET* 7 (2004). The same applies to the company law directives. The common practice to refer to these directives as "EU" law comes from the fact that the European Community is an integral part ("Pillar I") of the European Union.

<sup>209</sup> *See* Art. 5, Treaty on European Union, Dec. 24, 2002, O.J. 5 (C 325) (2002) (EU Treaty) (specifying the institutions of the European Community as exercising powers under the EC Treaty and the EU Treaty)

for an exact understanding of jurisdictional interaction. This latter relationship varies depending on the area being discussed. Within areas where the Community has been delegated competence that is not concurrent, the ECJ has interpreted the EC Treaty to mean that EU law is supreme over that of the member states.<sup>210</sup> The German Constitutional Court (*Bundesverfassungsgericht*) has, however, expressly reserved national, sovereign power, which it has nevertheless pledged not to exercise so long as the Community remains within its delegated powers and does not violate basic rights guaranteed in the German Constitution.<sup>211</sup> Within those areas where the European Community has not been given exclusive competence, the relationship between the Community and the member states is governed by the relationship of "subsidiarity" provided for in Article 5 of the EC Treaty, which includes the imperative that "the Community shall take action . . . only if and in so far as the objectives of the proposed action cannot be sufficiently achieved by the Member States and can therefore, by reason of the scale or effects of the proposed action, be better achieved by the Community."<sup>212</sup> In Articles 43 through 48 of the EC Treaty, the Community is given the express duty to guarantee the freedom of a citizen or company from one member state to establish him-, her, or itself in any other member state, but the promulgation of company law beyond a certain level of safeguarding harmonization is not an express Community function. The company law area should therefore be thought of as one of "concurrent jurisdiction,"<sup>213</sup> to which the principle of subsidiarity could apply. Article 44(2)(g) EC Treaty expressly instructs the European Council to adopt directives to coordinate only "to the necessary extent the safeguards . . . required by Member States of companies . . . with a view to making such safeguards equivalent throughout the Community."<sup>214</sup> This express, yet limited delegation of authority means that the Community's exercise of power is evaluated primarily for any

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and Art. 249 EC Treaty (directing the European Parliament, Council and Commission to make regulations and issue directives.); *see also* Manfred Zuleeg, in *KOMMENTAR ZUM EU VERTRAG*, at vol. 1, p. 574.

<sup>210</sup> Case 26/62, *NV. Algemene Transporten Expeditie Onderneming van Gend en Loos v. Nederlandse Administratie der Belastingen* [1963] ECR 1, 12 ("the Community constitutes a new legal order of international law for the benefit of which the states have limited their sovereign rights, albe it within limited fields, and the subjects of which comprise not only Member States but also their nationals."). For a good discussion in German, *see* Zuleeg, *supra* note 209, at 582 *et seq.*

<sup>211</sup> *See* most recently the Decision of the Constitutional Court of June 7, 2000, 2 BvL 1/97, available at the website of the German Constitutional Court at <http://www.bverfg.de/cgi-bin/link.pl?entscheidungen>. An older decision (reprinted in English) expressing a similar line of reasoning on sovereignty is Brunner v. The European Union Treaty [1994] 1 CMLR 57.

<sup>212</sup> Art. 5, EC Treaty. Judt wryly calls the difficult concept of "subsidiarity" "a sort of Occam's razor for eurocrats." *JUDT, supra* note 101, at 715.

<sup>213</sup> *see* Zuleeg, *supra* note 209 at 623 *et seq.*

<sup>214</sup> *See* VANESSA EDWARDS, *EC COMPANY LAW* 3-14 (1999), and STEFAN GRUNDMANN, *EUROPÄISCHES GESELLSCHAFTSRECHT* 48, 69-72 (2004).

abuse of such delegation rather than by application of the principle of subsidiarity, which would add little to the analysis.<sup>215</sup>

A "directive" as referred to in Article 44(2)(g) and defined in Article 5 EC Treaty is binding as to the result to be achieved, and member states must carry its substance into their national law, but it leaves them free to choose the form and method of implementation.<sup>216</sup> Once a directive has been adopted, however, it works to pre-empt conflicting national legislation. The ECJ made this point clear in its *Inspire Art* decision,<sup>217</sup> where it concluded that the Eleventh Company Law Directive's list of required and optional disclosures for branches established in other member states is "exhaustive", and that any disclosure requirements imposed by a member state (in that case, The Netherlands) are pre-empted.<sup>218</sup> The harmonization program under Article 44 goes hand in hand with the regulatory competition discussed in Part V, and harmonization of company law was originally seen as a quid pro quo for allowing companies from other member states to operate in the host country. ECJ Justice Timmerman has observed that the harmonization program conducted on the basis of Article 44 was thus seen as "an entrance fee Member States accepted to pay for market integration."<sup>219</sup>

## 2. *The company law directives*

Ten of the company law directives adopted beginning in 1968 harmonized company law on many key aspects of forming and operating *public* corporations,<sup>220</sup> with only minor attention given to private companies. The First Company Law Directive, adopted in 1968, imposed a harmonized system of register disclosure for companies to publish facts regarding their incorporation, legal capital

<sup>215</sup> See GRUNDMANN, *supra* note 214, at 45, with further citations, and the discussion of Art. 44 EC Treaty in Troberg & Tiedge, in KOMM. ZUM EU VERTRAG, at vol. 1, p. 1535 *et seq.*

<sup>216</sup> A "directive" is an instrument proposed by the European Commission and issued by the European Council with the consultation or approval or notification of the European Parliament, and is defined as an instrument that is "binding, as to the result to be achieved, upon each Member State to which it is addressed, but shall leave to the national authorities the choice of form and methods." Art. 249, Treaty Establishing the European Community, Dec. 24, 2002, O.J. 33 (C 325) (2002), (EC Treaty). See CRAIG & DE BÚRCA, *supra* note 6, at 85 *et seq.* EU company law has been harmonized almost exclusively through directives enacted under Article 44(2)(g) of the EC Treaty, which provides that, "[i]n order to attain freedom of establishment . . . the Council . . . shall act by means of directives . . . coordinating to the necessary extent the safeguards . . . required by Member States of companies . . . with a view to making such safeguards equivalent throughout the Community." See EDWARDS, *supra* note 214, at 3 *et seq.* and GRUNDMANN, *supra* note 214, at 69 *et seq.* Articles 43-48 of the EC Treaty guarantee freedom of establishment, and thus "require the removal of restrictions on the right of individuals and companies to maintain a permanent or settled place of business in a Member State." CRAIG & DE BURCA, *supra* note 6, at 791.

<sup>217</sup> Kamer van Koophandel en Fabrieken voor Amsterdam and Inspire Art Ltd [2003] ECR I-10155.

<sup>218</sup> See *Inspire Art*, [2003] ECR I-10155, Par. 65-71.

<sup>219</sup> Christiaan Timmermans, *Harmonization in the Future Company Law in Europe*, in Klaus J. Hopt & Eddy Wymeersch, eds., CAPITAL MARKETS AND COMPANY LAW 623, 628 (2003); Stefan Grundmann, *The Structure of European Company Law: From Crisis to Boom*, 5 EBOR 601, 605 *et seq.* (2004).

<sup>220</sup> See GRUNDMANN, *supra* note 214, at 48 *et seq.* and EDWARDS, *supra* note 214, at 1 *et seq.*

and financial results, as well as to specify those persons authorized to represent the company in dealings with third parties.<sup>221</sup> The Second Company Law Directive, adopted in 1976, provided harmonized rules for the incorporation of public companies and the maintenance of their capital, including a procedure for auditing the value of in-kind contributions to capital, restrictions on dividend distributions and share repurchases, a prohibition of "financial assistance", mandatory preemptive rights, and a required shareholder vote for certain changes in the company's capital.<sup>222</sup> Even considered alone and taking into account that the Second Directive was somewhat pared down through 2006 amendments, it is obvious that these two Directives regulate core corporate characteristics. They provide rules on the creation and actual representation of the corporation as a legal person, the capital maintenance requirements that are by many considered a quid pro quo for its limited liability, the nature of certain rights attaching to its shares, and the rights of shareholders with respect to changes in the company capital. The remaining company law directives adopted before the mid-1980's harmonize accounting,<sup>223</sup> or address specific company actions or topics, such as mergers and divisions,<sup>224</sup> the establishment of branches in other member states,<sup>225</sup> or guarantee that the existence of

<sup>221</sup> See the First Council Directive (68/151/EEC) of 9 March 1968 on co-ordination of safeguards which, for the protection of the interests of members and others, are required by Member States of companies within the meaning of the second paragraph of Article 58 of the Treaty, with a view to making such safeguards equivalent throughout the Community, 1968 O.J. (L 65) 8; see also a consolidated version as amended thorough January 1, 1995, available at [www.eurlex.eu](http://www.eurlex.eu) (hereinafter the "First Company Law Directive").

<sup>222</sup> See the Consolidated version of Second Council Directive of 13 December 1976 on coordination of safeguards which, for the protection of the interests of members and others, are required by Member States of companies within the meaning of the second paragraph of Article 58 of the Treaty, in respect of the formation of public limited liability companies and the maintenance and alteration of their capital, with a view to making such safeguards equivalent (77/91/EEC) as amended thorough November 20, 2006 (hereinafter the "Second Company Law Directive").

<sup>223</sup> Accounting measures include: Fourth Council Directive (78/660/EEC) of 25 July 1978 based on Article 54(3)(g) of the Treaty on the annual accounts of certain types of companies, 1978 O.J. (L 222) 11; Seventh Council Directive (83/349/EEC) of 13 June 1983 based on the Article 54(3)(g) of the Treaty on consolidated accounts, 1983, O.J. (L 193) 1; Eighth Council Directive (84/253/EEC) of 10 April 1984 based on Article 54(3)(g) of the Treaty on the approval of persons responsible for carrying out the statutory audits of accounting documents, 1984 O.J. (L 126) 20; as well as the more recent Regulation No 1606/2002 of the European Parliament and of the Council of 19 July 2002 on the application of international accounting standards, 2002 O.J. (L 243) 1. For a thorough discussion of these measures, see GRUNDMANN, *supra* note 214, at §§ 14-16 and EDWARDS, *supra* note 214, at chapters V-VII.

<sup>224</sup> See Third Council Directive (78/855/EEC) of 9 October 1978 based on Article 54 (3) (g) of the Treaty concerning mergers of public limited liability companies, 1977 O.J. (L 295) 36; see also consolidated version as amended thorough January 1, 1995 at [www.eurlex.eu](http://www.eurlex.eu); and Sixth Council Directive 82/891/EEC of 17 December 1982 based on Article 54 (3) (g) of the Treaty, concerning the division of public limited liability companies, 1982 O.J. (L 378) 47.

<sup>225</sup> Eleventh Council Directive 89/666/EEC of 21 December 1989 concerning disclosure requirements in respect of branches opened in a Member State by certain types of company governed by the law of another State, 1989 O.J. (L 395) 36 (hereinafter the "Eleventh Company Law Directive"). This Directive is discussed at length in the European Court of Justice's decision in *Inspire Art*, [2003] ECR I-10155.

a single-shareholder company will be respected throughout the Union.<sup>226</sup> Following long and difficult negotiations among the member states, the European Union finally adopted longstanding proposals for a directive regulating takeovers<sup>227</sup> and a regulation/directive package enabling the creation of a "European company" ("*Societas Europaea*" – "SE"), which is a porous framework of EU law filled in by the national company law of its member state of incorporation and seat.<sup>228</sup> The company law directives and regulations outlined above prescribe mandatory minimum rules, but the SE Regulation introduces a certain amount of flexibility into national law. The Regulation allows shareholders to choose either a single-tier or a two-tier management board structure in settling up a *Societas Europaea*,<sup>229</sup> and to specify a percentage of less than 10% of the shareholders to call a shareholders' meeting.<sup>230</sup> Germany and the United Kingdom have implemented all of the EU directives into their company law, and the SE Regulation is both directly binding as law and tied into national law with special, national legislation directing how the gaps in the loose, supranational framework are to be filled in.<sup>231</sup> More recent company law directives facilitate cross-border mergers<sup>232</sup> and harmonize a number of shareholder rights with respect to receiving notice of an annual meeting, casting votes at the meeting, and granting a proxy for such votes.<sup>233</sup> Although no directive has directly set out to harmonize directors' duties of care and loyalty, the many *ex ante* rules in the directives referred to above, such as those restricting distributions to shareholders, prescribing procedural conduct for mergers, and limiting defenses against takeovers, as well as delineating how accounts should be prepared and signed, have a significant effect on management behavior. Such rules should be factored in when comparing the development of fiduciary duties in Delaware and EU member states. A growing body of ECJ decisions, which will be discussed at length in Part V, also has had an extremely important impact on company law.

<sup>226</sup> Twelfth Council Company Law Directive of 21 December 1989 on single-member private limited-liability companies, 1989 O.J. (L 395) 40.

<sup>227</sup> Directive 2004/25/EC of the European Parliament and of the Council of 21 April 2004 on takeover bids, 2004 O.J. (L 142) 12.

<sup>228</sup> See Council Regulation 2157/2001, of 8 October 2001 on the Statute for a European company (SE) 2001 O.J. (L 294) 1 (hereinafter the "SE Regulation") and Council Directive 2001/86/EC of 8 October 2001 supplementing the Statute for a European company with regard to the involvement of employees 2001 O.J. (L 294) 22 (hereinafter the "SE Directive").

<sup>229</sup> Art. 38(b), SE Regulation.

<sup>230</sup> Art. 55(1) SE Regulation.

<sup>231</sup> For Germany, see The European Company Implementation Act (*Gesetz zur Einführung der Europäischen Gesellschaft*), BGBl. vol. I, p. 3675 (Dec. 22, 2004). Although national law will fill in gaps in the Regulation, it is important to remember that many of the gaps have been left in areas already harmonized by earlier EU directives.

<sup>232</sup> See Directive 2005/56/EC of the European Parliament and of the Council of 26 October 2005 on cross-border mergers of limited liability companies, 2005 O.J. (L 310) 1.

<sup>233</sup> See Directive 2007/36/EC of the European Parliament and of the Council of 11 July 2007 on the exercise of certain rights of shareholders in listed companies, 2007 O.J. (L 184) 17.

EU law regulates every aspect of the capital markets through a general framework directives, directly applicable regulations and detailed "interpretive" directives. The areas covered include public offerings of securities,<sup>234</sup> the disclosure that listed companies must make to the market,<sup>235</sup> insider trading and market manipulation,<sup>236</sup> as well as the activities of brokers and trading facilities<sup>237</sup> and the operation of investment funds.<sup>238</sup> As mentioned above,<sup>239</sup> the shape of these capital market rules is often influenced by IOSCO, and thus also often resembles that of similar rules adopted in the United States, and EU-US work programs and agreements provide for cooperative efforts in certain regulatory activity and mutual recognition of specified disclosure frameworks. One important element of securities regulation that has not been harmonized at the EU level is the standard for civil liability in cases of securities fraud.<sup>240</sup>

### 3. EU implementing regulations

The detailed EU rules implementing general directives are adopted pursuant to a four-level approach devised in 2001 by an expert committee under the direction of Baron Alexandre Lamfalussy in its, "Final Report of the Committee of Wise Men on the Regulation of European Securities Markets."<sup>241</sup> This Report set forth "four levels", which are:

- *Level 1*: general principles, directives that member states implement;
- *Level 2*: detailed, implementing legislation adopted by the European Commission, in consultation with the Committee of European Securities Regulators (CESR);
- *Level 3*: interpretive regulations developed by CESR; and

<sup>234</sup> See Directive 2003/71/EC of the European Parliament and of the Council of 4 November 2003 on the prospectus to be published when securities are offered to the public or admitted to trading and amending Directive 2001/34/EC, 2003 O.J. (L 345) 64.

<sup>235</sup> See Directive 2004/109/EC of the European Parliament and of the Council of 15 December 2004 on the harmonisation of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market and amending Directive 2001/34/EC, 2004 O.J. (L 390) 38 (hereinafter the "Transparency Directive").

<sup>236</sup> Directive 2003/6/EC of the European Parliament and of the Council of 28 January 2003 on insider dealing and market manipulation (market abuse), 2003 O.J. (L 96) 16 (hereinafter the "Market Abuse Directive").

<sup>237</sup> See Directive 2004/39/EC of the European Parliament and of the Council of 21. April 2004 on markets in financial instruments amending Council Directives 85/611/EEC and 93/6/EEC and Directive 2000/12/EC of the European Parliament and of the Council and repealing Council Directive 93/22/EEC, 2004 O.J. (L 145) 1. The content of this directive clearly falls outside of what is usefully considered as "company law" and will not be discussed in this paper.

<sup>238</sup> At the time of this writing, the EU framework for the regulation of undertakings for collective investment in transferable securities (UCITS) is undergoing substantial modification. See the White Paper and other documents available at [http://ec.europa.eu/internal\\_market/investment/index\\_en.htm](http://ec.europa.eu/internal_market/investment/index_en.htm).

<sup>239</sup> See *supra* note 39 and accompanying text.

<sup>240</sup> See Luca Enriques & Tobias H. Tröger, "Issuer Choice in Europe," ECGI Law Working Paper N° 90/2007 (October 2007), at 12 *et seq.*, on SSRN at: <http://ssrn.com/abstract=1032281>.

<sup>241</sup> The text of the Report is available at <http://europa.eu.int>. For a detailed analysis of this four-level procedure, see FERRAN, *supra* note 208, at 61-126.

- *Level 4*: Commission polices for compliance.

Pursuant to this procedure, the Insider Dealing and Market Manipulation Directive, for example, has been fleshed out both by detailed implementing legislation<sup>242</sup> and CESR implementing measures.<sup>243</sup> Similarly, the Prospectus Directive has been supplemented with a very detailed Prospectus Regulation,<sup>244</sup> which operates something like the instructions in the US Regulation S-K on the information to be provided in disclosure documents,<sup>245</sup> and obviates detailed national legislation on the content of prospectuses. In fact, the German Securities Prospectus Act defines the required, minimum content of a prospectus under German law with a brief reference to the EU Prospectus Regulation.<sup>246</sup> The FSA's disclosure and transparency rules referred to in the previous section are to a great extent taken without change from this EU legislation. As discussed in Part V, the Transparency Directive includes provisions on applicable law that could have a significant impact on national securities markets by allowing the *home* member state of an issuer to regulate the disclosure requirements of a company, even if it is listed in another member state.<sup>247</sup>

#### 4. *The Europeanization of national law*

The growth of EU activity in the area of securities regulation is passing much of the legislative volume of rules in this area from the member states to the supranational entity. The hierarchical relationship between the European Union and its member states and the density of the EU measures in the areas of company law and capital markets also mean that member state law has, to a very significant extent, been shaped by EU law. For a US observer, the "marbling" of national law with

<sup>242</sup> Commission Directive 2004/72/EC of 29 April 2004 on implementing Directive 2003/6/EC of the European Parliament and of the Council as regards accepted market practices, the definition of inside information in relation to derivatives on commodities, the drawing up of lists of insiders, the notification of managers' transactions and the notification of suspicious transactions, 2004 O.J. (L 162) 70; and Commission Regulation (EC) No 2273/2003 of 22 December 2003 implementing Directive 2003/6/EC of the European Parliament and of the Council as regards exemptions for buy-back programmes and stabilisation of financial instruments, 2003 O.J. (L 336) 33; as well as Commission Directive 2003/125/EC of 22 December 2003 implementing Directive 2003/6/EC of the European Parliament and of the Council as regards the fair presentation of investment recommendations and the disclosure of conflicts of interest, 2003 O.J. (L 339) 73.

<sup>243</sup> CESR, "Additional Level 2 Implementing Measures for Market Abuse Directive," CESR/03-213b (Aug. 2003).

<sup>244</sup> Commission Regulation (EC) No 809/2004 of 29 April 2004 implementing Directive 2003/71/EC of the European Parliament and of the Council as regards information contained in prospectuses as well as the format, incorporation by reference and publication of such prospectuses and dissemination of advertisements, 2004 O.J. (L 149) 1.

<sup>245</sup> See 17 C.F.R. Part 229.

<sup>246</sup> See § 7 of the German Securities Prospectus Act (*Gesetz über die Erstellung, Billigung und Veröffentlichung des Prospekts, der beim öffentlichen Angebot von Wertpapieren oder bei der Zulassung von Wertpapieren zum Handel an einem organisierten Markt zu veröffentlichen ist* – Wertpapierprospektgesetz or WpPG).

<sup>247</sup> See Transparency Directive, at Art. 3.



supranational elements will appear quite different than the two-tiered state/federal structure that prevails in the United States. As will be discussed in further detail in Part V, the ECJ also guides national law that has not already been harmonized or supplanted pursuant to its reading of the EC Treaty, thus creating an additional supranational impact on local law.

An awareness of the pervasive presence of EU law in both the German and the UK legal systems should give warning to those who would argue a strong form of legal origin influence. The respective bodies of company law have both been "Europeanized" and exist alongside a large body of EU securities law. Although EU law has not yet focused on private limited companies – and thus ECJ decisions have addressed conflicts in national law regarding this business form – the *Aktiengesetz* and the Companies Act 2006 contain a very large number of substantially identical provisions that implement EU law. In public companies, the appointment of directors and their management of the company in areas other than those regulated by directives has been left to national law, and thus in this important area of the law divergences do exist and continue to arise, although reason and pressure for international best practices by institutional investors have led to significant uniformity in this area as well.

### **C. Within Germany and the United Kingdom**

Although company law is national law in both Germany and the United Kingdom, each of these countries contains sub-jurisdictions and regulatory bodies to which power must be delegated or with which jurisdiction must be shared. Thus the Companies Act 2006 makes special allowances for divergence in the case of the law of Scotland and Northern Ireland, and the adoption of rules for the Frankfurt Stock Exchange occurs partly in cooperation with the state (*Land*) of Hesse, where the city of Frankfurt am Main is located.

#### *1. Germany*

Germany is a federation, but the *Länder* do not adopt company or securities laws of their own, and thus there is no competition for charters within Germany. The *Aktiengesetz* is also quite inflexible, and leaves little room for individualized company structures. Section 23(5) AktG provides that the company charter may deviate from the provisions of the law only where expressly provided for in the law, and such express grants are not generously provided. As Prof. Karsten Schmidt notes, pursuant to German corporate law, "*the constitution-like, prescribed structure of the stock corporation may be altered only slightly by the articles of incorporation, given that – contrary to limited liability companies and partnerships – the stock corporation is governed by the principle that the form of*

*constitutional documents is strictly prescribed.*"<sup>248</sup> Indeed, Prof. Hans-Joachim Mertens quipped in an essay written shortly after German reunification that a future economic historian would have great difficulty in discerning whether the *Aktiengesetz*, with its strictly prescribed structure, originated in the capitalist or in the communist half of Germany.<sup>249</sup>

Securities exchanges do exist in many German *Länder* and their rules are adopted in a semi-public manner in connection with the *Land*. As mentioned above, Germany's largest securities exchange, the Frankfurt Stock Exchange, is in the *Land* of Hesse. Pursuant to § 32 of the German Exchange Act,<sup>250</sup> the federal government has issued an exchange admission regulation providing guidelines on the procedure to be used and requirements to be met when admitting securities to listing on a German exchange.<sup>251</sup> A governing body of the exchange, the "exchange council" (*Börsenrat*) on which representatives of listed companies and market participants are seated is responsible for drafting the exchange rules.<sup>252</sup> These rules must be approved by the supervisory authority of the *Land*, which in Hesse is the Commerce Ministry.<sup>253</sup> As the Exchange Rules are issued pursuant to the German Exchange Act and under the supervision of the local state authority, they take on the character of a public law charter (*öffentlich-rechtliche Satzung*).<sup>254</sup> This gives listed companies additional options to

<sup>248</sup> SCHMIDT, *supra* note 147, at 771 (italics in original) (Author's translation). For an interesting discussion of mandatory corporate law in Continental Europe, see Sofie Cools, The Real Difference in Corporate Law between the United States and Continental Europe: Distribution of Powers, 30 DEL. J. CORP. L. 697 (2005).

<sup>249</sup> Hans-Joachim Mertens, *Satzungs- und Organisationsautonomie im Aktien- und Konzernrecht*, 3 ZGR 426 (1994).

<sup>250</sup> This section requires that the regulation contain "provisions necessary to protect the public and for orderly exchange trading, regarding: 1. admission requirements, and in particular: a) requirements for the issuer regarding its legal form, its size and the duration of its existence; b) requirements for the securities to be admitted regarding their legal basis, negotiability, face value, and printed format; c) the minimum amount of the issue; d) the requirement that the application for admission include all shares of the same class or all debt securities of the same issue; 2. the language and the content of the prospectus, in particular the securities to be admitted and the issuer, its capital, business activity, assets and liabilities, financial position, management and supervisory bodies, its recent development and prospects, any lockup agreements between the issuer and its shareholders, including any understandings and measures designed to secure performance on the agreement, as well as the persons or companies that take responsibility for the contents of the prospectus; 3. the date on which the prospectus is to be published; and 4. the admissions procedure." § 32(1) German Exchange Act, author's translation.

<sup>251</sup> See Exchange Admission Regulation, *supra* note 202.

<sup>252</sup> §§ 9 and 13 German Exchange Act.

<sup>253</sup> § 13(5) German Exchange Act. For a discussion of the approval process see Peter Foelsch, in *BANKRECHT UND BANKPRAXIS*, margin nos. 7/171, 7/183 (Thorwald Hellner & Stephan Steuer, eds., updated to 2007).

<sup>254</sup> *Id.* at 7/182.

challenge disputed exchange actions, such the delisting of a company under circumstances not expressly provided for in the exchange admission regulation.<sup>255</sup>

Although German exchange rules are drafted by private parties who can expect the sympathetic cooperation of the commerce ministry in their local *Land*, they coexist with an extensive body of EU securities regulation and the national laws implementing the latter, and must conform to the national regulation on admission to an exchange. As a result, the listing requirements of the Frankfurt Stock Exchange, for example, have little room to use their local freedom even though they are considerably lighter than both their UK and US counterparts. It is difficult to say whether their open-endedness expresses a business-friendly accommodation for listed companies or is simply the result of the heavy blanket of national and EU law resting on German companies, although the latter is most likely. The Frankfurt rules go to disclosures and accounting, with standards for certain exchange segments being somewhat stricter than required by law. For example, a company the shares of which are admitted to the premium market segment referred to as "prime standard" must publish reports, including financial statements on a quarterly, rather than merely semiannual basis, as required by the federal, Exchange Admission Regulation (*Börsenzulassungs-Verordnung*).<sup>256</sup> Such requirements are very light compared to their UK and US counterparts, and in no way regulate the composition of the boards or their actions. The latter topics are rather addressed by the Corporate Governance Code referred to above, compliance with which must be declared (or non-compliance disclosed and explained) in the notes to a listed company's financial statements.<sup>257</sup> The Code contains requirements that are very comparable to the corporate governance standards found in the NYSE *Listed Company Manual*, such as the creation of an audit committee on the supervisory board, with a chair who is an accounting expert and not a former manager,<sup>258</sup> disapproval of the general practice of managing directors migrating into the supervisory board,<sup>259</sup> recommendation that supervising directors of public corporations sit on the boards no more than five, separate companies (the *Aktiengesetz* sets the limit at 10),<sup>260</sup> a general policy of one share/one vote,<sup>261</sup> and a shareholder-friendly calling and holding of the annual meeting.<sup>262</sup>

<sup>255</sup> See Manfred Wolf, *Der Ausschluß vom Neuen Markt und die Aufnahme von Ausschlußgründen in das Regelwerk Neuer Markt*, 38 WM 1785 (2001), for an excellent analysis of the contract law problems arising in the unilateral amendment of this type of contract.

<sup>256</sup> See Rules of the Frankfurt Stock Exchange, §§ 62 and 63, available at the website of the Frankfurt Stock Exchange, <http://www.deutsche-boerse.com>, and Exchange Admission Regulation, §§ 53-62.

<sup>257</sup> See § 161 AktG.

<sup>258</sup> German Corporate Governance Code, at 5.3.2.

<sup>259</sup> *Id.* at 5.4.4.

<sup>260</sup> See *Id.* at 5.4.5, and § 100(2)(1) AktG for the statutory rule.

<sup>261</sup> German Corporate Governance Code, at § 2.1.2.

<sup>262</sup> *Id.* at § 2.3.

Particularly with regard to takeovers and securities trading, German law also delegates authority to the German Financial Services Supervisory Agency (*Bundesanstalt für Finanzdienstleistungsaufsicht* – BaFin) to adopt regulations. As CESR has increasingly issued more and more detailed EU legislation, the national substance of the BaFin regulations has become less significant. As a result, given that the Frankfurt listing rules are comparatively light and the *Kodex*, aside some best practice recommendations largely repeats the requirements of the *Aktiengesetz*, there is very little jurisdictional interaction within Germany. Nearly all company law is national law.

## 2. The United Kingdom

Although the United Kingdom is composed of England, Wales, Scotland and Northern Ireland – with each having a certain degree of autonomy and slight differences in laws that affect companies – there is no regulatory competition between the component states of the United Kingdom. The Companies Act 2006 applies equally to each state, but makes numerous references to the slight differences existing in the laws of the various states, such as with respect to variations in the requirements for registering charges against the company, which is closely linked to principles of local property law,<sup>263</sup> or the requirements for entering into contracts that bind the company, which is closely linked to principles of local contract law.<sup>264</sup> The Financial Services and Markets Act 2000 (FSMA) makes fewer, but similar, adjustments for differences in such areas as criminal law and related authorities, which display differences in the various UK component states.<sup>265</sup> Most significant "jurisdictional" interaction in the area of company law occurs between the UK Parliament and the bodies, primarily the Secretary of State, the FSA and the Panel on Takeovers and Mergers (the "Takeover Panel"), to which it delegates specific powers.

The Secretary has significant delegated authority under the Act, particularly in connection with the constitution of companies, such as prescribing model articles of association,<sup>266</sup> and receives power to issue other statutory instruments affecting a number of different rights.<sup>267</sup> Through the Companies Act 2006, the Takeover Panel receives the powers to issue rules for the regulation of takeovers in accordance with the EU Takeover Directive,<sup>268</sup> to enjoin persons from acting in violation of the rules,<sup>269</sup> to order the production of documents,<sup>270</sup> and to conduct hearings on the alleged violation of its

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<sup>263</sup> See Part 25 Companies Act 2006.

<sup>264</sup> See secs. 43 *et seq.* Companies Act 2006.

<sup>265</sup> See e.g., sec. 176 FSMA 2000 regarding the issuance of warrants.

<sup>266</sup> See sec. 19 Companies Act 2006.

<sup>267</sup> See e.g. sec. 71(4) Companies Act 2006, giving the Secretary the power to issue rules regulating challenges to company names.

<sup>268</sup> See sec. 943 Companies Act 2006.

<sup>269</sup> See sec. 946 Companies Act 2006.

<sup>270</sup> See sec. 947 Companies Act 2006.

rules.<sup>271</sup> The historical position of the Takeover Panel as a body composed of representatives of the industry meant that the type of person who was able to shape the UK takeover rules (e.g., institutional investors in the City of London) has been quite different than the type of persons who could lobby the US Congress in Washington to shape the US takeover rules (e.g., corporate management).<sup>272</sup> Because different rule-giving bodies represent different constituencies and have different procedures for drafting and issuing their rules, the constituencies that can exercise influence on those bodies is different. This displays how an understanding of relevant jurisdictions and their powers is a prerequisite to an understanding of the type of forces acting to cause historical development, which is outlined in the following Part V. As the Takeover Panel has recently been brought formally under the law through Companies Act 2006, it will be interesting to see whether its rules and decisions move at all in the direction of the more industry-friendly US counterparts.

The FSMA both created the FSA and delegated power to it, including the power to grant authorization to pursue a regulated financial activity.<sup>273</sup> Its rules address matters ranging from the disclosure of inside information and of shareholdings,<sup>274</sup> to the listing standards for UK securities exchanges,<sup>275</sup> i.e. the London Stock Exchange (LSE). The LSE's own rules primarily regulate its members rather than listed companies.<sup>276</sup> Unlike Germany, local government is not involved in the FSA's rule-making process. The FSA Listing Rules provide an extensive set of initial and continuing obligations for listed companies that not only specify financial criteria and regulate disclosure, but also provide guidelines on how specific types of transactions are to be approved<sup>277</sup> and the manner in which

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<sup>271</sup> See sec. 951 Companies Act 2006.

<sup>272</sup> See the very instructive discussion by John Armour & David A. Skeel, Jr., *Who Writes the Rules for Hostile Takeovers, and Why?—The Peculiar Divergence of US and UK Takeover Regulation*, 95 GEO. L.J. 1727 (2007). This analysis shows how the nature of a rule-giving body can channel certain types of constituency influence into its rules. It builds on ideas found in Romano, *The Sarbanes-Oxley Act*, *supra* note 85, which focuses on the rule-giver's state of mind in accepting or rejecting solutions offered by various constituencies. A more recent paper looks at the motives and available funds that constituencies such as corporate management can use to influence rule-giving bodies. See Lucian A. Bebchuk & Zvika Neeman, "Investor Protection and Interest Group Politics" (November 2007). Harvard Law and Economics Discussion Paper No. 603 Available at SSRN: <http://ssrn.com/abstract=1030355>. A combination of jurisdictional analysis (Armour & Skeel), situational analysis (Romano), and analysis of motive and opportunity for influence (Bebchuk & Neeman) should be able to offer a legal history that explicates the complete dynamics of legal change.

<sup>273</sup> See sec. 20 FSMA 2000.

<sup>274</sup> See FSA Disclosure and Transparency Rules, DTR 2 and 5 (Jan. 2008).

<sup>275</sup> The FSA is the "competent authority" under EU law for supervising and regulating the securities exchanges. See sec. 72 FSMA 2000.

<sup>276</sup> See <http://www.londonstockexchange.com/en-gb/products/membershiptrading/rulesreg>.

<sup>277</sup> Transactions requiring shareholder approval include stock and stock option plans for management. See FSA Listing Rules, Rule 9.4 (Jan. 2008).

company directors may buy and sell the company's stock.<sup>278</sup> Thus, similarly to the regulatory composition in the United States, the shift from a non-listed to a public UK company brings with it a substantial increase in regulation. Unlike the United States, however, because the bulk of the listing rules come from the FSA rather than the exchange, it would be next to impossible for another UK exchange to compete for listing applicants by offering less regulation, although a "race-to-the-top" strategy based on stricter standards should be possible. Moreover, as discussed in Part V, the EU Transparency Directive's applicable law provisions allow competition between the shares of issuers from different home member states on the same exchange, altering the traditional rule according to which the marketplace controls the regulation of securities sold on the market.

#### **D. The United States and Its States**

The bodies with power to issue rules governing public companies in the United States are the states (e.g., the State of Delaware), the federal government (which enacted, e.g., the Exchange Act and the Securities Act) and the securities exchange on which a given company's shares are listed (e.g., the New York Stock Exchange and the Nasdaq Stock Market both issue their own listing standards).<sup>279</sup> The rules issued by each of these bodies tend to overlap and supplement each other.

##### *1. The Constitutional position of the US federal government*

Federal law focuses on disclosure in the contexts of securities offerings,<sup>280</sup> takeovers,<sup>281</sup> annual and quarterly reporting,<sup>282</sup> and the solicitation of proxies<sup>283</sup> for the annual meetings of shareholders, as well as combating fraud in connection with such activities.<sup>284</sup> In the area of company law proper, the federal government could constitutionally supplant state law, but has traditionally chosen not to do so.

Pursuant to Article VI, clause 2, of the U.S. Constitution, known as the "Supremacy Clause", the laws of the federal government preempt the laws of a state.<sup>285</sup> Preemption is not uniformly present in all cases. The federal preemption power runs on a sliding scale, beginning with those cases where exclusive powers of the federal government are specified in the Constitution, and gradually decreasing

<sup>278</sup> Transactions requiring shareholder approval include stock and stock option plans for management. *See* FSA Listing Rules, Rule 9.2.7 (Jan. 2008).

<sup>279</sup> The initial and continued listing standards of the NYSE are set forth in the NYSE LISTED COMPANY MANUAL, which is available in a continuously updated form at [www.nyse.com](http://www.nyse.com). The initial and continued listing standards of the Nasdaq Stock Market are set forth in the NASDAQ MARKETPLACE RULES (Rules 4000--7100), which are available in a continuously updated form at [www.nasdaq.com](http://www.nasdaq.com).

<sup>280</sup> *See* 15 U.S.C. § 77e(a) (2000).

<sup>281</sup> *See* 15 U.S.C. § 78m(a) (2000).

<sup>282</sup> *See* 15 U.S.C. § 78n(d) (2000).

<sup>283</sup> *See* 15 U.S.C. § 78n(a) (2000).

<sup>284</sup> *See* 15 U.S.C. § 77j(b) and 78j(b) (2000).

<sup>285</sup> U.S. CONST. art. VI, cl. 2. For an informative historical analysis of the US federalist structure, *see* Michael W. McConnell, *Federalism: Evaluating the Founders' Design*, 54 U. CHI. L. REV. 1484 (1987).

through cases in which the Supreme Court has found there is a presumption in favor of preemption, to where the legal position is neutral, to cases where there is a presumption against preemption, and finishing with those cases in which the states have a constitutional immunity from preemption.<sup>286</sup> Because the Constitution, in a provision known as the "Commerce Clause",<sup>287</sup> vests the federal Congress with the power to regulate commerce among the states, interstate commercial activity is a field where the argument for preemption is at its strongest.<sup>288</sup> Congress based its enactment of the various securities laws discussed above on the commerce clause,<sup>289</sup> and there is little doubt that Congress could replace the state corporate laws with a federal statute.<sup>290</sup> For example, although most US states have some form of law providing for disclosures in connection with the sale of securities (often referred to as "blue sky laws"), Congress in 1996 provided that these laws shall not apply to any securities listed on a national exchange.<sup>291</sup> The preempted state law was simply displaced. The same result could be achieved through the adoption of a federal company law, although this has not been seriously considered since the beginning of the 1920's,<sup>292</sup> and in the mean time a "tradition" has developed according to which corporations are understood as "creatures of the state,"<sup>293</sup> and corporate law is understood as an area in which there is a "longstanding prevalence of state regulation."<sup>294</sup> Thus,

<sup>286</sup> This sliding scale analysis is borrowed from Prof. Mark V. Tushnet, who uses it in a discussion of the foreign policy area, with the caveat that the five-point scale is "sufficient" for "the present purposes," which of course indicates that finer distinctions might be appropriate in different circumstances. See Mark V. Tushnet, *Globalization and Federalism in a Post-Printz World*, 36 TULSA L.J. 11, 19 (2000).

<sup>287</sup> U.S. CONST. art. VI, § 8, cl. 3.

<sup>288</sup> See Prof. Tushnet's discussion of *Gibbons v. Ogden*, 22 U.S. (9 Wheat.) 1 (1824), Tushnet, *supra* note 286, at 19 *et seq.*

<sup>289</sup> See LOUIS LOSS, JOEL SELIGMAN & TROY PARADES, *FUNDAMENTALS OF SECURITIES REGULATION* 98 *et seq.* (5<sup>th</sup> ed. 2004, supplemented to 2007).

<sup>290</sup> See e.g., Joel Seligman, *A Modest Revolution in Corporate Governance*, 80 NOTRE DAME L. REV. 1159, 1169 (2005) ("There was no real question given the United States Constitution's Supremacy Clause that the SEC could seek legislation that would supplant the states in corporate law for a specified category of corporations and that the federal law would preempt or exist concurrently with state law. The federal securities laws did exactly this with respect to state disclosure and fraud remedies during the New Deal"), and Mark J. Roe, *Delaware's Competition*, 117 HARV. L. REV. 588, 596 ("Congress's authority over interstate commerce means that the internal affairs "doctrine" is just an informal arrangement, not a hard limit on federal lawmaking").

<sup>291</sup> See the National Securities Markets Improvements Act of 1996 (the "NSMIA", Pub.L.No. 104-290, 112 Stat. 3416). The "blue sky" laws have become progressively less important as federal law has either expressly or tacitly pre-empted their application. Along these lines, the Securities Litigation Uniform Standards Act of 1998 (the "SLUSA", Pub.L.No. 105-353, 112 Stat. 3227) also removed a significant amount of activity from the state jurisdictions by pre-empting state class actions for specified types of securities fraud. See LOUIS LOSS, JOEL SELIGMAN & TROY PAREDES (5<sup>th</sup> ed. 2004), at 28 *et seq.* and 1189 *et seq.*

<sup>292</sup> See William W. Bratton and Joseph A. McCahery, *The Equilibrium Content of Corporate Federalism*, 41 Wake Forest L. Rev. 619, 653 (2006).

<sup>293</sup> *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 479 (1977) (refusing to apply the federal securities laws to matters of internal corporate management), citing *Cort v. Ash*, 422 U.S. 66, 84 (1975).

<sup>294</sup> *CTS Corp. v. Dynamics Corp. of America*, 481 U.S. 69, 70 (1987).

"except where federal law expressly requires certain responsibilities of directors with respect to stock holders, state law will govern the internal affairs of the corporation,"<sup>295</sup> as states are understood to have "broad latitude" in regulating such "internal affairs."<sup>296</sup> Internal affairs would generally include the formation and governance of a corporation and the rights and duties of its owners and managers.<sup>297</sup> For the reasons outlined, the federal government avoids encroaching on this area.

## 2. Federal laws

Federal laws and the extensive body of rules issued pursuant to them mostly require registration of companies, disclosure of financial and other information about the company and management, and make only minimal incursions into the internal affairs of the companies regulated.<sup>298</sup> Controversies arise, however, in connection with border areas where there is uncertainty as to whether the field has been preempted by federal law,<sup>299</sup> or when a federal remedy could be applied to an action taken under the state corporate law. For example, when a shareholder raised a federal challenge against a "short-form" merger that under Delaware law did not require shareholder approval, the Supreme Court rejected it because the matter was "internal" and did not exhibit the characteristics, such as misrepresentation or fraud, that the federal law was enacted to combat.<sup>300</sup> Federal/state conflicts also

<sup>295</sup> *Cort*, 422 U.S. at 84.

<sup>296</sup> *CTS*, 481 U.S. at 78, citing the decision of the Appeals Court's decision in the same case, *Dynamics Corp. of America v. CTS Corp.*, 794 F.2d 250, 264 (7<sup>th</sup> Cir. 1986).

<sup>297</sup> The concept of "internal affairs" comes from the area of conflicts of law. RESTATEMENT (SECOND) CONFLICTS OF LAW §302, Comment a (1971) defines "internal affairs" as referring to "the relations *inter se* of the corporation, its shareholders, directors, officers or agents. . . . involv[ing] primarily a corporation's relationship to its shareholders [and] includ[ing] steps taken in the course of the original incorporation, the election or appointment of directors and officers, the adoption of by-laws, the issuance of corporate shares, preemptive rights, the holding of directors' and shareholders' meetings, methods of voting including any requirement for cumulative voting, shareholders' rights to examine corporate records, charter and by-law amendments, mergers, consolidations and reorganizations and the reclassification of shares. Matters which may also affect the interests of the corporation's creditors include the issuance of bonds, the declaration and payment of dividends, loans by the corporation to directors, officers and shareholders, and the purchase and redemption by the corporation of outstanding shares of its own stock."

<sup>298</sup> In the original Exchange Act, incursions into the management of the corporation were limited to such requirements as disclosure of the shareholdings of managers and 10% stockholders, and the disgorgement of profits that such insiders made through short term dealings (within a period of six months) in the company's shares. *See* 15 U.S.C.A. §§ 78p(b) (2000). An exception to the limitation to disclosure rules was found in the Investment Company Act, which included a requirement that a specified percentage of independent or unaffiliated directors be seated on the board. *See* 15 U.S.C. § 80a-10 (2000).

<sup>299</sup> *See* *Edgar v. MITE Corp.*, 457 U.S. 624 (1982) (invalidating a state statute that imposed a waiting period of the consummation of takeover offers that was deemed to frustrate the balance achieved in the § 14 of the Exchange Act). On the question of "field preemption" as applied to corporate and securities law, *see* Roberta S. Karmel, *Reconciling Federal and State Interests in Securities Regulation in the United States and Europe*, 28 BROOKLYN J. INT'L L. 495, 500 *et seq.* (2003).

<sup>300</sup> *Green*, 430 U.S. 462 (The court found that, absent an allegation of misrepresentation or fraud – which are the key elements of Rule 10b-5 under the Exchange Act – the federal rule could not be used to invalidate a merger effected properly under state law). For an excellent discussion of this case, *see* Donald C.



arise when the SEC oversteps its authority under the Exchange Act in regulating an "internal" matter (such as the type of voting rights embodied in shares), which is usually provided for in state corporate laws.<sup>301</sup> No *legal* controversy arises, however, when the federal government expressly enters internal corporate affairs, as it did with §§ 301 and 402 of the Sarbanes-Oxley Act of 2002 (SOA),<sup>302</sup> which regulated the composition of corporate boards by requiring independent audit committees and their internal procedures by prohibiting most loans to directors. Thus by tradition, but not by law, the states control most of the internal affairs of corporations.

An important difference between US and EU company law arises because the US Congress may not – unlike the European Union – command the states to implement specified policies.<sup>303</sup> As a result, laws like the DGCL are essentially different from their counterparts in Germany and the United Kingdom because they are not marbled with elements of federal law; rather, state law and federal law occupy separate realms. For example, sec. 441 Companies Act 2006 requires companies to deliver their annual accounts for each financial year to the companies registrar. This requirement is found in UK law because an EU directive,<sup>304</sup> which had to be carried into national law, required it.<sup>305</sup> The same EU law requirement is found in German law<sup>306</sup> and will be found in a substantially similar form in the various company laws of all EU member states because national legislatures must comply with an obligation to implement the supranational directive. Because the US federal government cannot issue instructions to a state legislature, US federal laws, such as the Exchange Act, operate on a plane separate from that occupied by the state company law statutes. These two parallel systems manoeuvre around each other, and at times leave gaps or collide. The closest thing to an instruction to implement

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Langevoort, *Seeking Sunlight in Santa Fe's Shadow: The SEC's Pursuit of Managerial Accountability*, 79 Wash. U. L. Q. 449 (2001).

<sup>301</sup> See *The Business Roundtable v. Securities and Exchange Commission*, 905 F.2d 406 (1990). (The court found that the SEC's attempt to guarantee that all listed stock carried proportional voting rights exceeded the agency's authority under § 14 of the Exchange Act.)

<sup>302</sup> The Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (SOA).

<sup>303</sup> In 1997, the US Supreme Court reaffirmed that, "[t]he Federal Government may neither issue directives requiring the States to address particular problems, nor command the States' officers, or those of their political subdivisions, to administer or enforce a federal regulatory program." *Printz v. United States*, 521 U.S. 898, 932; 117 S.Ct. 2365, 2384 (1997).

<sup>304</sup> The First Company Law Directive.

<sup>305</sup> See Arts. 2(1)(f) and 3(1) and (2) of the First Company Law Directive.

<sup>306</sup> Germany implemented the First Company Law Directive in 1969 with The Law Implementing the First Directive of the European Council on the Coordination of Company Law (*Gesetz zur Durchführung der Ersten Richtlinie des Rates der Europäischen Gemeinschaften zur Koordinierung des Gesellschaftsrechts*) of August 15, 1969, BGBl vol. I, p. 1146. The required filing was previously specified in §§ 177 and 178 AktG, but has since been moved for housekeeping purposes into §§ 325-329 of the HGB, which apply to all stock corporations. The Commercial Code also provides for the creation of the register in which the filing must be made. See UWE HÜFFER, *AKTIENGESETZ* 881 (7<sup>th</sup> ed. 2006), and GÜNTHER HENN, *HANDBUCH DES AKTIENRECHTS* 589 (7<sup>th</sup> ed. 2002).

as used in the European Union is found in legislative orders via the SEC to the national securities exchanges to issue listing specific listing rules, as discussed below, and explains why listing rules serve a harmonizing function that is not found in state company law with the exception, perhaps, of the Model Business Corporation Act (the "Model Act").<sup>307</sup>

The Model Act might be thought of as a voluntary form of European-style harmonization. The American Bar Association's Section of Business Law (the "ABA") continuously updates and improves the Model Act, and publishes drafts for discussion in the ABA publication, *The Business Lawyer*. State legislatures are free to adopt the provisions with or without change. In 2000, it was reported that 35 states had substantially adopted the Model Act,<sup>308</sup> although the laws of such states is less used by large public companies than is the law of Delaware. As a result, corporate law in the United States is essentially divided into three camps: the majority of the states follows the Model Act, a few states, such as Oklahoma, follow the DGCL, and some large states like California and New York, which can afford their own drafting committees, choose to follow neither Delaware nor the Model Act.<sup>309</sup> Federal law has not been directly implemented into any of these corporate statutes.

Because US corporate law statutes offer creditors few safeguards against shareholders paying out the corporate capital to themselves, US company law reaches out in various directions to cobble together creditor rights. Some protections are found in federal law and others in harmonized, model laws. Federal law bankruptcy provisions on both fraudulent conveyances and equitable subordination are used to address cases in which shareholders unfairly vote themselves preferential treatment.<sup>310</sup> Rules on fraudulent conveyances are also used to limit such payouts,<sup>311</sup> and such rules have been drafted in a model act by the National Conference of Commissioners on Uniform State Law (NCCUSL),<sup>312</sup> which like the Model Business Corporation Act has been offered to the states for their

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<sup>307</sup> The Model Act is drafted by the Section of Business Law of the American Bar Association. The process of updating and adopting the Model Act will be discussed in more detail in Part III.A.2. The Model Act has been adopted in substance in 35 of the 50 US states. See Richard A. Booth, *A Chronology of the Evolution of the MBCA*, 56 BUS. LAW. 63, 66 (2000).

<sup>308</sup> See *Id.*

<sup>309</sup> See JONATHAN R. MACEY, MACEY ON CORPORATION LAW (2002), for a discussion of the states that have followed a specific provision of the DGCL or the Model Act.

<sup>310</sup> See David A. Skeel & Georg Krause-Wilmar, *Recharacterization and the Nonhindrance of Creditors*, 7 EBOR 259 (2006).

<sup>311</sup> See e.g., *Moody v. Security Pacific Credit Business, Inc.* 971 F.2d 1056 (1992) and *US v. Tabor Court Realty*, 803 F.2d 1288 (1986).

<sup>312</sup> The Uniform Fraudulent Transfer Act, which was drafted by NCCUSL in 1984, revised a Uniform Fraudulent Conveyance Act that had existed since 1918. The 1984 version has been adopted by 42 states. See the NCCUSL website, at <http://www.nccusl.org>.

voluntary adoption. This process has significantly harmonized the shape of such rules in the United States.<sup>313</sup>

### 3. *Exchange Rules*

The initial and continued listing requirements of national securities exchanges are merely contractual in nature,<sup>314</sup> and would be invalid if they violated either state or federal law.<sup>315</sup> Pursuant to the Exchange Act, national securities exchanges are "self regulatory organizations" ("SROs"), and their rules, including the listing standards, are subject to the approval of the SEC,<sup>316</sup> which supervises their adoption according to a procedure provided for in § 19 Exchange Act.<sup>317</sup> In accordance with this procedure, the SEC supervises all significant rule changes of national exchanges and may instruct the exchanges to adopt specific rules. Because the SEC operates under power delegated to it through the Exchange Act, it may not instruct a securities exchange to adopt a rule in an area not covered by such delegated power. The Court of Appeals for the Federal Circuit found in 1990 that an SEC rule that would have required exchanges to maintain a one share/one vote policy was beyond the agency's statutory authority because, in the court's opinion, voting rights were part of internal corporate governance and beyond the disclosure focus of the Exchange Act.<sup>318</sup> This decision, although certainly binding, is generally not considered to demarcate the limits of the SEC's delegated power with great authority, and as Professor Joel Seligman has observed, the court's decision not only ignores the SEC's plenary power under the Exchange Act to change or abrogate exchange rules,<sup>319</sup> but also fails to explain how, if exchanges can adopt rules that go well beyond disclosure, and the SEC has unlimited

<sup>313</sup> The NCCUSL website shows 45 states that have adopted the Uniform Fraudulent Transfer Act, which it released in 1984 by revising a 1918 Uniform Fraudulent Conveyance Act, and that New York State introduced the act in 2007.

<sup>314</sup> *Merrill Lynch, Pierce, Fenner & Smith v. Ware*, 414 U.S. 117, 131 (1973).

<sup>315</sup> See RESTATEMENT (SECOND) OF CONTRACTS § 178 (2005) and JOHN D. CALAMARI & JOSEPH M. PERILLO, *THE LAW OF CONTRACTS* 495 (4<sup>th</sup> ed. 1998). Aside from the invalidity under contract law, § 19(b)(3)(C) Exchange Act provides that a "rule change of a self-regulatory organization which has taken effect . . . may be enforced by such organization to the extent it is not inconsistent with the provisions of this title, the rules and regulations thereunder, and applicable Federal and State law."

<sup>316</sup> See § 19(b) Exchange Act and LOSS & SELIGMAN (2004), at 776.

<sup>317</sup> The procedure by which national securities exchanges may adopt rules is provided for in § 19(b) Exchange Act. According to this provision an exchange must file copies of any proposed rule change with the SEC, stating the proposed rule's basis and purpose. The SEC then provides notice of the proposal and gives interested persons an opportunity to comment. Usually within 35 days, the SEC will then order the rule change or institute proceedings to determine whether the proposal should be disapproved. Under certain circumstances rules may enter into effect immediately without the waiting period. No rule proposal can become effective without SEC approval. See LOSS, SELIGMAN & PAREDES, *supra* note 289, at 776 *et seq.*

<sup>318</sup> See *Business Roundtable*, 905 F. 2d at 411-413.

<sup>319</sup> See § 19(b)(3)(C) Exchange Act ("the Commission summarily may abrogate the change in the rules of the self-regulatory organization . . . and require that the proposed rule change be refilled.")

power over this process, the SEC's own affirmative capacity can be limited to disclosure rules.<sup>320</sup> The expansion of the Exchange Act into "internal" matters through the Sarbanes-Oxley Act may lead future courts to reach different conclusions regarding the scope of the SEC's power in such matters.

#### 4. *Within Delaware*

In accordance with the above, if a company is listed, the composition and behaviour of its board will to a certain extent be governed by federal rules, and even if it is not listed but must register with the SEC, the conduct of its general meetings and the disclosure required from directors and major shareholders will be governed by the same body of rules. Because the DGCL offers a flexible set of default terms, what remains mandatory with Delaware law are the constitution of the company and matters falling under the rubric "internal affairs", particularly the duties of care and loyalty owed by directors and controlling shareholders to the company and the minority shareholders. Professor Jeffrey Gordon has aptly described laws like the DGCL as containing "four sorts of mandatory rules . . . : procedural, power allocating, economic transformative, and fiduciary standards setting."<sup>321</sup> These categories would include such matters as (*procedural*) establishing a mandatory procedure for calling shareholder meetings, (*allocating*) giving shareholders the right to elect and remove directors, (*transformative*) requiring a shareholder vote on transactions that would change the nature of the corporation, and (*fiduciary*) duties of care and loyalty applied by courts to "to restrain insiders in exercising their discretionary power over the corporation and its shareholders in contingencies not specifically foreseeable and thus over which the parties could not contract."<sup>322</sup> The elaboration of this last category, fiduciary duties, has been the most important contribution of the Delaware courts, particularly through decisions handed down during the second half of 20<sup>th</sup> Century.<sup>323</sup> Allocation of power and the opportunity to vote on major decisions that would affect the nature of the company are provided for in the DGCL, but may be shaped significantly in the certificate of incorporation. The way in which a matter is put up for a vote will be governed by federal proxy rules if the company is registered with the SEC or by a combination of minimalist rules and fiduciary standards under Delaware law if it is not.

<sup>320</sup> LOSS, SELIGMAN & PAREDES, *supra* note 289, at 778 *et seq.*

<sup>321</sup> Jeffrey N. Gordon, *The Mandatory Structure of Corporate Law*, 89 COLUM. L. REV. 1549, 1591 (1989).

<sup>322</sup> *Id.* at 1593.

<sup>323</sup> In the case of Delaware, it is thought that the courts' introduction of stricter fiduciary duties was a reaction to the critical stance taken by former SEC Chairman William Cary in 1974, when he accused the state of leading a "race to the bottom" (*see* William L. Cary, *Federalism and Corporate Law: Reflections on Delaware*, 83 YALE L. J. 663 (1974)). In a landmark decision of 1977, *Singer v. Magnavox Co.*, 380 A.2d 969 (Del. 1977), the Delaware Supreme Court imposed strict fiduciary duties on the management of a parent company in a cash out merger with a subsidiary. *See* Bratton & McCahery, *supra* note 292, at 680.

There is no interaction between Delaware and a lower, local body or a securities exchange. As explained above, national securities exchanges adopt their rules in coordination with the SEC. Although the DGCL does refer to a "Secretary of State," this office has neither the authority to issue statutory instruments nor any significant role in checking the adequacy of a company's request for incorporation. Fraudulent conveyance rules, if applied, would be taken from the law of the State of Delaware or another state, depending on the law applicable to the transaction, or from federal Bankruptcy Law.

## **V. HISTORICAL DEVELOPMENT IN US AND EU COMPANY LAW**

### **A. Internal and External Influences within the System**

Part IV examined the jurisdictional relationships that define legal functions. The analysis was static in that it looked at the rule-giving bodies in each jurisdiction, the areas their respective powers cover, and the relative supremacy of each body. This Part V will examine how the interaction of these jurisdictional components has contributed to evolution of company law in the US and EU legal systems over time. Actions in one jurisdiction cause reactions in other jurisdictions within the system. For example, if the upper level in a legal system orders a sub-unit to desist from regulating an entity based in another sub-unit, this opens the field to competition between the entity forms from the various sub-units. On the other hand, if the upper level imposes its own rules on such entities, the uniformity of rules within the overall system excludes sub-unit competition. In this way, the development of the system as a whole depends on the forces exercised on each system component. The legal nature of the jurisdictions and their sub-units as described in Part IV sets the legally permissible boundaries for this interaction (e.g., the US federal government will never command a state to implement a federal directive). Here, the interaction itself will be examined with reference – but not detailed study – of the exogenous influences that set this system development into motion.

The problem comparisons discussed in Part II.C neglected the importance of some historical influences while over-emphasizing others. In the example from the Origin Theorists, the presence of strong capital markets in the United States and the United Kingdom at the close of the 20<sup>th</sup> Century is attributed to the presence of common law while the presence of weak capital markets in Continental Europe is attributed to the presence of civil law. This theory was seen to have ignored: (i) the strong capital markets in Continental Europe before 1914, (ii) the destructive effects of two world wars on Continental Europe, (iii) the political effects of the Cold War on Continental Europe, (iv) the stimulating effect of capital flight on US markets, and (v) the fact that differences between (rationalist) French culture and (empiricist) British culture run much deeper and wider than differences in the legal systems. When a carefully researched understanding of relevant historical events is seen in the context

of the legally possible jurisdictional actions and reactions,<sup>324</sup> the historical dimension of legal development can be more fully understood.

This Part will discuss the main pressures working to form the development of company law in the United States and Europe by examining jurisdictional interaction on the historical axis. Major political events earlier during the century, such as the world wars and the Cold War, as discussed carefully by Roe in his critique of the Origin Theorists, will be referred to only parenthetically, and emphasis will be placed on the influence of jurisdictional interactions – regulatory competition, planned harmonization, and market-led convergence – which during recent decades have exercised great influence. As this paper attempts to offer a framework for comparing the company laws of Germany, the United Kingdom and Delaware, it will try to isolate similarities and differences in the systematic interaction of the jurisdictions within the European Union and the United States as discussed in the foregoing Part IV.

## **B. US Corporate Law: the Forces of Regulatory Competition**

### *1. A history of gradual growth*

As corporate law in the United States developed in an essentially British society (which excluded the native North Americans) after the close of the colonial period, it did not suffer anything like transplant effects, and the distance between the United States and Europe also kept the United States mostly free of foreign invasion, the imposition of foreign law and the destruction of property through warfare.<sup>325</sup> Corporate law developed side-by-side with the US economy, at first gradually and then rapidly towards the turn of the century. Early corporations were specially chartered by state governments and often provided services on a monopoly basis that a government itself might have traditionally provided.<sup>326</sup> The first enabling statute for business corporations, entitled a law "relative to incorporations for Manufacturing purposes," was enacted by the State of New York in 1811,<sup>327</sup> and similar enabling statutes gradually replaced special chartering as a basis for incorporation. From a comparative point of view, it is particularly meaningful that at the very outset of corporate activity, the US Supreme Court held corporate charters to be constitutionally protected contracts vested with

<sup>324</sup> The importance of the legal framework of course depends on the nature of the historical event. Reactions to economic boom or bust will likely be kept within the constitutionally permissible framework whilst reactions to war and revolution might very well sweep such framework aside.

<sup>325</sup> The major exception to this peaceful growth was the US Civil War between 1861 and 1865, which left the US South largely destroyed and under the administration of an occupation army. The great industrialization and growth in financial markets at the eve of the 20<sup>th</sup> Century mostly bypassed this area. See KENNEDY, *supra* note 114, at 18.

<sup>326</sup> See LAWRENCE M. FRIEDMAN, *A HISTORY OF AMERICAN LAW* 130 (3<sup>rd</sup> ed. 2005).

<sup>327</sup> See *Id.* at 134

protection from arbitrary state interference, thus ensuring private corporations a strong position under the law.<sup>328</sup>

The development of corporation law during the latter half of the 19<sup>th</sup> Century was marked by increasing flexibility and liberalization, with a growing latitude for management decisions.<sup>329</sup> The gradual changes in attitudes towards corporations and business were accompanied by positive attitudes towards securities dealing, which gradually overcame opinions that sought to restrict speculation in securities as an unproductive activity giving rise to deceit.<sup>330</sup> It will be remembered that a US corporation's "internal affairs" are governed by the laws of the state of its incorporation regardless of where it bases its center of administration. In the late 1890's a number of states began to compete for tax revenue by fashioning their corporate laws to attract promoters planning to incorporate new companies and managers who might decide to reincorporate an existing company in a different state.<sup>331</sup> The State of Delaware joined this race after the future US president, Woodrow Wilson, who was then governor of the leading corporate charter state, New Jersey, amended the New Jersey corporate statute to make it less business friendly,<sup>332</sup> which resulted in many New Jersey corporations reincorporating in Delaware, and began Delaware's climb towards the top of the corporate law market.<sup>333</sup> This "regulatory competition" for corporate charters has been a primary engine of development for corporate law until today. The debate on whether such competition creates the best law for society, whether it is a race to the "bottom"<sup>334</sup> or the "top",<sup>335</sup> is still ongoing.

## 2. *A systemic balance of state and federal law*

Regardless of which direction regulatory competition leads, it is a fact of system dynamics that the more corporate law that is enacted by an authority with jurisdiction over the entire territory (here, the federal government), the less matters the territorial sub-units (here, the states) will have on which they can distinguish themselves and compete. An increase in the amount of corporate law found at the federal level thus leads to a decrease in competition among laws at the state level. As discussed above, the federal government has largely avoided regulating corporate "internal affairs". Congress has historically entered the field of company law only after economic and political shocks convinced a significant portion of the national population that state law had failed to prevent insiders from

<sup>328</sup> See *Dartmouth College v. Woodward*, 4 Wheat. 518 (1819).

<sup>329</sup> See FRIEDMAN, *supra* note 326, at 395 *et seq.* and Bratton & McCahery, *supra* note 292, at 627 *et seq.*

<sup>330</sup> See BANNER, *supra* note 203, at 198 *et seq.*

<sup>331</sup> See FRIEDMAN, *supra* note 326, at 399.

<sup>332</sup> Bratton & McCahery, *supra* note 292, at 629.

<sup>333</sup> Bratton & McCahery, *supra* note 292, at 626 *et seq.*

<sup>334</sup> See Cary, *supra* note 323.

<sup>335</sup> See ROBERTA ROMANO, *THE GENIUS OF AMERICAN CORPORATE LAW* (1993).

deceiving outside investors. Thus intervention of the federal government has not eliminated the "equilibrium" of regulatory competition between the states because it has restrained itself from straying too far from mere disclosure rules, and reacted only when its hand was forced by events.<sup>336</sup>

During the period of the great "trusts", such as Standard Oil, and their abuses that marked the end of the 19<sup>th</sup> century, the federal government seriously considered replacing the state corporate statutes with federal law, but the project eventually lost momentum in light of more active antitrust prosecution.<sup>337</sup> After the stock market crash of 1929 and the severe economic depression that followed, the federal government entered the securities field in force with the Securities Act, the Exchange Act (which created the SEC), the Public Utility Holding Company Act of 1935,<sup>338</sup> the Trust Indenture Act of 1939, the Investment Company Act and the Investment Advisers Act of 1940.<sup>339</sup> In 2002, following the revelation of serious accounting misrepresentations by major corporations such as Enron and WorldCom, and the collapse of the stock markets, the federal government enacted the Sarbanes-Oxley Act. This Act sought to reinforce the existing system of disclosure by decreasing conflicts of interest, increasing accountability, and adding new types of disclosures. Conflicts of interest were reduced by strictly controlling the services that auditors could provide to the companies they audit,<sup>340</sup> by inserting an audit committee composed of independent directors into the boards of listed companies,<sup>341</sup> and by flatly outlawing company loans to directors.<sup>342</sup> These were clear incursions into the internal affairs of the regulated companies, but were incursions related to the overall disclosure system. Disclosures were improved by imposing internal checks on the creation of disclosure documents (i.e., accounts) and the persons who were responsible for their preparation. Accountability was increased by requiring chief operating officers and chief financial officers to personally sign required disclosures and attest to the accuracy and completeness of their contents subject to civil and criminal liability.<sup>343</sup>

With regard to the federal element in the regulatory competition system, it will be remembered that bankruptcy law, certain provisions of which serve capital maintenance functions, is federal law,<sup>344</sup>

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<sup>336</sup> Bratton & McCahery, *supra* note 292, at 619 *et seq.*

<sup>337</sup> Lawrence E. Mitchell, "The Creation of American Corporate Capitalism: The First Public Response – The Seeds of a Legislative Solution," pp. 13 *et seq.* (2004), available from SSRN at <http://ssrn.com/abstract=586184>.

<sup>338</sup> The Public Utility Holding Company Act of 1935, 15 U.S.C.A. §§ 79-79z-6 (2000).

<sup>339</sup> The Investment Advisers Act of 1940, 15 U.S.C.A §§ 80b-1-80b-21 (2000).

<sup>340</sup> §§ 201-202 SOA.

<sup>341</sup> § 301 SOA.

<sup>342</sup> § 402 SOA.

<sup>343</sup> §§ 302 and 904 SOA.

<sup>344</sup> Bankruptcy Code, 11 U.S.C. §§ 101-1330 (2000).



and fraudulent conveyances are regulated by a state law usually modeled on the NCCUSL's Uniform Fraudulent Transfer Act. Nevertheless, even when one takes into account the federal elements discussed above, the degree of freedom left to the state corporate statute is still significantly higher than what is left to EU member states. For listed companies, however, the detailed, mandatory listing requirements may bring the respective amounts of breathing room more or less into alignment.

The initial and continued listing requirements of US securities exchanges are indeed quite extensive, and before the 1930's, they attempted to serve the investor protection function later performed by the securities laws and federal rules.<sup>345</sup> They cover a broad range of matters, from the "internal" composition of a company's board<sup>346</sup> and transactions that must be put to the shareholders for approval,<sup>347</sup> to the "external" provision of information to the public,<sup>348</sup> to minimum requirements for total assets and the required public dispersion of the company's shares.<sup>349</sup> These requirements are contractual conditions to a company's listing on a given exchange, and a serious violation of these conditions can lead to a company being expelled from the market through involuntary de-listing.<sup>350</sup> These requirements thus tend to be pervasive and mandatory, and thus further reduce the range of possible competition between the laws of individual states.

### 3. *Outreach statutes and foreign corporations*

The relationships among the US states in the area of company law offer interesting opportunities for comparison with similar relationships in the European Union. Because US state law in this area exists in the shadow of federal power to regulate interstate commerce, the states in their dealings with each other may not enter an area preempted by federal law or unduly impede interstate activity.<sup>351</sup> Courts have sought a balance between a state's reserved and traditional powers to police business within its borders and its obligations under the Constitution. This tension arises in the problem of "foreign" and "pseudo-foreign" corporations. The term "foreign corporation" is used to denote a company established and existing under the laws of a jurisdiction, whether that of a foreign country or

<sup>345</sup> See Coffee, *The Rise of Dispersed Ownership*, *supra* note 92, at 34 *et seq.* (giving a comparative analysis of the shareholder protection provided by the securities exchanges and describing their function in the history of shareholder protection), and Robert B. Thompson, *Collaborative Corporate Governance: Listing Standards, State Law and Federal Regulation*, 38 WAKE FOREST L. REV. 961, 972 (2003) (noting that NYSE rules against watered stock had been in force for members since 1869).

<sup>346</sup> See NYSE LISTED COMPANY MANUAL, *supra* note 279, at para. 303A.01 *et seq.*

<sup>347</sup> See *Id.* at para. 312.03.

<sup>348</sup> See *Id.* at para. 202.00 *et seq.*

<sup>349</sup> See *Id.* at para. 101.01. For an analysis of the NYSE listing process and requirements, see Michael Gruson, Andrew B. Jászky, Jonathan M. Weld, *Issuance and Listing of Securities by Foreign Banks and the U.S. Securities Laws*, in REGULATION OF FOREIGN BANKS (Michael Gruson & Ralph Reisner, eds. 4<sup>th</sup> ed. 2005).

<sup>350</sup> See NYSE LISTED COMPANY MANUAL, *supra* note 279, at para. 8.

<sup>351</sup> See *Edgar*, 457 U.S. 624 and *Pike v. Bruce Church, Inc.*, 397 U.S. 137 (1970).

another state of the United States, other than the state in which it is doing business.<sup>352</sup> Although the term "pseudo-foreign" corporation is not found in statutes, the legal literature uses it to designate a corporation that although incorporated elsewhere, has most of its shareholders and business activity in the host state. Most states require merely that a foreign corporation register with the state and provide an in-state agent who can be served with process papers if a judicial action is filed against the foreign corporation.<sup>353</sup> Some states, however, apply significant parts of their own corporate statutes to pseudo-foreign corporations. For example, California applies rules regarding the election of directors (including by cumulative voting), their duties, and the participation of shareholders in the company to any corporation that is not listed on a national stock exchange if over half of its shareholders of record have California addresses and the company's payroll is mainly paid in the state.<sup>354</sup> New York requires the same type of foreign corporations (i.e., unlisted companies with significant operations in the state) to provide information to shareholders and applies New York law to actions against and liability of company directors.<sup>355</sup>

The power that states have to impose such requirements on corporations formed under the law of another state has not been clearly defined,<sup>356</sup> but is considered to be extensive. A state may completely ban foreign corporations from operating within state territory,<sup>357</sup> but may not deprive such corporations of their constitutional rights or interfere with interstate commerce (thus foreign corporations retain the right to do business *through* state territory).<sup>358</sup> There is no authoritative federal court decision on whether a state may regulate the internal affairs of a corporation in the manner done by the laws of California and New York, although there has been considerable speculation on the matter.<sup>359</sup> Aside from a finding that such statutes interfere with interstate commerce or are preempted

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<sup>352</sup> See e.g., Del. Code Ann. tit. 8, § 371(a) and § 1.40(10) RMBCA.

<sup>353</sup> See e.g., Del. Code Ann. tit. 8, § 371(b) and § 15.03(a) RMBCA.

<sup>354</sup> § 2115 California Corporations Code.

<sup>355</sup> §§ 1315-1320 New York Business Corporation Law.

<sup>356</sup> See remarks of Prof. John C. Coffee, Jr., John C. Coffee, Jr., in John C. Coffee, Jr., *et al. Symposium: The Direction of Corporate Law: The Scholar's Perspective*, 25 DEL. J. CORP. L. 79, 103 (1999). One of the most detailed analyses of this state-to-state relationship has been written in German. See STEFAN KLEIN, *DIE RECHTSSTELLUNG AUSWÄRTIGER GESELLSCHAFTEN IM DEUTSCHEN UND US-AMERIKANISCHEN RECHT* (2004).

<sup>357</sup> See FLETCHER (2005), at § 8386, and 36 AM. JUR. 2<sup>D</sup> FOREIGN CORPORATIONS § 182 (2001), and also see *Railway Express Agency, Inc. v. Virginia*, 282 U.S. 440 (1931) and *Eli Lilly & Co. v. Sav-On-Drugs, Inc.*, 366 U.S. 276, 279 (1961).

<sup>358</sup> See e.g., *Phillips Petroleum Co. v. Jenkins*, 297 U.S. 629, 56 S.Ct. 611 (1936); *Furst v. Brewster*, 282 U.S. 493, 51 S.Ct. 295 (1931); *Cudahy Packing Co. v. Hinkle*, 278 U.S. 460, 49 S.Ct. 204 (1929); FLETCHER CYCLOPEDIA OF PRIVATE CORP. *Foreign Corporations* § 8388 (2005); and 36 AM. JUR. 2<sup>D</sup> FOREIGN CORPORATIONS § 192 (2001).

<sup>359</sup> See Richard M. Buxbaum, *The Threatened Constitutionalization of the Internal Affairs Doctrine in Corporation Law*, 75 CAL. L. REV. 29 (1987); Willis L.M. Reese & Edmund M. Kaufman, *The Law Governing Corporate Affairs: Choice of Law and the Impact of Full Faith and Credit*, 58 Colum. L. Rev.

by an expanding federal regulation of corporations,<sup>360</sup> there is little constitutional basis for challenging the statutes. First, a principal constitutional tool for guaranteeing the citizens of one state certain freedoms and rights in another state, the "privileges and immunities clause" of the US Constitution,<sup>361</sup> has been held not to apply to corporations.<sup>362</sup> Second, no federal decision has authoritatively applied another potentially applicable constitutional provision, the "full faith and credit clause,"<sup>363</sup> to guarantee that the structure of internal affairs governance of a corporation created in one state be respected in such form in another state.<sup>364</sup> It is important for this question that pseudo-foreign corporation laws of the type used in California have already existed without significant challenge for about 50 years, making it unlikely that they would be struck down on any ground other than federal preemption – if federal rules on internal affairs continue to expand as they have in the Sarbanes-Oxley Act and in the very unlikely event that they would apply to *unlisted* companies. Given that state courts do not have ultimate authority in matters of federal constitutional law, the predictable assertions of authority that have been made by the Delaware and California courts should not be given undue weight on this issue.<sup>365</sup>

Therefore, although cases addressing possible conflicts between *federal* and state law have stressed that because corporations are "creatures of the states," state law should be given considerable deference in questions of internal affairs,<sup>366</sup> this does not necessarily mean that such deference must be given in equal degree if there is a conflict between two *states* with regard to "foreign" corporations

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1118 (1958); Donald C. Langevoort, *The Supreme Court and the Politics of Corporate Takeovers: A Comment on CTS Corp. v. Dynamics Corp. of America*, 101 HARV. L. REV. 96 (1987), and KLEIN (2004), at 360 *et seq.*

<sup>360</sup> On this question, *see* Langevoort, *The Supreme Court*, *supra* note 359, at 110 *et seq.*

<sup>361</sup> U.S. Const., art. IV, § 2 ("The Citizens of each State shall be entitled to all Privileges and Immunities of Citizens in the several States.").

<sup>362</sup> *See* Bank of Augusta v. Earle, 38 U.S. 519 (1839), discussed in GEVURTZ, *supra* note 153, at 37-38, and Pembina Consol. Silver Mining & Milling Co. v. Pennsylvania, 125 US 181, 8 S Ct 7 (1888).

<sup>363</sup> U.S. Const., art. IV, § 1 ("Full Faith and Credit shall be given in each State to the public Acts, Records, and judicial Proceedings of every other State.").

<sup>364</sup> For a thorough, recent discussion (in German), *see* KLEIN (2004), at 383 *et seq.* and for older treatment by US scholars, *see* Buxbaum, *supra* note 359, at 43 *et seq.* and Reese & Kaufman, *supra* note 359, generally.

<sup>365</sup> *See* Draper v. Paul N. Gardner Defined Plan Trust, 625 A.2d 859, 665-66 (1993) (In a case involving a Delaware corporation doing business primarily in California, it was necessary to decide whether California or Delaware law controlled the standard for dismissing a derivative suit filed by a shareholder, and the Delaware Supreme Court found that the matter was governed by Delaware law, asserting that application of the internal affairs doctrine is mandated by constitutional principles, except in "the rarest situations.") The courts of California, on the other hand, have approved imposing their cumulative voting provisions on pseudo-foreign corporations (*Wilson v. Louisiana-Pacific Resources, Inc.*, 138 Cal. App. 3d 216, 187 Cal. Rptr. 852 (1982)), and applied conflicting, Californian rules on shareholder information rights to Delaware corporations (*Valtz v. Penta Investment Corp.*, 188 Cal. Rptr. 922 (1983)).

<sup>366</sup> *See* CTS, 481 U.S. at 86, and *Green*, 430 U.S. at 479.

that base their operations in the host state. This has led the states to adopt provisions on "foreign" corporations that vary in the requirements that they impose on such companies. As will become clear in Part V.B, US states have a considerably freer hand than their EU member state counterparts under the decisions of the ECJ in regulating the presence of "foreign" corporations doing business on their soil.<sup>367</sup> Nevertheless, given the degree to which company law has – and is still being – harmonized throughout the European Union, the "threat", if any, that foreign companies pose to host member states is probably smaller than what might be imagined in the United States.

#### 4. *A foreseeable future of stable development*

In the United States, the comparatist can look back on a 200 year history of company law that has not been significantly interrupted by war or tumultuous ideological turnarounds. The long-term trend has been for authority to gradually pass from the states to the federal government. States, originally held back by various cultural, economic and political forces, entered the fray to compete for franchise revenues by loosening their grip on companies until abuses and market breakdowns provoked federal action, such as the "trust busting" at the turn of the 20<sup>th</sup> Century, the enactment of the securities laws in the 1930's, the various amendments and rules added to the latter over the decades, and most recently the Sarbanes-Oxley Act of 2002. Professors William W. Bratton and Joseph A. McCahery see "no political incentives that might encourage federal micromanagement of the charter market." They observe: "Failing that, corporate federalism remains robust, so long as the federal government and stock exchanges continue to refrain from allocating to themselves so much subject matter as to cause Delaware's customers to question the efficacy of their rent payments."<sup>368</sup> Along these lines, the future shape of US company law will likely be decided by a combination of the stability of the securities markets and the popular weight of the respective arguments for and against state chartering. Those arguments may well be led in person or by the intellectual successors of Prof. Lucien A. Bebchuk in one corner and Prof. Roberta Romano in the other. Romano has convincingly argued that market forces lead the way to higher quality law:

[T]he diffusion of corporate law reform initiatives across the states [leads to] . . . experimental variation regarding the statutory form thought to be best suited for handling a particular problem, followed by a majority of states eventually settling upon one format. . . . The dynamic production of corporation laws exemplifies how federalism's delegation of a body of law to the states can create an effective laboratory for experimentation and innovation. . . . Innovation enhances revenues from charter fees and the local corporate bar's income from servicing local clients.<sup>369</sup>

<sup>367</sup> See Part III.B.1 of this paper.

<sup>368</sup> Bratton & McCahery, *supra* note 292, at 696.

<sup>369</sup> Roberta Romano, *The States as a Laboratory: Legal Innovation and State Competition for Corporate Charters*, 23 Yale J. on Reg. 209, 246 *et seq.* (2006).

Nevertheless, Bebchuk has countered that such market forces are driven by the interests of the constituencies in control of corporations, not by the general good:

[There is a] divergence between the interests of managers and controlling shareholders and the interests of public shareholders. . . . managers may well seek, and states in turn may well provide, rules that . . . serve the private interests of managers and controlling shareholders. . . . states seeking to attract incorporations have an incentive to focus on the interests of shareholders and managers, they will tend to ignore the interests of other parties. As a result, state competition may well produce undesirable rules whenever significant externalities are present.<sup>370</sup>

This argument is unlikely to be settled in the near future. The comparative view from Europe, however, is relatively clear. It is safe to say that the manner in which the US states and federal government have engaged in and reacted to diversity in company law among the individual states and the need to develop uniform rules has been and will continue to be markedly different from the process in Europe.

### **C. Company Law in Europe: Integration by Chance and by Choice**

#### *1. Historical influences preceding EU market integration*

In 1811, as New York was adopting the first US corporate law statute, the Duke of Wellington was in Portugal fighting armies allied with Napoleon Bonaparte, who controlled most of Continental Europe.<sup>371</sup> As would be the case for many wars to come, the financing for the military campaigns waged from Brittany to Moscow was arranged in London, and it was at this time that the Rothschild brothers began their banking career by channeling currency to the Duke of Wellington and transferring subsidy payments from London to Britain's various European allies.<sup>372</sup> Thus, although Britain was deeply involved in a number of major conflicts that had a much lesser effect on the United States, these conflicts tended to strengthen its centrality as a corporate and financial center. Indeed, in a first of many transactions to come, the Rothschild brothers arranged a Sterling denominated bond issue for war torn Prussia in 1818, creating what Prof. Niall Ferguson calls a "watershed in the history of the European capital market . . . . [a] deliberate Anglicisation of a foreign loan . . . a new departure for the international capital market."<sup>373</sup> Such developments solidified and further developed corporate and financial structures that had been originally devised in the British overseas trading companies like the Massachusetts Bay Company and the East India Company,<sup>374</sup> and thus neither British markets nor

<sup>370</sup> Lucian Arye Bebchuk, *Federalism and the Corporation: The Desirable Limits on State Competition in Corporate Law*, 105 Harv. L. Rev. 1435, 1509 (1992).

<sup>371</sup> Richard Holmes, "Wellington, Arthur Wellesley, Duke of," in *THE OXFORD COMPANION TO MILITARY HISTORY*, ed. Richard Holmes (Oxford 2001).

<sup>372</sup> NIALL FERGUSON, *THE HOUSE OF ROTHSCHILD: MONEY'S PROPHETS, 1798-1848* 85 *et seq.* (1998).

<sup>373</sup> *Id.* at 124.

<sup>374</sup> Margaret Wilkinson, "companies, trading," in *THE OXFORD COMPANION TO BRITISH HISTORY*, ed. John Cannon (Oxford 1997).

British company law was affected by the kind of devastating shocks that Roe describes in his article discussed in Part II.C, above.

Germany had a very different experience. Following the French occupation referred to above, the gradual unification of the German states, which was greatly accelerated and completed by Otto von Bismarck in 1871,<sup>375</sup> roughly coincided with the adoption of the first German Stock Corporation Act in 1870,<sup>376</sup> which was an enabling statute rather than a system of concessions.<sup>377</sup> Prof. Alfred Chandler has compared this period to a similar industrial expansion and search for corporate vehicles that could amass large quantities of capital taking place in the United States.<sup>378</sup> Thereafter, however, any comparison with either the United States or the United Kingdom is impossible. No country experienced greater swings of events, legislation and ideology in the 20<sup>th</sup> Century than Germany. In 1914, German stock markets boasted more listed companies than the United States.<sup>379</sup> Yet during a mere thirty years from 1919 to 1949, the German state abruptly jolted through five forms of government: from a monarchy to a democracy to a Nazi dictatorship,<sup>380</sup> and then split into two separate governments, one democratic and the other communist.<sup>381</sup> As Nazi ideology came to dominate Germany, legal scholars advocated the idea of having a strong leader (a *Führer*) on company boards, and the position of a Chairman/CEO who could override the will of his board was introduced into the *Aktiengesetz* in 1937.<sup>382</sup> Following the Second World War, US and British occupation forces also advocated changes to German company law in the image of their own laws, such as by introducing registered shares,<sup>383</sup> and when occupation was finished, Germany set out to create one of the most labour-friendly company laws in history.<sup>384</sup> Following the Cold War, Germany essentially adopted an

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<sup>375</sup> See LOTHAR GALL, *BISMARCK, DER WEIßE REVOLUTIONÄR* 449 *et seq.* (2001).

<sup>376</sup> This was the first *German* corporate statute mainly because Germany as a state was just coming into existence. The first corporate statute in Germany was the Prussian statute, which existed since 1848. See THEODOR BAUMS (ed.), *GESETZ ÜBER DIE AKTIENGESELLSCHAFT FÜR DIE KÖNIGLICH PREUBISCHEN STAATEN VOM 9. NOVEMBER 1843* (1981).

<sup>377</sup> See Semler, *supra* note 124, at Intro., margin no. 21.

<sup>378</sup> ALFRED CHANDLER, *SCALE AND SCOPE: THE DYNAMICS OF INDUSTRIAL CAPITALISM* 428 *et seq.* (1990). See also Brian R. Cheffins, *Mergers and Corporate Ownership Structure: The United States and Germany at the Turn of the 20th Century*, 51 *Am. J. Comp. L.* 473 (2003).

<sup>379</sup> See Erik Nowack, *Investor Protection and Capital Market Regulation in Germany*, in *THE GERMAN FINANCIAL SYSTEM* 425, 426 (Jan Pieter Krahen & Reinhard H. Schmidt, eds. 2003).

<sup>380</sup> See e.g., MICHAEL STOLLEIS, *GESCHICHTE DES ÖFFENTLICHEN RECHTS IN DEUTSCHLAND: WEIMARER REPUBLIK UND NATIONALSOZIALISMUS* 74, 316 (2002).

<sup>381</sup> See GOLO MANN, *DEUTSCHE GESCHICHTE DES 19. UND 20. JAHRHUNDERTS* 981 (1992)

<sup>382</sup> Semler, *supra* note 124, at Intro., margin no. 26.

<sup>383</sup> See Hanno Merkt, *Die Geschichte der Namensaktie*, in *DIE NAMENSAKTIE* 83 *et seq.* (R. von Rosen & W. Seifert, eds. 2000).

entire framework of securities and takeover legislation<sup>385</sup> and amended its corporate law significantly as recommended by a panel of experts to bring it in line with international best practice,<sup>386</sup> which was often quite similar to US practice. Extreme currents of history no longer buffet Germany, and it is reasonable to assume that in the foreseeable future the development of German company law will be influenced most by the integration of the European and world markets and actions taken through or together with the European Union.

## 2. Market integration from harmonization to competition

Part IV.A explained in some detail how European directives shaped the company laws legislation of the member states beginning in 1968. This program has substantially harmonized the laws governing public companies and created a system of securities laws that is nearly identical across the Union. About the time that this drive to harmonization was beginning to wane, a new preference for home country rule and subsidiarity came upon Europe,<sup>387</sup> partly from the judicial initiative of the ECJ,<sup>388</sup> and partly in connection with the politics of introducing majority rule through the Single European Act.<sup>389</sup> The harmonization process stopped. However, a series of ECJ decisions beginning in 1999 and decided on the basis of the right of establishment guaranteed companies in Articles 43 and 48 of the EC Treaty made deep cuts into the national company laws of the member states, including Germany. As the substance of *public* companies, particularly the creation and maintenance of their capital, has been harmonized, the relevant cases arose in respect of *private* companies.

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<sup>384</sup> The Law on Co-Determination of Employees in the Supervisory Boards and Management Boards of Enterprises Engaged in the Mining Iron and Steel Industries was adopted in 1951, the Works Constitution Act was adopted in 1952 and the Co-Determination Act of 1976 was adopted in that year. See a brief discussion of co-determination in Part III.A, above.

<sup>385</sup> The Securities Trading Act was adopted in 1994, the Securities Prospectus Act was adopted in 1998, the Takeover Act was adopted in 2001, and the Exchange Act was thoroughly reformed in 2002.

<sup>386</sup> See THEODOR BAUMS, ed., BERICHT DER REGIERUNGSKOMMISSION CORPORATE GOVERNANCE: UNTERNEHMENSFÜHRUNG, UNTERNEHMENSKONTROLLE, MODERNISIERUNG DES AKTIENRECHTS (REPORT OF THE GOVERNMENT COMMISSION ON CORPORATE GOVERNANCE) (2001).

<sup>387</sup> See Timmermans, *supra* note 219, at 626 *et seq.* and Grundmann, *supra* note 219, at 617, arguing that the principle of home rule is essentially disclosure or information-oriented in nature.

<sup>388</sup> A major breakthrough in the philosophy of home country rule came in the famous *Cassis de Dijon* movement of goods case, Case 120/78, Rewe-Zentrale AG v. Bundesmonopolverwaltung für Branntwein [1979] ECR 649.

<sup>389</sup> The "Single European Act" was a political commitment signed in 1986 to create a single, integrated European market ("an area without internal frontiers in which the free movement of goods, persons, services and capital is ensured") by 1992. Among other things, it introduced voting by qualified majority on a number of matters that had required unanimity and were consequently deadlocked, addressed increased cooperation as a monetary union, and gave more power to the European Parliament. See CRAIG & DE BÚRCA, *supra* note 6, at 12 *et seq.*

In *Centros Ltd. v. Erhvervs- og Selskabsstyrelsen*,<sup>390</sup> the ECJ found that Denmark must allow a UK private limited company freely to establish itself in its territory, even if Danish citizens used the company for the sole purpose of evading Denmark's stricter laws on capital adequacy and conducted none of the company's business in the United Kingdom.<sup>391</sup> In *Überseering BV v Nordic Construction Company Baumanagement GmbH*,<sup>392</sup> the ECJ found Germany's conflict of laws rules as they had been applied to a Dutch company to impede freedom of establishment. Unlike the United States, which applies the "incorporation theory,"<sup>393</sup> meaning that the internal affairs of a corporation are governed by the laws of its state of incorporation, Germany has traditionally applied the "real seat" (or *siège réel*) theory, meaning that the internal affairs of a corporation are governed by the laws of the state where it has its center of administration.<sup>394</sup> The application of the real seat theory to a Dutch company whose shares came to be owned by Germans and which was operated in Germany, resulted in the German courts applying German law to the company, finding that it was not properly constituted and registered as a German corporation, and then denying it the legal capacity to sue in a court of law.<sup>395</sup> The ECJ, following its decision in *Centros*, found that denying a company duly formed in another member state legal capacity to be party to legal proceedings was "tantamount to an outright negation of the freedom of establishment conferred on companies by Articles 43 and 48" of the EC Treaty.<sup>396</sup> The Court rejected Germany's argument that application of its own company law to pseudo-foreign corporations was justified because it enhanced legal certainty, and the protection of creditors and minority shareholders.<sup>397</sup> It is unclear whether the *Überseering* decision has changed Germany's conflict of laws rules for corporations, the substantive law that results from their application, or both.<sup>398</sup> The seat theory will remain for companies incorporated outside of the European Union unless a friendship treaty applies,<sup>399</sup> or legislation currently being discussed in Germany to adopt the incorporation theory

<sup>390</sup> Case No. C-212/97, *Centros Ltd v Erhvervs- og Selskabsstyrelsen*, [1999] ECR I-01459.

<sup>391</sup> *Centros*, [1999] ECR I-01459, at par. 39.

<sup>392</sup> Case C-208/00, *Überseering BV v Nordic Construction Company Baumanagement GmbH*, [2002] ECR I-09919.

<sup>393</sup> SCOLES et. al., *supra* note 152, at § 23.2.

<sup>394</sup> See Wulf-Henning Roth, *From Centros to Ueberseering: Free Movement of Companies, Private International Law, and Community Law*, 52 ICLQ 175, 180-81 (2003), and SCOLES et. al., *supra* note 152, at § 23.1. According to Prof. Roth, the "center of administration" as understood in Germany is "the location where the internal management decisions are transformed into the day-to-day activities of a company." *Id.* at 181, citing the decision of the German High Federal Court reported in the German Federal Law Reporter on Civil Cases (BGHZ), vol. 97, p. 269, at 272.

<sup>395</sup> *Überseering*, [2002] ECR I-09919, at pars. 6-12.

<sup>396</sup> *Überseering*, [2002] ECR I-09919, at par. 93.

<sup>397</sup> *Überseering*, [2002] ECR I-09919, at pars. 83-94.

<sup>398</sup> Roth, *supra* note 394, at 207-208.



also applies to non-EU companies. In its next, major decision in this area, *Kamer van Koophandel en Fabrieken voor Amsterdam and Inspire Art Ltd.*,<sup>400</sup> the ECJ held that a Dutch outreach statute against pseudo-foreign corporations was inconsistent with the EC Treaty. The statute required the branches of companies incorporated abroad to make disclosures beyond those provided for in the Eleventh Company Law directive, and imposed unlimited liability as a penalty for a failure to comply with these and other requirements, such as a minimum capital requirement.<sup>401</sup> From the perspective of a comparative analysis with US federalism, the *Inspire Art* decision is interesting in that it is based both on freedom of establishment (which is not guaranteed for companies by the US Constitution),<sup>402</sup> and the theory that member state action has been expressly preempted by an EU directive,<sup>403</sup> which is the strongest theory for invalidating state law under the US Constitution.

Under the ECJ decisions in the cases such as *Centros*, *Überseering*, and *Inspire Art*, member state laws will be unlawful if they burden the freedom of establishment of a company formed under the laws of another member state, unless the laws of the host state remain with the criteria set forth in *Gebhard v Consiglio dell'Ordine degli Avvocati e Procuratori di Milano*, which require that the law be:

- applied in a non-discriminatory manner,
- justified by imperative requirements in the public interest,
- suitable for securing the attainment of the objective which they pursue, and
- not go beyond what is necessary in order to attain it.<sup>404</sup>

The vertical impact of these decisions is to apply a clear principle of supremacy of EU law over member state national company law, and the horizontal impact is to create standards that a member state may use in assessing the permissibility of the impact of its company law and related legislation may have on companies formed under the law of another member state. One clear rule from the decisions is that although member states may protect themselves from fraudulent actions by foreign companies, the deliberate use of a system of company law that relies on disclosure, especially one

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<sup>399</sup> For example, the friendship and commerce treaty between the United States and Germany provides in Article VII that "[n]ationals and companies of either Party shall be accorded, within the territories of the other Party, national treatment with respect to engaging in all types of commercial, industrial, financial and other activity for gain, whether in a dependent or an independent capacity, and whether directly or by agent or through the medium of any form of lawful juridical entity. for the recognition of companies and their right to enter and trade in the jurisdiction." Treaty of Friendship, Commerce and Navigation, July 14, 1956, U.S.- Germany, art. VII, 7 U.S.T. 1839.

<sup>400</sup> *Inspire Art* [2003] ECR I-10155.

<sup>401</sup> *Inspire Art*, [2003] ECR I-10155, at par. 143.

<sup>402</sup> See subsection A.2, of this Chapter.

<sup>403</sup> *Inspire Art*, [2003] ECR I-10155, at pars. 66-72.

<sup>404</sup> *Gebhard v Consiglio dell'Ordine degli Avvocati e Procuratori di Milano* [1995] ECR I-4165, par. 37.

found in the First and Eleventh Company Law Directives, rather than legal capital, to protect creditors does not constitute such fraudulent action.<sup>405</sup>

### 3. *A curious twist for EU securities law*

Especially from a comparative point of view, EU securities law currently offers an interesting chance for observation. A securities exchange is essentially an organized market with specific rules for entry, and these rules apply only to persons participating in or listed on the market. This "market oriented" logic is the foundation for the theory on the "bonding" function of dual listing<sup>406</sup> and has traditionally governed rules for applying securities law.<sup>407</sup> The applicability of a nation's securities laws is usually determined by a trader's or a vendor's entrance into that nation's territory or market. The US Regulation S,<sup>408</sup> for example, takes the rational step to remove sales of securities from US supervision if no offers or sales are made to persons in the United States and the US market is not conditioned for sales of the securities through "directed selling efforts" in the United States.<sup>409</sup> Unlike the rules governing a corporation's "internal affairs" – which under the incorporation theory are derived from the state of incorporation and travel with the corporation wherever it goes – the rules applicable to the *sale* of securities had been derived from the place of sale. However, in an interesting twist that locks securities law and company law together, the EU Transparency Directive has turned this traditional rule around with respect at least to disclosure rules. Under the title "Integration of securities markets," Article 3 of that Directive provides:

1. The home Member State may make an issuer subject to requirements more stringent than those laid down in this Directive. The home Member State may also make a holder of shares . . . subject to requirements more stringent than those laid down in this Directive.
2. A host Member State may not . . . as regards the admission of securities to a regulated market in its territory, impose disclosure requirements more stringent than those laid down in this Directive or in Article 6 of [the Market Abuse Directive].<sup>410</sup>

<sup>405</sup> See Timmermans, *supra* note 219, at 633.

<sup>406</sup> For a classic discussion of the bonding function, see Coffee, *Future*, *supra* note 52, at 691 *et seq.*, and for a more recent discussion, see Laurent Frésard & Carolina Salva, "Does Cross-listing in the U.S. Really Improve Corporate Governance? Evidence from the Value of Corporate Liquidity" (Sept. 2007) EFA 2007 Ljubljana Meetings Paper Available at SSRN: <http://ssrn.com/abstract=958506>.

<sup>407</sup> See e.g., EU Market Abuse Directive, Art. 10.

<sup>408</sup> See 17 CFR §230.901 *et seq.*

<sup>409</sup> See Meritt B. Fox, *The Political Economy of Statutory Reach: U.S. Disclosure Rules in a Globalizing Market for Securities*, 97 MICH. L. REV. 696, 708 *et seq.* (1998).

<sup>410</sup> EU Transparency Directive (2004/109/EC), Art. 3. The law applicable under the Market Abuse Directive retains the traditional market orientation approach and is that of the member state in which the securities are listed on a regulated market. EU Market Abuse Directive, 2003/6/EC, Art. 10. Also see Enriques & Tröger, *supra* note 240, at 22.

For EU issuers of equity securities, the "home member state" is the state of its registered office,<sup>411</sup> which would be the state of incorporation. As a result, EU issuers will carry any disclosure obligations exceeding the EU floor with them regardless of the market on which their securities are traded. This reverses the traditional choice of law rule for securities regulation, advances the need to consider a venue for listing to the time of incorporating the company, and adds an element that will be taken into consideration in regulatory competition between member states. As Prof. Eilís Ferran has observed, this regime removes competition with respect to home state issuers because they will be locked into any higher standard of disclosure, but could exactly for this reason create a flight to re-incorporate in states where securities regulators have the strongest reputations.<sup>412</sup> Depending on whether private remedies seeking civil liability in connection with securities fraud are codified within securities laws themselves or in general remedies for misrepresentation or fraud, differences in such remedies (potential plaintiffs or defendants, standards of culpability, or matters of proof and causation) could reinforce or counteract this migratory pressure. Following a detailed survey of EU securities legislation in connection with provisions on applicable law, Professors Luca Enriques and Tobias H. Tröger conclude that considerable latitude for regulatory arbitrage exists in Europe "with regard to the regime of private liability for false statements in disclosure documents, the public administration and enforcement of securities laws in general, and less densely harmonized takeover law."<sup>413</sup> Regulatory competition in European securities law could thus contribute more to future competition for company charters than the differences in corporate law statutes.

This type of competition may also add diversity to markets. Under the Transparency Directive a company incorporated in Germany and listed on the London Stock Exchange will under UK law be subjected to rules no stricter than the those provided for by the European Community, but if Germany were to impose stricter rules on its own companies, the stock of the German company could compete against that of the UK companies *on the UK market*. This could potentially have an effect similar to market segments, such as the LSE's "Main Market" and AIM (Alternative Investment Market),<sup>414</sup> or Frankfurt's "prime standard."<sup>415</sup> By allowing securities to fly different national flags that can legally signal stricter governance, securities regulation and stock exchange rules in Europe could – rather than levelling regulatory competition as in the United States – actually increase it. This would offer new possibilities for states to compete in the charter market while all but eliminating competition between national exchanges.

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<sup>411</sup> EU Transparency Directive (2004/109/EC), Art. 3.

<sup>412</sup> FERRAN, *supra* note 208, at 154.

<sup>413</sup> Enriques & Tröger, *supra* note 240, at 58.

<sup>414</sup> The London Stock Exchange, Annual Report 2007, 12 *et seq.*

<sup>415</sup> Rules of the Frankfurt Stock Exchange, §§ 60 *et seq.*

#### 4. *A future for regulatory competition of corporate law in Europe?*

By rolling back the member state regulation of foreign corporations affecting freedom of establishment, the ECJ opened the gates to significant regulatory competition of company law. Indeed, as discussed above, scholarly speculation in recent years has focused only on whether the motivational and legal conditions for regulatory competition exist in Europe,<sup>416</sup> not on the legality of the competition itself. Disclosure and securities fraud regimes could provide such a motive. For the private companies addressed by the recent ECJ decisions, however, as Prof. Theodor Baums, a member of the European Commission's advisory group of non-governmental experts on corporate governance and company law, has observed, even though the Commission is moving away from harmonized regulation,<sup>417</sup> the proposed creation of a European Private Company "could well take the form of a regulation so as to create a true organizational form that can be used in all member state."<sup>418</sup> The existence of such an entity under EU law would greatly reduce incentives for state competition among private companies. For public companies, a European task force set out in 2007 to create a "European Model Company Law Act" comparable to the US Model Business Corporation Act.<sup>419</sup> Such a model act would offer member states a chance voluntarily to harmonize that part of company law which has not already been shaped by directives and the decisions of the ECJ. Especially for the newer and smaller member states, this type of pre-packaged legal expertise could prove extremely attractive.<sup>420</sup> Given the currently foreseeable range of technical possibilities in company law, the pressure of internationally active investors to seek ever-increasing uniformity in securities regulation, the possible introduction of an EPC, and the creation of a European Model Company Act, the space for competitive signaling will likely become even smaller than it is now. However, as it has in the past, competition can always still arise in connection with unforeseen innovations, and the possibility of flagged securities competing on a single exchange – thus replicating the work done by market segments with different listing standards – is a very interesting development. None of these possibilities should be excluded by the comparatist examining company law in the European Union.

## VI. CONCLUSION

This paper has attempted to provide guidance in approaching comparative company law. It identifies some common errors that occur in comparative law, offers some guidelines to help avoid such errors, and provides a framework for entering into studies of the company laws of three major

<sup>416</sup> See e.g., Armour, *supra* note 131, and Enriques & Tröger, *supra* note 240.

<sup>417</sup> Theodor Baums, "European Company Law Beyond the Action Plan," ECGI Working Paper 81/2007 (March 2007), at 9 *et seq.*

<sup>418</sup> *Id.* at 16.

<sup>419</sup> See Theodor Baums, *The European Model Company Law Act Project*, [available currently in German as ILF Working Paper no. 75, January 2008] (2008).

<sup>420</sup> *Id.* at [5].

jurisdictions. Part I discusses some of the problems that can arise in comparative law and offers a few points of caution. These approach coordinates aspire to be useful for practical, theoretical and applied (legislative) comparative law. Part II presents some relatively famous, concrete examples of comparative analysis gone astray, and the debate they generated, in order to demonstrate the utility of heeding the approach coordinates. It further explains how "anecdotal" comparisons, simplified or deductive comparisons and comparisons with strong prejudices yield little knowledge about the legal systems they analyze. Part III provides an example of using functional definition to demarcate the area to be compared, here, "company law", offering an "effects test" to determine whether a given provision of law should be considered as functionally part of the rules that govern the core characteristics of companies. It does this by presenting the relevant company law statutes and related topical laws of Germany, the United Kingdom and the United States, using Delaware as a proxy for the 50 states. Part IV analyzes the field of functions that comprises "company law" in the United States and the European Union. It selects as the predominant factor for consideration the jurisdictions, sub-jurisdictions and rule-making entities that have legislative or rule-making competence in the relevant territorial unit, analyzes the extent of their power, presents the type of law (rules) they enact (issue), and discusses the concrete manner in which the laws and rules of the jurisdictions and sub-jurisdictions can *legally* interact. Part V looks at the way these jurisdictions do interact on the temporal axis of history, that is, their actual influence on each other, which in the relevant jurisdictions currently takes the form of regulatory competition and legislative harmonization. An understanding of the type of historical development a particular jurisdiction has experienced and is currently living clarifies not only possible causal connections between legislative changes and changes in legal systems, but gives a better insight into how the respective countries and jurisdictions can be usefully compared. This Part concludes with the finding that a mild form of regulatory competition can be expected to characterize the development of company law in the United States and that a judicially led opening of competition may be tempered by an increasing uniformity in company vehicles, although the future competition of various national securities on a single securities market presents interesting possibilities in Europe.

This paper would give an explanatory framework that can be filled in with more detailed analysis. The potential influence of certain constituencies on the bodies responsible for certain types of rules in each jurisdiction and the effects of linking an ever-greater number of sub-jurisdictions within inter- or supranational frameworks are examples of such detailed analysis. Economic, historical and political studies, in particular, would have to accompany any conclusions worked out within the framework presented. This paper offers an "approach" to comparative company law that can also serve as an "introduction" to comparing the company laws of the United Kingdom, the United

States and Germany. As is the task of scholarship generally, it hopes to clear the way for future progress in the field. As information on foreign law is sometimes rather difficult to find, it also attempts to provide as much detailed information as possible in its analysis of US, German and UK law.

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Abs. 1 KWG  
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