

# The Delaware effect

## *EU Company Law*

### Exam question

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Explain the so called “Delaware-effect”. Is there a risk of a Delaware effect in the European Union?

### The Delaware-effect

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#### Delaware effect

- A scenario in which MS compete to attract (re)incorporations.
- Delaware's legal regulations have made it the leading incorporating State in the U.S.
  - The Delaware Division of Corporations (2007)
    - “Delaware presently serves as the State of incorporation for 58 % of publicly traded companies and 59 % of Fortune 500 companies.”
  - (Delaware’s company law has been rather lax compared to that of other states.)

#### Company law: U.S. vs. EU

- U.S.:
  - Regulation of Companies is conducted at the state level.
    - Thus, each state has its own corporate laws.
    - Conflict of laws rules in the United States allow competition.
      - U.S. states apply the internal affairs doctrine, whereby a corporation is governed by the law of the state in which it is incorporated.
  - Primarily regulate the relationships between the shareholders and the directors.
- EU:
  - In the absence of harmonization, the power to regulate companies is vested in the MS.
  - (To a certain degree) a compromise accepted by the different MS out of regard for the superior goals of the Union.
    - EU regulation reflects the national interpretations of corporate law and what is taken into consideration by the national laws.
    - Also concern creditors and employees.
      - Employee protection is regulated in a number a MS (Germany the most), and to some degree in the directives.

#### Forum-shopping

- The practice of choosing the most favorable jurisdiction or court in which a claim may be heard.
- Technically, the correct jurisdiction and venue.
- This decision is based on which court is likely to consider the case most favorably.
- It often involves weighing a number of factors, including proximity to the court, the reputation of the judge in the particular legal area, the likely type of available jurors, and subtle differences in governing law and procedure.

#### Regulatory competition

- The process whereby regulators deliberately set out to provide a more favorable regulatory environment in order to promote the competitiveness of domestic industries or to attract more business activities from

abroad.

- Legislation becomes a competitive parameter which a state uses to create competitive advantages for itself in competing for inward investment and other economic benefits.
- There will be regulatory competition when states compete to offer legislation with the characteristics that users demand.
  - Most often low-cost regulation.
- → Often results in deregulation.
- **Precondition:**
  1. MS should freely be able to offer competitive company law to attract decision-makers.
    - Harmonization limits the scope of regulatory competition.
  2. Free mobility
    - Companies and natural persons must be able to choose between different legislative regimes.
- Subject of much skepticism in EU.
  - MS are afraid that regulatory competition could lead to a situation where there could be a deterioration of what they consider to be important national interests.
    - Ex: Minimum capital requirements, as seen in Centros and Inspire Art.
- Traditional response of the EU.
  - Harmonization

## The risk of the Delaware effect in Europe

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### What is the fear about?

The situation feared in the EU is one in which the establishment of a market for company incorporations will have **negative consequences for the protection of the interests of shareholders, creditors, and employees.**

This could be the case if the MS were to **deregulate** their existing company laws in order **to make them more attractive** for incorporation.

- Where deregulation leads to regulation of lower quality than is demanded by firms.
- The fear that interests safeguarded by the law will suffer.
- Regulatory competition => “Delaware effect”
- 2 opposite theories:
  - “Climp to the top” theory
    - Competition contributes to the creation of optimal laws.
  - “Race to the bottom” theory
    - Most relaxed (liberal) company law will attract companies.
- European opinion → “race to the bottom”.

## The state of free movement

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### Primary and secondary establishment

Natural persons have the right to establish a company in any MS. - art. 43 EC

Companies have the right to secondary establishment, through a branch, subsidiary etc

- Art. 43 EC and 48 EC

## Incorporation theory vs. real seat

Conflict of law rules

- Incorporation theory
  - The law where the company is incorporated (and registered) is applicable to the company.
  - => Look into the register and you know which company law to use.
  - Used in UK, The Netherlands, Scandinavia and now to some extent in Germany.
- Real seat theory
  - The law of MS where the “real seat” (central administration / board of directors / real business) is located is applicable to the company.

Implementing the incorporation theory => no restrictions to free movement.

- All that matters to the incorporation MS is that the conditions for incorporation are met.

Applying the real seat theory => restricts the free movement

- If the real business is outside the MS of incorporation, it will not recognize the company, and it must be wound up.

## Case law

### Centros and Überseering

=> Receiving MS must recognize a company if it is correctly incorporated in another MS.

### Daily Mail and Cartesio

=> “Home state” may impose restrictions to move seat outside MS.

- Daily => Registered office must be in UK
- Cartesio => Real seat must be in Hungary

### Conversion – Cartesio

If a company voluntarily wants to change status, and become a subject of the receiving state

- Host state may not restrict the conversion, if the receiving state allows for the conversion.
- => Conversion must be as easy as possible – according to receiving state!

## Mergers

Another possible way of free movement.

- Create subsidiary in country where you want to move.
- Merge primary company with the subsidiary into new company in receiving state.

Possible due to merger directives

- 3<sup>rd</sup> directive – merger directive
- 10<sup>th</sup> directive – cross-border merger directive

Sevic

- Merger of German and Luxembourg company with German company as the continuing.
- Restriction that German law did not allow cross border merger as merger is a form of establishment.
- The need to protect creditors, minority shareholders and employees can justify some restrictions but not a total denial of cross border mergers.

- Now other forms of movement also protected by Art. 43 EC.
- Requires MS to formulate balanced rules on cross border merger, fission, conversion of corporate form if such exist for domestic companies.
- Should one still distinguish between state of incorporation and incoming state?
- ECJ
  - Followed from art. 43 EC
    - restrictions “on entering” or “on leaving” national territory are prohibited’.
  - Cross-border merger = one way of exercising the freedom of establishment:
    - the merger operation allows a company without dissolution to transform itself, thus providing a way, within a single operation, to pursue an activity in a new company format without interruption; saving time, costs, and the complications associated with a dissolution or liquidation and a new company formation.

## Conclusion

Free movement is greatly protected. Case law has pushed the boundaries. Only real seat countries restrict the movement.

- => Competition possible within the incorporation theory countries.
  - The book states, that incorporation of companies in UK has exploded since the Centros case.

## The harmonization program

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So is there a risk of a race.

### What are the reasons for forum-shopping?

- Capital requirements
- Publicity
- Employee involvement

### Publicity

Delt with in 1<sup>st</sup> directive.

### Capital requirement

Delt with in 2<sup>nd</sup> directive

### Employee involvement

Delt with in various directives.

- Employee participation during
  - division of the company - 6<sup>th</sup> directive
  - Takeovers - 13<sup>th</sup> directive
- SE directive
- EWC directive

## Conclusion

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Potential race to the bottom → but the efforts of harmonization greatly restricts