Is regulatory competition the future for European integration?

Simon Deakin*

Summary

■ Opinion is divided on the merits of regulatory competition in the context of European integration; supporters see it as a mechanism for market-driven change while opponents fear a race to the bottom. This paper argues that the US model, while often taken as a benchmark in these debates, is specific to certain features of American constitutional practice and is of little direct relevance to the EU. EU-style harmonization is more flexible than federal legislation in the US and inherently more capable of engendering regulatory learning. Regulatory competition will become more important within the EU in fields such as labour and company law, but will take a distinctively European form. ■

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According to its proponents, regulatory competition offers a market-driven mechanism for achieving economic and political integration, which will confer upon Europe the dynamism which the United States has long enjoyed. For its opponents, regulatory competition promises to unleash a race to the bottom in social and environmental standards. The debate has been sharpened by recent decisions of the European Court of Justice, above all the *Centros* case.[1] *Centros* has been read as deciding that Member States must not, in principle, impede the rights of companies to access the company law regimes which they regard as best suited to them. In reaction to the ECJ's decision in *Centros* and a line of related cases, by late 2005 several thousand German small and medium size enterprises (SMEs) had registered under English law and a smaller number of middle-sized listed companies had moved their jurisdictional base from Germany to the UK. The companies concerned took these steps, it appears, in order to avoid certain aspects of German company law which are aimed at protecting the interests of creditors and workers. *Centros* is not the only threat to state autonomy in the area of economic and business regulation. Other decisions have challenged the application of collective agreements and protective labour practices in high-wage states to workers and enterprises from lower-wage countries, on the grounds that such agreements and practices constitute a barrier to the free movement of labour and capital. These judicial moves are potentially far more significant than the much more controversial, but in practice somewhat limited, "Bolkestein Directive" on the transnational provision of services.[2]

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[1] Case C-212/97 *Centros Ltd. v. Erhvervs-og Selkabsstryrelsen* [1999] ECR I-1459.

[2] See European Commission, Proposal for a Directive of the European Parliament and of the Council on services in the internal market, Brussels, 5.3.2004,

This paper takes a closer look at the institutional features of regulatory competition in both America and Europe in an attempt to assess the significance of recent EU developments and debates. It will argue that the contrast, frequently made in the debate, between a "competitive" and "decentralised" model of US federalism, on the one hand, and a "directed" and "centralised" European one, on the other, has been overdrawn. Both systems have mechanisms in place for promoting regulatory competition as a learning process based on experimentation. In each case the relationship between federal powers and state rights has become highly complex over time. The EU can lay claim to having already put in place, prior to the *Centros* case, the conditions for effective regulatory learning between states. Paradoxically, it is this system which *Centros* (or one interpretation of it) is in danger of undermining, with results which are as yet unclear but which might prove to be of profound importance for the project of European integration.

In developing this argument, part 1, below sets out some theoretical considerations relating to the regulatory competition debate. Section 2 examines the *Centros* case and the European Court of Justice's free movement jurisprudence in the light of the US experience of regulatory competition. Section 3 then takes a look at the contrasting styles of federal legislation and harmonization in the US and EU respectively. Section 4 concludes.

1. Theoretical perspectives on regulatory competition

Regulatory competition may be defined as a process involving the selection and deselection of laws in a context where jurisdictions compete to attract and retain scarce economic resources. The earliest, and still influential, theoretical models (in particular Tiebout, 1956) envisage a situation in which states supply laws in response to the demands of the "consumers" of those laws, namely individuals and corporations, who have the power to switch the resources under their control to alternative jurisdictions. In equilibrium, under conditions of perfect competition, laws are matched to the wants of consumers, thereby

COM(2004) 2 final/3, for the background to this Directive. Even prior to the amendments made by the European Parliament in the course of the Directive's passage, the so-called "country of origin" principle was more or less excluded in the area of labour market regulation, allowing the host state to apply basic labour standards on its own territory to workers and enterprises from other member states.

maximizing allocative efficiency or welfare in an economic sense. To the extent that the wants of the consumers of laws are heterogeneous, so are the laws, so that the result is a degree of variety within the federal system as a whole. Regulatory competition therefore promotes both efficiency and diversity.

The normative implication of the basic model is that split-level governance, involving the sharing of legal powers between a central, federal authority and lower-level states, regions or localities, is to be preferred to a unitary state, in which the central authority acts as a monopoly law maker. The principal role of the central authority in a federation is to ensure that the conditions for the free movement of economic resources from one jurisdiction to another are maintained, which means legislative and judicial action to remove barriers to trade and eliminate distortions of competition. Harmonisation of standards from the centre is rejected, on the grounds that it blocks the competitive process, limits the capacity for learning based on diversity, and, by centralising rule-making powers, exacerbates the threat of rent-seeking or regulatory capture by interest groups.

More recent models, imbued with the spirit of new institutional economics and evolutionary game theory, argue that competition in the market for legal rules may be less than perfect, and that there may, as a result, be a dual role for the federal authority: on the one hand, correcting coordination failures of the "prisoner's dilemma" type which arise in dealings between states, and on the other setting federal-level standards to combat externalities in the form of negative spill-over effects. Responses of the first type are associated, in the EU context, with the principles of "mutual recognition" and "non-discrimination" in relation to the movement of goods, persons, services and capital; the second type is exemplified by harmonizing measures which are designed to forestall a "race to the bottom" in social and environmental protection.

Whether there is a danger of a race to the bottom in the absence of harmonization is not a question which can be answered *a priori*. In game-theoretical accounts, where multiple equilibria are possible, a sub-optimal outcome is one possibility, but only one. According to Revesz (2001, p. 5), writing in the context of US environmental law:

> "In the absence of perfect competition, the game-theoretic interactions among the states could lead to underregulation absent federal intervention. In such cases, federal minimum standards would be desirable. But it is equally plausible that in other instances the reverse would be true: that the game theoretic inter-

> actions between the states would lead to overregulation absent federal intervention. In such cases, federal regulation would be desirable as well, but in such cases federal maximum regulation would be called for. Accordingly, there is no compelling race-to-the-bottom justification for across-the-board federal minimum standards…"

Thus the normative implications of the game-theoretic approach are somewhat unclear. It may be read as offering a corrective to the view that the devolution of rule-making powers to the lower tiers of governance is always to be preferred, which is an implication often drawn from the pure competition model. In effect it invites a more precise type of inquiry into the justifications which might be offered for federal-level intervention in specific areas of regulation. The optimal level of regulation cannot be known in advance and without a close regard to context. It also points to the need for a nuanced analysis of the different regulatory mechanisms which are available to the federal power and to the ways in which they are received and implemented at lower levels within the system. The purpose of federal intervention is not to identify optimal rules—rules which would have been arrived at spontaneously under conditions of pure competition—and then enforce them. The question, rather, is *what kind of institutions are needed to alter the legal environment in such a way as to induce the cooperation which is needed for regulatory competition to function effectively?* This kind of perspective ties in with the debate about the meaning of the term "subsidiarity" in relation to European integration, a debate which is essentially concerned with the question of which levels and mechanisms of governance are most appropriate for dealing with particular issues.

2. Institutions underpinning regulatory competition in the US and EU

The constitutional rules and principles which have brought about the conditions for regulatory competition in the US and EU were not devised with that aim explicitly in mind; they were justified instead by reference to broader principles, such as the protection of economic freedoms, the promotion of inter-state trade, and the advancement of transregional or transnational economic integration. Regulatory competition came about as an unintended side effect of legislative or judicial action, and only afterwards was given the appearance of being the product of rational design. The decision of the US Supreme Court in

Paul v. *Virginia* in 1868[3] illustrates the point. This decision underpins the US rule that the applicable law of a corporate entity is that of the state in which it has been incorporated. In the US this is known as the "internal affairs doctrine", in the sense that it determines which law governs relations between the firm's internal organs and bodies, principally the board and the shareholders. Even if a company's head office, or physical or other assets, are elsewhere, it can choose to be governed by the law of another state including one with which it has no physical connection of any kind, and crucially, to have that choice respected by the courts of other states.

Without *Paul* v. *Virginia*, the primacy in company law achieved in modern times by the state of Delaware would have been impossible. This is because *Paul* v. *Virginia* came to be understood as having decided that once a company had chosen to incorporate in a given state and had been validly registered there, the courts of all other US states were required to recognise that choice. If the Supreme Court, acting as the principal federal judicial forum, had not imposed this uniform "conflict of law" rule on the different states, a kind of "mutual recognition" rule for companies, the most basic precondition for regulatory competition for in company law—free movement for economic resources—would have been absent.

However, all this was far from the minds of the Supreme Court Justices who decided *Paul*. They held that states were free to impose regulatory burdens on out-of-state or "foreign" corporations which were not involved in inter-state commerce, as defined by the then prevailing interpretation of the US Constitution's commerce clause; thus it was a decision upholding state-level autonomy against the principles of non-discrimination and mutual recognition (as they would now be known). Commerce clause jurisprudence began to curb the powers of states to impose discriminatory rules and requirements on the cross-border provision of goods and services from the 1870's onwards, but the category of inter-state commerce remained narrowly defined for several more decades. Moreover, "charter competition", based on the willingness of certain states, of which New Jersey was initially the most significant, to attract incorporations from companies whose main operations were based elsewhere, only began to develop from the late 1880's onwards as a consequence of the end-of-century merger boom. It was at this stage that the *Paul* case was read as estab-

[3] 9 Wall 168.

lishing the converse proposition to the one it had established—namely that discrimination against foreign corporations was not permissible when an issue of inter-state commerce arose. As Tung (2005, p. 68) suggests:

> "Functional explanations for the (internal affairs) doctrine have cause and consequence exactly backwards. The internal affairs doctrine was not designed to enable private choice and charter competition. Instead, charter competition evolved around the pre-existing internal affairs doctrine. But no-one intended this at the doctrine's origin. The doctrine did not honor private choice but its opposite—states' territorial monopolies. Moreover, the doctrine may serve the ends of consistency and predictability in the modern context, as functional explanations have observed. But at the doctrine's origin, consistency and predictability were subsidiary concerns to—and byproducts of—courts' concerns for the sovereignty of the incorporating state."

It can be argued that regulatory competition was inevitable once the courts began to develop an expansionary commerce clause jurisprudence which was founded on the policy of removing barriers to inter-state trade. But the point which emerges from a close, historical analysis is that the institutions which came to underpin regulatory competition in US corporate law were, and are, shaped by the contingent circumstances under which they first emerged. This makes them not so much a universal model for other jurisdictions and contexts, but rather a specific, historical response to a given set of institutional pressures.

The process by which Delaware achieved its pre-eminence exemplifies this point. Charter competition began in the final quarter of the nineteenth century when New-York based corporations began to re-incorporate in New Jersey to take advantage of a looser regulatory regime, designed by members of the New York corporate bar. In the 1890's and 1900's Delaware displaced New Jersey when the latter, under the influence of the Progressive political movement, introduced a number of regulatory constraints on large corporations including controls over the holding of shares in one company by another. The Delaware corporate regime had been initially designed to facilitate the operations of the Du Pont corporation, which, at that stage, was the only sizable company registered in the state. The Delaware law was drafted in the interests of the Du Pont family and suited other large, family-dominated firms at this time (Charny, 1994). Since it obtained its initial advantage, a number of factors have served to consolidate Delaware's position. In particular, specialization means that Delaware now enjoys an advantage over other states in terms of the large body of case law which it has built up, the expertise of its courts and the speed with which they can deal with complex corporate litigation, and a concentration of professional legal and financial expertise with links to the state (Roe, 1993, 2005).

Whether Delaware represents the last word in the efficiency of legal rules is another matter. There are broadly two views. Those who claim to identify a race to the bottom argue that since, under Delaware law, it is managers, not shareholders who typically decide issues of incorporation, the legislature and courts have a tendency to decide in favour of management and to dilute norms of shareholder protection (Cary, 1974). Delaware is certainly less shareholder-friendly than, for example, English law is, in limiting the ability of shareholders to challenge the board and in allowing director entrenchment. Delaware's courts are also generally thought to have adopted a broadly pro-management stance on issues of takeover law in the 1980's and 1990's, allowing boards considerable leeway to put in place anti-takeover defences and poison pills (Bebchuk and Ferrell, 1999). At best, the courts "zig-zagged" between management and shareholder positions, in an attempt to avoid alienating either side (Roe, 1993). The apparent susceptibility of the courts and legislature to interest group pressure during this period suggests that a state-level governance mechanism may be no more immune in principle from deleterious public-choice effects than one based at federal level (Roe, 2005). On the other hand, a large body of work claims to have identified in Delaware law a largely successful resolution of the agency-cost problem inherent in manager-shareholder relations in large, listed corporations (Winter, 1977; Romano, 1985, 1993; Easterbrook and Fischel, 1991, ch. 10). If Delaware was inefficient, why had it not lost business to rival states offering, through superior legal protections for shareholders, a lower cost of capital?

This debate looks set to continue without a clear resolution, largely because of the inherent difficulty in providing a definitive test for the rival claims concerning Delaware' inefficiency: there is no effective benchmark, Delaware having long ago seen off viable alternative models. US corporate law may be state law, but its most striking feature, when compared to that of the EU, it its uniformity. The wide differences which can be found between EU member states, according to such fundamental matters as the nature and extent of protection granted to shareholders, the powers and duties of boards, and the position of employees and creditors, have no equivalent in the US. In US history, there are many examples of state-level laws which departed from the now-dominant shareholder-value orientated system, by, for example, qualifying the limited liability of shareholders, and imposing limits on the use of corporate group structures for the concentration of capital (the issue over which first New York and then New Jersey lost their preeminence as the preferred state of incorporation for large companies). None of that diversity now exists; US company law has been characterised, for much of the last century, by a *race to converge*. Delaware's primacy is that of a monopolist, able to preserve its historical advantage by exploiting the positive network externalities of a specialist bar and judiciary and a legislature more finely attuned than any other to corporate opinion.

Close attention to institutional and historical context may also be an aid to understanding the more recent rise of regulatory competition in the EU. The EU rules which make up the broad counterpart to the US Constitution's commerce clause—the principles of free movement for goods, workers, services and capital, and freedom of establishment for enterprises—provide the starting point for the analysis. On the face of it, as fundamental provisions of EU law, they form the basis for a liberal economic constitution guaranteeing free movement for economic resources.[4] The ECJ's case law has long accepted the principles of mutual recognition and non-discrimination, albeit with some significant doctrinal distinctions according to the precise context which is being considered. However, these principles have also been subject both to provisions of the EC Treaty which embody a number of derogations on public policy grounds from the free movement principle, and to a further set of derogations developed by the Court as its jurisprudence has evolved. Thus from the inception of this process, respect for the autonomy and territorial sovereignty of the member states has operated as a countervailing force to pressure for economic liberalisation.

No decision better illustrates this tension than *Centros* itself. There is no uniform conflict of law rule governing company law in the EU; member states are divided in the approach they take to determining the applicable law of the company. The UK, Ireland, the Netherlands

[4] The failure of the member states, so far, to adopt the Constitutional Treaty, is of no legal or institutional consequence in this context. The Constitutional Treaty would have involved little more than a tidying up exercise as far as these provisions were concerned.

and Denmark operate a "state of incorporation" rule, according to which the applicable law is that of the state in which the company is incorporated or registered. Several other member states have traditionally operated the so-called "real seat" or *siège réel* doctrine. Although the effects of this doctrine are complex, it generally means that courts will regard the applicable law as that of the member state in which the company has its main centre of operations—its head office or principal place of business. The effect is to render impossible the kind of market for corporate charters or constitutions which operates in the US, since a company cannot switch its state of incorporation at will.

The legality of the *siège réel* doctrine was an obvious target for free movement jurisprudence from an early stage and a body of case accordingly developed (see Mortimer, 1996). However, the process took a decisive turn in favour of a strict reading of the free movement principles in this context in the *Centros* case which was decided in 1999. Two Danish citizens incorporated a private company of which they were the sole shareholders, named Centros Ltd., in the UK. One of the two shareholders then applied to have a "branch" of the company registered in Denmark for the purposes of carrying on business there. Centros Ltd. had never traded in the UK. The Danish Registrar of Companies refused to register the branch, on the grounds that what the company was trying to do was not to register a branch or overseas presence, but its principal business establishment. The Registrar took the view that Centros had been incorporated in the UK in order to avoid Danish minimum capital requirements which are designed to protect third party creditors and minimise the risk of fraud.

The Court ruled that the refusal to accede to the registration request was contrary to the freedom of establishment principle. It held, firstly, that there was a potential infringement of freedom of establishment in any case where "it is the practice of a Member State, in certain circumstances, to refuse to register a branch of a company having its registered office in another Member State", because:

> "The provisions of the Treaty on freedom of establishment are intended specifically to enable companies formed in accordance with the law of a Member State and having their registered office, central administration or principal place of business within the Community to pursue activities in the Member States through an agency, branch or subsidiary…That being so, the fact that a national of a Member State who wishes to set up a company chooses to form it in the Member State whose rules of company law seem to him the least restrictive and

> to set up branches in other Member States cannot, by itself, constitute an abuse of the right of establishment. The right to form a company in accordance with the law of a Member State and to set up branches in other Member States is inherent in the exercise, in a single market, of the freedom of establishment guaranteed by the Treaty".[5]

The Court then went on to consider whether the Danish government could show that the refusal to register Centros Ltd. was justifiable in the circumstances. This involved a consideration of whether there was some countervailing policy objective behind the Danish practice and whether, in the particular circumstances of this case, the proportionality test was to be satisfied. The Danish government argued that the registrar's action was intended to maintain Danish law's minimum capital requirement for the formation of private companies. The purpose of this law was:

> "first, to reinforce the financial soundness of those companies in order to protect public creditors against the risk of seeing the public debts owing to them become irrecoverable since, unlike private creditors, they cannot secure these debts by means of guarantees and, second, and more generally, to protect all creditors, public and private, by anticipating the risk of fraudulent bankruptcy due to the insolvency of companies whose initial capitalisation was inadequate."[6]

The Court ruled that the justification offered was inadequate since "the practice in question is not such as to attain the objective of protecting creditors which it purports to pursue since, if the company concerned had conducted business in the United Kingdom, its branch would have been registered in Denmark, even though Danish creditors might have been equally exposed to risk".[7] In other words, the registrar's decision failed the proportionality test since it was inconsistent—the vital factor in his refusal was, it seems, the failure of the company to trade in the UK, but this was immaterial to the protection of creditors since they would have been no better off if the company had previously traded and, as a result, had been able to get its branch registered in Denmark.

[5] *Centros*, Judgment of the Court, at paras. 26-27.
[6] Ibid, at para. 32.
[7] Ibid, at para. 35.

Centros and the cases which have followed it—*Inspire Art*, *Überseering*, and *SEVIC Systems*[8]—have understandably given rise to a huge amount of academic and related commentary, most of which has welcomed the possibility of regulatory competition emerging in the EU as a mechanism for company law reform. It is perhaps no coincidence that the European Commission is also pursuing a company law and corporate governance reform programme which is broadly consistent with the liberalizing tendency which the *Centros* case has been taken to represent. The response of the corporate sector to *Centros* has also been impressive. There has been a substantial number of incorporations of German and Danish SMEs in the UK, running into tens of thousands of firms, apparently taking advantage of *Centros* to avoid minimum capital requirements in those countries (see Armour, 2005; Becht, Mayer and Wagner, 2005). At the same time, a number of other legal systems have begun to water down their creditor protection laws. Laws on codetermination—mandating employee participation in supervisory boards—are forming the next target. In May 2006 the German airline Air Berlin registered as a UK-based public limited company or plc, apparently in order to avoid German codetermination laws, a move which, it has been predicted, others will follow.[9]

Unlike the US Supreme Court in *Paul* v. *Virginia*, the ECJ can hardly have been unaware of the significance of its recent decisions for the issue of regulatory competition; even if its judgment was couched in the more neutral legal language of freedom of movement and non-discrimination. The clamour for a Delaware-type mechanism in European company law had been growing for several years. However, there are significant limitations to the *Centros* judgment which suggest that some of the hopes and fears invested in it may not be realized. *Centros* illustrates the pivotal role in the freedom of movement jurisprudence played by the open-ended public policy or "justification" defence, the result of the Court's own jurisprudence, which is there to protect state autonomy against the excessive encroachment of the market principle. Although the Court took a narrow and, for some, controversial reading of the efficiency implications of creditor

[8] Case C- 208/00 *Überseering v. Construction Company Baumanagement GmbH (NCC)* [2002] ECR-I Case C-167/01 *Kamer van Koophandel en Fabrieken voor Amsterdam v. Inspire Art Ltd.* [2003] ECR-I 10115; Case C-411/03, *SEVIC Systems AG*, Judgment of 13 December 2005, OJ C 289, 29.11.2003.
[9] German companies flee to the UK, Financial Times, 24.6.2006.

protection rules,[10] it did not in any way qualify the importance, in principle, of a defence based on alternative public policy considerations. This will be a vital consideration if a codetermination case comes before the Court in future. It is not just the efficiency arguments which can be mounted in favour of codetermination which may influence the Court. Codetermination, and worker participation in management decision making more generally, are long-standing institutions in a considerable number of Member States, and the principle of employee information and consultation is recognized as an important component of EU law by virtue of references to it in the EC Treaty[11] and by several directives.[12] This is not to say that the Court will inevitably hold in favour of a codetermination law if one comes before it. It is simply to point out that the emergence of regulatory competition in company law in the EU will take place against the backdrop of a particular legal and institutional configuration which is very different from that which applies in the United States, and which may be expected to impact on the scope of the principle of free movement for economic resources.

The same point applies with even greater force to two high-profile cases in which the freedom of movement principle has recently run up against social policy considerations, namely *Viking*[13] and *Laval*. *Viking* concerns the reflagging of a Finnish passenger vessel under Estonian law in order to reduce labour costs associated with Finnish labour legislation and collective agreements, a move which was prevented by industrial action; *Laval*[14] arises from industrial action taken by Swedish unions to force a Lithuanian building company, carrying out work in Sweden using workers who were Lithuanian nationals, to

[10] See Barnard and Deakin (2002) for critical discussion of the Court's view that the creditor protection law at issue in that case was ineffective in achieving its desired aim. According to Becht, Mayer and Wagner (2005, p. 18), there is evidence of a lower survival rate among "Centros-driven incorporations". These authors suggest that "this race to the bottom in standards of corporate legislation may give rise to agency conflicts between investors and managers on the one hand and the public interest on the other".
[11] EC Treaty, Art. 137(1)(f).
[12] In particular the European Works Council Directive (94/45/EC), the Directive on Employee Participation in the European Company (2001/86/EC) and the Information and Consulation Directive (2002/24/EC).
[13] *Viking Line ABP v. International Transport Workers' Federation* [2006] 1 CMLR 27; see Davies (2006).
[14] Swedish Labour Court Decision (2005 No. 49); see Eklund (2006).

observe the terms of a local collective agreement. In *Viking* the legality of the industrial action was challenged on the grounds of its incompatibility with the principle of freedom of establishment (as in *Centros*), while in *Laval* the challenge invoked the principle of freedom of establishment. Both cases will be heard by the ECJ later in 2006. At the time of writing (June 2006) the outcome of these legal proceedings is not known but some of the relevant considerations may be noted.

Firstly, *Viking* and *Laval* are labour law cases to which, arguably, different principles apply to those which govern company law cases such as *Centros*. The principle of state autonomy in labour law matters is one which is respected in the structure and provision of the EC Treaty and in institutional practice from the inception of the common market in the 1950's (see further section 3, below). The Court had held in earlier judgments[15] that labour market considerations can justify the application of basic labour standards in a high-cost "host state" to contractors and workers from a lower-cost "home state". In this way, the Court has previously upheld in a labour market context the principle of territoriality in the application of mandatory laws which it rejected in a capital market context in *Centros*.

Secondly, *Viking* and *Laval* raise the issue of the right to strike as a fundamental right which is recognized by the legal order of the EU in such a way as to qualify the free movement principle (see Eklund, 2006). Although the outcome of this argument is as yet unclear, it is a further reminder that certain features of the European context which may be expected shape the evolving nature of regulatory competition in ways which have no parallel in the US setting.

3. Pre-emption, harmonization, and regulatory learning in the US and EU

So far we have been considering rules and mechanisms which serve to maintain the principle of the free movement of economic resources against state-level "distortions" and "interferences". What of regulations, derived from the central or federal legislature, which address externalities arising from the interplay of economic forces at state or local level? It would be incorrect here to contrast a US model of state autonomy and inter-jurisdictional competition with a European one

[15] Case 279/80 *Webb* [1981] ECR 3305 and Case C-113/89 *Rush Portuguesa* [1990] ECR-I 1417.

centred on harmonization. Federal legislation in labour and capital markets has been a highly significant presence in the US context since the passage of the New Deal legislation of the 1930's. The law governing collective bargaining and union security is federal law, in the form of the National Labour Relations Act, which is composed of the Wagner Act of 1935 and the amending Taft-Hartley Act 1949. In the area of securities law, the Securities Act 1933, the Securities and Exchange Act 1934 and, more recently, the Sarbanes-Oxley Act 2002, are all federal statutes.

Thanks to the doctrine of pre-emption, these federal statutes occupy the field to the exclusion of state law. It is only in those areas where the federal legislature has carved open a space for state-level initiative that regulatory competition has been able to develop. An example of this is the leeway granted to states by the Taft-Hartley Act, to enact exceptions to union security laws which underpinned the closed shop. This led to the introduction of "right to work" statutes in many southern and western states in the 1950's and 1960's. Laws which might improve on the protective standards set out by the federal legislation are ruled out by the pre-emption doctrine. In effect, a race to the bottom in labour standards is possible, but a race to the top is ruled out. The rigid and, in the view of many commentators, flawed structure of workplace representation set out in the legislation of the 1930's remains fixed in place (see Weiler, 1990).

In securities law, the introduction of federal legislation in the 1930's and its more recent extension in the Sarbanes-Oxley Act has led to tensions with the principle of state autonomy in company law. Because the two fields are so close to one another, Delaware has, at best, a precarious independence. This has led to some to suggest that the federal legislator has acted both as a competitor to Delaware, and, to a certain degree, as an implicit regulator (see Roe, 2005). Critics of federal intervention have argued for the introduction of a more flexible regime based on issuer choice of jurisdiction, mimicking the process of regulatory competition in company law (Romano, 1998). However, the prospects for such a development are remote, in a post-Enron environment which has seen an intensification of the federal power in securities markets.

The history of harmonizing legislation in labour and company law in the EU has proceeded along different lines. The EU has no general power to regulate labour and capital markets in the interests of promoting inter-state trade along US lines. Its social policy powers are limited (see Deakin, 1996). The Treaty of Rome contained only a few provisions on labour law; the most important was Article 119 (now 141), which enshrined the right to equal pay between men and women. This provision owed its existence to French concerns that its apparently more protective sex discrimination laws would be a source of competitive disadvantage. A similar justification led to the inclusion of a Treaty provision relating to annual leave rights. But for the most part, social policy was outside the scope of the Treaty. This was no accident. The founders of the European Economic Community accepted the view, set out in a report commissioned from the ILO, that harmonizing measures in the labour law field were unnecessary. The implementation of the common market was expected to lead to upward pressure on wages and social welfare provisions, as states competed to attract scarce labour. At the point, in the mid-1950's, when the member states were all politically committed to the expansion of the welfare state and to the maintenance of conditions of full employment, this was not an unreasonable assumption. It was not until the early 1970's, when the EEC's expansion from six to nine states coincided with the end of the post-war consensus on the welfare state and full employment, that the member states felt it necessary to instigate the Community's first social action programme. This led to directives on equality of treatment and employment protection, which were adopted using general powers to regulate the common market. These initiatives paved the way for the significant expansion of social policy measures in the 1980's during the period of the Delors presidency. The Single European Act of 1986, the Treaty of Maastricht in 1992 and the Treaty of Amsterdam in 1997 each led to a widening of legislative powers in the social policy field, but it remains the case that these powers are narrowly confined, with certain areas (most notably minimum wages, collective bargaining and the right to strike) excluded altogether from the law making powers of the Community's central organs. In effect, state autonomy is still the order of the day in the social policy field, with only marginal incursions from Community law.

The power to introduce harmonising measures in the field of company law originated in the freedom of establishment provisions of the Treaty of Rome. Under Article 44(2)(g) of the EC Treaty (originally Article 54(3)(g)), the Council can adopt directives aimed at "coordinating to the necessary extent the safeguards which, for the protection of the interests of members and others, are required by Member

States of companies and firms… with a view to making such safeguards equivalent throughout the Community". Thus an element of uniformity in the laws protecting the right of shareholders and "others" (this could cover a range of stakeholder interests) was thought to be necessary in order to forestall a "race to the bottom". Directives were adopted from the late 1960's onwards, and by the early 1970's some commentators were arguing that the Community needed a thorough-going harmonization programme; the "virtual unification of national company laws" (Schmitthoff, 1973, p. 9) would ensure that a European Delaware was avoided. However, the prescriptive approach of the first company law directive gave way to so-called "second generation" measures which set out basic accounting and audit standards in the form of a menu of options based largely on existing member state practice (Villiers, 1998). Member-state autonomy was also observed in the "third generation" measures which were based on the principle that harmonization measures should be limited to measures which could be shown to be essential to the functioning of the single market, and in the "fourth generation" or framework directives of the 1990's which were based on the articulation of general principles rather than detailed prescription and which involved a degree of delegation of rule-making powers to trade and professional bodies at both member state and transnational level.

The initial decision to attempt a degree of harmonization in labour and capital markets through directives, as opposed to regulations which are directly applicable in national law, is significant in itself. Directives are not self-enforcing; they depend for their effectiveness on implementing measures taken by member states. Thus they do not operate in the manner of pre-emptive federal legislation along US lines. Moreover, most directives in this area, particularly in the social policy field, are designed to set a "floor of rights". Most such directives make explicit reference in their texts to "minimum standards" which states must observe but on which they can improve, while many also contain "non-regression clauses" which are intended to prevent member states from using the implementation of a directive to reduce the pre-existing level of protection guaranteed by national law. A "race to the top" is thereby encouraged.

This distinctive European approach has been described using the term *reflexive harmonization*. (Deakin, 1999, 2006; Barnard and Deakin, 2002; Zumbansen, 2006). The guiding idea here is to get away from the opposition between regulatory competition and harmonization.

Regulatory competition is seen as a process of discovery through which knowledge and resources are mobilized, the end point of which cannot necessarily be known. Competition as a learning process depends on norms which establish a balance between "particular" and "general" mechanisms (Sugden 1997, p. 487), between, that is, the autonomy of local actors, and the effectiveness of mechanisms for learning based on experience and observation. An essential prerequisite is the preservation of local-level diversity, since without diversity, the stock of knowledge and experience on which the learning process depends is necessarily limited in scope. Critics of the European Commission's social action programmes of the 1980's and 1990's argued against social policy harmonization on the grounds that variety within the Union as a whole should be preserved: "hidden in the historical experience of economic integration, there is … a very important aspect of "system dynamics": international competition in the field of the welfare state serves as a kind of process of discovery to identify which welfare state package—for whatever reason—turns out to be economically viable in practice" (Paqué, 1997, p. 109). As this critique recognized, there is a strong argument against the use of harmonizing legislation to cement in a single "best" solution. However, this is not, on the whole, how harmonization works within the EU. It can be argued that European-style harmonization has evolved to play the role of maintaining the appropriate relationship between "particular" mechanisms operating at the sub-federal level, and the "general" mechanisms by which learning across the Union as a whole takes place. The model of reflexive harmonization holds that the principal objectives of judicial intervention and legislative harmonization alike are two-fold: firstly, to protect the autonomy and diversity of national or local rule-making systems, while, secondly, seeking to "steer" or channel the process of adaptation of rules at state level away from "spontaneous" solutions which would lock in sub-optimal outcomes, such as a "race to the bottom". Whereas, in the US, federal preemption alternates with inter-state jurisdictional competition, European practice shows that a range of other options is available, some of which combine regulation and competition.[16]

[16] The model of reflexive harmonization has much in common with the "open method of coordination" which has become influential in the sphere of employment policy and a number of other areas, but with the important difference that reflexive harmonization involves the use of directives which in principle have certain binding legal effects, while in the case of the OMC these are absent. For a re-

The use of harmonizing legislation to open up a space for regulatory learning is a feature of several recent directives. The directive governing employee participation in the European Company or *Societas Europaea* (SE) involves a carefully crafted compromise between the goal of providing a transnational legal form for large European companies and concerns that, in the process, national standards in respect of codetermination would be diluted.[17] Board-level representation for employees is not, in general, mandatory in an SE, but a mandatory element is introduced if employee participation at board level is a mandatory requirement of the national law governing a substantial part of the workforce to be employed by the new entity (the "before and after principle"): more than 25 per cent of the combined workforce in the case of a merger, or more than 50 per cent where a holding company or subsidiary company option is used. An SE may not be registered until an agreement for employee participation has been made with employee representatives (the "special negotiating body" or SNB). The SNB is empowered to make an agreement governing board-level representation for workers where this is required under the "before and after principle". If no agreement is made, "standard rules", which operate as a default mechanism, apply. Where an SE is formed by merger, the SNB may agree to waive the right to apply national-level provisions on board-level representation. The effect is that there is no straightforward escape from codetermination through the SE option, as long as the member states themselves retain national-level laws which mandate this form of employee participation. However, some flexibility is introduced in the form of the right of the SNB to negotiate a different arrangement. It remains to be seen how flexible this route will prove to be in practice.

The Thirteenth Company Law Directive on takeover bids, adopted in 2004,[18] was also an exercise in compromise. Contrary to the hopes of its proponents, who had envisaged it as a measure which would roll out a liberal-market model of takeover regulation along similar lines to that of the UK's City Code on Mergers and Takeovers, the

cent assessment of the OMC in various contexts see De Schutter and Deakin (2006) and for theoretical considerations on deliberative processes within the EU, see Cohen and Sabel (1997).

[17] Council Directive 2001/86/EC supplementing the Statute for a European Company with regard to the involvement of employees.

[18] Directive 2004/25/EC of the European Parliament and of the Council on takeover bids.

Takeover Directive allows member states to retain laws which permit multiple voting rights and limit shareholder sovereignty in various ways, such as allowing anti-takeover defences to be put in place in advance of bids. Some of these provisions are transitional and the general thrust of the Directive, in favour of the principle of one share one vote and proportionality between investment risks and decision-making powers, is clear. However, rather than impose a single model on member states, the Directive sets out a framework within which the goal of a more liberal takeover regime can be implemented in one or more of a number of ways, which may take into account specific features of the legal and institutional environments of the different member states.

Recent directives in the social policy field illustrate the sense in which directives involve deliberative processes both in their formation and in their implementation. The Maastricht Treaty established a role for "social dialogue" between the peak-level federations representing trade unions and employers' associations in the formulation of EU-level labour standards. One possible option is for framework agreements between the "social partners" to be given legal effect as directives; this is the route which resulted in the adoption of directives on parental leave, part-time work and fixed-term employment in the late 1990's.[19] Another possibility is for the Community's regular law-making organs to act in a case where the social partners cannot reach a consensus on a framework agreement. This was the route eventually taken in the case of the directive on information and consultation of employees at national level which was adopted in 2002.[20] A third possibility is for the social partners to reach an agreement which has no independent legal force, and which they monitor and police; an agreement along these lines on employment conditions in teleworking was arrived at in 2002.[21]

Each of the directives just referred to sets out standards in the form of default provisions which can be adjusted through agreement between the social actors at sectoral, enterprise or plant level. It is therefore likely—indeed, intended—that a variety of practices will result from the implementation of the directives. The impact, to date, of the three directives adopted in the late 1990's, suggests that this mode of governance can act as a catalyst for mutual learning. These

[19] Respectively, Directives 96/34, 97/81/EC and 99/70/EC.
[20] Directive 2002/14/EC.
[21] Social Partners' Framework Agreement on Teleworking (16 July 2002).

directives have a number of related goals, principal among which is the so-called "normalisation" of so-called flexible forms of work (part-time and fixed-term employment). This implies some re-regulation, in the form of a requirement of equality treatment between part-time and fixed-term workers respectively and "normal" full-time, indefinite-duration workers, and a degree of liberalisation, in the form of the removal of barriers to the adoption of flexible working arrangements. Encouragement for parents to share childcare responsibilities is a linked aspect of this policy.

The directives have had divergent effects, depending on the pre-existing state of the law in different member states (Mückenberger and Weinreich, 2006; Deakin, 2006). In Germany, the fixed-term employment directive has led to a de facto loosening of the conditions for this form of employment, which are now spelled out in legislation where before they were the result of case law. In Britain, by contrast, where no justification for departing from the "norm" of an indefinite-duration contract of employment was needed, the directive has had the effect of requiring such a justification for the first time in a way which is having a substantial impact on employment practices in sectors reliant on fixed-term employment. In Germany the legislation implementing the part-time work directive went beyond what was necessary in enacting a right to work part-time where family circumstances justified it; in Britain, a more limited right to request flexible working was enacted as part of a wider process of legislating for "work-life balance" issues. Finally, the passage of the parental leave directive has triggered a debate in both countries about a system of leave-sharing between female and male parents, a system which is not required by the directive but around which a political consensus appears to be building, influenced by the example of existing practice in the Nordic member states. In short, convergence on a uniform set of legal instruments for regulating flexible work and the work-life balance is unlikely to be the end result of the process of implementation of these directives; however, that process has triggered a reassessment of policy which may lead in time to greater convergence of practice in at least two member states whose laws were previously at opposite ends of the spectrum.

4. Conclusions

The US approach to regulatory competition has been widely advocated, following the *Centros* case, as a model for the EU, particularly in the field of corporate law. However, that model possesses features which are specific to the particular constitutional tradition and trajectory of the US. The relationship between federal legislation and inter-jurisdictional competition at state level has been important in shaping, for example, the pre-eminence achieved by Delaware in the area of company law. The federal power has acted as a regulator and, at times, as a competitor to the states. In a context where federal legislation, through pre-emption, can occupy the field to the complete exclusion of state laws, it is not surprising that commentators should stress the advantages of allowing local level initiatives to develop. The European context is far removed from this. Legal encouragement for economic integration takes a variety of forms which combine a degree of centralised regulation or guidance with state-level autonomy, in particular over the mode of implementation of policy goals. Directives have become flexible mechanisms for the promotion of regulatory learning, and for the preservation of the legal and institutional diversity on which that process rests. In this sense, the EU already possesses a system of regulatory competition which is suited to its own trajectory and purposes. Thanks in large part to the impetus provided by *Centros* regulatory competition will have a significant role to play in the future of the European project, but this role will continue to be shaped by the distinctive institutions and mechanisms of European integration.

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