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Mission Statement
The *Erasmus Law Review* seeks to foster independent critical scholarship as relevant to the discipline of law.
The Board of Editors encourages the submission of legally relevant manuscripts by legal scholars and practitioners as well as those versed in other disciplines relevant to law, such as criminology, sociology, political science and economics.
The *Erasmus Law Review* usually commissions articles around specific themes, although 'calls for papers' on specific topics might be issued occasionally and will be published on the Review's website. All prospective articles are submitted to double-blind peer review (two reviews per article), and final publication is dependent on the outcome of these reviews.

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Nederlands uitgeversverbond
Groep uitgevers voor vak en wetenschap

Introduction

Kristin Henrard*

This issue of *Erasmus Law Review* continues and completes the bridge initiated by issue 9:3 between the original format of working exclusively with thematic issues, and also having issues on submissions. It gives the floor to three promising doctoral students of Erasmus School of Law, who are now nearing the completion of their research. In addition, this issue carries an inspiring contribution by one of our esteemed professors. Typical for a non-thematic issue, a broad variety of topics are covered, ranging from the methods of investigation at the disposal of private investigators in the corporate sector, and the Court of Justice of the EU's case law regarding restrictions to the free movement of capital, over the methodology of comparative tax research, to discussing policy responses to hedge funds activism.

1. *Clarissa Meerts* highlights the methods of investigation at the disposal of private investigators in the corporate sector. While not aiming to provide an exhaustive comparison between public and private methods of investigation, she argues that lack of formal investigative powers of the latter goes hand in hand with more flexibility. Also, Meerts highlights the need for more research into the field of corporate investigations inter alia because of the lack of oversight of these private investigations, notwithstanding their often large impact on the lives of people involved.
2. *Ìlektra Antonaki* investigates whether the development in the case law of the Court of Justice of the EU regarding the definition of a trade restriction to the free movement of goods could be transposed somehow to the terrain of free movement of capital, thus moving beyond the three criteria that have been developed to define capital restrictions in the golden shares case law. Antonaki advocates the narrowing down of the current wide interpretation of capital restrictions so that member states would be allowed to act as shareholders of strategically sensitive privatised companies to protect public interest requirements.
3. *Reneta Buijze* provides an important contribution to the methodology of comparative tax research concerning cross-border tax issues, while focusing on tax incentives for cross-border donations. She advocates the use of categorisations of tax jurisdictions while identifying ideal types for each category. As these categorisations already take into account the different relevant legal levels, and the ideal types (common characteristics) of these categories are at a high level of abstraction, and thus not that quickly outdated, the typical challenges of the study of cross-border tax issues are tackled.
4. Finally, Professor *Alessio Pacces* discusses the policy response to hedge funds activism from a law and economics perspective, more particularly by analysing this in light of Hirschmann's seminal study of feedback mechanisms in large organisations. In this piece, he argues that Hirschman's theory can help frame the question of whether and under what conditions activism is desirable, which in turn can inform policymaking in this field. Ultimately, Pacces claims that regulation should enable individual companies to choose whether to curb hedge funds activism depending on what is efficient for them.

We hope that you will enjoy reading this mosaic of articles.

Kristin Henrard, Editor-in-Chief

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A World Apart? Private Investigations in the Corporate Sector

Clarissa Meerts*

Abstract

This article explores the investigative methods used by corporate security within organisations concerned about property misappropriation by their own staff and/or others. The research methods are qualitative: interviews, observations and case studies carried out between October 2012 and November 2015. The findings include that, even though corporate investigators do not have the formal investigative powers enjoyed by police and other public agencies, they do have multiple methods of investigation at their disposal, some of which are less used by public investigative agencies, for example the in-depth investigation of internal systems. Corporate investigators also rely heavily on interviews, the investigation of documentation and financial administration and the investigation of communication devices and open sources. However, there are many additional sources of information (for example, site visits or observations), which might be available to corporate investigators. The influences from people from different backgrounds, most notably (forensic) accountants, (former) police officers, private investigators and lawyers, together with the creativity that is necessary (and possible) when working without formal investigative powers, make corporate security a diverse field. It is argued that these factors contribute to a differentiation between public and private actors in the field of corporate security.

Keywords: Corporate security, private investigations, private troubles, public/private differentiation

1 Introduction

> I remember from my time in the police that we were always complaining that private investigators were able to do anything and could just barge in somewhere. And now that I'm on the private end we as private investigators complain that we *can't* go in because we don't have the authority to do so. If someone doesn't want to cooperate we can't do much. [Respondent 5]

Many concerns have been raised about the existence of a private market for security; however, much less attention has been given to the actual activities of this field.[1] As the quote above shows, a recurrent image of private investigators is that they have much leeway and are not bound by rules or moral considerations in their investigations. Interestingly, private investigators, on the other hand, often feel restricted because they do not have the legal investigative powers law enforcement agencies are endowed with. Our knowledge about the large (and growing) involvement of private actors in the field of security provision is still somewhat behind the curve and merits more extensive scientific attention.[2] One of the relatively under-researched parts of the private security industry is what will be called 'corporate security' in this article. Although there is little recent work on the corporate security industry in its entirety, earlier work has been done on its specific parts.[3] The article aims to provide insight into private corporate investigations. This focus on the investigations instead of a specific kind of investigator (for example forensic accountants) makes for a more encompassing understanding of the field. The commonalities between these various investigators warrant such an approach, in spite of the differences between them. The recent emergence of forensic departments in law firms, and developments in investigative methods (e.g. with regard to IT tools used for investigations) furthermore indicate that the sector is one in development, making it interesting to take a closer look at the sector as a whole. A good understanding of the activities of the sector will facilitate a solid discussion on the positives and negatives of the corporate investigations industry.

The article explores the corporate security industry by focusing on private, corporate investigations into behav-

* Clarissa Meerts, MSc., is a PhD student at the Criminology Department of the Erasmus University Rotterdam. This research was made possible by funding by the NWO MaGW Research Talent 2011 grant (the Netherlands Organisation for Scientific Research, Division of Social Sciences) and by the assistance of anonymous interviewees and participants in the observations. The author would, furthermore, like to thank Nicholas Dorn, Sanne Taekema and anonymous reviewers for their useful comments on earlier drafts of this article.

1. *See*, for example, the report of KRO Brandpunt, 'Bespied door de baas' (1 June 2014). Available at <http://brandpunt.kro.nl/seizoenen/2014/afleveringen/01-06-2014>.
2. K. Walby and R. Lippert (eds.), *Corporate Security in the 21st Century: Theory and Practice in International Perspective* (2014).
3. On the different parts of the industry, there is some interesting work available. *See*, for example, J.W. Williams, 'Reflections on the Private versus Public Policing of Economic Crime', 45 *British Journal of Criminology* 316 (2005). M. Gill and J. Hart, 'Exploring Investigative Policing: A Study of Private Detectives in Britain', 37 *British Journal of Criminology* 549 (1997). M. Nalla and M. Morash, 'Assessing the Scope of Corporate Security: Common Practices and Relationships with Other Business Functions', 15 *Security Journal* 7 (2002).

iour by firms' staff, management, subsidiaries and subcontractors that is considered problematic by these firms. The greater part of 'incidents' occurring within organisations never reaches the criminal justice system, and it is important to take a closer look at the actions of these corporate investigators.[4] These incidents may concern (alleged) criminal behaviour such as fraud, but they may just as well be about behaviour that is considered undesirable rather than criminal, for example conflicts of interests. Although all kinds of unwanted behaviour may be investigated by corporate investigators, most incidents have an economic background (theft, fraud, favouritism in the granting of contracts, etc.). Working outside the formal investigative powers of public law enforcement agencies, corporate investigators operate in ways tailored to the problems that concern their clients. The services provided by corporate security investigators include, for example, forensic accountancy, (private) investigations more generally, IT services, asset tracing, drafting and implementing integrity codes and (assistance with) settlement and prevention tactics.[5]

'Corporate security' is a broad term that contains all actors that are involved in the investigation of incidents within organisations (consisting of economic loss, misappropriation of assets, reputational issues and the like). The field is quite diverse and includes private investigators, forensic accountants, in-house security departments and lawyers. Clients of corporate security may be both commercial and (semi-)public organisations. Respondents indicate that most of their clients are medium- to large-scale companies, which they attribute to the costs of investigations. In this article the term 'client' is used to indicate the consumers of corporate security services. In the case of an in-house corporate security department, the client is for example the company's management.

Some corporate investigative methods are broadly similar to those used in public policing (e.g. interviewing the people involved or observing someone – although the degree of duress, rights of the interviewee, etc. may differ), whereas other investigative methods are more private in origin and in 'ownership' (e.g. forensic accounting methods or an audit of internal systems). Corporate investigators have the same investigative powers as any citizen, which means in practice that they can operate with considerable flexibility.[6] Depending on their professional background, investigators may or may not need a permit under Dutch law (the Wpbr). The Wpbr only applies to private investigation firms, excluding in-house departments (not working for a third party), forensic accountants and lawyers (as they have their own (but general) regulations). The Dutch regulation of corporate investigations is thus rather scattered. The Privacy code of conduct, obligatory to Wpbr- permit holders seems to be followed by most respondents, though. In addition, more general laws such as the criminal code and privacy legislation (the WBP) apply to all investigators.

Many rights and possibilities of corporate investigators are derived from the rights the client has as an employer.[7] In broad terms, employers are allowed to exercise control over their employees; however, they should take certain restrictions into account. In general, principles such as legitimacy, subsidiarity, proportionality and the right to privacy apply. When corporate investigators investigate a case, they might gather a great deal of information by talking to people (interviewing), by looking into internal systems (e.g. personnel logs), firms' communications (email, phone records), financial systems (accounting, sales and other systems) and open sources (e.g. social networks) and by tracing assets. Crucially, in terms of access and speed, there is no need for them to wait for the approval of a prosecutor or judge prior to the use of these methods – corporate investigators merely need approval by the client/management. On the other hand, it is impossible for corporate investigators to, for example, lay claim to financial records of *other* firms, or to enter other premises – these being powers granted exclusively to public law enforcement. This may mean that it proves impossible for corporate investigators to investigate an incident fully. Many corporate investigators have a background in law enforcement. One frequently mentioned reason for this career switch is the perceived bureaucracy of the state apparatus and the expected freedom private investigators enjoy. However, corporate private investigators, on their part, feel that they are limited in their possibilities as well, as they lack formal investigative powers. When formal powers of investigation are necessary for a full investigation, law enforcement agencies have to get involved. Whether or not police and prosecution are mobilised by a report to the police depends on the client. This decision might be influenced by some advice provided by corporate investigators, although some investigators refrain from giving advice.

In this article the focus is on investigations into incidents within organisations. How do corporate investigators conduct their investigations and what kind of methods of investigation and sources of information do they have at their disposal? Clients rely on investigators to provide them with the information they need to react to the incident at hand – it is interesting to take a closer look at the ways this information is gathered. In the article the investigative process is considered, from the moment an incident is reported to the investigators to the moment investigators report their findings. The discussion reflects upon the material presented in this arti-

4. N. Dorn and C. Meerts, 'Corporate Security and Private Settlement: An Informal Economy of Justice', in J. Shapland and P. Ponsaers (eds.), *The Informal Economy and Connections with Organised Crime: The Impact of National Social and Economic Policies* (2009) 113.
5. Williams (2005), above n. 3; C. Meerts, 'Corporate Security – Private Justice? (Un)settling Employer-Employee Troubles', 26 *Security Journal* 264 (2013).
6. Williams (2005), above n. 3.
7. J.W. Williams, 'The Private Eyes of Corporate Culture: The Forensic Accounting and Corporate Investigation Industry and the Production of Corporate Financial Security', in K. Walby and R. Lippert (eds.), *Corporate Security in the 21st Century: Theory and Practice in International Perspective* (2014) 56.

cle, arguing that the field of corporate security is characterised by a double differentiation – both externally (from law enforcement) and internally (within the corporate security field).

1.1 Methodology

This article is based on qualitative data gathered between October 2012 and November 2015, as part of a PhD research, funded by a NWO Research Talent grant. An important source of information for the research consists of fifty-four semi-structured interviews that have been conducted with corporate investigators (thirty), clients (ten) and law enforcement professionals (fourteen).[8] Respondents were approached through snowball sampling and gatekeepers, making use of previous contacts and previous research by the current author. Snowball sampling has proven an effective way to reach respondents in a 'hidden' setting.[9] Although corporate investigators themselves are not hidden, and indeed sometimes advertise their services, there is no clear overview of how many corporate investigators there are in the Netherlands – partly because only those who call themselves private investigation firms officially require a permit. Clients highly value the discretion applied by corporate investigators and as such, many investigations remain private. Clients are therefore difficult to reach without referral by a gatekeeper. Because many investigations remain out of sight of the criminal justice system, finding law enforcement professionals with knowledge on the subject is equally challenging without a gatekeeper. Referral by a trusted gatekeeper furthermore has the added benefit that participants tend to trust the interviewer more easily, which may lead to more accurate data. To mitigate the problem of selectivity, multiple gatekeepers and starting points for snowballing have been used. At later stages of the research, saturation of respondents occurred, which is an indication that important respondents have been reached. However, a snowball sample is inevitably a purposive selection.

For each group of respondents a slightly modified topic list was used, so as to take full advantage of the knowledge of the respondent. Topics included regulation, private investigation methods, private settlement decisions and relationships between public and private investigators. Interviews had an average duration of one hour and twelve minutes, with the shortest interview spanning twenty-six minutes and the longest two hours and fifteen minutes. All interviews were conducted face-to-face, and most interviews were with a single person, although a few were conducted with two respondents at a time. When possible, the interviews were recorded to be transcribed verbatim at a later time. One respondent did not consent to being tape-recorded,[10] and on eight occasions it was not practical to record the conversation; in these cases extensive notes were taken.

In addition, two observations were conducted, one with an independent corporate security firm (end of 2012, seven weeks) and one with an in-house corporate security department within a large Dutch firm (early 2015, six weeks). The two different settings were chosen to see whether the general picture of corporate investigations would be similar in the different contexts. From these observations, rich data has been derived. The observations were recorded in a daily observation report, based on an observation schedule. During the observations both informal conversations and interviews were conducted.[11] In addition, the observations provided twenty-one case studies, which were separate case files from investigations done by the observed investigators. Cases were selected on the basis of criteria such as employee involvement, sensitivity of the incident, the type of settlement chosen and the involvement of law enforcement. They were analysed using a topic list, describing, among other things, the case, the (type of) client, the investigative methods, the interests that were involved, the settlements chosen and the role (if any) of law enforcement. Not all information could be gathered from the case files; however, additional questions to the investigators often provided an answer here.

All data gathered is treated with utmost confidentiality and has been anonymised to ensure that no information can be traced back to the respondent or his or her employer. The article should not be regarded as generalising to the Netherlands as a whole; the statements made are indicative of the respondents in the research (who do suggest that their statements are more generally applicable).

2 The Appeal of Private Investigations

In the Netherlands, as in many other countries, private parties do not have legally defined powers of investigation. This circumstance means corporate investigators are restricted in their investigations as they are not allowed to, for example, enter or search premises without the consent of the owner. This type of far-reaching investigative power is reserved for law enforcement and safeguarded by legal norms.[12] On the other hand, not

8. The respondents are not equally divided among the three groups. The reason for this lies partly in the fact that the research project is ongoing and not all data had been gathered at the time of writing. In addition, the choice was made to put emphasis on the investigators. Saturation was achieved. Care was taken that the selection of respondents reflected the Dutch situation. For example, among the group investigators, respondents were selected from private investigative firms, in-house security departments, forensic accountancy departments and law firms.
9. M. Lamont and P. White, *Report on Workshop on Interdisciplinary Standards for Systematic Qualitative Research: Cultural Anthropology, Law and Social Science, Political Science, and Sociology Programs* (2014).
10. The reason given for this was that the respondent felt she could not guarantee anonymity to her clients if the conversation was recorded. The respondent seemed to talk freely once she was assured of anonymity and that the conversation was only recorded through notes.
11. These formal interviews (four in observation 1 and seven in observation 2) are included in the total number of interviews mentioned above.
12. *See* the Dutch Criminal Code.

being endowed with investigative powers also means that the strict regulations and procedures a criminal investigation has to follow are not applicable to a private investigation. This gives the investigators considerable leeway to act within their means as they see fit. Private persons are allowed to investigate behaviour that is harmful to them – or to ask other private persons to do so – as long as they do not violate any laws. Legal persons are considered private persons in this sense, and when they act as client to corporate investigators, corporate investigators may use the investigative possibilities of their client. As an employer, a company has the right to control certain behaviours of its employees, and many companies have made provisions in the labour contract for the use of this information for investigative purposes.[13] Corporate investigators thus often have access to a lot of information.

Because of the large diversity of actors with different backgrounds working in this field – ranging from former police officers to lawyers, IT specialists and forensic accountants – there is a wide variety of skills and expertise, going well beyond those of police investigations. These skills are applied to provide clients with swift results that can be used to prevent future incidents and, possibly, restore at least some of the damage done. The different backgrounds of corporate investigators also mean that different rules and regulations apply. As mentioned above, specific legal regulations with regard to private investigations are provided only for Wpbr-permit holders (private investigation firms). For forensic accountants and lawyers working as investigators, there are the more general rules and disciplinary proceedings in place for their profession as a whole (additionally, in forensic accountancy there are principles of law expressed in (non-binding) guidelines). In-house investigators are governed by internal regulations. All investigators have to adhere to the law on the protection of personal data (WBP), and most respondents state they apply themselves to the more stringent principles of law applicable to accountants[14] and the privacy code[15] that has been written by the representative organisation of private security firms (which has been approved by the data protection authority). It would go beyond the scope of this article to discuss these different rules and regulations in depth, but where applicable, they are mentioned. It should be noted, however, that most rules regulating corporate investigators' behaviour remain very general. The Privacy code of conduct for Wpbr-permit holders is the most specific set of rules; however even these do not give guidance in every situation.[16]

The diversity in backgrounds and accompanying expertise make the corporate security field of interest to prospective clients. In his work on forensic accounting and corporate investigations, James Williams has pointed out certain advantages of corporate investigations from the viewpoint of clients.[17] The flexibility in investigative methods and solutions; the orientation on private troubles rather than criminal acts; and the possibility of discretion and control are important characteristics that lead clients to prefer a corporate investigation over the involvement of law enforcement agencies. This indicates that distinctions between public and private remain relevant in the field of corporate security even though integrated networks of security seem to emerge in other areas such as public spaces or shopping areas.[18]

The article takes a closer look at the types of investigative methods and sources of information which make it possible to provide clients with the services and information they need. While corporate investigators stress their professionalism and neutrality, it is the client and its interests that are leading. Investigations are directed towards answering the questions that have been formulated in the assignment by the client. Thus, the services that are provided are tailor-made to meet the needs of the client. For example, when investigating a suspicion of fraud, corporate security investigators can be very cautious in their investigations, so as not to create unrest within the company. The interests of the client are prioritised in the investigations and this may mean that the investigations need to take a more subtle approach than the police would take.

> Ok so the police come in, take the administration. Do you have any idea what that does to an organisation? People go home sick, totally lost. And with us, things go more quietly. They don't even notice. They do when we start interviewing and that will produce unrest of course but that's at the end of the investigations. What we do is more subtle, we do custom made work. [Respondent 1]

Investigative firms and departments differ in their backgrounds and structure, as reflected by the observations conducted during this research. For example, there are large and small investigations bureaus (or forensic departments within accountancy or legal firms), and there are large and small in-house departments within large companies. Observation 1 was within an independent corporate security company, with six employees at the time of observation, of whom five were involved in (all kinds of) investigative activities. Observation 2 was within an in-house security department within a large Dutch company, with fifteen employees at the time, of whom eleven were involved in investigative activities. In Observation 2, there was a division of labour, with one team being responsible for the intake and registration of cases, one team focusing primarily on desk research and

13. C.D. Schaap, *De private forensisch fraudedeskundige. Een feitelijke en juridische positionering* (2008).
14. NIVRA/NOvAA, *NBA-handreiking 1122. Praktijkhandleiding persoonsgerichte onderzoeken voor accountants-administratieconsulenten/registeraccountants* (2010).
15. Nederlandse Veiligheidsbranche (NVB), *Privacygedragscode sector particuliere onderzoeksbureaus van de Nederlandse Veiligheidsbranche* (2016).
16. *Ibid*.
17. Williams (2005), above n. 3.
18. Williams (2014), above n. 7.

one team (in the lead of the investigations) focusing on interviewing.

3 The Ambit and Language of Corporate Investigations

Depending on the position of the investigators, an investigation usually starts with an intake of the assignment (in the case of an external investigator) or the report of an incident to the security department (in the case of an in-house department).[19] In both cases it is customary that the 'owner of the problem' – be that the manager of the suspected employee, the Board of Directors or someone else – and the investigators talk about the reported incident in order to have a clear idea of the scope of the problem. The extent to which this is possible at the start of an investigation may differ widely. Respondents indicate that investigations may start with a very clear suspicion towards one person or a pretty straightforward problem, but it is also possible that the question put to the investigators is very broad. It happens, for example, that the client is merely aware that something is not quite right, but cannot put his finger on the actual issue. This means that the assignment of corporate investigators may be very specific or pretty broad. Respondents state that the goal is to define the assignment as strictly as possible before starting with the investigations. This is especially relevant for investigations conducted by external firms (as distinct from in-house or self-investigations) and in cases in which a certain individual is investigated (person-oriented investigations).[20] While this predetermined focus is helpful and beneficial to involved persons in the sense of the protection of their privacy, it also has the danger of the investigations being pushed in a certain direction. 'So carefulness and clarity are important in your investigations, making sure you are not being used as the stick to beat the dog and the individual is treated fairly' [Respondent 27].

However narrow an investigation may be at the start, during the investigative process the scope of the assignment may, in consultation with the client, be broadened or narrowed down. A broader scope usually means more investigations and thus more expenses, which makes deliberation with the client necessary. Respondents from in-house investigative units indicate they have more independence in determining the scope of the investigations. According to respondents, the dialogue with the 'problem owner' is especially relevant in the first phase of the investigations.

> [The level of contact with the client] depends on the phase your investigations are in, the nature of the issues involved. In the beginning of the investigations you're going to have much more contact with the client about things like, what kind of information are you going to need, what's available internally, which information will need to be secured right away… That's contact on the operational level, with the IT-department, the business line, the department that's responsible for the issue. And the question is for example, will it be necessary to collect your information quietly or do the employees already know there's going to be an investigation and is it ok for you to contact the department and deliberate? How are we going to secure the information, is it a lot, are we going to gather everything, digitalise the information and put it in a big computer so we can search efficiently later on? Or is it limited in scale and maybe already digitally present? Well, those are the kinds of questions that are relevant at the start of your investigations. [Respondent 13]

After the assignment is determined and the problem defined, the investigations can commence. The methods to be used depend on the case. The use of cameras may be very helpful to see who has taken money from a cash register, but it might prove useless in case of loss of money through digital channels. In addition, the internal information and systems that are available partly determine the path the investigations will take. Some clients may have their own camera systems, track-and-trace devices or other useful tools for investigations, while others do not. In some cases, an employee suspected of wrongdoing is kept in place purposively so investigators might catch him or her in the act. In others, the employee is suspended from active duty at an early stage of the investigations so he or she may cause no further harm. This also depends on the severity of the matter.

> With someone who has an important position in the organisation you don't want to wait until you have the results of the investigations before you act, he will be suspended immediately. That person will therefore know about the investigations in advance. When it's about the disappearance of items from the work floor or someone taking money from the till, you can wait and see what happens if you for example would mark a certain item [CM: to see who takes it]. There's much less of a rush there and the critical risk is less prominent. [Respondent 50]

In general, corporate investigators prefer a suspension over an immediate dismissal of the involved person for the duration of the investigations. 'Sometimes the circumstances warrant immediate action. We prefer a suspension [CM: over a dismissal]. So they are still held to comply with your investigations because of their labour relation with the client' [Respondent 1].

The order in which the various methods are used may differ. However, it is common to start with the investigation of administration and the interviewing of witnesses. The interview of the involved person(s) is usually reserved for the end of the investigations, so as to be

19. *Ibid*.
20. As distinct from broader investigations into the organisation, not focusing on an individual but an issue.

able to confront the person with the evidence against him or her. During the investigations, many corporate investigators keep an investigative journal for internal use. This journal records relevant actions taken by the investigators, contacts they may have had with people and other relevant information. Especially when there are multiple investigators involved in a case, this may prove very useful (however, respondents also indicate that the thoroughness with which this journal is kept differs among investigators). The journal can be regarded as a log and may be used for the eventual report.

After the investigations have been concluded, a draft report is made. Relevant parts of the report are then usually handed to the involved person to read, in accordance with the adversarial principle (see paragraph 6 of this article). After all involved persons have had the opportunity to exercise their right of inspection, the draft report is finalised and given to the client.[21]

As do most professional procedures, private investigations have their own language. In legal terms, the public and private activities are separated by different terminology. During my interviews and observations, most respondents from the private sector referred to their activities with different words than commonly used for criminal justice investigations, and some made a point of avoiding 'law enforcement terminology'. Interestingly, clients and law enforcement respondents seem to make less of an issue of this. However, most respondents avoid, for example, the word 'suspect', using the words 'subject' or 'involved person' instead.[22] The same goes for the information source of personal communication: private investigators do not *interrogate* but they *interview*.[23] This difference in terminology also emphasises the difference in investigative powers, as the power to interrogate someone is exclusive to law enforcement agencies. The Privacy code of conduct of the representative organisation of private security in the Netherlands (NVB) states:[24]

> This code of conduct abstains from the use of concepts that are present in the criminal code to avoid confusion with the detection of crimes by law enforcement agencies. Private investigations do not take place under the authority and responsibility of the public prosecution office after all, and furthermore, its goals are different.

The differences in terminology seem to separate private investigators and law enforcement on a symbolic level, something that respondents seem to confirm. As one of the investigators in one of the observations said, 'I'm no private police'. Even though there are many corporate investigators with a law enforcement background, and their work may seem similar to the work of police and prosecution, there are notable differences. In what follows, the principal components of a private corporate investigation are discussed. First, the various sources of information, leading up to the eventual confrontation in the interview, are explored. Paragraph 5 discusses the next step in the investigations, in which the involved person is confronted with the information that has been gathered. Finally, paragraph 6 examines the investigative report, which concludes the investigative process.

4 Gathering Information: Investigative Methods Leading up to Confrontation

4.1 Internal Documentation

An important source of information for corporate investigators is 'the paperwork'. 'It's difficult to assess whether the person is telling the truth and by starting with the financials, you can get a sense of what might have happened' [Respondent 5]. When business is conducted, actions are documented. This (digital or) paper trail is a very valuable source of information in the reconstruction of where the money went. Since the client usually is the organisation where the irregularities occurred, its records are generally available to the investigators. Because the client can order its employees to cooperate fully with the investigations, relevant parts of the organisation may deliver documented information quickly. These documents include 'anything that has been written down'. 'We usually start with the records. And that is a very broad concept of course. There are financial records, digital but also hard copy. Digital is for example the books and hard copy the invoices, source documents, everything that the books are based on' [Respondent 5].

The way these documents are constructed depends on the type of services or products the client delivers, but generally there are invoices, contracts, tenders and project reports available. These source documents may provide an overview of what happened fairly quickly.

> That provides you with a lot of information, transactions are documented of course. There is someone ordering, there is someone who approves it, there is someone who enters it into the system.… Payments are usually cashless, which means there are bank records of them. So you try to gather all relevant information, refine your knowledge and document it. [Respondent 28]

Much can be derived from the financial administration of an organisation. Sometimes this provides a straight-

21. J. van Wijk, W. Huisman, T. Feuth & H.G. van de Bunt, *Op deugdelijke grondslag; een explorerende studie naar de private forensische accountancy* (2002).
22. This article also avoids 'criminal law terminology', as the use of these terms would be incorrect in this context. An involved person, for example, is not a suspect in the sense of a criminal procedure (and as such does not enjoy the same rights). The adversarial principle could be interpreted as being a criminal justice term (as it is a leading principle in criminal proceedings); however, in the Dutch legal system, this is a term that is used in all legal proceedings, from administrative to civil to criminal, and is thus not specifically linked to the criminal justice system.
23. *See* for example NVB, above n. 15.
24. *Ibid*.

forward story and not much additional investigating is necessary. Outgoing payments from the accounts of the client often provide information on the person who received the money. However, there are situations where constructions are used to disguise the path the money has taken and to hide the recipient. Information provided by the client might not be enough to trace the money or find out what happened. The access to documentation is limited to internal information from the client, although involved persons may (and sometimes do) provide access to their personal accounts. Sometimes this means that – because of the lack of investigative powers – corporate investigators will not be able to pinpoint the problem. 'There are situations where you need the powers of investigation of the police. Especially in these financial investigations. Sometimes you need a warrant to get bank records. We can't get to bank records of third parties – that would be highly illegal' [Respondent 1]. This problem of access makes it more difficult for corporate investigators to investigate the incident fully when, for example, subcontractors are involved. 'In the big investigation I told you about, there was a subcontractor involved and he had his administration, probably, at home. It wasn't available at our client company so we figured he kept it at home. We asked him for it but he didn't give it to us of course' [Respondent 5].

4.2 Internal Systems

There are many different 'internal systems' an organisation may use. Generally speaking, all these internal systems may be put to use for an internal investigation, as long as certain requirements are met (e.g. the employer has to announce in general terms to his employees that their movements may be tracked). Most of these systems are not meant for investigative purposes but can be used anyway. What kind of system is available depends largely on the (economic) activities of a client company. For example, logistics companies often have track-and-trace systems in their vehicles, and security cameras are used more often in a large warehouse than on an office floor.

4.2.1 Communications and Data Carriers

One category of internal systems revolves around employees' communications and use of data carriers. Email-inboxes, mobile phones, PC's, laptops and USB sticks may be searched when they are owned by the employer.[25] This means that investigators are allowed to investigate the use of company facilities. There are multiple, more and less intrusive ways to investigate communications and data carriers. According to the widely used principles of proportionality and subsidiarity, investigative methods should be proportional to the goal (and the interest of the client in reaching this goal) (proportionality), and the least intrusive methods should be used when possible (subsidiarity). For example, one could use a phone tap to record a telephone conversation, but one could also use mediation to track a phone. Mediation and inspection of phone bills are less intrusive because while they show where the phone has been and who has (been) called, the content of the conversation is not recorded. Often, mediation is a very useful tool. For example, in one of the cases used for the case studies, mediation was used to prove that an employee was near the building where some equipment was stolen on the day of the theft, even though he had called in sick and was no longer working in the building.

When, for example, some property has gone missing it might be helpful to also know what has been said in phone conversations or by email. Phone calls cannot be retrieved retrospectively, so a recording device has to be present at the time of recording. Taking the principle of subsidiarity into account, respondents state that they try to avoid this type of information gathering as it is considered to be intrusive, even though privacy legislation does allow it.[26] When it comes to email, older information could be retrieved. Email-boxes may be 'imaged' and stored in a database to search. This also goes for 'the digital environment' more generally. 'In the larger investigations, data recovery is a standard ingredient. This may become pretty complex because you have to take privacy regulations into account and when the data crosses the national border, this may be a problem' [Respondent 28]. Data carriers such as PC's, laptops, USB sticks and tablets can also be investigated with regard to content or activity (e.g. internet logs), as long as they are company property.[27] The growing use of BYODs (bring your own device, usually a laptop) may in this light prove problematic for investigators, as the investigation of these devices is not permitted. As mentioned before, private investigators lack the powers of investigation law enforcement has, and therefore their access is limited (though still quite extensive). Within the boundaries of available information, corporate investigators may, however, investigate more effectively than law enforcement would.

> Of course they [law enforcement agencies] may demand information and we will have to provide that. But often they don't quite know what kind of information they need. For example they ask for the laptop of the involved person. But with that they don't have access to our system, just the computer. You need authorised log in codes to access the system and they don't have that. I sometimes try to explain this but unless you're talking to someone from a specialised high tech team, they don't know what you're talking about. They don't understand how our systems work. Neither do I for some part but we have people here who do. Generally they just look at the laptop and stop there. There's an entire world of

25. NVB, above n. 15.

26. *Ibid*.

27. As long as they are accessible by the investigator. For example, when a work laptop is used and stored at home, investigators may only access it when the employee has handed it back to the employer. NVB, above n. 15.

information behind that which they'll never see. [Respondent 43]

4.2.2 Other Internal Systems

In addition to the aforementioned communication systems, there are many other internal systems that may provide information. Many companies, for example, use a key card system for employees to gain access to a building. These can be used to find out whether someone has been present at a certain site.[28] Track-and-trace or GPS systems are also used by some employers to keep track of their deliveries or vehicles, and these may provide information on someone's whereabouts. In addition, regular personnel files, such as a record of someone's work history at that employer, can be used as background information. A more controversial internal system is the blacklist. Although a blacklist meant for internal use is allowed by privacy law, it is obligatory to report sector-wide use of this beforehand to the data protection authority.[29] Many respondents indicate that they are not sure whether their blacklist meets the criteria, but they do keep a database with information on people who have been investigated or fired in the past.[30] These are often used as reference points in investigations (and in the process of hiring new staff). When an organisation has an in-house security department, this department often is the keeper of the blacklist. If not, another department (such as human resources) manages the list. In the latter case, investigators are not involved in the management of the blacklist (as they are not part of the organisation keeping the list). External investigative firms also keep their own records though, consisting of the documentation of their investigations. These are used as information for other investigations or background checks as well.[31]

Finally, the use of (hidden) cameras is not entirely free from controversy. Cameras may provide valuable information, for example when the footage can be used to ascertain which employee took money from the cash register. Although it is allowed to record employee's movements, privacy law prohibits the use of cameras in certain places (such as the bathroom). Furthermore, employees should be made aware of the possibility of camera surveillance.[32] 'We have many cameras placed in our buildings and people know this, they are made aware of it. When we have a missing item at a certain location, we can inspect the camera footage and look for suspicious actions that are not part of the work process' [Respondent 15]. Under certain circumstances, the use of covert cameras is allowed.[33] Respondents indicate that the use of covert cameras is the exception rather than the rule.

4.3 Open Sources

Much information can be derived from open sources. A large proportion of both professional and social life occurs online and for a person who knows where to look, the internet contains a lot of interesting information. In one of the observations, the investigations were organised in such a way that some investigators focused on doing 'desk research'. This contains the investigations of internal systems as discussed above, but also the investigation of open sources. One investigator was highly skilled in this type of desk research and had several (fictitious) accounts on social media sites so he had easy access to this information. Social network sites such as Facebook and LinkedIn may provide a broad overview of someone's life (e.g. posts, photographs, likes, sites followed) and professional network (which may be useful, for example, to show that a third party that is involved knows the involved employee).

In addition, there are some very valuable generally available or for-subscription databases. These might contain information on Chamber of Commerce records, name and address data and domain name registration. Many investigators have a subscription to these databases. Additionally, traditional media and the internet more generally (and search engines more specifically) could also provide a lot of valuable information to investigators.

4.4 Other Sources

Depending on the type of incident and the circumstances surrounding it, there are multiple additional methods of investigation. For example, observation can be useful, although most of my respondents did very few observations. Observing someone is allowed under privacy law, although not in every circumstance. In general terms, an observation is less likely to be considered a breach of privacy when it is done in a public place and for a short period of time. More intrusive forms of observation (such as dynamic observation using a tracking device) may be allowed, depending on the circumstances.[34] Observations (and the use of camera footage) are for example, used when an employee is suspected of sick leave fraud. Site visits may also prove useful to see whether the 'reality on paper' matches the 'actual reality'. 'For example, go and take stock for yourself and make sure that what's in the administration, is in fact what's in stock. To determine that, ok there is a possibility that the warehouse keeper or someone else took something' [Respondent 13]. Some organisations furthermore do a standard search of employees and their belongings when they leave the workplace.

> We also search people before they leave. We use a metal detector for that as well. Sometimes this may bring things to light. You know, situations where people take something that isn't theirs and that the

28. Although this circumstance alone is not sufficient proof, as people tend to use each other's key cards even when this is prohibited by the company code.
29. *See* Art. 22 under 2 sub b WBP; CBP, *Een zwarte lijst gebruiken* (2015).
30. This does not necessarily mean that the blacklist does not comply. Many larger companies have a privacy officer who is better informed on these issues than the respondents mentioned here.
31. NVB, above n. 15.
32. CBP, *Cameratoezicht op de werkplek* (2015).
33. NVB, above n. 15.
34. *Ibid.*

alarm will ring. They're asked to empty their pockets and well, if something's in there that doesn't belong to you, you're going to have a good conversation with me. [Respondent 15]

Other activities of corporate security investigators include the evaluation (and correction) of previous investigations, the evaluation of internal control systems, the calculation of damages in light of a civil claim and the tracing of assets. When a report is made to the police (which often happens only after the internal investigations have been concluded), law enforcement information may also be used to investigate further. However, law enforcement agencies are very careful with information sharing, as some investigators from the observations noted:

> That's the thing. They *think* there's no room but there is. The shutters close on mention of information sharing but that's not necessary. When I report a crime to the police, I would like to get some information on their interrogations etc. They say, 'no that's impossible because of privacy'. They're so afraid to get it wrong that the solution is not to share anything. We don't need operational details, it would be very helpful if they could just give us directive information without them having to have to start an entire investigation. Just to let us know whether we're on the right track. [Conversation in observation 2]

5 The Interview: Confronting the Involved Person

The interview is the most important source of information for corporate investigators, according to respondents. It usually is the last phase of the investigations, in which all information that has been collected is used to confront the involved person. Interviews with witnesses often occur at an earlier stage as they are informative (adding to the big picture). Many corporate investigators have a law enforcement background and are experienced interviewers. However, there are notable differences between an interview and a police interrogation. For example, there is no formal caution at the start of the interview because the interviewee is not a suspect in the sense of a criminal procedure. However, respondents indicate that they do point out at the start of the interview that the interviewee is not obliged to cooperate and that he cooperates on a voluntary basis.[35]

> His statement is made freely, I mean if during our conversation he decides not to want to talk about it, ok that's his story. I'm not sure he's going to be better off with that but when someone walks out the door, he walks. I'm not going to grab him by the neck and say, ok now you're going to talk. [Respondent 15]

The voluntary nature of the cooperation of an employee should not be overstated. There is a definite power imbalance between the employee and the investigators (providing a service to the employer). Investigators stress their independence within the assignment they receive. 'We have our own set of rules on how we conduct our investigations and we give this to our client at the intake of the assignment. Sometimes they say, can't you do this and that. No, sorry. These are the rules, this is how we do things' [Respondent 2]. However, this does not mitigate the power imbalance much. An employee is technically free to refuse to cooperate – in practice, he or she can feel forced to cooperate with the investigations by his employer. Investigators are aware of this 'limited voluntariness'.

> We caution people at the start of an interview, so to speak, by saying they are not obliged to cooperate. But they feel obliged of course. Sometimes someone asks, what will happen if I don't? Well then I will have to talk to your manager about that. An interview is very confrontational. I dare say we give high priority to fair play, we stick to our own procedures. But we're not treating someone with kid gloves. If someone has done something wrong, it's ok to let him feel that. We are about finding the truth, which can be in someone's advantage too. If you did nothing wrong and we're totally off track, here's your chance to fix that. [Respondent 44]

The Privacy code of conduct, binding to private investigation firms and used by many other investigators as well, pays attention to the question of undue pressure:

> The mere questioning of someone by a private investigator produces a certain amount of pressure. As interviews are done on a voluntary basis, as a rule there will be no undue duress. It is hard to draw the line between what is and what is not allowed. Keen interrogation is in itself legitimate. It is thus allowed to confront someone denying involvement with evidence and to point out his weak position. Undue pressure is exerted, however, when physical pressure is used. Making false promises and verbal abuse are also illegitimate.[36]

In addition to the legally defined rules, most corporate investigators have their own guidelines for investigations and interviews. These include the right of representation by a lawyer or union representative and the general obligation for the investigators to treat the interviewee with respect and refrain from applying undue pressure and presenting false information.[37] Moreover, interviewees are given the opportunity to have a break and are offered something to drink and eat. 'As of late we also include this in the interview report – that someone has been treated correctly, had something to drink

35. *Ibid*.

36. *Ibid*.

37. *See* for example GrantThornton, *Grant Thornton Forensic & Investigation Services B.V. Reglement onderzoekswerkzaamheden* (2010).

and had to opportunity to use the bathroom. That's also to have proof of this for a possible court case of course' [Respondent 45]. Because 'the first thing a lawyer tries to do, also in a police investigation, is to discredit the statement that has been made by the involved person' [Respondent 44].

Some respondents empathise with the interviewee, saying that they can understand the position he or she is in during an interview. However, most state, for example, that

> you need to be completely neutral in these things. You didn't contribute to this misery, you're just hired to get a clear picture of the mess and fix it. You need to be professional about that. Of course, you need to be friendly. When someone needs a break, you offer him one and you record this in the interview report. 'At that and that time interviewee was very emotional and we took a break'. So you also report what time you continued, you give the man some water, maybe suggest that he takes a walk in the garden. And sometimes, I join them, have a smoke, then some other kind of conversation unfolds. And when he's ready, you reopen the interview. [Respondent 1]

Interviews are generally done by two interviewers. There are multiple reasons for this, one of the most important being the need to have a witness for what has been said during the interview. Furthermore, having two people present is beneficial to the expedition of the interview.

> One of us takes care of the conversation, the other takes notes. So, we can make a report of the conversation on the spot and print it out and then the interviewee can read it and sign. When there are corrections that need to be made we will adapt the document, print again and sign it. The interviewee signs for having been made aware of the content of the interview report and he gets his own print to take with him. It happens that people don't want to sign because they do not agree or because they want to talk with a lawyer. In that case, we sign it anyway. And sometimes people don't even want to talk to us. [Respondent 44]

As the cooperation is voluntary, people may refuse their assistance in an investigation. This could mean that he or she does not want to talk to the investigators, or that the interview takes place but the person will not answer relevant questions. As the above quote shows, the interviewee is asked to sign the interview report with the interviewers, which he may refuse to do. In this case, a note is made at the end of the interview report and in the final report (see also below).

5.1 The Interview Process

Respondents explain that although an interview is often done in a comparable manner, there are no specific standard ways to conduct an interview. Different interviewers have different styles. There is also a difference with regard to the type of person who is interviewed (a witness or an involved person). Interviews with witnesses are more informative than confrontational and often happen at an earlier stage. (Self-imposed or formal legal) rules regarding the interview with a witness are less stringent than when it comes to an interview with an involved person. It is required by privacy law that an involved person is made aware of the investigations he is subject to at the very beginning of investigations.[38] However, there are some exceptions to this rule, for example for the protection of the rights of others (including the client).[39] In practice, this means that involved persons are often notified about the investigations at the moment of their interview, which often is at the conclusion of the investigations. Although there are situations 'in which you need to talk to the involved person as soon as possible, you often postpone this interview until you know exactly which questions to ask, based on the information you gathered' [Respondent 2]. The situation is then also avoided in which the involved person might destroy incriminating evidence.

> In principle, you provide the involved person with the code of conduct for investigations at the earliest occasion, unless investigative interests are opposed to this. So in case you have to start your investigations and the involved person is still working there, there's a chance evidence will be lost. For example because he erases all files from his computer or removes and destroys physical documents from the administration. That would be a reason not to inform him just yet. You will first have to secure the evidence and only after that, when you know everything is safe, you will notify him. [Respondent 2]

Interviews may take a very different turn from what investigators had anticipated. It is therefore important to stay flexible when conducting an interview.

> Sometimes you decide on a certain tactic for an interview but it turns out very differently. I remember a case where we were expecting this person to be uncooperative and so we decided to start with a confrontation right off the bat. But we entered and he was very open and he wanted to talk to us. You start with a certain tactic but just like that it's useless and then you need to converse with someone in a different manner than you'd expected. And it also depends on the subject matter. Or for example when someone is very emotional. Of course there are parts you can prepare beforehand but when you discover during the conversation that the important stuff is somewhere else you have to let go of your prepared list and move to that subject. So you can devise a certain grid but in practice it seems that you need to be very flexible with that. [Respondent 5]

38. Arts. 33 and 34 WBP.

39. Art. 43 WBP.

As this quote shows, however, interviewers do apply certain tactics during an interview, and they prepare for it.[40] The level and depth of preparation depend in part on the information that is already available. When the interview is used as a close to the investigations, usually there already is much information and 'you can write much down in advance, you can make a draft of the interview report and confront him with it. Then you add his reaction, his declaration' [Respondent 44].

The two interviews that I was able to attend during the observations had a certain structure. This structure is also put forward by respondents.

> There's always a difference between interviewers, I always say, you need to do your own thing. But the standard elements are that you start with a social talk, an explanation of the context of the interview, his rights and sometimes his duties. So basically what's in our code of investigations. And usually, you move from a general conversation to more specific elements. In this conversation you need to explain your assignment also. So you use a funnel so to speak, as an interview technique. The more specific questions are somewhere in the middle of the conversation. And then you start to show your evidence to the interviewee. There's a turning point in an interview from informative to confrontational. That structure is always there. [Respondent 1]

In general, the interviewers seem to build the interview around three phases. The first of these is centred on pleasantries – the interviewers start with light conversation to make the person feel at ease. This includes small talk, for example about a person's job. The voluntary nature of the conversation is stressed in this phase. 'I want to tell you that you are here voluntarily, which means that you don't have to cooperate and when you want to leave, you are free to do so. But of course we hope you will cooperate with us' [Observation 2].

After the interviewee has had the opportunity to talk freely about what he thinks is the reason he is there, the interviewers start with the second phase, 'confrontation'. Here the evidence that has been gathered through other channels is used to confront the interviewee with 'the holes in his story'. The ambience changes from being amicable to more stern. Respondents state they treat the interviewee with respect and do not apply undue pressure. This was also the case during the interviews witnessed by me during the observations. The mere setting of the interview, however, could put pressure on the person, even when no boundaries are being crossed. Especially when the employee is without representation, he might feel pressure to talk even though he does not want to. The interviewers are experienced, and, as mentioned earlier, respondents indicate that interviews are done in couples, which brings a certain force with it.

The final phase of the interview is the conclusion. At this stage the important information that has been discussed is summarised and either typed up directly or the interview notes are checked to make sure they are complete. Most respondents prefer to finish the interview report on the spot.

> When it comes to an involved person, [drafting the report at a later time] may not be the best course of action because then you run the risk he will rethink what he has said. 'I said that but maybe it wasn't wise to do so, so I want it deleted'. When you correct the report directly, print it, let him read it and comment and ask him to sign, this risk is much smaller. [Respondent 2]

The atmosphere seems to change back to amicable in this last stage. The interviewers and interviewee might discuss what will happen next and what the motivation was for the transgression. If the report is typed up on the spot, the interviewee – in accordance with the adversarial principle – gets the opportunity to read it and comment on factual errors. He is then asked to sign the document, along with the interviewers. This is also voluntary – the interviewee is not obliged to sign. 'For example, this involved person X refused to sign his interview reports. We did sign, these were the statements he made to two witnesses [interviewers]. So if it comes to a trial, we can testify under oath about this' [Respondent 1]. If the report is typed up at a later time, the interview report is sent to the interviewee to comment upon and sign. Respondents do not deem it problematic if the interviewee refuses to sign the document. When this occurs, a note is made that the document has been offered to the person to read and sign but that he or she has refused to do so. Generally, this is considered to provide enough information to make the interview report usable.[41]

Interview reports differ in size, but they are often a summary of what has been said instead of a verbatim account. The interview reports available to me during my research were mostly limited to a few pages. This is not a good indicator of the duration of the actual interview – only the relevant parts of the conversation are summarised in the interview report. This means that the interviewers have quite some freedom in drawing up the interview report. However, the interviewee has the opportunity to amend the report when he thinks important parts are missing. The interviewee sometimes wants to exclude certain information from the interview

40. There are many (mostly US) textbooks, e-learnings and other professional information available on different approaches and interview techniques. In this paragraph the broader outlines of the interview as a source of information are described – these very detailed instructions on how to interview are beyond the scope of this article. Additionally, the fieldwork reveals that many corporate investigators feel that interviewing can be taught but much importance is given to experience and following one's own instincts. Although they state that there are no standard ways to interview, stressing the importance of flexibility, they seem to broadly follow the process as delineated in this paragraph. *See also* N.F. Coburn, 'Corporate Investigations', 13 *Journal of Financial Crime* 2006 (348).

41. Van Wijk *et al*., above n. 21.

report, 'for example private information that his manager has no business knowing' [Respondent 45]. It happens that investigators honour the request of the interviewee, but only when the excluded information is not relevant for the case.

> And when someone wants to change something we don't agree with, we make a note of that and sign that too. Openness, transparency, completeness. Pro and contra. Those are important principles. It rarely happens that an interview report is reproduced in full in the final investigations report but such a comment will be mentioned in the report when relevant – either to support or to defy your conclusions. [Respondent 1].

The fieldwork reveals that using the methods of investigation discussed, corporate investigators are often able to provide a pretty complete reconstruction of the incident. Using phone records, combined with open sources such as social media, investigators can map who has been in contact with whom, where a third party lives, works, etc. Furthermore, investigations into financial records and other relevant documents can provide insight into fraudulent financial transactions. When it comes to theft from a shop, for example, cameras and employee log files can be very useful. Although all methods and sources of information described here are valuable, respondents tend to place most importance on the interview as a source of detailed information. Usually, the investigations lead up to the interview with the involved person(s). In these interviews, information can be checked, details added and errors corrected – that is, when the interviewee decides to cooperate. All this information needs to be made available to the client in a concise and clear way. To achieve this, an investigative report is written.

6 Reporting on the Investigations

Once the investigations have been concluded and the questions that were the basis for the assignment can be answered, the information has to be made available to the client. Reports are often quite short and to the point, as respondents indicate that this format is best appreciated by their clients. A report needs to be clear on the facts and easy to read.[42] Depending on the nature of the assignment and the complexity of the incident, reports may be merely 2 pages (not including appendices), while others may span 150 pages. 'The size of a report varies between assignments but thirty pages is usually about the length for us. Sometimes they are very factual, then a lot of appendices might be attached, for example interview reports' [Respondent 36]. Some investigators prefer to use appendices, while others prefer to integrate relevant parts of interview reports or other findings in the report without them being attached. 'These interview reports are for internal use, to build our case. They are not an integral part of the eventual report. We do use them to quote from, especially crucial parts' [Respondent 5].

It is difficult to give a standard format of an investigative report, as there are notable differences in the way the findings are presented. However, most investigative reports contain the following subjects:[43] 'A report is typically formatted like, what was the assignment, what was the scope, what did we do and what did we find?' [Respondent 36]. Some investigators also add some legal information, a preface with some kind of disclaimer or other relevant information. Opinions seem to differ with regard to the necessary information for a report, although there is some consensus that a report should be transparent about the presented findings and how these have come to the fore. The client needs to be able to assess the validity of the report and interpret its findings.[44] Some commentators suggest that it is necessary to have a predetermined goal for the investigations, for example a report to the police or a dismissal.[45] When agreed upon between client and investigator, this predetermined goal is usually presented in the report. However, in practice the decision about what to do with the results is often made only after the results are clear. 'For example, we hand in the report and the client says, "I didn't know it was this serious, I want to report to the police after all". Ok, so then we go and report to the police' [Respondent 1].

The standard of evidence in a civil procedure is lower than that which is used in criminal court. 'Improperly obtained evidence is not as problematic for the procedure in civil court. A civil judge will not readily dismiss evidence, he might reprimand you for it but he has heard it anyway and will use it. Plus, often it is not the only evidence you have, you can build your case with the other evidence as well' [Respondent 50]. Cases may also be concluded entirely without the involvement of a judge,[46] which makes the way evidence is gathered even less of an issue in that sense. However, respondents indicate that they feel it is important to 'go by the book', both in a moral sense and because in many cases the decision about how to handle the matter is made only after the investigations have been concluded and the report is handed in to the client. Some respondents therefore state that they try to aim for the standard of evidence that is used for criminal investigations. 'You

42. L. van Almelo and P. Schimmel, *Feiten maken het recht; Forensic accounting revisited* (2014).

43. There are some (very general) standards provided for forensic accountants, but not all corporate investigators use them. NIVRA/NOvAA, above n. 14.

44. J.F. Rense, 'De private onderzoeker; (ver)plicht tot hoor en wederhoor?', 78 *Maandblad voor Accountancy en Bedrijfseconomie* 76 (2004).

45. P. Schimmel, *Fraudebeheersing; een leidraad van preventie tot detectie* (2011).

46. C. Meerts, 'Over pragmatisme en strategie verschillende routes voor private opsporing en afhandeling van onregelmatigheden binnen organisaties', 56 *Tijdschrift voor Criminologie* 115 (2014).

have the highest standards for the burden of proof there, beyond reasonable doubt. If it complies with that, it will comply with the others as well. So this way, these other settlement possibilities will all remain an option' [Respondent 1].

Before the report is handed over to the client, the involved person will usually get the opportunity to read the relevant parts of the report and comment on it. This implementation of the adversarial principle is derived from accountancy rules; however, most respondents state they comply with this rule even if they do not have an accountancy background.[47]

> And especially when it concerns an involved person – you're required to do so because it's a person-orientated investigation – we use the adversarial principle. The first phase of that is to invite him to answer some questions. And the second is that when you make a final draft of your report containing parts that concern that person, you give him the opportunity to react to it. So he can read it and comment on it. And those comments are added to the final report…. And I think this is a good thing and very reasonable. I think that's very important, it can't be the case that you just go about your investigations without ever speaking with this person and still write a report about him. Obviously, that's not right. [Respondent 5]

Not every involved person takes the opportunity of reading the relevant parts of the report. Respondents indicate that this is not necessarily problematic, however it does mean that caution should be applied when presenting findings.

When the adversarial principle has been applied and the draft is amended, the report can be finalised and signed. Not every investigation yields enough information to answer the questions asked in the assignment. When this is the case, a report is made about the findings and the lack of certainty is stated. Whether or not a conclusion of findings is drawn in this final report depends on the type of investigator. For example, forensic accountants consider drawing conclusions from the presented facts or providing advice to their client in a report 'not done'.

> We are hired for the *fact finding*, a forensic accountant does not assign value or interpret findings. At the most, the report will state the rules that are applicable and the behaviour that it concerns. The rule and the behaviour will be presented side by side but it will not be stated that the conduct was improper. Clients always ask for a conclusion, 'just write down what you think'. But that would be subjective. The report sticks to the facts. [Respondent 36]

Others prefer to give some advice on how to proceed but the extent of this advice also differs among respondents. This respondent, for example, does include some advice on the possible ways of settlement but provides no opinion on the best solution in the current case:

> Every case is different, the interests involved are different. Every time you're faced with a different web, different tensions. The outcome is different every time. But you know, I don't really care about that. We have a job to do and do it well. You can provide your client with the options but I'm not going to be the one to say, this is the way to go. Who am I to say they should report to the police? [Respondent 1]

Corporate investigators with a legal background are more inclined to provide advice on how to proceed:

> And eventually you will come to the point that you write your report and explain your findings but also draw conclusions based on that. That could be that there must be measures taken against certain persons or that the structure of the organisation should be changed…. And it could also lead to the question whether or not the incident should be reported to the police. And that's often a tough one to answer. [Respondent 30]

The extent to which corporate investigators may influence decisions about settlement of the incident differs; however, respondents indicate that the actual decision is not taken by investigators. The client is the one who decides. In in-house security departments, the division between the investigators and the decision makers may get blurry at times. 'Whether or not it needs to be reported to the police is a decision that does not concern HR. They want to take the decision, but it will be me who sees whether or not I find it useful. The policy is, report every time, in practice it hardly ever happens. I'm the one who has to go there and file the report so I'm the one deciding' [Respondent 48].

> We do the investigations and that's it. Two of my colleagues have a different opinion, when they say someone's guilty he should be fired, another has a more nuanced take on the matter. Our job is the investigation, getting the evidence and building a case that would hold up in court if necessary. The decisions lie with the involved manager and HR. [Conversation in observation 2]

Interestingly, respondents working in an in-house corporate security department indicate that not every investigation merits a report.

> We don't always write a report, we get a lot of rubbish cases. In that case, it's no use to write an entire report. The rule is that when they want to fire someone, we do write a report for the involved business unit, with an advice attached, for example about the processes that made the transgression possible. But when they are just going to give the involved person an official warning, there will be no report. Maybe

47. Rense, above n. 44.

we'll give some advice but nothing written down. When there is no report, your notes, the journal and our registration system 'are the report'. [Respondent 43]

In such a case, the case notes are simultaneously the final product of the investigations.

7 Discussion: Differentiation?

This article has explored the investigative methods that are used by corporate security in its investigations into incidents within organisations. Having to work without the investigative powers of law enforcement agencies might pose some problems for corporate investigators, but it also provides possibilities. There are instances when the information provided by the client and gathered through the cooperation of various people proves to be inadequate to reconstruct what happened. Corporate security cannot force people to cooperate[48] (although a certain amount of duress might be present), nor is it allowed to, for example, enter and search private premises. This may mean that a report to the police will be necessary if clients want to investigate the incident fully (which they may not).

Conversely, corporate security is more flexible than the police are.[49] It is responsive to clients' needs, and because of the close connection to the client and a contractually created duty of confidentiality, much information is readily available. Furthermore, because of this and the absence of the need to wait for formal approval from for example a judge, corporate investigations can be executed and concluded fairly swiftly. The absence of formal investigative powers may have sparked the creativity of investigators to take a broader approach to investigations and use methods of investigation that may be regarded as more private in nature. The use of forensic accounting techniques, IT tools and open sources (for a large part digital social networks) does not fall in the category of 'traditional police work' (although the police are also increasingly making use of these techniques and information sources).

This article has focused solely on the methods of investigation that *private* investigators have at their disposal. As such, the methods of investigation that law enforcement officials might use have not been discussed, and a full-blown comparison between public and private is not within the scope of this article. One important defining characteristic of law enforcement, though, is its power of investigation and the legitimate use of force. Respondents who have previously worked in public law enforcement indicate that they feel handicapped by not being able to use formal powers of investigation. The lack of investigative powers and the use of more specifically private investigation methods mark a line of differentiation between public and private actors in this field (external differentiation). This seems to be underlined by the avoidance of 'criminal justice terminology' by corporate investigators.

In addition to the private investigation methods that may be used by corporate investigators, another defining characteristic of the field is the diversity of people working in it. Although there are many former police officers working in corporate security, there are also numerous 'private actors' active in the sector: forensic accountants,[50] private detectives[51] and in-house security departments (consisting also of people with a background specific to the sector of the company where they work).[52] In more recent years, lawyers have also established a place in the private investigation industry.[53] These different actors also bring their own expertise and skills to the table. The internal differentiation within this field may also be discerned in the different rules and regulations that apply to the different actors. And yet, although there certainly are differences between these actors, there is also a large common ground between them. Together, these actors – from varying backgrounds, with specific occupational cultures, all lacking formal investigative powers and yet all enjoying a high degree of discretion and operational flexibility – constitute the corporate security field in the Netherlands.

Thus, we might conclude that the field in which corporate security moves is characterised by differentiation. First, externally, there is differentiation between private actors and public authorities in relation to the methods used, the power to use them and the rules one has to comply with. Second, there is internal differentiation within corporate security, according to professional backgrounds. This article has focused upon the first of these – the public/private differentiation – by taking a closer look at corporate investigation methods. As Williams has previously noted, public and private actors are not interchangeable here.[54] Interestingly, corporate security respondents seem to (symbolically) emphasise this differentiation between them and law enforcement, by avoiding the use of 'law enforcement terminology'. Private corporate investigators have created a formalised professional private sphere, in which they use their skills and expertise to provide clients with the services they need. Previous research has remarked upon the benefits for organisations of such a private solution over a police investigation (and subsequently, a criminal tri-

48. Neither can the police, of course, although they do have the power to summon documents, enter buildings without consent (when this is approved by a prosecutor or judge), etc.
49. Williams (2005), above n. 3.
50. *Ibid*.; J.W. Williams, 'Private Legal Orders: Professional Markets and the Commodification of Financial Governance', 15 *Social & Legal Studies* 209 (2006); Williams (2014), above n. 7; Van Wijk *et al*., above n. 21.
51. Gill and Hart (1997), above n. 3; M. Gill and J. Hart, 'Private Security: Enforcing Corporate Security Policy Using Private Investigators', 7 *European Journal on Criminal Policy and Research* 245 (1999).
52. Nalla and Morash, above n. 3.
53. B.C.G. Jennen and H.J.TH. Biemond, 'Het interne fraudeonderzoek: enkele juridische overwegingen', 4 *Tijdschrift voor de Ondernemingsrechtpraktijk* 57 (2009).
54. Williams (2005), above n. 3.

al).[55] Thus, differentiation rather than convergence between public and private seems to be the key concept in the field of corporate security.

One implication of this differentiation between public and private and within the private sphere is the difficulty with regard to oversight over the activities of corporate security. As mentioned, different actors have different regulations to comply with, some more formal and binding than others. The distance between public and private and the large proportion of activities that stay completely in the private sphere make it all the more difficult to control the applications of these rules. Although not as intrusive as the formal powers of investigation of law enforcement, corporate investigations may have a large impact on the lives of the people involved: a lot of information may be gathered about a person, and the consequences (loss of employment, repayment of damages, a criminal prosecution) may be considerable. This research has not found indications of illegal action by investigators – however the looseness and diversity of rules and the lack of oversight make for some potential for abuse.[56] Even when all the (formal or self-imposed) rules are followed, the impact of private corporate investigations may be substantial, and there is also the possibility of the abuse of the power imbalance that exists between the organisation and the person(s) under investigation. More research into the field of corporate investigations and private settlements is therefore warranted. One interesting line of research would be to focus on the interaction between the rules on the one hand and the behaviour of investigators in practice on the other.

55. *Ibid*.; C. Meerts, 'Corporate Security: Governing through Private and Public Law', in K. Walby and R. Lippert (eds.), *Corporate Security in the 21st Century: Theory and Practice in International Perspective* (2014) 97.

56. There are some disciplinary and civil cases about the behaviour of investigators. *See*, for example, ECLI:NL:TACKN:2016:49, ECLI:NL:CBB:2016:148 and ECLI:NL:RBMNE:2015:5572. (Grave) misbehaviour of investigators is not very readily assumed.

Keck in Capital? Redefining 'Restrictions' in the 'Golden Shares' Case Law

Ilektra Antonaki*

Abstract

The evolution of the case law in the field of free movement of goods has been marked by consecutive changes in the legal tests applied by the Court of Justice of the European Union for the determination of the existence of a trade restriction. Starting with the broad Dassonville and Cassis de Dijon definition of MEEQR (measures having equivalent effect to a quantitative restriction), the Court subsequently introduced the *Keck*-concept of 'selling arrangements', which allowed for more regulatory autonomy of the Member States, but proved insufficient to capture disguised trade restrictions. Ultimately, a refined 'market access' test was adopted, qualified by the requirement of a 'substantial' hindrance on inter-State trade. Contrary to the free movement of goods, the free movement of capital has not undergone the same evolutionary process. Focusing on the 'golden shares' case law, this article questions the broad interpretation of 'capital restrictions' and seeks to investigate whether the underlying rationale of striking down any special right that could have a potential deterrent effect on inter-State investment is compatible with the constitutional foundations of negative integration. So far the Court seems to promote a company law regime that endorses shareholders' primacy, lacking, however, the constitutional and institutional legitimacy to decide on such a highly political question. It is thus suggested that a refined test should be adopted that would capture measures departing from ordinary company law and hindering market access of foreign investors, while at the same time allowing Member States to determine their corporate governance systems.

Keywords: Keck, selling arrangements, market access, golden shares, capital

1 Introduction

Twenty-two years have passed since the Court of Justice of the European Union delivered its seminal judgement in *Keck and Mithouard*.[1] Things have changed since then and Europe is no longer the same. The Internal Market has evolved to such an extent that it is argued that we have probably reached the last stage of the dynamic process of economic integration, which represents a fully integrated, efficient and competitive European market that can successfully respond to the challenges posed by the globalised economy of our times.[2] Yet, some patterns of the past sometimes come to the fore to remind us that some questions still remain to be answered. After a plethora of cases dealing with all sort of national regulations, we are still trying to figure out the appropriate test that can provide us with an economically sound and legally solid solution to the eternal conundrum of what qualifies as a 'trade restriction'. Also we are still trying to reach a conclusion as to whether the various tests that the Court has occasionally applied in one freedom can be equally applicable to the others. The present article does not purport to have the answer to this immensely complex and multivariate challenge. But it does attempt to reflect upon the critical notion of 'restriction' as developed through the case law of the Court in the field of goods and draw some parallels with the case law in the field of capital. In particular, it focuses on the golden shares case law and seeks to investigate whether the doctrine of 'selling arrangements' as formulated by the Court in *Keck*[3] together with the refined 'market access' test can be transposed in the free movement of capital in the form of 'investments arrangements'[4] that would be excluded from the scope of Article 63 TFEU. The analysis that follows is divided into three parts: the first part provides a brief overview of the case law in the free movement of goods, depicting the evolution of the scope of measures having equivalent effect to quantitative restrictions (MEEQRs); the second part turns to the free movement of capital and attempts to identify three criteria that are used in order to define the notion of capital restrictions in the golden shares case law; and finally, the third part seeks to formulate a *Keck*-inspired test that could delineate the contours of capital restrictions and to explore whether this test could be regarded as a new avenue that the Court could potentially follow in its legal reasoning

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1. Joined Cases C-267/91 and C-268/91, *Keck and Mithouard*, [1993] ECR I-06097.
2. E. Spaventa, 'Leaving Keck Behind? The Free Movement of Goods After the Rulings in Commission v. Italy and Mickelsson and Roos', 34 *European Law Review* 914, at 929 (2009).
3. Joined Cases C-267/91 and C-268/91, *Keck and Mithouard*, at 16.
4. The term was coined by A. Biondi, 'When the State is the Owner – Some Further Comments on the Court of Justice "Golden Shares" Strategy', in U. Bernitz and W. Ringe (eds.), *Company Law and Economic Protectionism: New Challenges to European Integration* (2010) 95, at 96-97.

when dealing with special shareholdings in privatised companies.

2 Selling Arrangements and Market Access in the Free Movement of Goods

2.1 The Pre-*Keck* Case Law on MEEQRs

The establishment and development of the European Union's (EU) Internal Market has been to a large extent supported and promoted by the dynamics of negative integration. It was the Luxembourg Court that stepped in and took the lead in overcoming the political stagnation of the 1960s/1970s and facilitating the process of economic integration. With the two landmark decisions in *Dassonville*[5] and *Cassis de Dijon*,[6] the Court unleashed the powers of negative integration and inaugurated a new era, where any national rule capable of hindering, directly or indirectly, actually or potentially, intra-Community trade could be regarded as an MEEQR.[7] The principle of mutual recognition was proclaimed as the predominant criterion for determining whether a trade restriction existed or not.[8] This meant that the principles of non-discrimination and anti-protectionism were soon replaced by the strikingly broad and 'inherently nebulous'[9] concept of market access. The far-reaching consequences did not take too long to make themselves felt: in the aftermath of the two rulings, a wave of speculative national litigation mushroomed, calling for all sorts of national regulations to be disapplied as contrary to the free movement provisions.[10] Most of the contested measures were indistinctly applicable regulatory requirements that applied without distinction to domestic and foreign goods or traders and did not restrict or affect inter-State trade. This avalanche of legal actions against national rules regulating marketing and selling conditions was perceived as an intrusion into the domain of national regulatory autonomy, and it was increasingly suggested that the Court should clarify and delineate the boundaries of Article 34 TFEU.[11] In the same vein, Advocate General Tesauro in *Hünermund* courageously admitted that he had changed his mind in relation to his views in a previous case law,[12] and he opined that the *Dassonville* formula could not be construed as meaning that a potential reduction in imports caused solely and exclusively by a more general (and hypothetical) contraction of sales could constitute an MEEQR.[13] Accordingly, he asserted that rules that regulated the manner in which a trading activity was carried out were in principle to be regarded as falling outside the scope of Article 34 TFEU, insofar as they did not intend to regulate trade itself and they were not liable to render market access less profitable (and thus indirectly more difficult) for importers.[14] He believed that this approach was in line with the principle of mutual recognition established in *Cassis de Dijon* and did not in any way undermine its truly integrationist inspiration.[15] A different (i.e. more intrusive) interpretation of Article 34 TFEU 'would ultimately render nugatory the Treaty provisions … or in any event devalue them'.[16]

2.2 The *Keck* Ruling and the Introduction of the Concept of Selling Arrangements

The Court sooner or later realised that its broad definition of MEEQR and its blurry and ill-defined market-access approach had opened a Pandora's box. Thus, in 1993, when it was called upon to rule on the compatibility of a French prohibition on resale at a loss, it decided to put an end to the opportunistic and unsubstantiated litigation (though arguably in a clumsy manner). It explicitly expressed its intention to re-examine and clarify its case law in view of the increasing tendency of traders to invoke Article 34 TFEU as a means of challenging any rules whose effect was to limit their commercial freedom even where such rules were not aimed

5. Case 8-74, *Dassonville*, [1974] ECR 00837.
6. Case 120/78 *Cassis de Dijon*, [1979] ECR 00649.
7. Case 8-74, *Dassonville*, at 5.
8. C. Barnard, *The Substantive Law of the EU* (2014), at 656.
9. P. Oliver and S. Enchelmaier, 'Free Movement of Goods: Recent Developments in the Case Law', 44 *Common Market Law Review* 649, at 674 (2007).
10. J. Snell, 'The Notion of Market Access: A Concept or a Slogan?', 47 *Common Market Law Review* 437, at 447 (2010). *See e.g.* Case 286/81, *Oosthoek's Uitgeversmaatschappij BV*, [1982] ECR-04575 concerning a Dutch rule prohibiting the offering of free gifts for sales promotion purposes; Case 155/80, *Sergius Oebel*, [1981] ECR 01993 regarding a German prohibition on night-work in bakeries; Case C-69/88 *H. Krantz GmbH*, [1990] ECR I-00583 on a Dutch rule granting tax authorities the power to seize goods sold on instalment terms with reservation of title in case the purchasers were not able to repay their tax debts; Case C-145/88 *Torfaen Borough Council* v. *B & Q plc.*, [1989] ECR 03851 on the British prohibition of Sunday trading; Case C-23/89, *Quietlynn Limited and Brian James Richards*, [1990] ECR I-03059 regarding the British legislation prohibiting the sale of lawful sex articles from unlicensed sex establishments; Case 382/87, *R. Buet*, [1989] ECR 01235 concerning a French prohibition on canvassing in connection with the sale of English-language teaching material; Case C-271/92, *Laboratoire de Prothèses Oculaires*, [1993] ECR I-02899 dealing with a provision in the French Code de la Santé Publique reserving solely to holders of an optician's certificate (Diplôme d' opticien-lunetier) the sale of optical appliances and corrective lenses; Case C-126/91, *Yves Rocher*, [1993] ECR I-02361 on a German rule prohibiting advertisements using price comparisons (displaying the new price and comparing it with the old one so as to catch the eye).
11. E.L. White, 'In Search of the Limits to Article 30 of the EEC Treaty', 26 *Common Market Law Review* 235 (1989); L.W. Gormley, 'Case 145/88, Torfaen Borough Council v. B&Q PLC (formerly B&Q Retail Ltd.), Preliminary reference under Art. 177 EEC by the Cwmbran Magistrates' Court on the interpretation of Arts. 30 & 36 EEC. Judgment of the Court of Justice of the European Communities of 23 November 1989', 27 *Common Market Law Review* 141 (1990); A. Arnull, 'What Shall We Do on Sunday?', 16 *European Law Review* 112 (1991); K. Mortelmans, 'Article 30 of the EEC Treaty and Legislation Relating to Market Circumstances: Time to Consider a New Definition?', 28 *Common Market Law Review* 115 (1991); J. Steiner, 'Drawing the Line: Uses and Abuses of Article 30 EEC', 29 *Common Market Law Review* 749 (1992).
12. Opinion of Advocate General Tesauro in Case C-292/92, *Ruth Hünermund*, [1993] ECR I-06787, para. 26.
13. *Ibid*., para. 25.
14. *Ibid*.
15. *Ibid*.
16. *Ibid*., para. 27.

at products from other Member States.[17] Thus, it introduced the famous (or rather infamous) concept of selling arrangements: rules that restricted or prohibited certain selling arrangements were not such as to hinder directly or indirectly, actually or potentially trade between Member States as long as two conditions were fulfilled: (i) they applied to all relevant traders operating within the national territory; and (ii) they affected in the same manner, in law and in fact, the marketing of domestic products and of those from other Member States.[18]
The exact content of the concept of selling arrangements was revealed in subsequent case law: rules on shop opening hours,[19] rules requiring processed milk for infants be sold only in pharmacies[20] and certain restrictive rules on advertising[21] are some examples of the type of national regulatory provisions that were captured by the concept of selling arrangements and were thus excluded from the scope of Article 34 TFEU. In general terms, rules relating to the place and time of sales as well as to the marketing of specific products were in principle considered to be caught by the *Keck*-formula.[22]
However, the somewhat artificial dichotomy between product rules and selling arrangements proved inadequate and sparked an academic debate.[23] Lawrence Gromley noted that the exclusion of selling arrangements from the scope of Article 34 TFEU would lead to a lack of judicial review of ostensibly innocent measures, which could, however, constitute disguised restrictions on inter-State trade.[24] Stephen Weatherill, while recognising that the ruling excluded from the scope of the Treaty certain regulatory choices that do not damage the realisation of economies of scale, he nevertheless considered that it had a 'disturbingly formalistic tone' and it was 'flawed by the absence of an adequate articulation of just why it was possible to conclude that no sufficient impact on trade between States was shown'.[25] He thus proposed a refined *Keck*-test that would allow Member States to apply national regulatory measures to imported goods as long as they would apply equally in law and in fact to domestic and foreign goods and they would not impose *direct* or *substantial* hindrance to market access.[26]
The origin of this refined test can be traced back to the Advocate General Jacobs' opinion in *Leclerc-Siplec*,[27] where he expressed his famous objection to the *Keck*-inspired presumption of lawfulness of selling arrangements and proposed the adoption of a test based on '*substantial* hindrance on market access' for determining whether non-discriminatory rules infringed Article 34 TFEU.[28] The *significance* of the impact on market access was also espoused by other Advocates General[29] and legal scholars as a criterion for establishing the existence of an MEEQR.[30] It was argued that the case law offered room for *de minimis* considerations in free movement law, in the sense that 'minimal restrictive effects' did not affect market access, while several trade restrictions hindered *significantly* market access and thus impinged on Article 34 TFEU.[31] However, the position of the Court was less clear. Although it had ostensibly rejected the adoption of a *de minimis* test in the free movement assessment,[32] it effectively accepted a similar test by acknowledging that if the effect on market

17. Joined Cases C-267/91 and C-268/91, *Keck and Mithouard*, at 14.
18. *Ibid*., at 16.
19. Joined Cases C-401/92 and C-402/92, *Boermans*, [1994] ECR I-02199; Joined Cases C-69/93 and C-258/93 *Punto Casa and PPV*, [1994] ECR I-02355; Joined Cases C-418/93 *et al*., *Semeraro Casa Uno and Others*, [1996] ECR I-02975; Case C-483/12, *Pelckmans*, published in the electronic Reports of Cases.
20. Case C-391/92, *Commission* v. *Greece (processed milk for infants)*, [1995] ECR I-01621.
21. Case C-292/92, *Ruth Hünermund*, [1993] ECR I-06787; Case C-412/93, *Leclerc-Siplec* v. *TF1 Publicité*, [1995] ECR I-00179; Joined Cases C-34/95, C-35/95 and C-36/95, *De Agostini*, [1997] ECR I-3843; Case C-405/98, *Gourmet*, [2001] ECR I-1795.
22. Case C-71/02, *Herbert Karner*, [2004] ECR I-03025, at 38.
23. The *Keck* judgement and its implications for the functioning of the internal market have been extensively analysed by legal scholars. *See* indicatively L. Gormley, 'Reasoning Renounced? The Remarkable Judgment in Keck & Mithouard?', 5 *European Business Law Review* 63 (1994); M.P. Maduro, 'Keck: The End? The Beginning of the End? Or Just the End of the Beginning', 1 *Irish Journal of European Law* 30 (1994); N. Bernard, 'Discrimination and Free Movement in E.C. Law', 45 *International and Comparative Law Quarterly* 82 (1996); C. Barnard, 'Fitting the Remaining Pieces into the Goods and Persons Jigsaw?', 26 *European Law Review* 35 (2001); A. Tryfonidou, 'Was Keck a Half-Baked Solution After All?', 34 *Legal Issues of Economic Integration* 167 (2007); I. Lianos, 'Shifting Narratives in the European Internal Market: Efficient Restrictions of Trade and the Nature of "Economic" Integration', 21 *European Business Law Review* 705 (2010); C. Barnard, 'What the Keck? Balancing the Needs of the Single Market with State Regulatory Autonomy', 2 *European Journal of Consumer Law* 201 (2012); S. Weatherill, 'The Road to Ruin: "Restrictions on Use" and the Circular Lifecycle of Article 34 TFEU', 2 *European Journal of Consumer Law* 359 (2012).
24. L.W. Gormley, 'Two Years After Keck', 19 *Fordhman International Law Journal* 866, at 885-886 (1996).
25. S. Weatherill, 'After Keck: Some Thoughts on How to Clarify the Clarification', 33 *Common Market Law Review* 885, at 887 (1996).
26. *Ibid*., at 903.
27. Opinion of Mr. Advocate General Jacobs in Case C-412/93 *Leclerc-Siplec*, [1995] ECR I-00179.
28. *Ibid*., para. 39.
29. Opinion of Advocate General Stix-Hackl in Case C-322/01, *DocMorris NV*, [2003] ECR I-14887, para. 78, where he underlined that 'The decisive factor should therefore be whether or not a national measure *significantly* impedes access to the market'. *See also* Opinion of Mr. Advocate General Van Gerven in Case C-145/88, *Torfaen*, [1989] ECR-03851, para. 24, where he argued that there was no room for a *de minimis* test, because Article 34 TFEU already presupposes a *serious*, and therefore a *more than appreciable*, obstruction to trade between Member States.
30. M.S. Jansson and H. Kalimo, 'De Minimis Meets "Market Access": Transformations in the Substance – and the Syntax – of EU Free Movement Law?', 51 *Common Market Law Review* 523 (2014). It is interesting to note that the authors of this article distinguish three substantive groups of *de minimis* thresholds: the magnitude (severity) of the restrictive effect, the probability of the restrictive effect and the causality between the measure and the restrictive effect. *See also* Steiner, above n. 11; Barnard (2014), above n. 8, at 147; H. Toner, 'Non-discriminatory Obstacles to the Exercise of Treaty Rights – Articles 39, 43, 49, and 18 EC', 23 *Yearbook of European Law* 275, at 285 (2004). Conversely, *c.f.* Weatherill (1996), above n. 25, who refrains from describing the 'direct or substantial hindrance to market access' test as a *de minimis* threshold.
31. Jansson and Kalimo, above n. 30, at 526.
32. Joined Cases 177 and 178/82, *Jan van de Haar*, [1984] ECR-01797, at 13; Case C-67/97, *Ditlev Bluhme*, [1998] ECR I-08033, at 20; Joined Cases C-1/90 and C-176/90, *Aragonesa de Publicidad and Publivía* v. *Departamento de Sanidad*, [1991] ECR I-4151, at 24; Joined Cases C-277/91, C-318/91 and C-319/91 *Ligur Carni and Others*, [1993] ECR I-6621, at 37.

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access was 'too uncertain or indirect'[33] or 'purely hypothetical',[34] then the contested measure did not infringe free movement provisions.

2.3 The Post-*Keck* Market Access Test

The Court started widening the scope of Article 34 TFEU by restricting the scope of selling arrangements and gradually adopted an over-inclusive 'market access' test.[35] In particular, in subsequent case law, the Court interpreted the two conditions contained in paragraph 16 of *Keck* as meaning that certain selling arrangements could not escape the scrutiny of the free movement provisions if they were discriminatory or they imposed additional burdens on imported goods (in the sense of the 'dual burdens' that the principle of mutual recognition was intended to eliminate under the *Cassis de Dijon* judgement). Cases such as *Familiarpress*,[36]*De Agostini*,[37]*Gourmet*[38] and *Alfa Vita*[39] signalled the transition from an approach based on a formalistic distinction between 'product rules' and 'selling arrangements' to a more straightforward test based on 'market access hindrance'.[40] Progressively, the Court departed from the *Keck*-test, without, however, overruling it explicitly. In *Commission* v. *Italy (trailers)*[41] and *Mickelsson and Roos*,[42] the Court reintroduced a refined market access test according to which rules restricting the use of products hinder the market access of foreign products and therefore constitute MEEQR prohibited under Article 34 TFEU.[43]

In the same vein, in *LIBRO*,[44] the Court ruled that book price-fixing[45] of German language books in Austria constituted an MEEQR contrary to Article 34 TFEU,[46] as it could potentially hinder market access for German book importers.[47] Furthermore, the predominance of the 'market access' test was very recently reiterated in the *Scotch Whisky* case,[48] where Court held that the Scottish imposition of a minimum price per unit of alcohol prevented the lower cost price of imported products being reflected in the selling price to the consumer and was thus capable of hindering the access to the UK market of alcoholic drinks that were lawfully marketed in other Member States.[49]

However, this 'market access' test is sometimes qualified by an additional step, which requires that the measure at issue have a *direct/substantial/significant* effect on inter-State trade. Thus, in *Ker-Optika*, the Hungarian prohibition on the selling of contact lenses via the Internet was deemed to be an MEEQR within the meaning of Article 34 TFEU, because it deprived traders from other Member States of a particularly effective means of selling those products and therefore *significantly* impeded market access.[50] Although admittedly the Court is not very consistent in the terminology or the precise tests that it uses, the fact nonetheless remains that its analysis implicitly includes a quantitative element: only measures that *directly/substantially/significantly* affect

33. Case C-69/88, *H. Krantz GmbH*, [1990] ECR I-00583, at 11; Case C-190/98, *Volker Graf*, [2000] ECR I-00493, at 25 (in the field of free movement for workers). Conversely, in Case C-415/93, *Bosman*, [1995] ECR I-04921, at 103, the Court found that the transfer rules at issue *directly* affected players' access to the employment market in other Member States and were thus capable of impeding the freedom of movement for workers. Similarly, in Case C-384/93, *Alpine Investments*, [1995] ECR I-01141, the Court ruled that the prohibition of cold calling by telephone for financial services *directly* affected access to the market in services in the other Member States and was thus capable of hindering intra-Community trade in services.
34. Case C-299/95, *Friedrich Kremzow* v. *Republik Österreich*, [1997] ECR I-02629, at 16, where the Court interestingly ruled that whilst any deprivation of liberty may impede a person from exercising his or her right to free movement, a purely hypothetical prospect of exercising that right does not establish a sufficient connection with Community law to justify the application of free movement provisions.
35. This over-inclusive market access test has been criticised by some scholars. *See e.g.* Catherine Barnard notes that the intrusion into national regulatory autonomy can have profound repercussions for national legislation adopted by democratic governments, as almost every national regulatory requirement can in one way or another affect the economic freedom of market operators, even if that was never the intention of the legislator and the effect on trade is inappreciable. *See* Barnard (2014), above n. 8, at 20.
36. Case C-368/95, *Familiapress*, [1997] ECR I-03689.
37. Joined Cases C-34/95, C-35/95 and C-36/95, *De Agostini*.
38. Case C-405/98, *Gourmet*.
39. Joined Cases C-158/04 and C-159/04, *Alfa Vita*, [2006] ECR I-08135, at 19.
40. For the notion of the market access, *see* Snell (2010), above n. 9; G. Davies, 'Understanding Market Access: Exploring the Economic Rationality of Different Conceptions of Free Movement Law', 11 *German Law Journal* 671 (2010); C. Barnard, 'Restricting Restrictions: Lessons for the EU from the US?', 68 *Cambridge Law Journal* 575 (2009); E. Spaventa, 'From Gebhard to Carpenter: Towards a (Non)-Economic European Constitution', 41 *Common Market Law Review* 743 (2004); Case C-531/07, *Fachverband der Buch- und Medienwirtschaft* v. *LIBRO Handelsgesellschaft mbH*, [2009] ECR I-03717.
41. Case C-110/05, *Commission* v. *Italy (trailers)*, [2009] ECR I-00519.
42. Case C-142/05, *Mickelsson and Roos*, [2009] ECR I-04273.
43. For an academic discussion, *see* for instance L. Prete, 'Of Motorcycle Trailers and Personal Watercrafts: The Battle over Keck', 35 *Legal Issues of Economic Integration* 133 (2008); P. Pecho, 'Good-Bye Keck?: A Comment on the Remarkable Judgment in Commission v. Italy, C-110/05', 36 *Legal Issues of Economic Integration* 257 (2009); P. Wenneras and K.B. Moen, 'Selling Arrangements, Keeping Keck', 35 *European Law Review* 387 (2010); P. Oliver, 'Of Trailers and Jet Skis: Is the Case Law on Article 34 TFEU Hurtling in a New Direction?', 33 *Fordhman International Law Journal* 1423 (2011); G. Davies, 'The Court's Jurisprudence on Free Movement of Goods: Pragmatic Presumptions, Not Philosophical Principles', 2 *European Journal of Consumer Law* 25 (2012).
44. Case C-531/07, *Fachverband der Buch- und Medienwirtschaft* v. *LIBRO Handelsgesellschaft mbH*, [2009] ECR I-03717.
45. Specifically, the case concerned an Austrian law prohibiting Austrian importers of German-language books from fixing a retail price below that fixed or recommended by the publisher for the State of publication.
46. Case C-531/07, *Fachverband der Buch- und Medienwirtschaft*, at 21-22.
47. *Ibid*.
48. Case C-333/14, *The Scotch Whisky Association and Others*, [2015] n.y.p.
49. *Ibid*., at 32.
50. Case C-108/09, *Ker-Optika*, [2010] ECR I-12213, at 54. By the same token but in a different context, recently the Court found that the Spanish legislation prohibiting tobacco retailers from importing tobacco products and forcing them to procure their supplies from authorised wholesalers hindered the access of these products to the market. This was despite the contentions of the Commission and the Spanish Government that the legislation at issue had to be assessed in the light of Art. 37 TFEU, because it concerned the operation of a monopoly of a commercial character and the restrictions on trade that are inherent in the existence of such a monopoly. *See* Case C-456/10 *Asociación Nacional de Expendedores de Tabaco y Timbre (ANETT)* v. *Administración del Estado* [2012], published in the electronic reports of cases, at 21, 43.

inter-State trade are captured by the MEEQR definition. By contrast, measures with *hypothetical*, *remote*, *uncertain* or *indirect* effect on market access escape from the internal market scrutiny.[51]

3 Defining Capital Restrictions in the Golden Shares Case Law

3.1 Golden Shares in Europe

In the early 2000s, after almost a decade from the *Keck* judgement, the Court was faced with the question whether the doctrine of selling arrangements could be applied in the field of the free movement of capital and, more precisely, in the golden shares case law. This case law raises important legal, political and economic questions, as it addresses issues, which lie at the heart of the fundamental interplay between the State and the Market.

The origins of golden shares can be traced back to the post-war economic history of Europe. In the aftermath of the Second World War, a widespread public ownership thrived in Europe in an effort to resuscitate the war-ravaged economies, boost growth and create national champions in strategic industries, which were deemed essential for national economy. The two privatisation waves that followed (the first in the late 1970s and 1980s as a result of the policy pursued by Margaret Thatcher in the UK and the second in the 1990s because of budgetary constraints imposed by the Maastricht Treaty and the subsequent efforts of Member States to reduce their public debts) did not thwart state intervention in the market.[52] One way of retaining control over the previously state-owned and subsequently privatised companies was through the creation of golden shares.

The notion of golden shares refers to the special rights that Member States usually maintain in strategically sensitive privatised companies (telecommunications, energy, postal services, car industries, etc.).[53] These special rights grant to the State the right to control changes in ownership and/or veto certain strategic decisions in order to prevent hostile takeovers, guarantee the provision of services of general interest, and safeguard public security and other public interest objectives.[54] The use of golden shares became a widespread phenomenon in Europe in the 1990s and 2000s. The Commission was not particularly content with these developments and regarded the establishment of special holdings in national champions as an expression of economic patriotism.[55] Fearing that this trend could severely obstruct the functioning of the Internal Market, it initiated a number of infringement proceedings against the Member States that had maintained special rights in privatised companies.

The conclusion that can be drawn after more than twenty years of litigation[56] is that golden shares constitute a restriction on the free movement of capital because of their *dissuasive* effect on investment. However, they may be justified by legitimate objectives in the public interest if the State provides sufficient evidence that the measures at issue comply with a strict proportionality test and requirements of legal certainty.[57] Therefore, just like in the other freedoms, the Court is confronted with the challenge of striking a fair balance between economic freedom (here in the form of foreign direct or portfolio investments in privatised companies) and the Member State's need to protect the overriding reasons in the public interest. Only here, the implications of its rulings

51. It could be argued that the 'substantial effect' test refers to a certain threshold that needs to be met in order for a measure to constitute an MEEQR, whereas the 'remote effect' test seeks to establish a link of causality between the contested measure and restriction on inter-State trade. Be that as it may, this distinction is not unproblematic, that is why some authors see a convergence of the two tests. *See* in particular Barnard (2014), above n. 8, at 147; Weatherill (1996), above n. 25, at 900; D. Doukas, 'Untying the Market Access Knot: Advertising Restrictions and the Free Movement of Goods and Services', 9 *Cambridge Yearbook of European Legal Studies* 177 (2007).
52. S. Grundmann and F. Möslein, 'The Golden Share – State Control in Privatised Companies: Comparative Law, European Law and Policy Aspects', *Euredia* 623, at 633 (2001-2002).
53. Oxera, 'Special Rights of Public Authorities in Privatised EU Companies: The Microeconomic Impact', Report Prepared for the European Commission (2005), at 3, available at: <http://ec.europa.eu/internal_market/capital/docs/2005_10_special_rights_full_report_en.pdf>.
54. Commission Staff Working Document, 'Special Rights in Privatized Companies in the Enlarged Union – A Decade Full of Developments' (2005), at 4, available at: <http://ec.europa.eu/internal_market/capital/docs/privcompanies_en.pdf>.
55. *See* in particular the highly cited Communication of the Commission on certain legal aspects concerning intra-EU investment, OJ C 220 of 19 July 1997, at 15-18. The concept of 'economic patriotism' or 'economic protectionism' implies the 'assertion of selfish interests in defiance of market forces, by those in a position to influence the outcome to that end by legal means', *see* J. Rickford, 'Protectionism, Capital Freedom and the Internal Market', in U. Bernitz and W. Ringe (eds.), *Company Law and Economic Protectionism: New Challenges to European Integration* (2010) 54, at 55; J. Rickford, 'Free Movement of Capital and Protectionism After Volkswagen and Viking Line', in M. Tison, H. De Wulf, C. Van der Elst & R. Steennot (eds.), *Perspectives in Company Law and Financial Regulation – Essays in Honour of Eddy Wymeersch* (2009) 61, at 62.
56. Case C-58/99, *Commission* v. *Italy*, [2000] ECR I-03811; Case C-367/98, *Commission* v. *Portugal*, [2002] ECR I-04731; Case C-483/99, *Commission* v. *France*, [2002] ECR I-04781; Case C-503/99, *Commission* v. *Belgium*, [2002] ECR I-04809; Case C-463/00, *Commission* v. *Spain*, [2003] ECR I-04581; Case C-98/01, *Commission* v. *United Kingdom*, [2003] ECR I-04641; C-174/04, *Commission* v. *Italy*, [2005] ECR I-04933; Joined Cases C-282/04 and C-283/04, *Commission* v. *The Netherlands*, [2006] ECR I-09141; Case C-112/05, *Commission* v. *Germany*, [2007] ECR I-08995; Joined Cases C-463/04 and C-464/04, *Federconsumatori and Others and Associazione Azionariato Diffuso dell'AEM SpA and Others v Comune di Milano*, [2007] ECR I-10419; C-274/06, *Commission* v. *Spain*, [2008] ECR I-00026; C-207/07, *Commission* v. *Spain*, [2008] ECR I-00111; Case C-326/07, *Commission* v. *Italy*, [2009] ECR I-02291; Case C-171/08, *Commission* v. *Portugal*, [2010] ECR I-06817; Case C-543/08, *Commission* v. *Portugal*, [2010] ECR I-11241; Case C-212/09, *Commission* v. *Portugal*, [2011] ECR I-10889; Case C-244/11, *Commission* v. *Greece*, [2012], published in the electronic reports of cases; Case C-95/12, *Commission* v. *Germany*, [2013], published in the electronic reports of cases.
57. So far only on one occasion did the Court find that the contested special rights were justified by public interest requirements and were also consistent with the principles of proportionality and legal certainty, and that was in Case C-503/99, *Commission* v. *Belgium*.

are far more profound, as they can affect the national corporate governance systems and the varieties of capitalism that exist in Europe.[58]

3.2 Selling Arrangements in Golden Shares Case Law

Not surprisingly, the Member States have consistently expressed their strong opposition to this line of case law, arguing that it essentially deprives them of their right to choose the corporate governance regime that suits best to the structure of their economy and corresponds to the needs of their industrial policy. Among their various defences, some Member States attempted to draw a parallel between golden shares and selling arrangements, arguing that a *Keck*-like approach should apply in relation to the special shareholding retained in privatised companies.[59] However, they did not manage to convince the Court to moderate its rigid legal reasoning in order to prevent a replication of the legal ramifications of the over-extensive application of the free movement rules, as the one occurred in the aftermath of *Dassonville* and *Cassis de Dijon*.

It emerges from the case law that the Court has not formulated a clear and consistent test as to what constitutes a capital restriction. Nevertheless, we can identify certain criteria which – if combined – could result in a structured legal test for capital restrictions. These criteria are the following: (1) discrimination on grounds of nationality, (2) derogation from ordinary company law and (3) positive effect on capital flows. The first criterion has appeared only once in the golden shares case law,[60] and because of its straightforward discriminatory nature, it is undisputed that it constitutes a restriction on the free movement of capital, which can only be justified by the objectives provided for under the Treaties.[61] Therefore, it will not be further analysed, as there is a wide consensus as to its restrictive nature. The second criterion, namely derogation from ordinary company law, has been developed in the context of golden shares, and it constitutes the foundation for the construction and development of a *Keck*-inspired approach in the free movement of capital. This approach raises interesting and contentious legal questions, which will be addressed in Section 3.2.1. Finally, the positive effect on capital flows criterion, inspired by the 'substantial hindrance' test originating from the free movement of goods, could perhaps contribute to the formulation of a more prudent test for capital restrictions in the golden shares case law. Its possible implications will be addressed in Section 3.2.2.

3.2.1 The 'Derogation from Ordinary Company Law' Criterion

The 'derogation from ordinary company law' criterion was introduced in the golden shares case law in order to determine, first, whether a special shareholding qualifies as a State measure and, second, whether it has a restrictive effect on capital movements. In reality, these two steps form part of one and the same test: if the State acts in its capacity as public authority and introduces special rights in a privatised company in derogation from ordinary company law in order to avail itself of a privileged position to the exclusion of private individuals, it restricts the free movement of capital; if, on the other hand, it acts in its capacity as a shareholder of a privatised company through a private act[62] in accordance with national company law, the special shareholding at issue constitutes an 'investment arrangement' that does not restrict the free movement of capital.

So far, most of the cases concerned golden shares introduced in derogation from the national company law in force at the time. Thus, the conclusion of the Court was, in most cases, justified by the need to prevent the State from exercising its regulatory powers in order to arbitrarily benefit from special prerogatives in the management of privatised companies. However, it is one thing to maintain a level-playing field between the State and private shareholders, and it is another to impose on all Member States a certain model of corporate governance that adheres to a strict principle of proportionality between ownership and control[63] and does not allow

58. Varieties of Capitalism (VoC) is a theory from the field of political economy, which essentially distinguishes between coordinated and liberal market economies on account of the corporate governance regime and the methods of production in these economies. It was introduced in 2001 by the influential work of P.A. Hall and D. Soskice, 'An Introduction to Varieties of Capitalism', in P.A. Hall and D. Soskice (eds.), *Varieties of Capitalism: The Institutional Foundations of Comparative Advantage* (2001). Following this development, literature in this field has been gradually flourishing, revealing the importance of VoC in European Integration Theory. *See* indicatively J. Snell, 'Varieties of Capitalism and the Limits of European Economic Integration', 13 *Cambridge Yearbook of European Legal Studies* 415 (2012); P. Zumbansen and D. Saam, 'The ECJ, Volkswagen and European Corporate Law: Reshaping the European Varieties of Capitalism', 8 *German Law Journal* 1027 (2007); D. Kinderman, 'Challenging Varieties of Capitalism's Account of Business Interests: The New Social Market Initiative and German Employers' Quest for Liberalization, 2000-2014', *Discussion Paper No. 14/16* (2014).
59. Case C-463/00, *Commission* v. *Spain*; C-98/01, *Commission* v. *UK*; C-171/08, *Commission* v. *Portugal*; C-543/08, *Commission* v. *Portugal*; C-219/09, *Commission* v. *Portugal*. Although the present article focuses primarily on the five aforementioned cases, it should be noted that the arguments are drawn from the entire golden shares case law, with the seminal VW case being one of the leading examples (Case C-112/05, *Commission* v. *Germany*, [2007] ECR I-08995).
60. Case C-367/98, *Commission* v. *Portugal*, [2002] ECR I-04731. The case concerned, amongst others, a prohibition precluding investors from other Member States from acquiring more than a given number of shares in certain Portuguese undertakings. This was of course a discriminatory restriction on the free movement of capital.
61. Although the Case C-367/98 *Commission* v. *Portugal* concerned a *directly* discriminatory measure, it should be noted that *indirectly* discriminatory measures are also covered by this criterion (one could for example envisage a situation where the national measure entails discrimination on the basis of the residence of the shareholders or the Members of the Board of Directors).
62. Usually through an amendment of the articles of association.
63. The principle of proportionality between ownership and control implies that any shareholder should own the same fraction of cash flow rights and voting rights. The OECD notes that proportionality as an economic welfare enhancing proposition is not self-evident. In fact, proportionality-limiting mechanisms are available in most countries, and they may actually be efficiency enhancing because they help overcome agency and incentive problems. *See* in particular OECD, 'Lack of Proportionality between Ownership and Control: Overview and Issues for Discussion' (2007), available at: <www.oecd.org/daf/ca/40038351.pdf>.

room for control-enhancing mechanisms (CEMs).[64] The analysis that follows attempts to shed light into this delicate distinction by examining some of the Court's golden shares rulings.

3.2.1.1 The British Airports Authority Case

One of the cases that can be used as a paradigm of a rigorous and over-inclusive interpretation of Article 63 TFEU is the *Commission* v. *UK* (BBA) case.[65] British Airports Authority (BAA), Britain's biggest airport operator, was privatised in 1986 as part of the privatisation policy pursued by Margaret Thatcher. The privatisation process was governed by the Airports Act 1986. The UK Government retained control over the newly formed company that took over the functions of the previously state-owned enterprise by retaining a special shareholding. In particular, the Articles of Association of the privatised BAA provided for a rule that prevented the acquisition of more than 15% of the voting shares in the company. Furthermore, they introduced a procedure that empowered the UK Government to give consent to certain major operations of the company, such as disposal of assets, control of subsidiaries and winding-up.

The UK Government argued first that national company law allowed the existence of different classes of shares as well as the existence of differences in the rights attached to them in relation to sharing the company's profits and to its management.[66] Secondly, BAA's Articles of Association could not be equated to national legislation (and thus regarded as a State measure), as their adoption was a mere application of private law mechanisms allowed under ordinary company law.

These arguments were not accepted by the Court. It held that the fact that BAA's Articles of Association were to be approved (and were actually) by the Secretary of State pursuant to the Airports Act 1986 meant that the UK had acted in its capacity as a public authority and not as a shareholder, and therefore the restrictions had not arisen from a normal operation of company law.[67] However, one might wonder whether the approval by the Secretary of State was a sufficient condition for a private law act – adopted in compliance with national company law – to be regarded as a State measure. Surely, it cannot be denied that there was an approval by the Secretary of State, but this cannot alter the nature of the Articles of Association as a private agreement among the shareholders. The State did not use its public authority powers in order to derogate from ordinary company law and benefit arbitrarily from a privileged status by distorting the market; rather it acted as a shareholder and made use of the possibilities offered by ordinary company law, just like any private investor could have done in a similar situation.

Secondly, the ordinary law criterion was used as a basis to advance the argument that the contested special rights should be interpreted in the light of the Keck ruling. The UK Government reminded the Court of its own efforts to keep a tight rein on the speculative litigation that emerged in the field of goods after Dassonville and Cassis de Dijon by adopting a more moderate approach in Keck. The application of a Keck-informed test would entail the exclusion of the contested special rights from the scope of capital restrictions under Article 63 TFEU.

In particular, it was argued that the measures at issue were applied equally to foreign and domestic investors and they did not restrict market access. Rules of private law such as the ones in the BAA's Articles of Association, which did not derogate from normal company law and merely determined the characteristics of the special shareholding, could not possibly amount to a restriction on market access.[68] It was further contended that the Member States were entitled to engage in economic activities on the same basis as private market operators, within the framework of contracts governed by private law. As there was no secondary legislation on this matter, EU law could not impose on a company the obligation to be placed under market control or to attach to its shares the rights that all actual or potential investors might wish to see attached to them.[69] If the special shareholding were open to challenge, this would mean that holders of ordinary shares could rely on the Treaty in order to renegotiate the rights attached to the shares they had bought.[70] In other words, ordinary shareholders would be allowed to convert their ordinary shares into special shares. This interpretation, however, could not be accepted, as EU law could not impose a specific

64. CEMs are various instruments that allow for the separation of ownership from control in listed companies, such as multiple voting rights shares, non-voting shares, pyramid structures, voting right ceilings, ownership ceilings and supermajority provisions. A study that was conducted by ISS Europe, Shearman and Sterling and the European Corporate Governance Institute in 2007 at the request of the European Commission showed that CEMs are relatively common across the EU. Of all the 464 European companies considered, 44% have one or more corporate CEMs (or other alternative mechanism). The countries with the highest proportion of companies featuring at least one of these mechanisms are France, Sweden, Spain, Hungary and Belgium. *See* Report on the Proportionality Principle in the European Union, External study commissioned by the European Commission (2007), available at: <http://ec.europa.eu/internal_market/company/docs/shareholders/study/final_report_en.pdf>; *See also* Commission of the European Communities, 'Impact Assessment on the Proportionality between Capital and Control in Listed Companies', Commission Staff Working Document, SEC(2007) 1705, at 4, available at: <http://ec.europa.eu/internal_market/company/docs/shareholders/impact_assessment_122007.pdf>. The latter document presents the pros and cons of possible policy actions, also including an evaluation of the consequences of not undertaking any regulatory action in this field. The impact assessment was validated by the Commission's impact assessment board. After weighing the arguments advanced, Commissioner McCreevy decided that there was no need for an action at EU level on this issue. Therefore, DG Internal Market and Services terminated their work in this area. This should be regarded as an indication that the political institutions of the Union have decided to maintain their neutrality with respect to the principle of proportionality and pay homage to the Member State's right to organise their corporate governance regimes.
65. Case C-98/01, *Commission* v. *UK*.
66. *Ibid*., at 26.
67. *Ibid*., at 48.
68. *Ibid*., at 29.
69. *Ibid*., at 31.
70. *Ibid*., at 35.

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model of corporate governance. This was – and still remains – a domain reserved for the national legislator.

However, the Court found that while the contested measures were not discriminatory, they nonetheless affected the position of a person acquiring a shareholding as such and were thus liable to deter investors from other Member States from making such investments and consequently affected their access to the market. Although, in principle, it did not exclude the possibility of developing a concept similar to that of selling arrangements in the area of free movement of capital, it nevertheless rejected it on the facts, by stating that the measures at issue were not comparable to the rules concerning selling arrangements.[71]

It could be argued that the outcome of this case might have been different were it not for the approval of the Articles of Association by the Secretary of State. This approval was the decisive factor that led the Court to rule that the golden shares at issue were at variance with national company law and could not be regarded as 'investment arrangements'. Nevertheless, the Court did not explain how the approval by the Secretary of State altered the fact that the introduction of special shareholding was permitted under national company law. This criterion is decisive of determining whether a measure constitutes a restriction on capital movements. The UK Government argued emphatically that national company law did not preclude special shareholding. It was in fact so convinced of the merit of its arguments that it did not advance any justification arguments. This proved fatal for the outcome of the case, as the Court did not even examine whether the restriction could be justified by overriding reasons in the public interest.

3.2.1.2 The Portugal Telecom and GALP Energia Cases

Contrary to the BAA case, in *Commission* v. *Portugal (Portugal Telecom SGPS SA)*,[72] the Court rightfully found that the contested special shareholding amounted to a State measure liable to restrict the free movement of capital. The special rights at issue included, among others, a right to elect at least one-third of the total number of directors, including the chairman of the board of directors, a right to elect one or two of the members of the executive committee and an approval procedure for important decisions, such as the appropriation of net income of the year, alterations to the articles of association and increases in share capital, and relocation of its registered office. Although the preferred shares were introduced in the Articles of Association, the Court noted that these Articles were adopted not only immediately after the adoption of the decree-law authorising the creation of golden shares within Portugal Telecom, but in particular at a time when the Portuguese Republic had a majority holding in the company's share capital and thus exercised control over that company.[73] Furthermore, as underlined by Advocate General Mengozzi, the creation of those golden shares was not the result of a normal application of company law: in derogation from the Portuguese Commercial Companies Code, the golden shares retained in Portugal Telecom were not transferable.[74] Therefore, in those circumstances, the Court rightfully regarded the introduction of golden shares in Portugal Telecom as a State measure liable to restrict the free movement of capital. It was clear that the Portuguese Government had departed from the ordinary provisions of company law in order to avail itself of a privileged position in the privatised telecommunications company.

Similarly, in *Commission* v. *Portugal (GALP Energia SGPS SA)*,[75] the Court held that the right of the State to appoint the chairman of the Board of Directors in GALP Energia SGPS SA was not stemming from a normal application of company law, since the Portuguese Commercial Companies Code expressly precluded the right to appoint certain directors being attached to certain categories of shares.[76] The national law at issue and GALP's Articles of Association derogated from general company law with the sole intention of benefitting the public authorities.[77] Consequently, the right of the State to appoint the chairman of GALP's Board of Directors was attributable to the Portuguese State and was thus falling within the scope of Article 63 TFEU.[78]

3.2.2 *The 'Positive Effect on Capital Movements' Criterion*

The test that has been developed so far is essentially based on the derogation from ordinary company law criterion, which could allow us to distinguish between investment arrangements and restrictions on capital movements. Although this test could be regarded as sufficient for determining whether the contested golden shares constitute a restriction on the free movement of capital, it is suggested that a quantitative dimension could be added in order to enable the Court to take into account some factual evidence in borderline and exceptional cases in which there is a strong likelihood that the special shareholding has actually promoted and encouraged cross-border capital flows.

71. Case C-98/01, *Commission* v. *UK*, at 45-48.
72. Case C-171/08, *Commission* v. *Portugal*.
73. *Ibid.*, at 53. Nevertheless, it should be noted that it is disputed whether the fact that a State makes use of its majority shareholding in order to introduce special rights in the Articles of Association – when this is allowed by national company law – is sufficient to qualify this act as a 'State measure'. Special rights are usually introduced by those in control, either in the initial phase of incorporation or after an amendment of the Articles in view of a planned divestiture. *See* C. Gerner-Beuerle, 'Shareholders between the Market and the State. The VW law and Other Interventions in the Market Economy', 49 *Common Market Law Review* 97 (2012), at 118.
74. Opinion of Advocate General Mengozzi in Case C-171/08 *Commission* v. *Portugal*, para. 62.
75. Case C-212/09, *Commission* v. *Portugal*.
76. *Ibid.*, at 5.
77. *Ibid.*, at 53.
78. *Ibid.*, at 54.

So far the Court has found that special shareholding in privatised companies amounts to a restriction on capital movements, even when there is factual evidence that this shareholding has no negative impact on the acquisition of shares in the undertaking concerned by foreign investors. Member States have tried to invoke the 'substantial hindrance' criterion, as developed in the free movement of goods, in the area of free movement of capital, but the Court has resisted the pressure.

In particular, in *Commission* v. *Portugal (Energias de Portugal)*,[79] the Portuguese Republic contended that the provisions of national law at issue did not establish any *direct* or *substantial* obstacle to the access of direct investors or portfolio investors to the share capital of EDP. To the contrary, EDP's shares were among the most sought-after on the Lisbon Stock Exchange and a large number of those shares were in the hands of foreign investors.[80] This could probably be explained by the fact that the existence of public ownership in a national industry can be regarded as guaranteeing the financial stability and solvency of a company, and can thus act as an incentive for foreign public and private investors to buy shares in that company. However, the Court refused to engage in a factual examination of the actual impact of the special rights in question on cross-border investment and ruled that foreign investors, whether actual or potential, might have been deterred from acquiring stake in the capital of EDP.[81]

The rationale underlying the substantial hindrance criterion, as developed in the free movement of goods, could be transposed into the area of free movement of capital in order to give Member States the possibility to refute the premise of the Court's reasoning that golden shares are by definition a restriction on capital movements. This could take the form of a criterion based on a possible 'positive impact' of golden shares on capital movements, which would allow the Member States to prove that despite their prima facie-restrictive nature, the contested golden shares have actually incentivised cross-border investment and has increased the number of foreign shareholders.

In other words, when the contested special rights derogate from ordinary company law, there is a presumption of a restrictive effect on capital movements. However, this presumption is rebuttable: the Member State should be able to provide evidence to prove that the special rights at issue not only have not discouraged foreign investors but have actually had a positive effect on capital flows. Admittedly, one could argue that this criterion is loosely framed and it is difficult to be reconciled with the principle of legal certainty. Nevertheless, if used carefully and on a case-by-case basis, it could help redress some shortcomings arising from the erroneous premise that all golden shares inherently restrict capital movements.

4 In Search of a Refined Test for Capital Restrictions

The role of EU law in the formation of the national regimes of corporate governance lies at the heart of the underlying rationale of the Court's approach in the golden shares case law. The Court embraces the principle of proportionality between corporate ownership and control, implying that any shareholder should in principle own the same fraction of cash flow rights and voting rights. Its legal reasoning starts from the premise that the principle of proportionality between ownership and control should be respected, and thus any structure or mechanism that derogates from this principle should be disapplied as it discourages investors from acquiring shares in the undertaking concerned. According to this reasoning, the State's interference in the management of the company through the vehicle of golden shares is capable of depressing the value of the shares, thus reducing the attractiveness of an investment in that company.[82] The reason is that the State might exercise its special rights in order to protect the public interest, 'which might be contrary to the economic interests of the company'.[83]

The Court seems to embrace the shareholders' primacy value as a normative foundation of free capital flows in the Internal Market. State participation in preferred holding is regarded as a deterrent for foreign investors, thus restricting the free movement of capital. This view reflects an inherently political choice favouring unfet-

79. Case C-543/08, *Commission* v. *Portugal*. The national legislation at issue granted to the Portuguese State and to other public shareholders 'golden shares' in the company EDP – Energias de Portugal, the principal licensed distributor of electricity in Portugal and the undertaking acting as the last resort supplier. The special rights at stake included (a) the right of veto in respect of certain resolutions of the general meeting of the company's shareholders; (b) the right to appoint a director, where the State has voted against the nominees successfully elected as directors; and (c) the exemption of the State from the voting ceiling of 5% laid down in relation to the casting of votes.
80. *Ibid*., at 69.
81. *Ibid*., at 71.
82. Case C-171/08, *Commission* v. *Portugal (I)*, at 54.
83. Joined Cases C-282/04 and C-283/04, *Commission* v. *The Netherlands*, at 30. A similar view was expressed by Advocate General Maduro in Federconsumatori, where he opined that public ownership of shareholding does not reduce the attractiveness of investing in the company concerned, only insofar as the State respects the normal rules of operation of the market with a view to maximising its return on investment. *See* Opinion of Advocate General Maduro in Joined Cases C-463/04 and C-464/04, *Federconsumatori and Others*, paras. 25-26. In this case, for the first time, a shareholders' association successfully challenged the golden shares maintained by the Italian Government in the company Azienda Elettrica Milanese SpA active in the gas and electricity sector.

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tered liberal market economy,[84] as opposed to a market economy that allows the existence of corporate governance regimes with CEMs. It also reflects a policy approach advancing the maximisation of the shareholders' profits as the ultimate objective of a corporation. However, this approach is based on three premises, whose acceptance is far from evident: it implies that, first, the interests of the company are those of the shareholders, secondly, the shareholders' interests are embodied in the share value[85] and, thirdly, the existence of golden shares diminishes the share value.[86] The Court endorses the corporate governance school of thought that advocates shareholders' primacy as the ultimate objective of company law and seems to disregard the interests of other stakeholders such as employees, suppliers, creditors and ultimately the society as a whole.[87]

To accept that the mere existence of golden shares restricts the free movement of capital would imply that any type of special shareholding would amount to a restriction on capital movements. This would in turn mean that the free movement of capital is horizontally applicable and captures also acts of private shareholders, an interpretation that would have serious implications for the fundamental principle of private autonomy.[88]

Such a reading of the Treaty is open to question, as the constitutional foundations of the Internal Market do not seem to allow such a broad interpretation. Surely, the wording of Article 63 TFEU provides for the prohibition of 'all restrictions' on capital movements without any allusion to discrimination. However, this cannot be regarded as a *carte blanche* to abolish all national company law requirements that could potentially dissuade foreign investors from investing their capital in undertakings with mechanisms that do not adhere completely to shareholders' primacy. In his insightful contribution, Harm Schepel argues that the golden shares case law so far has advanced the rule that corporations should be governed with a view to maximise shareholders' profit to such an extent that it has turned Article 63 TFEU into a 'Charter of Shareholder Rights'.[89] It has managed to elevate the shareholders' primacy principle to a constitutional norm underpinning capital liberalisation.[90] However, the Court's underlying narrative is based on a utopian nostalgia for the traditional forms of capitalism. The transformations of modern economy have led to a high degree of 'financialisation', which is currently asso-

84. The structural bias of negative integration in favour of liberal market economies as opposed to social market economies has been thoroughly addressed by eminent scholars of the Max Planck Institute for the Study of Societies; *see* F.W. Scharpf, 'The Double Asymmetry of European Integration Or: Why the EU Cannot Be a Social Market Economy', 8 *Socio-Economic Review* 211 (2010); M. Höpner and A. Schäfer, 'Integration among Unequals: How the Heterogeneity of European Varieties of Capitalism Shapes the Social and Democratic Potential of the EU', *MPIfG Discussion Paper No. 12/5* (2012); M. Höpner and A. Schäfer, 'A New Phase of European Integration: Organized Capitalisms in Post-Ricardian Europe', 33 West European Politics 344 (2010); M. Höpner and A. Schäfer, 'Embeddedness and Regional Integration. Waiting for Polanyi in a Hayekian Setting', 66 International Organization 429 (2012). The latest contribution to the debate about the model of market economy in Europe came very recently by Advocate General Wahl. In his recent opinion in *AGET Iraklis*, he stated – in the very first paragraph – that the 'European Union is based on a free market economy, which implies that undertakings must have the freedom to conduct their business as they see fit'. This rather sweeping statement seems to disregard the reference to 'social market economy' in Art. 3 TEU. *See* Opinion of Advocate General Wahl delivered on 9 June 2016 in the Case C-201/15 *AGET Iraklis*.
85. Gerner-Beuerle, above n. 73, at 124.
86. However, this assumption is not empirically proven. In 2005, Oxera, authorised by the European Commission, provided an overview of the special rights retained by public authorities in privatised companies in the EU and an evaluation of their economic impact on the performance of affected companies. The Report examined six companies (Cimpor, Volkswagen, Repsol YPF, KPN, Portugal Telecom and BAA) and concluded that special rights held by public authorities tend to have a negative impact on the longer-term economic performance of EU privatised companies because four of the six companies examined tended to underperform relative to comparable companies not subject to special rights. However, the remaining two companies outperformed their comparators and, thus, this contradictory evidence was not consistent with the hypothesis that the impact of special rights is negative. Accordingly, Oxera concluded that: '… although there is some indication of a negative impact of special rights, the evidence obtained from the benchmarking analysis is disparate and does not allow any strong conclusions to be drawn. However, the results do not imply that special rights have no negative impact on companies' long-term performance'. *See* Oxera, above n. 53, at 68.
87. Gerner-Beuerle, above n. 73. *See also* M. O'Brien, 'Case C-326/07, Commission of the European Communities v. Italian Republic, Judgment of the Court of Justice (Third Chamber) of 26 March 2009', 47 *Common Market Law Review* 245, at 260 (2010), who criticises the Court for being 'very strict in its refusal to allow Member States to exercise control over ownership of shares, voting rights and management decision-making in private companies through golden share mechanisms'.
88. So far the Court has qualified the contested 'golden shares' as 'State measures' and has thus refrained from ruling explicitly on the question as to whether Article 63 TFEU is horizontally applicable (*see* Joined Cases C-282/04 and C-283/04 *Commission* v. *The Netherlands*, at 22; Case C-112/05 *Commission* v. *Germany*, at 27-29). However, Advocate General Maduro has advocated a horizontal applicability of the free movement of capital, noting that even when the State acts like any other shareholder under general company law, Article 63 TFEU should be applicable (*see* Advocate General Maduro in Joined Cases C-282/04 and C-283/04, *Commission* v. *The Netherlands*, para. 24). For an academic discussion, *see* Gerner-Beuerle, above n. 73; W. Ringe, 'Is Volkswagen the New Centros? Free movement of Capital's Impact on Company Law', in Dan Prentice and Arad Reisberg (eds.), *Corporate Finance Law in the UK and EU* (2011) 461; Saam and Zumbansen, above n. 61; H. Schepel, 'Constitutionalising the Market, Marketising the Constitution, and to Tell the Difference: On the Horizontal Application of the Free Movement Provisions in EU Law', 18 *European Law Journal* 177 (2012); E. Szyszczak, 'Golden Shares and Market Governance', 29 *Legal Issues of Economic Integration* 255 (2002).
89. H. Schepel, 'Of Capitalist Nostalgia and Financialisation: Shareholder Primacy in the Court of Justice', in C. Joerges and C. Glinski (eds.), *The European Crisis and the Transformation of Transnational Governan* (2014) 143.
90. *Ibid*., at 144.

ciated with rising stagnation in the real economy, social inequalities and high levels of unemployment.[91]

The choice of corporate governance model is a highly political question, which depends on various socioeconomic factors that differ across the globe. Carsten Gerner-Beuerle is right in doubting whether the Court of Justice, the judicial institution of the EU, could or should decide on such sensitive and highly political questions of national economic policy.[92] This question essentially boils down to the observance of the fundamental principle of separation of powers in the EU polity. The Court has been on several occasions accused of engaging in judicial activism,[93] which causes confusion as to its role as the judicial institution of the EU. Although this might sometimes be an overstatement, the fact remains that the role of the Court should be limited to what Article 19 TEU prescribes: to ensure that in the interpretation and application of the Treaties, the 'law' is observed.

Whether corporate governance should be dominated by the shareholders' primacy norm is a political question and should be clearly distinguished from the objective of market integration pursued by the Treaties.[94] It is doubtful whether the Court is the appropriate institution to design the corporate governance policy of the Member States. It is therefore argued that the premise of an over-inclusive interpretation of Article 63 TFEU cannot be reconciled with the discretion of the Member States in the field of corporate governance and the existence of different kinds of national company law regimes, which do not adhere strictly to the principle of proportionality between ownership and management.

This by no means should be interpreted as leaving room for suspicious State interferences that could lead to serious market abuses and distortions of competition. The Court should not refrain from disapplying distinctly or indistinctly national measures that obstruct capital flows and undermine the process of economic integration. However, it should respect the discretion of the Member States to decide on the corporate governance regime of their national economy, and it should intervene only when the national choices seriously undermine the objectives of market integration either by discriminating against foreign investors or by hindering the market access of foreign investors in derogation from ordinary company law.

Its prime objective should not be the maximisation of shareholders' profit, but the establishment of a well-functioning and integrated market economy, which respects the national policy choices as expressed through various mechanisms of national company law. This is why the question of whether the contested measure derogates from domestic company law has been a recurring theme in the golden shares case law and rightly so. It appears that it is the only criterion so far that can contribute to the development of a reasonable and coherent test to assess whether special shareholding in privatised undertakings constitutes restrictions on capital movements.[95]

It is thus proposed that a refined three-step test could be adopted in order to define capital restrictions.[96] It operates in the following way:

1. *Discrimination on grounds of nationality*. The first step asks whether there is discrimination on grounds of nationality. Special shareholding that discriminates between domestic and foreign investors constitutes a blatant restriction on the free movement of capital, which can be justified only by the grounds provided for in the Treaty.
2. *Derogation from ordinary company law*. The special shareholding that does not discriminate on grounds of nationality may be divided into two subcategories: (a) indistinctly applicable special shareholding that does not derogate from ordinary company law and does not exclude private shareholders can be regarded as investment arrangements (i.e. rules that structure the market and form the corporate governance regime of a Member State). These investment arrangements fall outside the scope of Article 63 TFEU. (b) Indistinctly applicable special shareholding that derogates from ordinary company law and it is available only to the State (to the exclusion of private investors) that constitutes a restriction on the free movement of capital prohibited under Article 63 TFEU. It can then be examined whether it can be justified by overriding reasons in the public interest in accordance with the principle of proportionality.

91. *Ibid*., at 152. On the highly topical issue of the interplay between capital liberalisation and social inequalities, *see* the recent bestseller of T. Piketty, *Capital in the Twenty-First Century* (2014). But it is not only left-wing economists who question the positive outcomes of capital liberalisation. Recently, the critique emanated from the International Monetary Fund (IMF), the institutional advocate of the international financial system. In an article published in its flagship magazine, three of the IMF's top economists argue that instead of delivering growth, two neoliberal policies have increased inequality, and in turn jeopardised the level and sustainability of growth. These two policies are, first, capital account liberalisation (i.e. removing restrictions on the movement of capital across a country's borders) and, second, fiscal consolidation (i.e. austerity). *See* J.D. Ostry, P. Loungani & D. Furceri, 'Neoliberalism: Oversold?', 53 *Finance & Development* 38 (2016).
92. Gerner-Beuerle, above n. 73, at 125, especially in the light of the political controversies during the negotiations for the adoption of the European Takeover Directive. For a thorough analysis, *see* Höpner and Schäfer, above n. 83.
93. The problem of securing respect for the rule of law by the Union itself and the debate about 'competence creep' by the Union institutions (including the Court of Justice in the exercise of its judicial functions) has been aptly addressed by the recent Editorial of the Common Market Law Review, wondering whether this is a Union that sacrifices its own rule of law on the altar of political expediency. *See* Editorial Comments, 'The Rule of Law in the Union, the Rule of Union Law and the Rule of Law by the Union: Three interrelated problems', 53 *Common Market Law Review* 597, at 599-600 (2016).
94. Gerner-Beuerle, above n. 73, at 126.
95. *Ibid*., at 108. However, the author admits that company law is a highly complex field of law with many different variations, exceptions and special provisions, making the determination of what complies with or derogates from ordinary company law a rather intricate and challenging exercise, at 138.
96. It should be noted that this article focuses on how to determine whether a special shareholding constitutes a capital restriction. The question of whether a capital restriction is justified by a legitimate objective and proportionate to the attainment of that objective is not addressed here.

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3. *Positive effect on capital movements*. The third step relates only to indistinctly applicable special shareholding that derogates from ordinary company law (subcategory (b) in step 2). Such measures are presumed to hinder the market access of foreign investors. However, this presumption is rebuttable. The Member State can provide convincing evidence proving that the existence of the golden shares in the undertaking concerned has actually encouraged capital movements. Although it is acknowledged that this criterion bears certain weaknesses, it could nevertheless temper the premise that the mere existence of golden shares restricts capital movements.

Overall, the conceptual foundation of the test that is being proposed here is the theory of *economic supranationalism* as opposed to *economic constitutionalism*.[97] Indistinctly applicable measures should be regarded as restricting the free movement of capital only if the Member State is making use of its public regulatory powers to structure the market in its favour by derogating from ordinary company law. The mere assumption that the State participation in a corporate structure in accordance with national company law hinders the market access of foreign investors is an overly broad interpretation of Article 63 TFEU, which oversteps the boundaries of the constitutional foundations of market integration. The refined test on capital restrictions would allow the Court to exercise thorough and scrupulous oversight of national rules that unjustifiably grant privileges to the State, while at the same time ensuring that it does not oversteps the boundaries of its judicial powers by implicitly imposing a specific corporate governance regime on the Member States.

5 Conclusion

The 'great transformation'[98] of modern economies has brought about fundamental changes in the structure and functioning of the Internal Market. These changes require a redetermination of the rationale underlying negative integration and a refinement of the market access test applied by the Court in the free movement case law. This test has undergone a significant evolution since the 1970s, and it can now be said that it has emerged as the predominant criterion for the establishment of a trade restriction. The *Keck*-distinction between product rules and selling arrangements – despite its theoretical appeal – has proved inadequate in practice. Nevertheless, it contributed greatly to the growing awareness of the need to clearly delineate the outer limits of the free movement provisions. This delineation guarantees legal certainty and allows democratically elected governments to exercise their national regulatory autonomy within the framework of the Internal Market. In the field of the free movement of goods, while the *Keck*-formula is ostensibly still considered to be good law, the market access test has practically prevailed, though in a shape that is qualified by de *minimis* considerations expressed in the form of a 'substantial hindrance on market access'. This serves as a safety net that allows the Court to uphold the legality of regulatory requirements with inappreciable effect on trade, while at the same time ensuring that national measures substantially hindering market access of foreign operators are set aside. Most of the time, this test has been applied successfully and together with the justifications/mandatory requirements and the prudent proportionality test has managed to strike a fair balance between economic freedom and societal values expressed in the form of overriding reasons in the public interest.

However, this has not been achieved in capital case law. The free movement of capital is different from the other freedoms in that it presupposes the existence of a regulatory framework.[99] Many national rules that could be regarded as obstacles to capital movements essentially 'establish the market and thus make capital movements possible in the first place'.[100] This means that the identification of capital restrictions is a particularly delicate exercise.

So far the Court's reasoning is based on the premise that all golden shares are by definition restrictions on capital movements, as they discourage foreign investors from acquiring shares in privatised undertakings in which the State retains some special rights. This article has attempted to identify the potential flaws in this legal reasoning and has questioned the assumption that the free movement of capital as enshrined in the Treaty advocates a corporate governance regime based on the shareholders' primacy principle. Drawing from the case law in goods, it is argued that the wide interpretation of capital restrictions could be narrowed down by the application of a *Keck*-inspired test that would allow Member States acting as shareholders of strategically sensitive privatised companies to protect public interest requirements, especially when the undertaking concerned provides services of general economic interest. While the acceptance of investments arrangements in the capital case law might seem unlikely in the near future,[101] the Court could nevertheless further develop the derogation from ordinary company law criterion in order to promote capital liberalisation, without, however, imposing a certain model of capitalism and corporate governance on the Member States.

97. Gerner-Beuerle, above n. 73, at 141.
98. To borrow the title of the seminal work by K. Polanyi, *The Great Transformation* (1944).
99. Gerner-Beuerle, above n. 73, at 136.
100. *Ibid*., at 137 citing Barnard (2014), above n. 8, at 245.
101. Biondi, above n. 4, at 96-97.

The Categorisation of Tax Jurisdictions in Comparative Tax Law Research

Renate Buijze*

Abstract

The number of comparative tax law studies is substantial. The available literature on the methodology behind these tax comparisons, however, is rather limited and underdeveloped. This article aims to contribute to the theoretical background of tax comparisons by explicating methodological considerations in a comparative tax research on tax incentives for cross-border donations and relating it to the available methodological literature. Two aspects of tax law make comparative research in tax law a challenging endeavour: its complexity and fast-changing nature. To overcome these issues, this article proposes to divide jurisdictions into a limited number of categories. In this process the different legal levels are analysed systematically, resulting in categories of jurisdictions. Among the jurisdictions in one category, common characteristics are identified. This results in an abstract description of the category. I use the term 'ideal types' for these categories. The high level of abstraction in the use of ideal types allows for comparison of tax jurisdictions, without the risk that the comparison gets outdated. An additional advantage of working with ideal types is that the conclusions of the comparison can be applied to all jurisdictions that fit in the ideal type. This increases the generalisability of the conclusions of the comparative tax research.

Keywords: Classification of jurisdictions, international comparative tax law, tax law methodology

1 Introduction

When researching tax law it is interesting to see how different countries deal with one and the same issue. Approaches can be very similar, but can also vary largely. Comparing different jurisdictions gives an idea of alternative measures to an issue. Usually, a legal comparison can provide insights into the political, social and cultural climate in a country. Contrasting one's own jurisdiction with another also improves the understanding of one's own jurisdiction. For these and for other reasons, many tax law scholars have engaged in tax law comparisons.

Also in the field of my research interest – tax incentives for philanthropy in personal income tax – scholars have conducted country comparisons.[1] One of the findings of the comparisons is that there is a high level of consensus regarding the encouragement of philanthropy through the tax system among high-income countries, as 87% of high-income countries provide a tax incentive for donations by individual benefactors in personal income tax acts.[2] Despite this high level of consensus in domestic situations, governments have far more diverging approaches when it comes to cross-border situations. Differences in approaches of governments towards the application of tax incentives to cross-border philanthropy emerge in the comparisons made by several tax law scholars. They analysed the impact of the developments in EU law on the application of tax incentives for cross-border donations. Furthermore, they compared the relevant tax provisions on the use of tax incentives for cross-border philanthropy of countries in and outside the EU.[3] Each of them, for obvious reasons, focused on a limited number of countries. These studies demonstrate that there are countries that restrict tax incentives for charitable giving to the own country. Others allow for tax incentives in personal income tax on cross-border gifts. The conditions under which a tax incentive for a cross-border gift can be obtained, however, vary largely and the full range of requirements passes by, from stringent requirements to limited requirements.

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1. For recent comparisons *see*, among others, S. Heidenbauer, 'Exclusiveness and Directness in Charity Law: A Comparison', 25 *Steuer und Wirtschaft International* 283 (2015); F. Vanistendael (ed.), *Taxation of Charities* (2015): and Nexus, McDermott Will & Emery LLP, Charities Aid Foundation, *Rules to Give by: A Global Philanthropy Legal Environment Index* (2014).
2. Nexus, McDermott Will & Emery LLP, Charities Aid Foundation, above n. 2. High income economies are those with a Gross National Income per capita of $12.736 or more, World Bank, 'New Country Classifications by Income Level', available at: <http://data.worldbank.org/news/new-country-classifications-2015> (last visited 17 July 2015).
3. *See*, among others, H. Jochum and A. Savvaidou, 'Deduction of Gifts and Contributions and Other Tax Incentives in the PIT and CIT for Non-Profit Entities or Activities', in F. Vanistendael (ed.), *Taxation of Charities* (2015) 61; T. von Hippel, *Cross-Border Philanthropy in Europe after Persche and Stauffer: From Landlock to Non-Discrimination?* (2014); S. Heidenbauer, S.J.C. Hemels, B.W. Muehlmann, M. Stewart, O. Thömmes & T. Tukić, 'Cross-Border Charitable Giving and Its Tax Limitations', 67 *Bulletin for International Taxation* 611 (2013); M. Stewart, 'Tax Deductibility of Cross-Border Giving: Australia Gives No Quarter', *Melbourne Legal Studies Research Paper* 605 (2012), S. Heidenbauer, *Charity Crossing Borders, the Fundamental Freedoms' Influence on Charity and Donor Taxation in Europe* (2011); and I.A. Koele, *International Taxation of Philanthropy* (2007).

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The example of tax incentives for cross-border philanthropy demonstrates that countries with a similar approach towards domestic situations can have divergent approaches to the same topic in cross-border situations. Comparison of these different approaches towards cross-border taxation, similarly to the comparison of domestic tax law, provides interesting insights. Conducting a comparative tax law research, however, can be challenging. In other legal areas one can rely on the available methodological literature when engaging in comparative research. The literature on comparative tax law, however, is rather sparse and fragmented. Comparative tax law studies either lacked a description of their methodological approaches or started from scratch and failed to engage with the comparative tax research conducted by others.[4] By making the method that I used explicit and relating it to other methodological contributions, this article aims to contribute to the methodological understanding of comparative tax law, more specifically to the comparison of measures for cross-border taxation. Furthermore, the newly developed guidelines used during the classification of tax jurisdictions are put forward. This seems worthwhile since few scholars have made their methodology explicit. It is an invitation to others to make their methodology in comparative tax law explicit as well, in order to strengthen the field of comparative tax law.

The categorisation of tax jurisdictions took place in the light of a study I conducted on tax incentives in personal income tax for cross-border charitable gifts.[5] Through the analysis of the relevant tax sources, I classified tax jurisdictions into ideal types that capture the spectrum of different approaches governments hold towards the application of tax incentives in cross-border situations. The ideal types vary from jurisdictions that support cross-border donations with a tax incentive, to governments that restrict tax incentives to domestic donations and models that represent the more moderate approaches between these extremes.

The article starts with a brief description of the status of comparative tax law within comparative law in Section 2. Section 3 identifies two main challenges that arise when comparing legislation on cross-border taxation, namely the complexity of tax systems and the rapid legislative change. The article continues with the description of the method I have used to compare countries' approaches towards tax incentives for cross-border philanthropy in Section 4. Special attention is paid to the classification of tax jurisdictions. Section 5 reflects on the use of ideal types in comparative tax law. In the last section I make some concluding remarks. Although the central aim of this article is to advance the methodology of comparative tax law, the discussion may be helpful for the study of cross-border legislation in other legal fields as well.

4. O.Y. Marian, 'The Discursive Failure in Comparative Tax Law', 58 *The American Journal of Comparative Law* 415 (2010).
5. R. Buijze, *Charitable Fundraising for the Arts in the Era of Globalization: International Tax Barriers for Arts Organizations*, forthcoming PhD thesis, Erasmus University Rotterdam.

2 Comparative Law and Comparative Tax Law

2.1 Comparative Law and Comparative Tax Law

> It may indeed be that the mere interpretation of positive rules of law in the way traditionally practised by lawyers does not deserve to be called a science at all, whether intellectual or social. Perhaps legal studies only become truly scientific when they rise above the actual rules of any national system, as happens in legal philosophy, legal history, the sociology of law, and comparative law.[6]

This provocative statement by Zweigert and Kötz stimulates the reflection on traditional legal research. It shows that the discipline of law can benefit from approaches that go beyond the study of the national system. At the same time, it depicts that comparative law gains value when it goes beyond the study of foreign law and does not run ashore at the descriptive comparative law of country reports. Instead, these informative descriptions constitute the starting point for a critical comparative reflection on the phenomenon studied.

Comparative law is one method to go beyond the study of national legal systems. It has the potential to obtain a more profound understanding of law that is less directed to national legal systems and more targeted to overarching approaches and/or deeper underlying principles. Comparative research allows scholars to identify general, universal applicable legal principles. It allows them to understand, organise and structure law. And it allows the discovery of model solutions for preventing or resolving conflicts.[7] Comparative law, however, is not an aim in itself. Instead, it is a method that provides a structure to find an answer to a research question.[8]

The discipline of comparative law came into being around the turn of the previous century. The first conference on comparative law was held in 1900 in Paris.[9] Since then, many scholars have written on the methodology of comparing jurisdictions, although they do not perceive comparative law as a full-grown methodology.[10]

By comparative tax law, I refer to the methods used in comparative law applied to the field of tax law. Some scholars argue that comparative tax law is not just a

6. K. Zweigert and H. Kötz, *An Introduction to Comparative Law* (1998), at 4.
7. H.P. Glenn, 'The Aims of Comparative Law', in J.M. Smits (ed.), *Elgar Encyclopedia of Comparative Law* (2012) 65 and Zweigert and Kötz, above n. 6, at 4, 15.
8. Glenn, above n. 7, at 65 and W. Devroe, *Rechtsvergelijking in een Context van Europeanisering en Globalisering* (2010), at 37, 38.
9. V. Heutger and E. Schrage, 'Legal History and Comparative Law', in J.M. Smits (ed.), *Elgar Encyclopedia of Comparative Law* (2012) 505, at 512.
10. Zweigert and Kötz, above n. 6, at 33.

methodology, but a substantive body of knowledge.[11] I agree with their line of reasoning that the methodology used is mainly a technique derived from comparative law and can lead to new knowledge in itself. In this article, however, I would like to focus on the former: the methodological contribution the approach and techniques of comparative tax law make to the discipline of tax law. Therefore, I address comparative tax law as a methodology in this article.

Comparative tax law has developed somewhat in isolation of comparative law in general, for two reasons. First of all, the emphasis in traditional comparative law used to be on private law. Key works on comparative law, until recently, did not address legal comparisons in tax law, although they paid attention to other fields of law, such as contract law, tort law, family law and, more recently, areas in public law, such as administrative law and constitutional law.[12] Second, owing to the high level of specialisation in tax law, tax specialists are usually the ones conducting comparative tax law instead of legal comparatists.

Comparisons are of great importance, though, in the field of tax law. Civil servants and practitioners who negotiate or apply tax treaties, for instance, need to have knowledge of one or more foreign jurisdictions in order to understand and apply the treaty. The increasing integration of supranational legislation with domestic tax law demands more knowledge of comparative tax law as well. In the EU, this is caused by the harmonisation of indirect taxes and the harmonisation on sub-areas of direct taxes. Furthermore, there is no other area in law for which the Court of Justice of the European Union (CJEU) has produced as much jurisprudence as for tax law, which requires amendments of national tax legislation.

The importance of comparative tax law for practice has put its mark on comparative tax law in academia. Most of the research in this field is pragmatic. Moreover, it is often descriptive in nature, describing the legal practice on a specific topic in a selection of jurisdictions. In cases where it is more analytic, the emphasis in the research is often on one single country. When considering the importance of comparative tax law for practice[13] and the large number of tax scholars who engage in comparisons,[14] it is surprising that relatively little has been written on the methodology of comparative tax law. Tax law is notoriously fast changing and complex, which makes the comparison of tax law a challenging endeavour. Therefore, methodological guidance is important for tax law comparatists.

11. R.S. Avi-Yonah, N. Sartori, & O. Marion, *Global Perspectives on Income Taxation Law* (2011), at 1-2 chapter 2 and Marian, above n. 4, at 421.
12. *See*, amongst others, Zweigert and Kötz, above n. 6; P.G. Monetary (ed.), *Methods of Comparative Law* (2012) and M. Adams and J. Bomhoff, *Practice and Theory in Comparative Law* (2012).
13. V. Thuronyi, 'Tax Law', in J.M. Smits (ed.), *Elgar Encyclopedia of Comparative Law* (2012) 867.
14. *Ibid*.

2.2 Methodology in Comparative Tax Law

The methodology of comparative law is rather young and develops by trial and error.[15] This definitely holds for comparative tax law. Tax law scholars for a long time omitted to contribute to methodology shaping. Not that there was a total absence of methodological literature, but the majority of tax law comparatists started from scratch in developing their method and omitted to take the work of others into account. Furthermore, they omitted to explicate how they got to the used methodology after earlier attempts. This resulted in largely varying, sometimes even conflicting, but underdeveloped methodology for comparative tax law and a lack of comparative tax discourse,[16] and made it difficult to learn from one another. A conversion is going on, however. Marian, for example, related existing comparative tax law research to the methodological framework of comparative tax law.[17] By doing so he contributed to the methodology, or discourse as he calls it, of comparative tax law. I believe this is an important step, since comparative legal methods have a lot to offer to the discipline of tax law.

Comparative legal methods have the potential to contribute to the field of tax law in several ways. Through comparison with other tax jurisdictions, comparative tax law allows for a better understanding of the own system.[18] It stimulates scholars to think creatively about legal problems and broadens their perception of the technical available measures to achieve a certain policy goal.[19] When designing new legislation, comparative tax law can provide inspiration and it can identify best practices and threats to the success of potential new legislation. Furthermore, it can be used to add structure to the field of tax law, which can be used in further research. Besides, comparative tax law can help gain an understanding of the legal context.[20] Finally, it is relevant for practice. It gives insight into the underlying differences between jurisdictions, which is necessary, for example, to manage cross-border transactions.

2.3 Different Kinds of Comparative Tax Law

The degree and type of comparative research conducted in tax law differ largely. There is comparative tax law that provides analytical comparisons, where comparisons of national systems are made within a specific assessment framework. This type of comparative tax law is normative and/or evaluative. An example of methodological explanation of comparative tax law that uses

15. Zweigert and Kötz, above n. 6 at 33 and W. Twining, *Globalization and Comparative Law* (2000) at 191-92.
16. Marian, above n. 4, at 417.
17. *Ibid*.
18. W.B. Barker, 'Expanding the Study of Comparative Tax Law to Promote Democratic Policy: The Example of the Move to Capital Gains Taxation in Post-Apartheid South Africa', 109 *Penn State Law Review* 703, at 708 (2004-2005) and H.J. Ault and M.A. Glendon, 'The Importance of Comparative Law in Legal Education: United States Goals and Methods of Legal Comparisons', 27 *Journal of Legal Education* 599, at 601 (1975).
19. H.J. Ault and B.J. Arnold, *Comparative Income Taxation: A Structural Analysis* (2004) and Ault and Glendon, above n. 18.
20. V. Thuronyi, *Comparative Tax Law* (2003).

an assessment framework to make an analytical comparison is the work of Barker.[21] He made a critical analysis of the South African capital gains tax in comparison with that in the United Kingdom and the United States, in order to assess how the tax system can help solve economic inequality in an emerging democracy. Barker is of the opinion that comparative tax law should go beyond mere description and should be critical. He states: 'Comparative analysis needs to confront the assumptions underlying tax law including its effect, efficiency, fairness, and acceptance by the people. This means it must go beyond descriptive focus on the "is" and evaluate the "is" in the terms of the "ought to be."'[22] Another interesting example that strives for the "ought to be" through a tax law comparison is the study by Infanti.[23] Infanti conducted research on the tax treatment of cross-border contributions to charities, just as I did. He, however, uses the comparative tax law method to demonstrate how –according to his presumption – simplification of the domestic tax regime can be achieved through tax coordination at the international level.

Moreover, there is research that makes comparisons based not on a normative assessment framework, but on the characteristics of the tax jurisdiction. This type of comparison aims not to evaluate, but to structure tax jurisdictions. The structure in itself can be seen as a result and helps gain insight into tax jurisdictions outside the own jurisdiction. What is more important, perhaps, is that the created structure can assist in answering more explanatory, predictive and defining research questions. Ault and Arnold, in their canonical work, created a structure along which they could discuss the income taxation of nine industrialised countries.[24] Unfortunately, these authors pay little attention to the theory underlying their comparison. The research in which I categorise high-income countries according to their approach towards the application of tax incentives for cross-border donations is a similar type of comparison. By explicating the used methodology, my work is aimed at providing insight into this type of tax law comparison.

Finally, a large part of the comparative tax law literature is descriptive in nature. Tax law scholars have written highly informative descriptions on the legislation in a specific field of tax law in their jurisdictions. Examples are country reports, which are bundled into edited volumes. These publications are very helpful for practitioners and academics that search for an introduction to a foreign tax jurisdiction. Tax legislation is complex, and therefore country reports are a very welcome starting point from which to get a basic understanding of a foreign jurisdiction. The purpose of these overviews is mainly informative, which is exactly why they are helpful to tax comparatists. On the other hand, some scholars might question whether they belong to comparative tax law in the narrow sense, since it misses a normative approach or does not produce a body of knowledge.[25] When a summary of the national reports is added to the edited volume, trends might be identified.[26] This, again, is perceived as comparative tax law by the majority of scholars.

3 Challenges in Comparative Tax Research on Cross-Border Taxation: A Complex and Fast-Moving Target

Comparative tax law research is complicated by three aspects of tax law: rapid legislative change, the complexity of tax systems and the heterogeneity of local tax concepts.[27] These challenges present in comparative tax research also appear, and are perhaps even more pronounced, when comparing topics in the field of cross-border taxation. The heterogeneity of local concepts, however, appears in many fields of comparative law and is discussed extensively by others.[28] Therefore, I will only mention that the translation of foreign tax concepts requires great caution and that one should be aware of the different meanings of seemingly similar concepts.[29] The other two factors, however, do require some explanation.

Comparative research on tax legislation is complicated by continuous political pressure and changing government standpoints. This results in ongoing changes in tax legislation over time. For instance, the requirements for *Algemeen Nut Beogende Instellingen* (Public Benefit Pursuing Entities) in the Netherlands have changed five times between 2008 and 2014.[30] When dealing with cross-border issues, one has to take into account (changes in) legislation in two countries. Political changes and decisions at the international level also add to the rapid pace of changes in tax law. The case law of the CJEU, for example, is a source of amendments to national law. This makes tax law, especially cross-border taxation, a fast-moving target that is difficult to grasp and poses the risk of comparative tax research getting outdated fast.

21. Barker, above n. 18
22. *Ibid.*, at 708.
23. A.C. Infanti, 'Spontaneous Tax Coordination: On Adopting a Comparative Approach to Reforming the U.S. International Tax Regime', 35 *Vanderbilt Journal of Transnational Law* 1105 (2002).
24. Ault and Arnold, above n. 19.
25. C. Garbarino, 'An Evolutionary Approach to Comparative Taxation: Methods and Agenda for Research', 57 *The American Journal of Comparative Law* 667, at 679 (2009).
26. Marian, above n. 4, at 455-56.
27. Garbarino, above n. 25, at 686-88.
28. *See*, among others, L. Hantrais, *International Comparative Research, Theory, Methods and Practice* (2009) at 72-94; G.R. de Groot and C.J.P. van Laer, 'The Dubious Quality of Legal Dictionaries', 34 *International Journal of Legal Information* 65 (2006).
29. *See*, among others, Garbarino, above n. 25, at 686-88; M.A. Livingston, 'Law, Culture, and Anthropology: On the Hopes and Limits of Comparative Tax', 18 *Canadian Journal of Law & Jurisprudence* 119 (2005).
30. S.J.C. Hemels and W. van Vliet, 'Anbi: regeling of ontregeling?' 17 *Vakblad Fondsenwerving* 27 (2015).

Another challenge in comparative tax research is to deal with the complex nature of tax law, especially in cross-border situations. The complexity of tax law stems from its distinctive tax vocabulary. Furthermore, the high degree of refinement in the tax provisions, which might be laid down in a large volume of varying legal sources, adds to the complex structure of tax law.[31] This complexity causes a high level of specialisation among scholars and practitioners. In several OECD countries, for example, specialisation in the field of tax law is the norm and generalists are exceptional.[32] The impact of national, international and/or supranational legislation on each other further adds to the degree of complexity of tax law, especially on cross-border tax issues. It provokes a 'vertical comparison', which is a comparison that compares legal systems at different legal levels.[33] A comparison that checks whether a tax system of an EU Member State is in line with the four fundamental freedoms as stipulated in the Treaty on the Functioning of the European Union (TFEU) would be an example.[34] So unlike the traditional horizontal comparison, which is a comparison occurring among systems belonging to the same level,[35] comparisons of (cross-border) taxation provoke both horizontal and vertical comparisons. Furthermore, in some cases an unequal comparison might arise because some countries have larger sovereign powers than others.

The foregoing factors make it difficult to get a hold on one's own tax jurisdiction, let alone fully understanding multiple tax jurisdictions. The boundaries between legal orders, expressed in horizontal and vertical relations, get blurred owing to the integration of legal orders.[36] At the same time, the large impact that legislation at the international and/or supranational level has on national legislation and vice versa increases the demand for comparative tax law. As Thuronyi nicely puts it: "EU integration fuels some of the demand for comparative tax law knowledge."[37]

To overcome the challenges that the fast-changing and complex nature of international tax law pose to comparative tax law, I propose a method for comparative tax law that categorises tax jurisdictions into ideal types. The benefits of this method are that it enables a systematic analysis of tax jurisdictions in their international legal context and that it provides durable outcomes. Besides, the ideal types enable generalisation of the conclusions to other countries. In the next section I explain how the tax jurisdictions are categorised into ideal types, so that other researchers can reflect on this method when engaging in similar comparative tax law research.

31. Livingston, above n. 29, at 120; Thuronyi, above n. 20, at 17-20.
32. Thuronyi, above n. 13, at 863.
33. A. Momirov and A. Naudé Fourie, 'Vertical Comparative Law Methods: Tools for Conceptualising the International Rule of Law', 2 *Erasmus Law Review* 291 (2009).
34. Treaty on the Functioning of the European Union (TFEU) and EU Treaty (as amended through 2007).
35. Momirov and Naudé Fourie, above n. 33.
36. Devroe, above n. 8, at 37-56.
37. Thuronyi, above n. 13, at 862.

4 The Comparison of Approaches to Tax Incentives for Cross-Border Philanthropy

4.1 Conducting Comparative Legal Research

Zweigert and Kötz distinguish the following five steps in conducting comparative research: (a) definition of the research topic and research question; (b) selection and interpretation of sources; (c) selection of countries; (d) comparison of the country reports and (e) building of a system.[38] Other comparative law scholars like Kamba and Örücü provide similar guidelines for conducting comparative law, albeit with slightly different emphasis.[39] Infanti, who also conducted research on the tax treatment of cross-border contributions to charities, adopted the guidelines proposed by Kamba.[40] Although we study the same topic, the different aims of our comparative tax law research, logically, direct me to a different approach. Whereas Infanti's work aims to develop a method that achieves simplification of the domestic tax regime through tax coordination at the international level, my research aims to explore the different approaches towards the application of tax incentives for cross-border donations. It is the steps identified by Zweigert and Kötz that I largely drew on in the comparison of approaches to tax incentives for cross-border philanthropy.

The comparative tax law research in which I explore the different approaches towards the application of tax incentives on cross-border donations is part of a larger research project that evaluates the solutions that allow private donors to benefit from the domestic tax incentive for donations on cross-border donations. This specific topic determines the scope of the comparison: a specific facility in personal income tax, and thus a micro comparison.[41]

The starting point of the actual research was the exploration of the literature on cross-border charitable giving. This exploration led to the main research question: 'What are the dominant approaches towards the application of tax incentives in personal income tax for cross-border individual giving?' In line with Zweigert and Kötz advice, I kept away from terms related to a specific jurisdiction. Instead, I selected a concept that grasps the functionality of the rules I wanted to study. I chose the term 'tax incentives' instead of 'tax credit', 'tax deduction' and the like, because the latter refer to measures used in specific jurisdictions, whereas the former covers

38. Zweigert and Kötz, above n. 6, at 32-47.
39. W.J. Kamba, 'Comparative Law: A Theoretical Framework', 23 *International and Comparative Law Quarterly* 485 (1974); A.E. Örücü, 'Methodology of Comparative Law', in J.M. Smits (ed.), *Elgar Encyclopedia of Comparative Law* (2012) 560.
40. Infanti, above n. 23.
41. Marian, above n. 4, at 449-51.

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the entire category of measures that support charitable giving through the income tax system.

For the exploratory research, I consulted scientific articles by tax law scholars from a diversity of countries. This provided a good idea of the primary sources to consult for the actual research. Although I had initially considered the comparison of domestic tax legislation and a separate discussion of international and supranational legislation, I soon learned that this was insufficient. Domestic tax legislation, bilateral tax treaties and supranational agreements all had to be taken into account in the comparison. During the data collection I thus searched for information relevant to tax incentives for charitable giving in all these three sources. The advantage of studying a tax benefit is that these benefits are generally well described in the written law. This is in contrast to other types of provisions, where unwritten rules might be present that can be difficult to track down for non-native scholars. The great consensus among high-income countries in regard to the application of tax incentives for charitable giving helped me a great deal in finding the relevant provisions in the legislation.

In addition to the written law, important case law was studied. This was initially limited to case law of courts at the international level such as the CJEU. Later, when it showed that in one jurisdiction written law was not in line with the CJEU case law and there was uncertainty about the law in practice, clarification was found in the case law of the highest tax.

To gain insight into the application of domestic tax law, in the first instance the original documents were consulted. But when language barriers forced consultation of secondary sources, I turned to respectable secondary sources, and explicitly noted in the reports wherever applicable that they were based on secondary sources.[42] Even though translations of the original documents were available, caution was required since certain concepts are difficult to translate. Besides, similar concepts can have a different meaning, owing to the influence of the socio-cultural context in a country.

The exploratory research included a broad variety of jurisdictions. For the actual research, the initial selection of jurisdictions had to be limited. Zweigert and Kötz propose two approaches for the selection of jurisdictions: (a) selecting jurisdictions from different legal families or (b) selecting on the basis of the function of the topic in the research.[43] I chose the latter, as I wanted to ensure that a variety of approaches towards the application of tax incentives for cross-border philanthropy were included in the research. In the exploratory research I had identified the main varieties of tax incentives for philanthropy. The exploratory research also provided insight into the relevant legal orders that influence the approaches governments hold towards the application of tax incentives for cross-border philanthropy. These factors were guiding in the selection of jurisdictions, in order to ensure that the existing diversity of jurisdictions would be represented in the selection.

On the basis of this purposeful selection I chose the following jurisdictions: Australia, Barbados, Belgium, France, Germany, Hungary, Japan, Netherlands, Spain, Sweden, the United Kingdom and the United States. This selection of jurisdictions includes examples of the entire spectrum of approaches towards the application of tax incentives on cross-border philanthropy. Additional countries would closely resemble one of the jurisdictions included in the selection and would therefore not foresee new insights. In other words, I had reached the point of decreasing marginal returns.[44] Since the research focuses on a very specific provision, it was feasible to study this rather large selection of jurisdictions. This would, for obvious reasons, be impossible if the research topic encompassed a more general rule.

Despite using a purposeful selection, unintendedly the selected jurisdictions cover most of the tax law families as identified by Thuronyi.[45] Barbados, Australia and the United Kingdom represent the Commonwealth family; the United States represents the American family; the French family is covered by France; Hungary belongs to the transition and post-conflict family; the Netherlands, Belgium, Germany and Sweden represent the Northern European family; Spain belongs to the Southern European family; and Japan represents the Japanese/Korean family. The families identified by Thuronyi that are not covered by this selection are the Latin American family and the miscellaneous family. None of the countries in the miscellaneous family are high-income countries and therefore fall outside my comparison. Among the Latin American family, Uruguay, Argentina, Chile and Venezuela qualify as high-income countries, and the latter three also seem to have a tax incentive for private giving in place.[46] The existing literature on cross-border charitable giving did not give rise to including these countries in the selection, although for the future it might be interesting to have a closer look at (one of) these countries.

For each of the twelve selected jurisdictions I made a brief country report. In order to enlarge the reliability of my interpretation of the sources consulted I cross-checked my findings with academic articles by native scholars of the relevant jurisdictions, in so far as these were available. To make the country reports comparable, I had to use an approach to all jurisdictions that would allow me to eliminate the elements that are peculiar to a jurisdiction, but stand in the way of comparison. These elements are, for example, tax concepts spe-

42. Respectable secondary sources were used in case language barriers prevented consultation of original legislation, such as the Tax Research Platform of IBFD (<http://online.ibfd.org>) country reports gathered by the European Foundation Centre and Transnational Giving Europe (<www.efc.be/programmes_services/resources/Pages/Legal-and-fiscal-country-profiles.aspx> and <www.transnationalgiving.eu/en/country-profiles/>), the Council on Foundations (<www.cof.org>) and the publication following the 2012 Conference of European Tax Law Professors (F. Vanistendael (ed.), *Taxation of Charities* (2015)).

43. Zweigert and Kötz, above n. 4, at 40-42.

44. *Ibid*., at 41.

45. Thuronyi, above n. 20, at 23-44.

46. Nexus, McDermott, Will & Emery, Charities Aid Foundation, above n. 2.

cific to one jurisdiction and cultural interpretations. To eliminate these, I followed the functional approach. This commonly used approach in comparative law, which is also adopted in comparative tax law, assumes that the basic function of legislation in each country can be compared. It starts from a specific problem and then examines which mechanisms are used in the jurisdictions studied to resolve it. The mechanisms for each function can then be grouped on the basis of the function.[47] My method differs from the functional approach in later steps, where the functional approach searches for similarities in tax legislation and is used as a tool "*for reform leading to harmonization or even unification of tax laws*".[48] Instead, my aim is not to reform tax law, but to map the different legislative models. Here I find my approach close to that of Thuronyi, who sees comparative tax law as an instrument that provides a structure for reference in tax law.[49] Besides, I did not focus solely on the similarities, but also took into account the differences between jurisdictions.

While constructing the country reports, similarities and differences between countries started to become clear. I could see patterns crystallising, and that is how I got to the division of jurisdictions into ideal types. However, before describing the categorisation of jurisdictions in the next section, a word of caution is necessary. Although categorisation is helpful as a system, the discussion of tax law in terms of ideal types does come with some drawbacks. As in every legal comparison, there are the language barriers to overcome.[50] Furthermore, jurisdictions are heavily interrelated with the societal and cultural background of the country.[51] In addition, one should look not only at the written law, but also at the law in action.[52] Therefore, getting a thorough understanding of a jurisdiction other than that in your home country can be difficult. One should be aware, when engaging in comparative tax law, that systems might seem the same but the institutional and cultural backgrounds might differ.[53] This can be a threat to a successful comparison. With the help of work by native scholars and the support of generous reviewers and colleagues, however, it is possible to get a grip on a foreign legal system.

4.2 Categorisation Regarding Tax Incentives for Cross-Border Gifts

The relation between the different legal levels and the level of openness of a country towards the application of tax incentives for cross-border philanthropy showed to be the key to a system based on which the different approaches could be divided into ideal types. According to Zweigert and Kötz, this 'system building' is the last step in comparative research,[54] as the division into ideal types enables a macro-perspective on a specific and detailed topic. Based on the type of tax incentive available, the availability of legal measures at different legal levels and the requirements imposed on qualifying donations, I built a system in which the jurisdictions can be ordered in a meaningful sequence. This requires some explanation. In the next paragraph I elaborate on the relevant factors.

At the national level countries choose a specific tax incentive scheme, such as a credit on taxes due, a deduction from taxable income or a percentage designation scheme. In principle, these tax incentives can all be applied in cross-border situations. Countries grant tax incentives in cross-border situations under certain conditions. They can allow for a tax incentive on direct cross-border donations or on cross-border donations through a local intermediary charity. The local intermediary charity is a qualifying charity in the country of the donor that receives the gift and then transfers it to a foreign charitable organisation. Since the transaction from the donor to the local intermediary charity is a donation to a domestic qualifying organisation, a tax incentive is granted on the gift. Obviously, a country that allows for direct cross-border donations has a more open approach than countries that only allow for tax incentives on indirect cross-border donations.

Through the design of the tax incentive and the requirements imposed on a qualifying donation, governments can nuance the application of the tax incentive. The requirements can vary from administrative requirements, to requirements on the location of the designated organisation, to definitions on what activities qualify as charitable and requirements over the control over the receiving charity. The requirements imposed on qualifying donations are a strong tool to limit or loosen the applicability of tax incentives to cross-border donations, for countries that allow for tax incentives on cross-border donations based on national legislation, but also for countries that allow this based on international and/or supranational legislation. The more requirements and the stricter the requirements imposed on a qualifying donation, the more difficult it is to make a cross-border donation with the benefit of a tax incentive, and thus the more closed a jurisdiction is on this issue.

At the international level, countries can engage in bilateral tax treaties in which they recognise each other's charities and mutually apply their tax incentives to cross-border donations. The more bilateral tax treaties a country has that include a provision on charitable contributions, the more open the approach of a country is.

Also at the supranational legal level, countries can engage in agreements on this topic. In the European Union (EU), for example, the CJEU in the *Persche* case ruled that based on the free movement of capital, donations to charitable organisations that meet the charity requirements of the donor's state should be treated equally, regardless of whether it concerns a donation

47. Garbarino, above n. 25, at 688.
48. Marian, above n. 4, at 438.
49. Thuronyi, above n. 20, at 2.
50. Devroe, above n. 8, at 50-3; de Groot and van Laer, above n. 28.
51. Devroe, above n. 8, Acco (2010), at 44; Thuronyi, above n. 20, at 23-25.
52. Barker, above n. 18, at 723-24.
53. Ault and Arnold, above n. 19.
54. Zweigert and Kötz, above n. 6, at 44-46.

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within an EU Member State or crossing borders between two EU Member States or an EU Member State and a country that is part of the European Economic Area.[55] EU Member States that want to limit the scope of this judgment can alter their national legislation in such a way that the requirements on qualifying donations become restrictive, as long as they stay within the limits of the *Persche* case.

The factors that influence the applicability of a tax incentive for cross-border donations, described in this section, are measures at different legal levels that are guiding in the comparison and ranking of tax jurisdictions according to their openness towards the application of tax incentives for cross-border donations. The road map in the next section summarises this in a more structured manner. Applying this road map results in four ideal types: (1) closed jurisdictions; (2) restrictive jurisdictions; (3) relatively open jurisdictions and (4) open jurisdictions. These ideal types inform us how open a jurisdiction is towards the application of a tax incentive on a charitable gift. Countries without a tax incentive in place at the domestic level fall outside the comparison.

Although the jurisdictions could have been divided into a different number of categories, four ideal types showed to be the right number, as these four ideal types summarise the spectrum of different approaches governments hold towards the application of tax incentives for cross-border philanthropy. While developing the system, I also made an attempt to divide the jurisdictions into three and five ideal types. Three ideal types did not allow inclusion of all the factors discussed above. More than four ideal types forced a divide on less meaningful components and would have made it more complex to deal with the categories.

4.3 Categorisation of Jurisdictions: A Road Map[56]

The categorisation of the jurisdictions into ideal types was done as systematically as possible, in order to increase the internal validity. The following steps were taken:

1. Does the domestic tax legislation allow for tax incentives on direct cross-border donations? If yes, > ideal type (4) open jurisdiction.
2. Does the domestic tax legislation allow for tax incentives on indirect cross-border donations (through a local intermediary charity) and/or does the country have international agreements, such as tax treaties and/or supranational agreements, that allow for tax incentives on cross-border donations
   a. with at least ten countries? And
   b. of which the facts and circumstances make it practically possible to obtain a tax benefit on a cross-border situation? If yes> ideal type (3) relatively open jurisdictions.
3. Does the country have international agreements, but with less than ten countries, and/or are the facts and circumstances such that it is impossible to obtain a tax benefit for a cross-border donation in practice? If yes> ideal type (2) restrictive jurisdiction.
4. None of the above? If yes> ideal type (1) closed jurisdictions.

4.4 Four Approaches towards the Application of Tax Incentives for Cross-Border Gifts

Based on the road map above, the different jurisdictions were divided into four categories that summarise the spectrum of the different approaches governments hold towards the application of tax incentives for cross-border donations. A last step to take was to identify the common qualities of each category, in order to define the four ideal types. To identify these characteristics, I went back again to the country reports, but this time to search for similarities within the jurisdictions that belong to one category. I described the ideal types as follows.[57]

Countries that stimulate charitable gifts through tax incentives in the domestic situation but not in a cross-border situation are considered closed tax jurisdictions. In their tax system, these countries provide a benefit to benefactors of charity organisations, for example, through a tax credit or deduction from taxable income. Closed jurisdictions, however, do not have domestic legislation that allows for a tax benefit for cross-border donations, nor do they have bilateral or supranational agreements with other countries on tax incentives for cross-border donations. Examples of these countries are Australia and Japan.

At present, countries that use a tax designation scheme (also known as percentage schemes) typically also belong to this ideal type. The majority of jurisdictions that apply a tax designation scheme to support philanthropy limit tax incentives on philanthropy to donations in the own country, although it is technically possible to allow for cross-border donations in a tax designation scheme. The tax designation schemes are designed such that taxpayers in their tax declaration can allocate a percentage of their taxes due to a charity that is included in a list of eligible charities. In this list often solely domestic charities are included. Since the gift to the charity is made through the tax declaration, it is difficult for the taxpayer to have a say in the spending of the contribution. This limits the possibility to use the recipient charity as an intermediary charity. Currently, most of the jurisdictions that use a tax designation scheme have a closed approach towards the application of tax incentives for cross-border charitable giving. This, however, is not inherent to tax designation schemes, but to how a specific jurisdiction adopts this tax designation scheme.

55. CJEU, 14 October 2008, Case C-318/07, *Hein Persche* v. *Finanzamt Lüdenscheid*.
56. In this section I cite my own work to illustrate the application of the method I propose in this article. *See* R. Buijze, 'Approaches Towards the Application of Tax Incentives for Cross-Border Philanthropy', 44 (1) *Intertax* (2016).
57. In the following paragraphs I cite my own research to illustrate the outcome of the method I propose. In the article I cite from, however, this text belongs to the core content of the research. *See* Buijze, above n. 56.

Hungary is one of the countries in the EU that uses a tax designation scheme and that I consider a closed tax jurisdiction.

In restrictive jurisdictions a tax incentive can be obtained for cross-border donations, based on bilateral tax treaties or supranational agreements. However, the scope of these agreements is limited, allowing for tax incentives on cross-border donations with no more than ten countries. Owing to the limited scope of the agreements these jurisdictions are considered restrictive.

Furthermore, countries with more agreements, but where it is practically cumbersome to receive a tax benefit, are included in this ideal type. I add this criterion to avoid that those countries where it is legally possible but practically close to impossible to receive a tax benefit on a cross-border donation, to end up in the relatively open category. For example, EU Member States need to allow for tax incentives in cross-border situations. However, in practice it proves to be extremely difficult in some Member States to obtain this benefit, since EU law based on the TFEU and CJEU case law is simply not applied. These jurisdictions try to restrict the tax incentives to the domestic situation as much as possible and are therefore effectively in the category 'restrictive jurisdictions'. A local intermediary organisation might provide a solution in this type of jurisdictions to obtain a tax incentive for cross-border donations. Examples of these jurisdictions are the United Kingdom, France and Spain.

A more moderate category are the relatively open tax jurisdictions, which do allow for tax incentives on cross-border donations, but mainly based on tax treaties and supranational agreements. The scope of these agreements is rather broad and covers more than ten countries. Furthermore, the facts and circumstances make it practically feasible to obtain a tax benefit on a cross-border donation. Besides, in these countries it is also possible to obtain a tax incentive for a cross-border donation through local intermediary charities. Belgium, Germany and the United States are examples of this ideal type.

Open tax jurisdictions are those countries that allow for tax incentives on cross-border donations, based on domestic tax regulations. They do so in cross-border situations with multiple countries. Regardless of whether donations are made domestically or internationally, tax privileges can be obtained. Thus, there is no discrimination between donations made to domestic charities and those made to foreign charities. In both cases the donor receives the same tax privilege. The Netherlands, Barbados and Sweden fit within this ideal type.

5 Reflections on the Categorisation into Ideal Types

Many scholars propose that only a limited number of jurisdictions can be compared, because of the available resources, accessibility to sources and time limitations. I subscribe to these claims. However, this greatly limits the generalisability of the findings of the research, since the legal comparison will only hold for the discussed jurisdictions. Under the most favourable conditions it can be cross-checked whether the conclusions drawn from the legal comparison can also apply to another jurisdiction. But this, of course, requires a full analysis of the additional jurisdiction. By limiting oneself to a small selection of countries, comparisons can get bogged down in studies that inform us on the current legal situation in the discussed jurisdictions and their differences and similarities. Although the informative value of these studies should not be underestimated, it does have limitations. Furthermore, a comparison of a small number of jurisdictions is not generalisable over time. As soon as legislation changes, the comparison is outdated, and thus the conclusions are largely obsolete.

To contribute to fundamental scientific knowledge, it is desirable to have more abstract findings, so that they can be applied to other jurisdictions. This is exactly what the categorisation I propose has to offer. Working with ideal types allows for conclusions at a higher level of abstraction. This stimulates conceptualisation and helps reveal relations within tax legislation. Findings can be generalised to other jurisdictions geographically, but also over time. Jurisdictions are not static, so if legislation is adjusted, it is sufficient to check whether the changes impact the categorisation of the jurisdiction. If necessary, the jurisdiction can be shifted to a different ideal type.

Although presented here in the light of cross-border taxation, the method might be of use to cross-border issues in other fields of law. The prerequisite is, though, that the approach can be grasped in an ordinal discrete variable, *e.g.* a qualitative measure that can be ordered in a meaningful sequence. Furthermore, this ranking of approaches has to be related to the different legal levels it is subject to. Another prerequisite to apply the method used here is that there is a certain degree of convergence among jurisdictions studied.

Distilling four ideal types that summarise the spectrum of approaches towards the application of tax incentives for cross-border donations, based on the analysis of twelve jurisdictions was possible because of the great convergence between different jurisdictions, despite the fact that each country's tax laws are unique.[58] Several causes are conceivable for this great coherence. Jurisdictions can belong to the same legal family, which are groups of jurisdictions characterised by their style of legal thought.[59] Another reason might be that governments adopt successful laws from other countries. This practice is known as legal transplants.[60]

In the field of cross-border charitable giving, countries might also look at each other for successful measures at different legal levels to restrict or open their jurisdiction

58. Thuronyi, above n. 20, at 15-17.
59. Barker, above n. 18, at 711.
60. *Ibid.*, at 716.

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towards the application of tax incentives for cross-border donations. This would explain why it was possible to clearly identify four different ideal types. This brings me to the similarities between the categorisation of tax jurisdictions I propose with that of the 'typological method' of legal comparisons.

The typological method is a variation of the functional method, which was briefly addressed in Section 4. In the functional method, law is studied in practice, according to its function. The typological method builds on this by searching for a solution to a specific problem in the different judicial systems around the world, the so-called wholesale approach. Solutions to the problem are distilled from jurisdictions, and from these specific solutions, type-solutions are identified. Type-solutions are model solutions under which the other solutions can be classified. The type-solutions are the base for a divide of jurisdictions in different categories of groups of solutions. These groups can intersect legal families.[61]

In the categorisation I propose, the type-solutions can be found in the different legal levels. Each different legal level provides a different type-solution that allows for the application of tax incentives on cross-border philanthropy. Based on these type-solutions, the different approaches towards the application of tax incentives are classified and indeed these groups do intersect legal families.

The congruence we see in the approaches of governments towards legal issues is also helpful for comparatists to assess the quality of the comparison. It helps to evaluate whether a broad enough scope was taken. If only few different approaches are found, one can wonder whether the researcher included enough jurisdictions. On the other hand, the researcher can be confident that his or her study is complete if the addition of jurisdictions does not lead to additional categories.[62]

Categorising jurisdictions into ideal types, however, is not suitable for every aim. In the discussion of tax jurisdictions in terms of ideal types, the peculiarities and nuances that every jurisdiction has are lost to a large extent. Therefore, the method proposed is not suitable when one aims at drawing conclusions for a specific jurisdiction. Detailed analysis of the jurisdiction concerned is necessary to draw conclusions for a specific jurisdiction. The aim of the ideal types is to achieve a certain level of abstraction and not to reach out towards specific jurisdictions. Although no conclusions can be drawn for one specific jurisdiction, a lot can be learned when using this approach. As Thuronyi writes:

> Doing meaningful comparative analysis is especially difficult in the tax area, where political pressure, chance and historical accident have all had an important influence on the development of the systems. However, with appropriate caveats and cautions, there is much to learn in the tax field from a comparative analysis of common problems. One need not believe in the existence of a Platonic Tax Form to find useful insights in the experience of others.[63]

6 Concluding Remarks

Comparative law methods can contribute to the field of tax law. It provides tools to gain a profound understanding of tax law, it uncovers universal applicable legal principles and helps to identify model solutions. For these and other reasons, tax law scholars have engaged in comparative tax law. Few of them, though, have made their methodology explicit, and among those who have explicated their method the majority failed to relate it to the methodology used by other tax law comparatists.

To contribute to the methodology of comparative tax law, this article elaborated on comparative research, specifically focusing on cross-border tax issues, the challenges involved and how to overcome these challenges. The two main challenges specific to comparative tax law on cross-border tax issues are the fast-changing nature of tax legislation and the complexity involved in cross-border tax issues because of the different legal levels involved.

To overcome these two issues in a study of the different approaches towards the application of tax incentives for cross-border donations, I developed a technique in which jurisdictions are categorised into ideal types. In essence, the categorisation takes place on the basis of measures available at the different legal levels to which the jurisdiction is subject and which resolve the cross-border tax issue. Through this method, categories are developed in which each country receives a ranking based on which it can be assigned to an ideal type.

By creating ideal types the model increases the comparability of jurisdictions regarding cross-border taxation. This results in a structured overview of the broad range of approaches towards international tax law. Once the ideal types are established, determining the position of one specific jurisdiction in the broad range of tax jurisdictions becomes more straightforward. This makes it easier to deal with changes in legislation. The method thus allows for easy expansion of the countries studied and is resistant to the dynamic nature of tax legislation. Besides, the use of ideal types allows for generalisation beyond the study of one specific jurisdiction. It enables a broader generalisation of findings.

The ideal types in themselves contain a body of knowledge. They provide an overview of different approaches towards a cross-border tax issue. However, they can also be used as the starting point for further research into more specific issues. One could, for example, analyse the legal measures a taxpayer can rely on in one of the ideal types and see which of the available measures solves a cross-border issue most effectively and efficiently.

61. Devroe, above n. 8, at 37-56.
62. Zweigert and Kötz, above n. 20, at 39-40.
63. Thuronyi, above n. 20, at xxii.

Exit, Voice and Loyalty from the Perspective of Hedge Funds Activism in Corporate Governance

Alessio M. Pacces*

Abstract

This article discusses hedge funds activism based on Hirschman's classic. It is argued that hedge funds do not create the loyalty concerns underlying the usual short-termism critique of their activism, because the arbiters of such activism are typically indexed funds, which cannot choose short-term exit. Nevertheless, the voice activated by hedge funds can be excessive for a particular company. Furthermore, this article claims that the short-termism debate cannot shed light on the desirability of hedge funds activism. Neither theory nor empirical evidence can tell whether hedge funds activism leads to short-termism or long-termism. The real issue with activism is a conflict of entrepreneurship, namely a conflict between the opposing views of the activists and the incumbent management regarding in how long an individual company should be profitable. Leaving the choice between these views to institutional investors is not efficient for every company at every point in time. Consequently, this article argues that regulation should enable individual companies to choose whether to curb hedge funds activism depending on what is efficient for them. The recent European experience reveals that loyalty shares enable such choice, even in the midstream, operating as dual-class shares in disguise. However, loyalty shares can often be introduced without institutional investors' consent. This outcome could be improved by allowing dual-class recapitalisations, instead of loyalty shares, but only with a majority of minority vote. This solution would screen for the companies for which temporarily curbing activism is efficient, and induce these companies to negotiate sunset clauses with institutional investors.

Keywords: Uncertainty, entrepreneurship, agency costs, loyalty shares, institutional investors

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1 Introduction

Shareholder activism in publicly held companies is much in the news, particularly hedge funds activism.[1] Activist hedge funds engage the management of an underperforming listed company in which they have bought a significant stake. Hedge funds seek to determine a change in the governance or in the strategy, from which they will profit by selling their shares at a premium after performance has returned to full potential.

Last year, the U.S. hedge fund Value Act Capital became the largest shareholder of the UK engineering company Rolls Royce, seeking to persuade the management to restructure the company.[2] Engagements by activist hedge funds have included pharmaceutical U.S. companies such as DuPont and Allergan.[3] Hedge funds activism has not spared giant corporations, such as Microsoft and Apple. The phenomenon is not limited to U.S. or UK companies. Activists have targeted several companies in continental Europe, such as the Swedish automotive company Volvo, the German steel company ThyssenKrupp, the Dutch bank ABN-AMRO, the French media company Vivendi and the largest Italian telecom operator, Telecom Italia.[4] Activism appears to

1. Shareholder activism can be identified as actions by a shareholder or a group thereof aimed at bringing about change in a public company without trying to gain control. *See* S. Gillan and L.T. Starks, 'The Evolution of Shareholder Activism in the United States', 19 *Journal of Applied Corporate Finance* 55 (2007). Only a small subset of hedge funds pursue activism. Activist hedge funds engage target companies with a peculiar strategy, described below in the text. This is called 'entrepreneurial activism', to distinguish it from more traditional forms of shareholder activism. *See* A. Klein and E. Zur, 'Entrepreneurial Shareholder Activism: Hedge Funds and Other Private Investors', 64 *Journal of Finance* 187 (2009). *Also see infra*, text to notes 35-40.
2. *See* 'Rolls-Royce Gets Activist Fund Value Act as Biggest Investor', *Bloomberg Business* (31 July 2015). available at: <http://bloom.bg/1Qjgm0Q> (last visited 17 June 2016). More recently, Rolls Royce agreed to reserve a board seat for Value Act conditional on a Value Act promising to keep ownership within a certain range and not seek the break-up of the company. *See* 'Rolls-Royce Agrees Value Act Board Deal', *Financial Times*, 2 March 2016, available at: <http://on.ft.com/1oXZXpu> (last visited 17 June 2016).
3. *See* J.C. Coffee, Jr., 'Lessons of DuPont: Corporate Governance for Dummies', *CLS Blue Sky Blog* (2015), available at: <http://clsbluesky.law.columbia.edu/2015/06/01/the-lessons-of-dupont-corporate-governance-for-dummies/> (last visited 17 June 2016).
4. *See The New Barbarians – Shareholder Activists Have Europe in Their Sights*, in Skadden's 2014 Insights – Global M&A, available at: <www.skadden.com/insights/new-barbarians-shareholder-activists-have-europe-their-sights> (last visited 17 June 2016).

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have an impact also in concentrated ownership structures, where one or more dominant shareholders are in control.[5] Even in dispersed ownership structures, hedge funds activists do not always manage to obtain from management all they want.[6] Because hedge fund activists have become one of the most powerful influencers of corporate governance worldwide, they have attracted significant attention from policymakers who, in most cases, are concerned with how to curb such power.

This article aims to discuss the policy response to hedge funds activism from a law and economics perspective. The analysis is based on a seminal study of feedback mechanisms in large organisations, ranging from governments to corporations: Albert Hirschman's book, *Exit, Voice and Loyalty*.[7] The problem Hirschman tried to address in his 1970 book is rather similar to activist hedge funds' concern: How to bring a company's performance back to full potential. Hirschman's theory can help frame the question whether and under what conditions activism is desirable, which in turn can inform policymaking in this field.

In Hirschman's terms, activism is the quintessence of voice. Voice of shareholders serves the important function of alerting the management about the decline of a specific company.[8] Voice is alternative to exit. Exit of shareholders also alerts the management about a company's decline, but more indirectly, through the price mechanism.[9] As a result, exit may postpone the realisation of decline until it is too late to do something about it. Takeovers are a good illustration of how the exit mechanism impacts corporate governance. Because takeovers are expensive, they operate as a feedback mechanism only in cases of severe underperformance.[10]

One important aspect of Hirschman's framework is loyalty.[11] The ability of shareholders to exit through liquid stock markets normally disincentivises them from exercising voice. This is not the case if there is loyalty to a given company. Making exit more expensive, loyalty commits shareholders to voice. Loyalty has become very popular in today's policy debate, but not quite in the same sense as Hirschman's. While to Hirschman loyalty meant a commitment device for shareholders to use voice instead of exiting an organisation they are dissatisfied with, for policymakers, loyalty distinguishes 'good' voice from 'bad' voice in corporate governance – hedge funds activism being an illustration of the latter.[12]

At first sight, concerns with shareholder voice are puzzling. Vocal shareholders, such as activist hedge funds, are doing other investors a favour. In dispersed ownership structures, hedge funds foster managerial accountability to investors, particularly when managers perform poorly. Similarly, in concentrated ownership structures, hedge funds are guarding minority shareholders against outright expropriation. In sum, the very presence of hedge funds activism reduces the average cost of capital for companies, by way of improving investor protection.[13]

The issue with hedge funds, however, is subtler. Hedge funds are blamed for injecting short-termism in corporate governance. Short-termism is a popular way to characterise stock market imperfection: Stock markets overweigh the short-term income of a company at the expense of its long-term profitability.[14] If financial markets were informationally efficient, there could be no conflict between short-term and long-term value maximisation. Although whether and to what extent stock markets are informationally efficient remains controversial, this article assumes that there may be indeed a conflict between the short term and the long term. Particularly, the stock market price may fail to incorporate future profit opportunities that are far into the future and highly uncertain. Still, this limitation of stock market prices tells us nothing about the desirability of hedge fund activism. The real question is whether, given the possibility that stock markets are short-termist, hedge

5. *See e.g.* T. Poulsen, T. Strand & S. Thomsen, 'Voting Power and Shareholder Activism: A Study of Swedish Shareholder Meeting', 18 *Corporate Governance: An International Review* 329 (2010) on Sweden; W. Bessler, W. Drobetz & J. Holler, 'The Returns to Hedge Fund Activism in Germany', 21 *European Financial Management* 106 (2013) on Germany; and M. Belcredi and L. Enriques, 'Institutional Investor Activism in a Context of Concentrated Ownership and High Private Benefits of Control: The Case of Italy', in J.G. Hill and R.S. Thomas (eds.), *Research Handbook on Shareholder Power* (2015) 383.
6. *See* M. Becht *et al*., 'The Returns to Hedge Fund Activism: An International Study', *European Corporate Governance Institute, Finance Working Paper* No. 402/2014 (2016), (revision 27 May 2016), reporting an average 53% success rate on a global level (61% in the USA; 50% in Europe; 21% in Asia). Success is defined as achievement of at least one of the outcomes sought for in the campaign.
7. A.O. Hirschman, *Exit, Voice, and Loyalty: Responses to Decline in Firms, Organizations, and States* (1970).
8. *Ibid*., at 30.
9. *Ibid*., at 22-24.
10. P. Bolton, M. Becht & A. Röell, 'Corporate Law and Governance', in A.M. Polinsky and S. Shavell (eds.), *Handbook of Law and Economics* (2007), at 879-880.
11. Hirschman, above n. 7, at 77-19.
12. Policymakers on both sides of the Atlantic have taken initiatives to promote long-term, loyal shareholding. Invariably, these initiatives consist in creating a disparity (in terms of voting power, cash flow rights or taxes) between long-term and short-term shareholders. *See* Aspen Institute, 'Overcoming Short-Termism: A Call for a More Responsible Approach to Investment and Business Management' (2009), available at: <www.aspeninstitute.org/sites/default/files/content/docs/pubs/overcome_short_state0909_0.pdf> (last visited 17 June 2016); J. Kay, 'The Kay Review of UK Equity Markets and Long-Term Decision Making (Final Report)' (July 2012), available at: <www.bis.gov.uk/assets/biscore/business-law/docs/k/12-631-kay-review-of-equity-markets-interim-report> (last visited 17 June 2016); 'Brussels Aims to Reward Investor Loyalty', *Financial Times* (23 January 2013), available at: <http://on.ft.com/WWciED> (last visited 17 June 2016); Report by the EU Parliament Committee on Legal Affairs on the proposal for a Directive of the European Parliament and of the Council amending Directive 2007/36/EC as regards the encouragement of long-term shareholder engagement and Directive 2013/34/EU as regards certain elements of the corporate governance statement (12 May 2015), available at: <www.europarl.europa.eu/sides/getDoc.do?type=REPORT&mode=XML&reference=A8-2015-0158&language=EN> (last visited 17 June 2016) (hereinafter Cofferati Report 2015).
13. R. La Porta *et al*., 'Legal Determinants of External Finance', 52 *Journal of Finance* 1131 (1997).
14. *See* C.A. Hill and B. McDonnel, 'Short and Long Term Investors (and Other Stakeholders Too): Must (and Do) Their Interests Conflict?', in C.A. Hill and S.D. Solomon (eds.), *Research Handbook on Mergers and Acquisitions* (2016) [forthcoming], available at: <http://ssrn.com/abstract=2699324> (last visited 17 June 2016) for an informal illustration.

funds activism undermines corporate governance by steering managers towards value-destroying choices.[15]

The scepticism of policymakers towards hedge funds activism is based on the assumption that short-termism is unambiguously value-destroying. Because hedge funds are guided by the stock market, where they realise the gains from activism, hedge funds must be short-termist too and induce management to sacrifice long-term shareholder value for short-term performance. Long term-shareholding could overcome this problem. So long as long-term shareholders face high costs of exit, they are to be considered loyal in Hirschman's sense. In exercising voice, long-term shareholders should have the incentives to care for the company's well-being in the long run. Although hedge funds are key to activate the voice of long-term investors,[16] several policy measures have been proposed to curb hedge funds activism aiming to encourage long-term shareholdings instead. A group of these proposals aim to reduce the impact of hedge funds through disclosure obligations, which would undermine hedge funds' business model while being neutral to longer-term shareholdings.[17] Another group of proposals aim at tilting the balance of powers towards more loyal shareholders, or at offering them financial incentives, by way of so-called loyalty shares.[18]

Albeit popular among policymakers, the short-termism argument is regarded with scepticism by a majority of commentators, who, accordingly, oppose the curbs of hedge funds activism and the favour towards loyal shareholders.[19] This is because the empirical evidence does not support the more radical formulation of the short-termism claim, namely that activism induces managers to go for the 'quick buck' and destroy long-term shareholder value.[20] On average, hedge funds activism brings about a substantial short-term increase in shareholder value, which is not reversed in the aftermath of the engagement. Although the empirical evidence also supports the view that managers occasionally engage in long-term value destruction to cater to short-term investors' sentiment,[21] hedge funds activism seems not to be directly responsible for this. What the empirical evidence does not and cannot tell us, however, is whether the presence of hedge funds activism is desirable for corporate governance *in general*.

In this article, I will argue that the short-termism debate does not shed much light on this crucial question. I will discuss several reasons. For one, short-term and long-term horizons are ill-defined. Any action can be characterised as short-term depending on the definition of the long term. This is not very helpful for policy purposes. Second, even if we identified a conventional definition of short term as opposed to the long term, which horizon is preferable for the purpose of managing a company would not be obvious.[22] What is the 'right term' to create value is a difficult question that may be impossible to answer with precision. Efficiency may require managing for the short term, for instance because, according to Hirschman's framework, in highly competitive markets feedback must be immediate in order to allow for timely 'recuperation' from underperformance. In this case, the problem may rather be long-termism than short-termism.[23] However, Hirschman was very clear that what is an efficient recuperation mechanism for a firm may be inefficient for another, and this circumstance is susceptible to change over time.[24] Therefore, efficiency may require as well managing for the long term, at least to the extent that the definition of long term allows for feedback to intervene timely. In this case, concerns for short-termism may be warranted.

The conflict between the short-term and the long-term view of profit maximisation varies with context and, as such, is impossible to resolve empirically. Even if one could identify the 'right term' with precision, that would vary with the individual company and over time. Because companies are not alike and are dynamic, the positive stock returns associated with the shortening of horizons commanded by hedge fund activism says nothing about the efficiency of the engagement. To claim that activism is value-enhancing one would need to compare the target's performance not with a market index, as in a typical event study, but rather with a counterfactual, similar firm that has not capitulated to activism *and* is insensitive to its threat.[25] The feasibility

15. M.J. Roe, 'Corporate Short-Termism – in the Boardroom and in the Courtroom', 68 *Business Lawyer* 977 (2013), at 985.
16. *See* R.J. Gilson and J.N. Gordon, 'The Agency Costs of Agency Capitalism: Activist Investors and Revaluation of Governance Rights', 113 *Columbia Law Review* 863 (2013). One interesting implication of this point is that, however short-termist hedge funds are, short-termism would not occur in corporate governance if investors with a long-term horizon were always decisive on an activist's campaign. As we will *see infra*, text to notes 116-118, the reality is more nuanced than this.
17. *See* A.O. Emmerich *et al*., 'Fair Markets and Fair Disclosure: Some Thoughts on the Law and Economics of Blockholder Disclosure, and the Use and Abuse of Shareholder Power', 3 *Harvard Business Law Review* 135 (2013).
18. *See* J. Fox and J.W. Lorsch, 'What Good Are Shareholders?' 90 *Harvard Business Review* 48 (2012); P. Bolton and F. Samama, 'Loyalty-Shares: Rewarding Long-term Investors', 25 *Journal of Applied Corporate Finance* 86 (2013); Cofferati Report (2015), above n. 12.
19. L.A. Bebchuk, A. Brav & W. Jiang, 'The Long Term Effects of Hedge Fund Activism', 113 *Columbia Law Review* 1637 (2015).
20. *See infra* text to notes 71-75.
21. B.J. Bushee, 'The Influence of Institutional Investors on Myopic R&D Investment Behavior', 73 *Accounting Review* 19 (1998); and B.J. Bushee, 'Do Institutional Investors Prefer Near-Term Earnings over Long-Run Value', 18 *Contemporary Accounting Research* 207 (2001).
22. *See* an extensive discussion of this point in J.M. Fried, 'The Uneasy Case for Favoring Long-Term Shareholders', *Yale Law Journal* 1554 (2014).
23. For empirical evidence that firms more exposed to competition benefit from the influence of short-term investors, *See* M. Giannetti and X. Yu, 'The Corporate Finance Benefits of Short Horizon Investors', *European Corporate Governance Institute (ECGI) – Finance Working Paper* No. 467/2016 (2016), available at <http://ssrn.com/abstract=2723357> (last visited 21 June 2016).
24. Hirschman, above n. 7, at 124.
25. *See* V.A. Atanasov and B.S. Black, 'Shock-Based Causal Inference in Corporate Finance Research', *ECGI-Finance Working Paper* No. 448 (2015), available at <http://ssrn.com/abstract=1718555> (last visited 21 June 2016); J.D. Angrist and J-F. Pischke, *Mostly Harmless Econometrics: An Empiricist's Companion* (2012).

of such research design is complicated by the fact that companies that are not engaged, but could be, react in anticipation of engagement and thus are not good as counterfactual.[26] Although recent studies of activism have made significant progress in coping with these causality issues,[27] the fact remains that firms that are (or can be) targeted by activism are radically different from those that are not (and cannot be). Consequently, the activists' views on, for instance, innovation cannot be compared with those of companies that are not susceptible to targeting by hedge funds. Most likely, their different performance over the same horizon – whether long or short – will be a reflection of the different kinds of innovation they engage in.

The debate on the right horizon for managing a listed company confounds the effect – short-termism – with the cause – uncertainty. Building on a long-standing tradition of students of uncertainty,[28] this article claims that the choice of the horizon to maximise profits belongs to the entrepreneur because he or she is the one to make choices under uncertainty. Consequently, this article claims that the problem of hedge fund activism is to be framed as a conflict of entrepreneurship between the activist and the incumbent management. In corporate governance, entrepreneurship is a bet on forthcoming change, which will be profitable if the change happens as predicted and unprofitable otherwise.[29] The size of the bet shows the entrepreneur's commitment to the project. This, in turn, affects the funds that can be raised from outside investors.[30] Investors are not anticipating the change the entrepreneur is betting on, which is a precondition for the change to be profitable if it occurs. Investors leave corporate control with the management so long as they trust them to be good entrepreneurs. When this is no longer the case, investors would rather hand control over to another entrepreneur, by exiting and letting somebody else take over or by directly raising their voice and voting for a new management.

From this perspective, hedge funds activism is a form of entrepreneurship, comparable to hostile takeovers.[31] Hedge funds aim to change the strategy, the management or the governance of a target company and profit from the unanticipated market gains from such changes. In so doing, hedge funds get in conflict with the managers or the dominant shareholders who control the target company. These people may oppose the activist's demands because they are entrepreneurs too and genuinely believe they have a superior view about the company's strategy. However, they may also resist activism because they derive private benefits from running the company below its potential. Whether the incumbent management's opposition to activism stems from vision or extraction of private benefits of control, let alone whether the management is right or wrong, is hard to say when the conflict occurs. However, the conflict is not really about whether a company should be managed for the short term or the long term. It is rather a conflict between two views of entrepreneurship, namely about how the company should look like in the future, including the scenario in which managers benefit from running it inefficiently. The real policy issue is which view should prevail and whether the law should do anything to help companies to make the right choice.

Extending the approach developed by Professors Enriques, Gilson and myself for takeover regulation,[32] this article argues that individual companies should decide 'who decides' when there is a conflict of views between an activist investor and the incumbent management or controlling shareholder. In the remainder of this article, I will articulate this claim as follows. In Section 2, I will start by reviewing theory and empirical evidence about hedge funds activism. As illustrated by Professors Gilson and Gordon,[33] support by the institutional owners is the key to activism's success. In view of this insight, the question is whether the loyal owners – namely the investors that cannot exit strategically – can be trusted to screen hedge funds activism. While optimising individual companies' exposure to exit and voice remains crucial for efficiency, the desirability of loyalty is today more nuanced than in the world of dispersed individual owners Hirschman was living in. The real issue about shareholder activism is not whether it is long-term or short-term, but whether a company should commit to insiders' or outsiders' entrepreneurship. In Section 4, I will argue that none of the main regulatory proposals to

26. M. Barzuza and E.L. Talley, 'Short-Termism and Long-Termism', *Columbia Law and Economics Working Paper* No. 526 (2016), argue, in a game-theoretic fashion, that a substantial part of managerial short-termism may occur 'off the equilibrium path', namely under the rational expectation of engagement by hedge funds. The effect of the threat of engagement is hard to capture empirically.

27. *See e.g.* A. Brav *et al*., 'Shareholder Power and Corporate Innovation: Evidence from Hedge Fund Activism', *Kelley School of Business Research Paper* 2014-05 (2014), analysing the impact of hedge funds activism on innovation with propensity score matching, and finding that while activism reduces innovation input, it does not diminish innovation output. *See also* K.J.M. Cremers *et al*., 'Hedge Fund Activism and Long-Term Firm Value' (2016), available at <http://ssrn.com/abstract=2693231> (last visited 21 June 2016). Based on a matched sample of companies not engaged by hedge funds, they find that companies that are engaged forego some long-term value creation. However, *see infra*, note 78 and accompanying text.

28. Uncertainty has been studied extensively by J.M. Keynes, *The General Theory of Employment, Interest and Money* (1936), (reprinted BN Publishing 2008), and F.H. Knight, *Risk, Uncertainty and Profit* (1921). According to Knight's influential distinction, uncertainty differs from risk because it cannot be assigned a probability; entrepreneurs typically make choice under uncertainty as opposed to the risky choices of other market players. Similarly, Keynes attributes to uncertainty a prominent role in forming long-term expectations, particularly of the entrepreneur as opposed to financiers. For both Keynes and Knight, entrepreneurship is the response to unquantifiable uncertainty.

29. A.M. Pacces, *Rethinking Corporate Governance: The Law and Economics of Control Powers* (2012), at 71-74.

30. A.M. Pacces, 'Control Matters: Law and Economics of Private Benefits of Control', *ECGI-Law Working Paper Series* No. 131 (2009).

31. Klein and Zur, above n. 1, at 187. Note, however, the difference between activist hedge funds, which aim to change the company's operation without taking over control, and hostile bidders, which, in contrast, seek immediately to purchase control. *See* H.G. Manne, 'Mergers and the Market for Corporate Control', 73 *Journal of Political Economy* 110 (1965).

32. L. Enriques, R.J. Gilson & A.M. Pacces, 'The Case for an Unbiased Takeover Law (with an Application to the European Union)', 4 *Harvard Business Law Review* 85 (2014).

33. Gilson and Gordon, above n. 16.

screen for efficient shareholder activism – enhanced disclosure obligations and the so-called loyalty shares – help companies to make that choice. On the contrary, a 'sticky' one-share-one-vote (1S1V) default[34] would enable individual companies to select the efficient regime and to alter it when it becomes inefficient down the road. Section 5 concludes.

2 Entrepreneurial Shareholder Activism

Shareholder activism is not new. Activists have always been prompting corporate managers to act on some issue, even unrelated to the conduct of the company's business. Particularly in the United States, activists have been able to add items on the agenda of the general meeting at the company's expense, by filing a so-called shareholder proposal.[35] However, such traditional activism has not been very effective, and before the advent of hedge funds activism, investors seemed unable to achieve concrete outcomes through this channel.[36] Despite the regulatory differences, a similar conclusion could be made about comparable channels for traditional activism in Europe.[37]

Hedge funds activism is different.[38] It does not simply aim to alert management on some issue by triggering a shareholder vote on it. It aims to achieve a change in the way the company is managed. Such change can be – although not necessarily is – quite radical, such as the departure of the CEO or some other executives, if not the restructuring of the company. Likewise, activist hedge funds may seek to stop a change wanted by the management, for instance an acquisition. For this reason, hedge funds activism is called 'entrepreneurial activism.' This is how I will refer to it in the remainder of the article. Differently from traditional activism, the mark of entrepreneurial activism's success is not so much the level of shareholder support at the general meeting, but whether the desired change(s) happens or not.[39] The business model of activist hedge funds explains why this is so. Differently from other institutional investors, hedge funds managers charge a performance fee in addition to a percentage of the asset under management.[40] This aligns their incentives with investors having a relatively high appetite for risk. Hedge funds profit from investing in stock that they can buy, hold and resell at a higher price. The purpose of entrepreneurial activists' engagement with the management of the target company is to achieve meanwhile a change that will boost the stock price.

Two factors are key for the success of entrepreneurial activism. First, the hedge fund needs to be able to buy the bulk of its stake in the company while the stock market does not anticipate the engagement. The moment the engagement is revealed, investors will anticipate gains and, discounting those for the probability that the engagement fails, the stock price will rise. Second, the activist needs to be able to persuade the management to implement the desired changes. To increase its leverage with the management, the activist can use several techniques, ranging from news campaigns to threatening a lawsuit, but the last resort is to wage a proxy context. Reached that point, the success of the engagement will depend on whether the activist has managed to attract sufficient support from other shareholders to get a favourable vote.

The support by institutional investors is crucial for successful engagement. The typical hedge fund stake in the target company is substantial, but not nearly a controlling one.[41] As a result, activists must persuade institutional investors to vote for them. By the same token, engagement may succeed based on the sheer threat of winning a contested vote.[42] The likelihood of winning the battle can be estimated while the investing public is still in the dark about the engagement. From the moment the hedge funds formulate their demands to the management, both parties start to speak with the largest institutional investors. Management will give in to the activists' demands when it is clear they are going to lose the vote, whereas hedge funds will withdraw from engagement when they realise that not enough institutional investors will vote for them. Most of the time the parties will settle somewhere in the middle. The fight becomes public only when no agreement can be reached. Consequently, a substantial portion of hedge funds engagement takes place behind closed doors, which, as I will explain shortly, has important consequences for empirical analyses.

As explained by Professors Gilson and Gordon, the tremendous influence activists have gained in corporate governance lately depends mainly on the re-concentra-

34. For a "Theory of Sticky Defaults" (subsequently renamed "Theory of Altering Rules"), *see* I. Ayres, 'Regulating Opt-Out: An Economic Theory of Altering Rules', 121 *Yale Law Journal* 2032 (2011).
35. Gillan and Starks, above n. 1, at 55.
36. *See* D. Yermack, 'Shareholder Voting and Corporate Governance', 2 *Annual Review of Financial Economics* 103 (2010). The situation has changed more recently, though, particularly in the United States with regard to the removal of staggered boards. *See* J.C. Coates IV, 'Thirty Years of Evolution in the Roles of Institutional Investors in Corporate Governance', in J.G. Hill and R.S. Thomas (eds.), *Research Handbook on Shareholder Power* 76 (2015).
37. *See e.g.* A. de Jong, G.M.H. Mertens & P.G.J. Roosenboom, 'Shareholders' Voting at General meetings: Evidence from the Netherlands', 10 *Journal of Management & Governance* 353 (2006).
38. *See* F. Partnoy, 'U.S. Hedge Fund Activism', in J.G. Hill and R.S. Thomas (eds.), *Research Handbook on Shareholder Power* 99 (2015), and earlier, J. Macey, *Corporate Governance: Promises Kept, Promises Broken* (2008), at 244-51, for an illustration of the difference between hedge funds activism and traditional forms of shareholder activism.
39. Becht *et al*., above n. 6.
40. Gilson and Gordon, above n. 16.
41. For their global sample, Becht *et al*., above n. 6, report an average stake of 11%. For the United States, other studies (Gilson and Gordon, above n. 16, at 899); N. Gantchev, 'The Costs of Shareholder Activism: Evidence from a Sequential Decision Model', 107 *Journal of Financial Economics* 610 (2013), at 621, report that activist investors hold 8% on average.
42. M. Becht *et al*., 'Hedge Fund Activism in Europe: Does Privacy Matter?', in J.G. Hill and R.S. Thomas (eds.), *Research Handbook on Shareholder Power* 116 (2015).

tion of ownership that has occurred in the past few decades.[43] In the world Hirschman was living in, voice by activists was not very promising because the dispersed individual stockholders of a Berle-Means Corporation would not bother to vote, particularly against the management of the company they decided to invest in.[44] However, even in the United States, the Berle-Means Corporation does no longer exist. Gilson and Gordon report that, in 2009, institutional investors held on average 73% of the equity of the thousand largest U.S. corporations.[45] Unsurprisingly, the voting power of institutional investors is also quite concentrated: the representatives of institutions jointly holding control of a typical U.S. company would fit around a boardroom table.[46] A recent study by the OECD provides similar results for the United Kingdom.[47] Moreover, concentration of non-controlling ownership is a documented phenomenon also in countries where dominant shareholders are frequent, such as Sweden and the Netherlands.[48]

If roughly two dozen institutional investors hold enough votes in the typical management-controlled company to be decisive, and a substantial portion of the voting rights also in companies with dominant shareholders, one would expect institutional investors, rather than hedge funds activists, to exercise voice. The reason why this has not happened is agency costs.[49] Institutional investors manage other people's money and do so with a business model that disincentivises monitoring of individual companies. Although institutional investors are very different from each other, for reasons of law, profiling and investment culture, they all hold a diversified portfolio of stock. Institutional investors charge flat fees based on assets under management, and the latter mainly depends on the institution's ability to attract funds from the competitors – that is, relative performance. Relative performance is unaffected by improving the returns of a particular portfolio company, because the competitors will free ride on that, while it is adversely affected by the cost of becoming informed about underperforming companies to engage with. Therefore, institutional investors are 'rationally reticent'.[50] They are not proactive in influencing corporate management, but they are responsive to other, entrepreneurial, actors who bring the case for engagement to their attention.

According to Gilson and Gordon, the activists' teaming up with institutional investors is beneficial for corporate governance. On the one hand, activists lower the agency costs of institutional ownership. On the other hand, institutional investors screen activists' proposals and likely sanction only those that increase shareholder value. Empirical evidence supports the conclusion that activists give other shareholders what they want. Several studies document the association of shareholder activism with an average increase in shareholder value.[51] Importantly, this increase stems from the activists' achieving outcomes of sort, namely garnering broad support from institutional investors. Moreover, the increase is larger for outcomes more related to strategic change than for others.[52]

Reducing agency costs undoubtedly improves the efficiency of corporate governance, which in this article is defined as maximisation of shareholder value.[53] However, this approach does not demonstrate that hedge fund activism is always value-increasing. Several objections, concerning the effectiveness of the screening by institutional investors and the short-termism of the activists' demands, have been raised.[54] In the remainder of this section, I will show that while the first set of objections appears to be overstated, the second claim has some merit, albeit in a different way than normally understood. Particularly, the empirical evidence can only reject the most trivial version of the short-termism claim, namely that the stock market gains brought about by the activist's engagement are subsequently reversed. However, empirical analyses cannot answer the more fundamental question of whether hedge funds activism increases (or decreases) value across the board.

It is sometimes argued that institutional investors do not really exercise judgment, but rather blindly follow the recommendations of proxy advisors, notably including global market leaders such as Institutional Shareholders Services (ISS) and Glass-Lewis.[55] The argument echoes

43. Gilson and Gordon, above n. 16, at 874.
44. Hirschman, above n. 7, at 46.
45. Gilson and Gordon, above n. 16, at 874.
46. *Ibid*., at 875.
47. M. Isaksson and S. Celik, 'Who Cares: Corporate Governance in Today's Equity Markets', 8 *OECD Corporate Governance Working Papers* (2013).
48. P. Lekvall (ed.), *The Nordic Corporate Governance Model* (Stockholm: SNS Forlag 2015) and A. de Jong *et al*., 'Changing National Business Systems: Corporate Governance and Financing in the Netherlands, 1945-2005', 84 *Business History Review* 773 (2010).
49. Gilson and Gordon, above n. 16, at 889-95.
50. *Ibid*., at 895.
51. Klein and Zur, above n. 1; A. Brav, J. Wei, F. Partnoy & R. Thomas, 'Hedge Fund Activism, Corporate Governance, and Firm Performance', 63 *Journal of Finance* 1729 (2008); C.P. Clifford, 'Value Creation or Destruction? Hedge Funds as Shareholder Activists', 14 *Journal of Corporate Finance* 323 (2008).
52. Becht *et al*., above n. 6.
53. There are two reasons to choose shareholder value as a welfare criterion for the purposes of this article. First, this article deals with shareholder feedback in corporate governance. Although Hirschman's framework applies to feedback from other stakeholders, hedge funds activism and the institutional investors' support that makes it viable are undoubtedly shareholders' reactions to a firm's governance. Second, this article contends that corporate governance is not directly responsible for the externalities generated by corporate enterprises (with the exception of entrepreneurship). *See infra*, text to notes 121-122. Therefore, the judgment on the desirability of hedge funds activism is independent of the effects on stakeholders different from shareholders. This approach allows using a simple Kaldor–Hicks test to determine whether hedge funds activism is efficient – namely whether shareholders are net better off. This is in line with mainstream finance literature on the impact of hedge funds activism. For a similar approach, albeit applied to takeovers, *see* Enriques and others, above n. 32, at 85.
54. *See* especially J.C. Coffee, Jr. and D. Palia, 'The Wolf at the Door: The Impact of Hedge Fund Activism on Corporate Governance', 1 *Annals of Corporate Governance* 1 (2016). But sceptics include, among others, Bolton and Samama, above n. 18, and M. Lipton, *Important Questions about Activist Hedge Funds*, available at: <http://corpgov.law.harvard.edu/2013/03/09/important-questions-about-activist-hedge-funds/> (last visited 21 June 2016).
55. Coffee and Palia, above n. 54.

policymakers' scepticism about proxy advisors.[56] It has a theoretical basis. Because the institutional investors' business model does not encourage monitoring individual companies, institutions used to be passive about voting. Recently, however, particularly U.S. legislation has compelled major categories of investors – mutual funds and pension funds – to disclose their voting policies.[57] Hence, to avoid embarrassment, institutional investors purchase professional advice from proxy advisors and, arguably, mechanically follow their advice. Because the quality of this advice is questionable,[58] institutional investors that follow it cannot be trusted to screen hedge funds activism effectively. However, the influence of proxy advisors on institutional investors may be overstated.

Virtually all mutual funds, which are the largest U.S. corporate owners taken together, subscribe to one or more proxy advisors, including ISS. However, only 25% of mutual funds always vote in line with the proxy advice, and, on an asset-weighted basis, reliance on management's advice is higher than reliance on ISS.[59] Reliance varies greatly among institutional investors because they differ considerably too, especially in their size, investment strategies and horizons. Not only do the largest U.S. asset managers, which have the largest dollar-value stakes, vote independently from ISS[60]; in some circumstances they are also more influential.[61] Even indexed funds, which passively track market indices, vote actively on a number of issues.[62] Finally, because proxy advisors cater to their customers' tastes and expectations, it is ultimately impossible to determine precisely how much advisors influence asset managers or are influenced by them.[63] According to one study, an ISS advice against the management shifts at most 10% of votes in U.S. uncontested elections.[64] Although there are no studies documenting the direct influence of ISS on activists' campaigns, such influence seems to be not as overwhelming as the standard narrative suggests.

Activist hedge funds could still avoid a thorough scrutiny by institutional investors if they used a strategy that made them win almost with certainty. This is a second powerful objection to hedge funds activism and is based on the so-called "wolf pack" strategy.[65] A wolf pack is a coalition of hedge funds aimed at maximising the impact of engagement. In the U.S., activists have to disclose their intentions within 10 days of crossing a 5% ownership threshold. In that time window, hedge funds can profitably increase their ownership, but they do not usually go above 10%. To improve the odds of the engagement, one hedge fund could 'tip' other hedge funds. Or, perhaps more plausibly given the money at stake, other hedge funds may independently decide to jump on the bandwagon and buy stock. In any event, because individual ownership remains below 10% and hedge funds are not collectively seeking control, wolf packs are immune from allegations of insider trading and of acting in concert for purposes of European takeover regulation.

Wolf packs often operate below the radar, which makes it difficult to estimate their incidence and impact empirically. Still, according to a recent international study, wolf packs account for about 22% of the overt engagements, increase the success rate (defined as achieving outcomes) from about 46% to 78% and are more profitable than individual engagements.[66] Based on this and other evidence, Professors Coffee and Palia have argued that wolf packs are a nearly riskless strategy for hedge funds to make money.[67] If the wolf pack puts together about one-third of the votes, as for instance in the Sotheby's case,[68] they need to get on board another 7%-10% to win. This is about as much as, on average, depends on the recommendation of proxy advisors. This argument suggests that wolf packs will tend to engage corporate management also when it is not efficient to do so.

The impact of wolf packs seems to be overestimated for a number of reasons. First, in more than one-fifth of the wolf packs that could be identified in the aforementioned study, hedge funds have failed to achieve outcomes – hence they have lost money. Second, although wolf pack members increase the success rate by buying from dissatisfied investors, whether the remaining investors are likely to follow ISS or to vote actively is a matter of speculation. Actually, the presence of large investors in the ownership of engaged companies, as in the Sotheby's case, suggests that asset managers who exercise judgment may still be the decisive shareholders.[69] Third, and most important, 78% of the overt engagements mapped internationally are *not* wolf

56. Communication from the European Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions, Action Plan: European company law and corporate governance – a modern legal framework for more engaged shareholders and sustainable companies, COM/2012/0740, 12 December 2012.
57. E.B. Rock, 'Institutional Investors in Corporate Governance' (21 July 2015). Forthcoming in Oxford Handbook on Corporate Law and Governance, *University of Pennsylvania, Institute of Law and Economics Research Paper* No. 14-37 (2015), at 13-14.
58. *See* R.M. Daines *et al*., 'Rating the Ratings: How Good Are Commercial Governance Ratings?', 98 *Journal of Financial Economics* 439 (2010).
59. P. Iliev and M. Lowry, 'Are Mutual Funds Active Voters?', 28 *Review of Financial Studies* 446 (2015), at 453.
60. *Ibid*., at 455.
61. S. Choi *et al*., 'Who Calls the Shots: How Mutual Funds Vote on Director Elections', 3 *Harvard Business Law Review* 35 (2013).
62. I. Appel, T. Gormley & D.B. Keim, 'Passive Investors, Not Passive Owners', 121 *Journal of Financial Economics* 111 (2016).
63. J. McCahery, Z. Sautner & L. Starks, 'Behind the Scenes: The Corporate Governance Preferences of Institutional Investors', *Journal of Finance* (2016) [forthcoming], available at: <doi:10.1111/jofi.12393>.
64. S.J. Choi, J. Fisch & M. Kahan, 'The Power of Proxy Advisors: Myth or Reality?', 59 *Emory Law Journal* 869 (2010).
65. Coffee and Palia, above n. 54.
66. Becht *et al*., above n. 6.
67. Coffee and Palia, above n. 54, at 29.
68. *Ibid*., at 31-32.
69. R.J. Gilson and J.N. Gordon, 'The Sotheby's Poison Pill Case: The Plate Tectonics of Delaware Corporate Governance' *CLS Blue Sky Blog*, available at: <http://clsbluesky.law.columbia.edu/2014/05/15/the-sothebys-poison-pill-case-the-plate-tectonics-of-delaware-corporate-governance/> (last visited 21 June 2016).

packs. There is obviously self-selection here. Hedge funds choose their battles. They decide to join and form a wolf pack only when success is more likely. Likewise, the leading hedge fund, who is getting the lion's share of the wolf pack gains, bears two sorts of risk: first, the risk that others will not join; second, conditional on the previous event, a higher risk of losing the engagement. Engagements without outcomes, with or without wolf packs, deliver insignificant to negative shareholder returns, but still they happen, revealing that hedge fund activism is not risk-free.[70]

The third and most recurrent objection to hedge funds activism is short-termism. Because hedge funds profit from targeting underperforming companies, changing or influencing their management, and reselling the stock at a premium, they may induce the managers to destroy long-term value to maximise short-term stock returns. This argument has several dimensions, which are often confused with each other. The more extreme version of the short-termism argument is that the sizeable shareholder gains brought about by activism are short-lived.[71] The empirical evidence does not support this part of the claim. However, the empirical evidence can neither support nor reject the short-termism claim in another important dimension. Managers and dominant shareholders subject to market pressure, including shareholder activism and the threat thereof, may be reluctant to invest in projects whose value cannot be incorporated in stock market prices before a few years hence.[72] Let us discuss the two short-termism critiques in turn.

Two recent studies reject the argument that hedge funds activism make managers go for the 'quick buck' while destroying long-term value. In the first study, Professors Bebchuk, Brav and Jang show that, in the United States, the short-term gains stemming from the announcement of the engagement are not reversed later on.[73] On the contrary, they document that short-term gains are correct anticipations of the consequences of engagement up to five years hence.[74] The second study, by Professors Becht, Franks, Grant and Wagner, which also includes non-U.S. activism, confirms that the positive stock returns associated with engagement are not short-term.[75] Activists have an average holding period of 1.7 years, but, more importantly, their buy-and-hold returns are abnormally positive only if outcomes are realised. Therefore, hedge funds are not short-termist in the conventional sense of 'cutting and running.' However, this says nothing about whether the stock markets are myopic relative to some horizon longer than the activists' holding period,[76] let alone about whether it makes sense to consider such a longer horizon to assess the performance of any particular company.

The limitations of stock market return as performance measure are not the only challenge in ascertaining the desirability of activism. A more fundamental problem for the empirical analysis is that activism produces unobservable effects based on the credible threat of engagement and that the companies that are explicitly engaged are different from those that are not.[77] Therefore, whether activism increases value compared with an average measure of performance (being that stock market return or some other balance sheet measure) cannot be inferred from the performance of observable activism.

The problem is twofold. For one, we observe only a portion of the true activism, the overt part. This would not be a problem if the distribution between overt and covert activism were random, but it is not. Better managed companies react in anticipation of hedge fund engagement. Moreover, activists go public only when it is in their interest to do so. Keeping the engagement confidential is in the interest of both contestants. The management and particularly the controlling shareholders have less to lose from non-public concessions to the activists, while the latter can make larger profits from those. Activists may have to make their campaign public precisely when the targeted company is more mismanaged, which overestimates the observable returns from engagement.

The second part of the problem is that companies that are or can be targeted by activists differ in several respects from those that are not and cannot be targeted. Consequently, showing that companies successfully engaged outperform a market index, on average, does not really prove that activism improves performance.[78] It only shows that target companies were undervalued relative to a market benchmark and that activism brings

70. Becht *et al*., above n. 6.
71. M. Lipton, 'Current Thoughts About Activism', available at: <http://corpgov.law.harvard.edu/2013/08/09/current-thoughts-about-activism/> (last visited 21 June 2016).
72. A slightly different version of this argument is that hedge funds activism undermines the long-term relationship of managers and controlling shareholders with other stakeholders. *See e.g.* C. Mayer, *Firm Commitment: Why the Corporation Is Failing Us and How to Restore Trust in It* (2013). Because this article deals with shareholder feedback in corporate governance, stakeholders are quite out of its scope; but I will, nonetheless, briefly discuss this part of the argument *infra*, text to notes 121-122.
73. Bebchuk and others, above n. 19.
74. Such long-term consequences are estimated on the basis of accounting and market data for time windows up to five years long. Both tests confirm that the returns are abnormally positive for the companies subject to engagement. Bebchuk and others, above n. 19.
75. Becht *et al*., above n. 6. The authors study the long-term results from the announcement to the exit of activist hedge funds, and compare them with the returns of a matching, counterfactual portfolio with no engagement. Such returns are positive so long as there are outcomes of engagement.
76. *See infra* text to notes 99-107.
77. Becht *et al*., above n. 42.
78. The credibility of empirical analysis is fundamentally based on the definition of a control group, which provides the counterfactual firm to which the firm receiving the treatment – *i.e.* hedge fund engagement – is to be compared in order to establish causality. *See* Atanasov and Black, above n. 25. Although, more recently, the empirical analyses of hedge fund activism have tried to improve on the identification of causality through matching samples (*supra* note 27), this does not entirely solve the problem. Matching creates an artefact, which may still differ from the counterfactual firm that has not been engaged, and therefore might not be sufficient to identify causality.

performance back in line with that benchmark. These studies cannot rule out the possibility that a target company would outperform the benchmark by a larger extent, if not engaged, because this counterfactual company does not exist and if it existed, it would be a different firm.[79]

From this perspective, the crucial conflict underlying hedge funds activism is between two views of the target firm, one by the activists and another by the incumbent management. These views normally differ on strategic issues, such as whether the company should be leaner, more focused on certain businesses and cost-effective in carrying them out, which hedge funds typically like to see. Hedge funds activism can thus be interpreted as a conflict between visions of the same firm, namely a conflict of entrepreneurship. Granted that the empirical evidence cannot tell us which view should prevail, in the next section I turn to theory for indications on how to resolve this conflict efficiently.

3 Hirschman and the Conflict between Inside and Outside Entrepreneurship

In his classic, *Exit, Voice and Loyalty*, Albert Hirschman was concerned with a problem similar to the one motivating hedge funds activism, namely how to avert the decline of a (business) organisation.[80] Hirschman called this problem 'recuperation',[81] which he understood as the action to correct temporary lapses in an organisation's efficiency. Therefore, Hirschman's theory can shed light on the conditions that make shareholder activism desirable for the efficiency of corporate governance.

Hirschman distinguished between two feedback mechanisms in organisations. Disgruntled members and customers can *exit* their organisation, or they can *voice* their disagreement. The relative desirability of exit and voice depends on which can effectively alert the organisation's management about the need for recuperation. Hirschman's framework applies to several kinds of organisation. In order to discuss the implications for shareholder activism, I will focus on three points he made about exit and voice. First, the optimal mix of exit and voice varies with context. Second, in corporate governance, investors tend to prefer exit to voice. Third, loyalty makes the commitment to voice credible.

According to Hirschman, there is no one-size-fits-all solution to the recuperation problem. Every organisation has an optimal level of exposure to exit and voice, which varies with time. At some point of their life cycle, business organisations may suffer from excessive exit, for instance when tough competition in relatively mature industries gives companies not enough time to realise decline from the exit of customers and shareholders.[82] In those situations, decline may be averted timely if the management listens to voice. In terms of the modern debate, insensitiveness to voice may lead management to procrastinate the status quo for want of better times, which might never come. I call this problem long-termism, to mirror the short-termism issue more frequently claimed in today's debate.[83] But, according to Hirschman, voice can be excessive too for a particular organisation, particularly when exit is costly or impossible. Managers' concern with voice by 'captive' customers, members or voters may distract them from the pursuit of efficiency, particularly when uncertainty about the outlook of business is high as opposed to protest being present and concrete.[84] In the modern parlance, this is a situation in which excessive sensitiveness to voice may lead management to focus on the short-term results necessary to mute the opposing voice. Thus, short-termism and long-termism of management are avoided only if individual companies receive feedback as an optimal mix of voice and exit.

Although Hirschman believed that the optimal feedback mechanism for purposes of recuperation depends on the individual organisation, he was not worried about excessive voice by investors in corporate governance. To the contrary, Hirschman welcomed more voice in business organisations, but typically from customers, because individual investors had rationally a strong preference for the so-called Wall Street Walk, namely exit.[85] This characterisation of shareholders parallels a long-standing tradition in the corporate governance literature. In a seminal article, Professor Manne famously argued that takeovers, which are based on exit, are superior to proxy fights, which are based on voice.[86] While markets, including the market for corporate control, are powerful coordination mechanisms, voting is plagued by free riding problems. To be sure, free riding affects takeovers too.[87] More important, the impact of takeovers and takeover threat on corporate governance may be overstated. On the one hand, decades of experience with takeovers have revealed that they are able to address only severe underperformance.[88] On the other hand, hostile takeovers are impossible for most companies around the world, and management seems able to always achieve

79. *See* Cremers *et al*. (2016), above n. 27. They find that in the long run, companies that have not been engaged outperform matching companies that have been engaged.
80. The full title of Hirschman's classic (1970), above n. 7, is *Exit, Voice, and Loyalty – Responses to Decline in Firms, Organizations, and States*.
81. Hirschman, above n. 7, at 3.
82. *Ibid*., at 24-25.
83. However, *see* the important exception of Giannetti and Yu (2016), discussed above n. 23.
84. Hirschman, above n. 7, at 70.
85. *Ibid*., at 46.
86. Manne, above n. 31.
87. S.J. Grossman and O.D. Hart, 'Takeover Bids, the Free-Rider Problem, and the Theory of the Corporation', 11 *Bell Journal of Economics* 42 (1980).
88. P. Bolton, J. Scheinkman & W. Xiong, 'Executive Compensation and Short-termist Behaviour in Speculative Markets', 73 *Review of Economic Studies* (2006).

some degree of insulation from hostile takeovers.[89] Thus, Hirschman rightly believed that business organisation could use more, not less, shareholder voice to timely avert decline.

Hirschman did not consider shareholder activism a viable channel for voice because he wrote before the rise of hedge funds activism. Entering hedge funds into Hirschman's framework implies both that investors' voice can be effective in corporate governance and that there may be too much of it. Hedge funds engage a company's management by using voice. Their incentives, though, are based on exit, namely on the purchase of undervalued stock from previous shareholders and the sale to future shareholders after a successful engagement.[90] Voice by institutional investors actually makes the difference because the success of hedge funds activism depends on the voting support by institutional investors. Therefore, to determine whether exposure to hedge fund activism results in efficient feedback, instead of managerial long-termism or short-termism, we need to delve into the incentives of institutional investors to screen and decide on hedge funds' proposals.

Institutional investors differ considerably from one another. These differences affect their incentives to act upon hedge fund engagements. According to Hirschman, the quality of voice depends on the *loyalty* of a customer or a member to an organisation. Loyalty is, in turn, defined by high cost of exit.[91] Because costly exit commits shareholders to voice, we can identify loyal institutional investors on the basis of their propensity to exit. In this vein, Professor Bushee divided institutional investors on the basis of portfolio turnover and the size of their stakes in portfolio companies.[92] Investors are *transient* when their turnover is high and the stakes are small. *Dedicated* investors are the opposite. As they focus on specific companies, their stakes are relatively large – although they are still diversified – and they trade relatively infrequently. *Quasi-indexers* are well exemplified by funds that track market indices, although they include more than strictly indexed funds. Because they mimic the indices they are tracking, such funds trade infrequently and have small stakes in portfolio companies. For the period 1983-2002, Bushee reports that transient investors accounted for 31% of U.S. institutional investors, whereas dedicated investors and quasi-indexers amounted to 8% and 61%, respectively.[93]

Although the above percentages are not asset-weighted and thus do not reflect the ownership of a typical U.S. corporation, they show the importance of transient investors. Transient investors are not loyal to any company; hence, they are the least committed to voice. Moreover, transient investors are ready to short-term exit. Therefore, they can cash in the announcement gains from engagement. If a company were owned primarily by them, hedge funds could easily have their way with management through a wolf pack strategy, namely buying collectively sufficient ownership on the market to outvote incumbent managers.[94] Even before the advent of entrepreneurial activism, disproportionate ownership by transient investors was associated with short-termist managerial behaviour.[95]

If companies are not primarily owned by transient investors, hedge funds activism does not necessarily lead to short-termism because of the screening by other long-term institutional investors. As they focus on the companies they invest in, dedicated investors perform such a screening although they are not to be considered 'loyal' in Hirschman's sense. In fact, they usually govern through exit.[96] Exit is costlier for dedicated than for transient investors because the larger size of their stakes prevents dedicated investors from profiting from short-term price movements. However, this is not enough to commit dedicated investors to voice because they are still better off *timely* exiting the companies they are dissatisfied with. Dedicated investors use their informational advantage to threaten managers with exit and execute the threat when they are persuaded that the company will be actually underperforming. So, in a sense, dedicated investors screen hedge funds activism by preempting it. But if they agree with the reasons for hedge funds engagement, they will rather sell than vote their shares.[97]

That leaves us with just one category of loyal institutional investors, in Hirschman's sense, to screen hedge funds' proposals with their voice. These are the quasi-indexers, which cannot exit strategically, but only to rebalance their index-tracking portfolios. Fortunately, they are also the largest category of investors. Although there are currently no data on how large the stake of quasi-indexers is in the typical listed company, it is fair to assume that they are often decisive.[98] Then the question about the desirability of hedge funds activism could be resolved in the affirmative if one could trust quasi-indexers to assess whether hedge funds activism is value-increasing and vote accordingly.

Identifying the right strategy to maximise profit is notoriously difficult. Stock markets are an impressive source

89. J. Arlen and E. Talley, 'Unregulable Defenses and the Perils of Shareholder Choice', *University of Pennsylvania Law Review* 577 (2003).
90. As Gilson and Gordon, above n. 16, at 897, put it, hedge funds are 'governance entrepreneurs' who profit from purchasing rights undervalued by 'rationally reticent' institutional investors. *See also supra* text to notes 49-50.
91. Hirschman, above n. 7, at 80.
92. Bushee, above n. 21.
93. B.J. Bushee, 'Identifying and Attracting the "Right" Investors: Evidence on the Behavior of Institutional Investors', 16 *Journal of Applied Corporate Finance* 28 (2004).
94. *See supra* text to notes 65-68.
95. Bushee, above n. 21.
96. A. Edmans and G. Manso, 'Governance through Trading and Intervention: A Theory of Multiple Blockholders', 24 *Review of Financial Studies* 2395 (2011).
97. Recent theory, field data and survey evidence all confirm that dedicated investors participate in corporate governance through exit. *See e.g.* A. Edmans, 'Blockholders and Corporate Governance', 6 *Annual Review of Financial Economics* 23 (2014) and McCahery and others, above n. 63.
98. As suggested by the recent DuPont case, where indexed investors such as Blackrock, Vanguard and State Street made the engagement fail, this assumption is plausible at least for the United States. *See* Coffee, above n. 3.

of information in this respect, but alas, they are imperfect.[99] Because they overreact to news, misprice risks and are prone to asset bubbles,[100] stock market prices may temporarily fail to incorporate the value of future profit opportunities. When this is the case, the Efficient Capital Market Hypothesis (ECMH) does not hold true.[101] Therefore, there might be a conflict between the pursuit of short-term results, which are immediately impounded in market prices, and long-term projects, whose expected results are underweighted or even overlooked by stock prices.[102] Short-termism is an issue for corporate governance only if it affects managerial choices.[103] Hedge funds could lead to short-termism in management because their business model relies on stock market prices – buying undervalued stock and reselling it after successful engagements. If, however, the crucial element of the strategy – engagement's success – depends on indexed funds, the real question becomes whether quasi-indexers too are biased towards short-termism.

The empirical evidence suggests that, under the screening by indexed funds, overt hedge funds activism does not lead to obvious short-termism. As discussed in the previous section, the data show that the short-term gains of successful hedge funds activism are not reversed in the subsequent five years, whereas there are no gains from engagements that turned out unsuccessfully for lack of (prospective) support by institutional investors. However, the performance of overt activism is uninformative about companies that have not been engaged, and therefore cannot lead to a conclusive judgment about hedge funds activism. A recent study reveals that in the long run the performance of engaged companies is lower than that of comparable companies that were not engaged.[104] Moreover, the question whether the sheer threat of activism induces short-termism in management and whether this is desirable cannot be answered empirically. I now turn to the reasons why theory too does not provide a unique answer to this question.

To begin with, short-termism is ill-defined. Because short-termism is an issue only if the ECMH fails, the value of a long-term option is defined only by what it is not: the market price failing to incorporate it. As a result, opinions of reasonable minds differ as to which long term is 'right' for purposes of profit maximisation. Second, even if one could settle on a conventional definition of long term (say, five years), companies oriented to the long term would be radically different from those oriented to a shorter term. Comparing the returns of these companies on horizons different from what they have chosen is not very meaningful.[105] Third, whether managing for the long term or the short term is preferable is theoretically unclear. Professor Fried has shown that, under certain conditions, pursuing the interest of long-term shareholders can lead management to destroy more value than if they managed in the interest of short-term shareholders.[106] More importantly, the 'right' horizon to maximise profit is endogenous to the company's business and the state of product market competition. Whether managers suffer from short-termism or long-termism relative to this horizon depends on company-specific circumstances.[107]

As recently put by Professor Gordon, the short-termism debate on hedge fund activism is a red herring for a deeper corporate governance problem.[108] The problem is in determining who should decide between alternative company strategies, each implying different horizons for feedback. I call this problem a conflict of entrepreneurship because it stems from two conflicting, potentially entrepreneurial views of the target company – the view of the activists versus that of the incumbent management. Such views are entrepreneurial to the extent that they reflect a shortcoming of stock prices rather than managerial opportunism. The stock price cannot fully

99. Even before the advent of behavioural finance, it was clear in both the legal and the economic scholarship that informational efficiency was a process rather than an instant result. *See* R.J. Gilson and R.H. Kraakman, 'The Mechanisms of Market Efficiency', 70 *Virginia Law Review* 549 (1984), and S.J. Grossman and J.E. Stiglitz, 'On the Impossibility of Informationally Efficient Markets', 70 *American Economic Review* 393 (1980). Arguably, behavioural finance as well as the debate stemming from the global financial crisis have not changed this basic insight, namely that informational efficiency is a relative concept depending on the speed with which prices adjust to existing knowledge. *See* R.J. Gilson and R.H. Kraakman, 'Market Efficiency after the Financial Crisis: It's Still a Matter of Information Costs', 100 *Virginia Law Review* 313 (2014).

100. The main problems undermining the efficiency of financial markets are limits of arbitrage (A. Shleifer and W. Vishny, 'The Limits of Arbitrage', 52 *Journal of Finance* 35 (1997)), excess volatility (A. Fuster *et al*., 'Natural Expectations, Macroeconomic Dynamics, and Asset Pricing', *National Bureau of Economic Research Working Paper* No. w17301 (2011)) and asset price bubbles (Bolton and others, above n. 88, at 577).

101. The ECMH is based on arbitrage. A fundamental principle of economics is that arbitrageurs would never forego a profit opportunity so long as they can grab it. When they cannot, because for instance they are capital constrained or there is uncertainty, price may deviate from fundamentals. Until this situation is corrected, market may overvalue short-term strategies and undervalue long-term strategies. Although this difference will be arbitraged away, eventually, long-term value might be destroyed in the process.

102. *See* A.G. Haldane and R. Davies, 'The Short Long', 29th *Société Universitaire Européene de Recherches Financiéres Colloquium: New Paradigms in Money and Finance?*, Brussels (2011) for extensive illustration of theory and evidence on the short-termism of financial markets.

103. The short termism of financial market does not necessarily imply that corporate managers are short-termist and, even more important, that short-termism is undesirable for corporate governance. *See* Roe, above n. 15.

104. *See* Cremers *et al*., above n. 27 (using several matching techniques to compare companies engaged and not engaged by hedge funds). On the limitations of matching methods to identify causality between hedge funds activism and firm variables, *see supra* note 78.

105. On these grounds, the findings of Cremers *et al*., above n. 27, are as questionable as those of their opponents (Bebchuk and others, above n. 19). In fact, as argued below in the text, the optimal horizon to maximise profits is endogenous to firm-specific circumstances.

106. Fried, above n. 22.

107. Giannetti and Yu, above n. 23, show that long-termism undermines the ability of companies to deal with a highly dynamic and competitive environment.

108. J.N. Gordon, 'Shareholder Activism, the Short-Termist Red-Herring, and the Need for Corporate Governance Reform', available at: <http://clsbluesky.law.columbia.edu/2016/03/28/shareholder-activism-the-short-termist-red-herring-and-the-need-for-corporate-governance-reform/> (last visited 17 June 2016).

account for the future because it is uncertain. Uncertainty is for entrepreneurs, not for markets, to bear.[109]

According to two prominent students of uncertainty – Frank Knight and John Maynard Keynes – financial markets are only one way to deal with uncertainty, by incorporating all available information into a probabilistic risk assessment.[110] Because nobody knows how a distant future, call it 'long term', will look like, stock markets process information within a relatively short horizon, in which no change from established trends can be assumed. The vast majority of investors make decisions under the same assumption, which is thus reflected by market prices too. The role of the entrepreneur is to deal instead with genuine uncertainty that, differently from risk, cannot be quantified. Entrepreneurship is based on long-term expectations, which incorporate all information available to financial markets, but differ from market price in one fundamental respect: they also include a guess about forthcoming change.[111] Therefore, when hedge fund activists and their opponents advocate two different strategies to 'beat the market', the discussion about the right horizon to assess performance may conceal a conflict between entrepreneurs having a different opinion about changes and their impact on performance. From this perspective, quasi-indexers become decisive between two entrepreneurial views on how the target company should move forward. Whether they are the right arbiters for this choice depends on context.

One strategic issue on which the views of activists and incumbent management often collide is quality and quantity of R&D expenditures. The incumbent management usually asks for the return on R&D expenditures to be assessed over a longer horizon. Activist hedge funds, instead, want the companies to be leaner and more focused on developing specific products, which usually results in cuts of R&D and personnel expenditures and larger short-term profits.[112] Overall reduction of R&D expenditures does not necessarily imply that the company is less innovative.[113] A recent study shows that activism can improve productivity and R&D *output* on several counts.[114] Still, granted that activism tends to reduce R&D *input*, this may not be the right choice for a number of companies. Another theoretical study, unrelated to activism, reveals that different kinds of innovation benefit from different organisational forms.[115] In particular, complex innovations with long life cycles benefit from conglomerate structures in which R&D can be redirected internally from a project to another. Those are precisely the structures that activists seek to break up.

Indexed funds are unlikely to stop hedge funds whenever saving on R&D expenditures appears to be the wrong strategy. The empirical evidence is that, although institutional investors generally support R&D investments, this support does not stem from quasi-indexers.[116] This aligns with theory. Quasi-indexers are highly diversified investors that do not benefit from firm-specific screening. Because their income depends on the assets under management, they choose low-cost voting policies that the market appreciates overall, including best practices in corporate governance and/or in a particular industry.[117] Arguably, indexed funds decide whether to support hedge funds based on the same criteria. Whether the target company should engage in linear or nonlinear innovation is a much more idiosyncratic question that quasi-indexers are not interested in answering.

Relying on the judgment by quasi-indexers is efficient in other situations. Not all instances of stock market underperformance that trigger hedge funds activism really depend on strategic choices. Often the matter is much simpler, namely whether the controlling management is wasting resources. There the advantage of quasi-indexers' voting in a standardised, predictable fashion on a hedge fund's memo showing waste is that they can commit the company's management to refrain from opportunism. This commitment is valuable, because it makes investors more willing to invest in the first place. Facing the threat of hedge funds teaming up with institutional investors, managers have to be more careful about misusing fee cash or being unresponsive to the competitive environment. In the absence of such 'recuperation mechanism,' as Hirschman put it, excessive consumption of perquisites, pet projects, if not empire building, could dissipate enormous value until the company is bankrupt or is acquired. Hedge funds activism can stop this well before the decline becomes irrecoverable. Moreover, because entrepreneurial activism is a credible threat in all countries where declining companies can be engaged, even dominant shareholders may have to refrain from self-dealing for fear of engagement by hedge funds.

As the example of R&D expenditures shows, the commitment towards outside investors supported by hedge funds activism risks becoming excessive when the reason for the activists' targeting a company is disagreement about the company's strategy. In such a situation, the strategy proposed by hedge funds in opposition to

109. *See supra* note 28 and accompanying text.

110. Knight, above n. 28, at 233-63; and J.M. Keynes, 'The General Theory of Employment', 51 *Quarterly Journal of Economics* 209 (1937).

111. *See* Keynes, above n. 28, at 96-106.

112. Coffee and Palia, above n. 54.

113. Bebchuk and others, above n. 19.

114. Brav *et al*., above n. 27.

115. S. Belenzon, P. Bolton & U. Tsolmon, 'The Organization of Innovation across Countries and Industries', *Unpublished Working Paper, Duke University* (2013).

116. *See* P. Aghion, J. van Reenen & L. Zingales, 'Innovation and Institutional Ownership', 103 *American Economic Review* 277 (2013). This study utilises an interesting strategy to identify causality. Companies' inclusion into market indices arguably matters for the investment by index trackers, but it is unlikely to affect R&D expenditures via other channels. Based on a similar identification strategy, another study reports a statistically insignificant impact of quasi-indexers on R&D (Appel and others, above n. 62), although according to a different study the presence of long-term indexers reduces R&D expenditures. *See* J. Harford, A. Kecskes & S. Mansi, 'Do Long-Term Investors Improve Corporate Decision Making?', *Finance Down Under 2015 Building on the Best from the Cellars of Finance Paper* (2015), available at <http://ssrn.com/abstract=2505261> (last visited 21 June 2016).

117. Appel and others, above n. 62, at 113.

the incumbent management is particularly difficult to evaluate. Moreover, the judgment of 'loyal' investors such as indexed funds cannot be relied on because the question is not simply whether existing resources are being managed efficiently, but rather how resources should be directed towards an uncertain future. This is an entrepreneurship question that indexed funds, with their typically small stakes in a particular company, do not have the expertise and the incentives to answer. In this respect, indexed funds crucially differ from venture capitalists, which specialise in dealing with entrepreneurship questions.[118]

If not the 'loyal' institutional investors, who should decide whenever hedge funds activism triggers a conflict of entrepreneurship? As Professor Mayer recently put it, there is a trade-off between commitment and control in corporate governance, and we should let individual companies decide which mix suits their circumstances best.[119] In Mayer's framework, control is understood as commitment to one particular constituency, namely commitment to outside investors. Another way to put the trade-off is whether the company should commit to the feedback engineered by entrepreneurial activists or to something else, for instance the entrepreneurship of inside management.[120] More in general, some companies may benefit from less investors control and more commitment to stakeholders other than the shareholders, including employees, creditors and entrepreneurs.[121]

Similarly to Mayer, this article contends that companies should decide 'who decides' in the event of hedge fund engagement. Differently from Mayer, however, this article argues that the dilemma about hedge funds activism is only whether a company should commit to inside or outside entrepreneurship, not to any other stakeholder. Here I follow the standard corporate governance argument against the inclusion of stakeholders in the company's objective function. This argument is twofold.[122] First, differently from shareholders, stakeholders can protect themselves through contracts. Second, the externalities of a business on stakeholders do not depend on corporate governance and therefore should not be addressed by corporate governance regulation. None of these arguments apply to entrepreneurship. Entrepreneurs cannot effectively protect their investment by contract. Moreover, lack of entrepreneurship in listed companies is a direct consequence (negative externality) of corporate governance. On this basis, in the next section, I will discuss how corporate law can support entrepreneurship by allowing companies to choose the desired degree of exposure to activism and to alter it over time.

118. *See* R.J. Gilson, 'Engineering a Venture Capital Market: Lessons from the American Experience', 55 *Stanford Law Review* 1067 (2003).
119. Mayer, above n. 72, at 234-36.
120. In the past, I have framed this as a trade-off between (entrepreneurial) discretion and (market) accountability. *See* Pacces, above n. 29, at 145-46.
121. Mayer, above n. 72, at 152-53.
122. *See* Pacces, above n. 29, at 74-82.

4 Evaluating the Policy Options

The policy debate on shareholder activism differs considerably from the foregoing discussion. Prompted by the standard narrative about the global financial crisis, policymakers hold institutional investors (including hedge funds) responsible for short-termism in corporate governance.[123] Ideally, policymakers would like to replace hedge funds' influence with the engagement of longer-term shareholders, regarded as more 'loyal,' albeit not exactly in Hirschman's sense. As we have seen, however, loyalty is no panacea. Neither is long-term ownership. This point is widely acknowledged also by academics sympathetic to the short-termism argument.[124] While these commentators argue that companies under the influence, or threat, of hedge funds activism cater to the short-termism of the stock market, they recognise that very many companies benefit from short-term market pressure. Companies that suffer from this pressure, however, should be able to effectively opt out of hedge funds' influence. Other commentators disagree with this point, claiming that short-termism is not a problem for anyone but the incumbent managers who seek insulation from activism, as previously from hostile takeovers, in order to disenfranchise the shareholders.[125]

Having argued that the short-termism debate cannot shed light on the limitations of shareholder activism, I will analyse the main policy proposals to curb activists' powers from the perspective of conflict of entrepreneurship.

The first set of proposals concern the disclosure of activists' ownership.[126] Activists' business model is fundamentally based on the purchase of undervalued stock (a so-called "toehold") while the market is still in the dark about the hedge fund's intentions. Thus, the obvious way to undermine activism is to reduce the size of the toehold that can be purchased profitably. Ownership disclosure regulation can have this chilling effect through the following policy variables[127]: (a) the threshold above which ownership needs be disclosed; (b) the time window available to activists since the crossing of the threshold; (c) the regulatory treatment of groups of activists. In the extreme, if a block larger than, say, 0.5% had to be disclosed within an hour of crossing the threshold by any group of shareholders intending to

123. *See e.g.* European Parliament, Amendments adopted by the European Parliament on 8 July 2015 on the proposal for a directive of the European Parliament and of the Council amending Directive 2007/36/EC as regards the encouragement of long-term shareholder engagement and Directive 2013/34/EU as regards certain elements of the corporate governance statement, 2014-2019, P8_TA(2015)0257 (hereinafter EP Amendments 2015).
124. *See* Bolton and Samama, above n. 18; Mayer, above n. 72.
125. *See*, most vigorously, L.A. Bebchuk, 'The Myth That Insulating Boards Serves Long-Term Value', 113 *Columbia Law Review* 1637 (2013).
126. *See supra* text to notes 16-17.
127. *See* L. Enriques, M. Gargantini & V. Novembre, 'Mandatory and Contract-Based Shareholding Disclosure', 15 *Uniform Law Review* 713 (2010) for a similar argument applied to takeovers.

vote against the management, hedge funds activism would likely disappear. Proposals along these lines, albeit less extreme, have been aired in the American debate but, partly owing to wide opposition by authoritative academics, the SEC is no longer considering changing the status quo.[128] A 5% threshold, a 10-day window to disclose it and the irrelevance of conscious parallelism in voting still make the U.S. legal environment one of the most favourable to shareholder activism worldwide. Many jurisdictions in Europe impose a lower threshold and a shorter window.[129] Note that, in Europe, the discussion about tightening ownership disclosure regulation is still ongoing.[130]

If we look at shareholder activism through the lens of conflict of entrepreneurship, curbing one of the opposing entrepreneurial activities, namely hedge funds activism, is not the way to solve the conflict. This approach would be economically justified only if hedge funds activism was on average detrimental to shareholder value, whether because of short-termism or otherwise. As shown in Section 2, this claim is not borne out by the empirical evidence, which actually suggests the opposite. However, the sheer threat of activism – whose effects are unobservable – could still be value-destroying if some of the activists' strategies were nearly riskless, as Professors Coffee and Palia have argued wolf pack strategies are.[131] Albeit impossible to falsify empirically, this claim seems as overstated as the actual impact of wolf packs.[132] Engagements by wolf packs remain a risky strategy that do not lead to obvious short-termism, for arguably, institutional investors would not support value-destroying engagements and, under this expectation, wolf packs would not be formed in the first place.

To be sure, as argued in the previous section, hedge funds activism could induce management to choose short-term strategies that are suboptimal for the particular company. Wolf packs would make this problem worse. However, from a conflict of entrepreneurship perspective, mandatory rules to curb the power of wolf packs, such as the inclusion of the group members in the leading activist's disclosure, are unwarranted. Companies that want to discourage activism, whether individual or in concert, have plenty of ways to do so. Countermeasures range from low-trigger poison pills (in the United States),[133] to functionally equivalent dilutive techniques in those jurisdictions where they are allowed (*e.g.* the Netherlands),[134] to dual-class shares, which in one way or another can be engineered nearly everywhere.[135] Importantly, activism is also observed in the presence of these countermeasures.[136]

The fundamental argument of this article is that hedge funds activism should be evaluated in the specific context in which it operates. For some companies, in a certain stage of their life cycle, exposure to activism is efficient; for others, or for the same companies at another point in time, it is not. From this perspective, the more interesting proposals in the policy debate are those offering individual companies instruments to tailor exposure to activism to their circumstances, for instance depending on whether it is optimal for them to profile on short-term or longer-term strategies.

Seemingly, one instrument for companies to tailor exposure to hedge funds activism is rewarding shareholders who were, or will be, invested in the company for some time with a higher voting power.[137] These shareholder voting structures are known under various names, but perhaps the better known designation in Europe – where they have been most popular of late – is 'loyalty shares.'[138] Although their assonance with Hirschman's framework is accidental, the function of loyalty shares is much in the spirit of Hirschman's argument that voice

128. *See* Coffee and Palia, above n. 54.
129. For instance, Germany, Italy, the Netherlands and the UK feature a 3% threshold and an obligation to disclose that varies between 2 and 4 days. *See* Gilson and Gordon, above n. 16.
130. A proposal was made recently by the Legal Affairs Committee of the European Parliament to mandate disclosure above 0.5%. *See* Cofferati Report (2015), above n. 12. This proposal, however, was not included in EP Amendments (2015). The discussion between the EU institutions on this and related curbs on shareholder activism is still ongoing at the time of writing.
131. Coffee and Palia, above n. 54, at 29.
132. *See supra* text to notes 69-70.
133. Coffee and Palia, above n. 54, at 32. However, *also see* Gilson and Gordon, above n. 69, on the unimportance of the poison pill when hedge funds garner sufficient support from the institutional investors.
134. Dutch preference shares are functionally equivalent to U.S. poison pills, and can be used to fend off both hostile takeovers and activism. *See* L. Chazen and P. Werdmuller, 'The Dutch Poison Pill: How Is It Different from an American Rights Plan?', available at <https://corpgov.law.harvard.edu/2015/12/01/the-dutch-poison-pill-how-is-it-different-from-an-american-rights-plan/> (last visited 21 June 2016).
135. *See* R. Adams and D. Ferreira, 'One Share-One Vote: The Empirical Evidence', 12 *Review of Finance* 51 (2008). The recent history of corporate mobility also reveals that companies who want dual class shares simply move to jurisdictions allowing them. *See* M. Ventoruzzo, 'The Disappearing Taboo of Multiple Voting Shares: Regulatory Responses to the Migration of Chrysler-Fiat', *ECGI Working Paper Series in Law* No. 288/2015. In the UK, the moves towards control enhancement of dominant shareholdings have triggered a tightening of (the Premium segment of) the listing regime, which has been criticised by some commentators. *See* B.R. Cheffins, 'The Undermining of UK Corporate Governance (?)', 33 *Oxford Journal of Legal Studies* 503 (2013) and R. Barker and I.H-Y. Chiu, 'Protecting Minority Shareholders in Blockholder-Controlled Companies: Evaluating the UK's Enhanced Listing Regime in Comparison with Investor Protection Regimes in New York and Hong Kong', 10 *Capital Markets Law Journal* 98 (2015).
136. On activism in controlled companies, *see* K. Kastiel, 'Against All Odds: Shareholder Activism in Controlled Companies' (2015), available at <http://ssrn.com/abstract=2628987> (last visited 22 June 2016). *See also supra* note 5.
137. Reward can be in terms of voting rights or cash-flow rights. Because most of the policy and academic debate has been on rewarding long-term shareholdings by means of voting rights, this article also focuses on voting power. However, it is important to note the prominent exception of Bolton and Samama, above n. 18, who have proposed to incentivise long-term shareholding exclusively by means of extra cash-flow rights.
138. *See* J. Delvoie and C. Clottens, 'Accountability and Short-Termism: Some Notes on Loyalty Shares', 9 *Law and Financial Markets Review* 19 (2015). However, see also, for the United States, the functionally equivalent expressions 'Time-Phased Voting' and 'Tenure Shares'. *See* respectively L. Dallas and J.M. Barry, 'Long-Term Shareholders and Time-Phased Voting', *Delaware Journal of Corporate Law (DJCL)* (2015); and D.J. Berger, S.M. Davidoff & B.A. Jedidiah, 'Tenure Voting and the US Public Company' (2016), available at: <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2740538> (last visited 22 June 2016).

can be excessive for a particular organisation. Loyalty shares are there to curb hedge funds activism in the companies that adopt them. The requirement of loyalty is the least important part of their effectiveness, although it has undoubtedly contributed to make loyalty shares politically palatable.

Loyalty shares are a French invention. While prohibiting multiple voting shares, French law allowed companies to grant one additional vote to shareholders that had held shares continuously for two years. This was optional for every French company until, in 2014, the *Loi Florange* made loyalty shares the default regime for listed companies. This move has virtually imposed loyalty shares on existing listed companies. Companies that did not have loyalty shares in place automatically got them, unless they opted out of the default rule. However, opting out of loyalty shares requires an amendment of the articles of association, which in France is governed by a two-third majority and hence can be vetoed by only one-third of the votes. Therefore, dominant shareholders could push loyalty shares despite the opposition of institutional investors, as the French government did recently in the Renault case.[139]

Loyalty shares have been popular elsewhere in Europe. Fiat-Chrysler Automobiles (FCA), Italy's largest family-owned corporation, reincorporated to the Netherlands allegedly in order to adopt loyalty shares, which were not allowed in Italy.[140] Subsequently, Italian law was amended and now allows listed companies to opt into French-style loyalty shares with a two-third majority. Italy allowed companies to amend their articles with a simple majority for a transition period, whose prolongation was stopped by the opposition of institutional investors and several academics, including the author of this article.[141] It is noteworthy that, in Europe, loyalty shares have been typically implemented by existing companies in the midstream, with dominant shareholders being decisive, although formally all shareholders fulfilling the loyalty requirements qualify for the extra vote(s).

Loyalty shares are appealing because they seem to empower all shareholders equally on a dimension other than the *size* of their investment, namely the *time* of their investment. Loyalty shares are thought to rebalance shareholder powers from activists to long-term investors. On the assumption that hedge funds activism leads to short-termism and that the latter is always detrimental for a company, policymakers, including some members of the European Parliament, advocated the introduction of loyalty shares across the European Union.[142] Similarly, academics have argued that allowing companies to opt into loyalty shares or other time-varying voting system would cope with short-termism precisely when it is detrimental. Surprisingly, however, institutional investors – including the owners that would qualify for the loyalty benefits – almost invariably oppose the introduction of loyalty shares.

Loyalty shares are not as good as they look, and they look different from what they are. To start from their flaws, loyalty shares do not really commit to anything, let alone to long-term strategies. Having held shares for any number of years says nothing about for how much longer investors will hold them, although this is crucial for their voting strategy. To cope with this problem, Professor Mayer proposed to allow companies to give voting rights proportional to a residual holding period to which investors commit ex ante. Super-voting loyalty shares would be inalienable for the committed period, and could only be redeemed prior to maturity at a penalty in terms of both price and voting rights.[143] Although ingenious, this proposal has a few shortcomings that are hard to overcome.

To begin with, the link between voting rights and holding periods, whether past or future, can be circumvented so long as disclosure of the ultimate beneficial ownership can be avoided. An intermediary company could qualify for the loyalty benefits by locking in ownership, but defer to its beneficial owners for how to vote the loyalty shares. Such beneficial owners, who could be transient investors, will de facto control the extra voting rights. To be sure, several mechanisms have been proposed to track loyalty to the beneficial owners, for instance special rules to register the loyalty shares as a precondition for enjoying their benefits.[144] In consideration of the administrative costs, the French legislator has decided to drop those mechanisms.[145] Moreover, in the absence of a case-by-case screening, which would require board discretion and thus expose to directors' opportunism, curbs on shareholders' arbitrage of voting rights are unlikely to work. As the experience with hedge funds activism suggests, the arbitrage of governance rights can be so profitable that it is difficult to imagine low-cost solutions that could cope with it.[146]

139. *See* 'Shareholders Rights in Europe – Short-Term or Short-Changed?', *The Economist* (May 2, 2015).
140. Ventoruzzo, above n. 135.
141. *See* the text of the petition and the response by the Italian Ministry of the Economy at <http://oneshareonevote.org> (last visited 17 June 2016).
142. This proposal, originally included in the Cofferati Report (2015), above n. 12, has disappeared from the official documents. However, it is still being considered. *See* K.J. Hopt, 'Corporate Governance in Europe: A Critical Review of the European Commission's Initiatives on Corporate Law and Corporate Governance', 12 *New York University Journal of Law & Business* 139 (2015), at 158.
143. *See* Mayer, above n. 72, at 265.
144. *See* Bolton and Samama, above n. 18; Berger *et al*., above n. 138.
145. Delvoie and Clottens, above n. 138, at 28.
146. Mayer, above n. 72, at 266-67, is more optimistic about the possibility to stop the arbitrage of voting rights between long-term shareholders and short-term beneficial owners. In his view, linking the extra voting rights to a future holding period makes it progressively more difficult for short-term beneficial owners to create liquidity through policies that undermine long-term returns – in the last period, it may be difficult for owners to sell shares whose long-term value has been undermined. This argument neglects the impact of stock market bubbles, which can go on for several years. As shown by H. Minsky, in *Stabilizing an Unstable Economy* (1986), refinancing debt can prop up asset prices (including stock prices) indefinitely, until a debt crisis occurs.

Furthermore, loyalty shares committing to a holding period entrench control. For instance, in the event of a takeover, only the shareholders loyal to the management would retain the extra voting rights; that might be enough to fend off a hostile bid. There are ways to get around this problem, but they all would make loyalty shares less attractive. For example, Eumedion – a Dutch foundation representing the interests of several institutional investors – proposed to cap the extra voting rights at 5% in order to prevent dominant shareholders from using loyalty shares as a control enhancing mechanism.[147] On a different note, having in mind shares rewarding loyalty exclusively with pecuniary benefits, professors Bolton and Samama suggested making such benefits expire in the event of a takeover bid.[148] Whereas a similar contingency approach could be applied to voting rights, it is very doubtful that loyalty shares would be as attractive if deprived of their entrenchment effect.

Loyalty shares are effectively dual-class shares in disguise. Formally, loyalty shares look different from dual-class shares because they allocate superior voting rights to *any* investor fulfilling the holding period requirements attached to them, not just to the holder of a specific class of shares. Hence, loyalty shares look like a remedy against short-termism, not an entrenchment device for managers or controlling shareholders.[149] In reality, loyalty shares are attractive precisely when they operate as dual-class shares. Loyalty shares are uninteresting for institutional investors. Transient investors do not care about loyalty. The commitment of quasi-indexers is independent of their voting rights, and they may forego loyalty benefits simply because of portfolio rebalancing. Only dedicated investors could be potentially interested. However, as we have seen, dedicated investors rather govern through exit. Hence, they would not accept committing to loyalty for extra voting rights, if that cost them the exit option. There remain only shareholders interested in control to profit from loyalty shares, namely the management and/or the dominant shareholders. While non-controlling shareholders are unlikely to care for the extra voting rights, the incumbents can use loyalty shares as super-voting shares against activist hedge funds who can only have access to common stock. This makes sense from a perspective of conflict of entrepreneurship. Companies that want to commit to the incumbents' as opposed to the activists' entrepreneurship will go for loyalty shares. Because this strategy undermines the overall impact of institutional investors, it is no surprise that also long-term investors oppose loyalty shares. What is unclear at this point is why the incumbent management prefers loyalty shares to classic dual-class shares structures.

A key difference between dual-class shares and loyalty shares is that only the latter can be introduced in the midstream. A founder concerned with the adverse impact of activism on certain styles of innovation could simply go public with dual-class shares, which companies increasingly do.[150] When the managers of an already listed company have the same concern, they cannot introduce a super-voting class of shares even with a favourable shareholder vote. Dual-class recapitalisations that exchange existing shares for two classes of shares, one with higher voting rights for the controlling group and one with lower voting rights for the investors, are not allowed either in Europe or in the United States.[151] Loyalty shares are a way out of this bind. Because formally they do not discriminate among shareholders, companies can issue them in the midstream. In the United States, this is part of the history of loyalty shares, which were all introduced in the short time when it was unclear whether dual-class recapitalisations were allowed.[152] Moreover, according to some commentators, introducing loyalty shares is still possible in the United States despite the exchanges' prohibition of recapitalisations, so long as no existing shareholder is worse off.[153] In Europe, room for loyalty shares has been created by national legislatures, where it did not exist before, and may be furthered by the European Union. But this has created the paradox, revealed by the French and partly the Italian experience, in which loyalty shares may be introduced despite the opposition of a majority of institutional investors.

It would be better to allow dual-class recapitalisations explicitly and regulate them in such a way as to avoid misuse by incumbent managers and controlling shareholders. The potential for misuse is significantly reduced if investors have veto power on the transaction. In the past, commentators were concerned that investors could be coerced into voting for recapitalisations because of their inability to coordinate.[154] The re-concentration of ownership by institutional investors has

147. *See* Eumedion, 'Draft Position Paper on The Position of Minority Shareholders in Companies with a Dominant Shareholder' (15 October 2015), available at <http://eumedion.nl/en/public/knowledgenetwork/position-papers/2015-10-draft-position-paper-protection-minority-shareholders.pdf> (last visited 3 July 2016). The Dutch government, however, sounded disinclined to adopt this proposal on the grounds that it would not necessarily fit the needs of some companies. Interestingly, the final version of Eumedion, *Position Paper on The Position of Minority Shareholders in Companies with a Dominant Shareholder* (26 June 2016), available at <http://eumedion.nl/en/public/knowledgenetwork/position-papers/2016-06-position-paper-minority-shareholders-final-version.pdf> (last visited 3 July 2016), does no longer include the proposal to cap the extra voting rights at 5%, but goes rather in the direction of the policy recommendations of this article (approval of the restriction by the majority of the minority and sunset clauses – *see* below in the text).

148. Bolton and Samama, above n. 18.

149. *See* Dallas and Barry, above n. 138.

150. *See e.g.* Enriques and others, above n. 32 (reporting 170 U.S. companies going public with dual-class shares between 2010 and 2012). *See also supra*, note 135 (Outside the United States, companies can choose to incorporate in a jurisdiction allowing dual-class shares).

151. *See* G. Ferrarini, 'One Share–One Vote: A European Rule?', 3 *European Company and Financial Law Review* 147 (2006).

152. Dallas and Barry, above n. 138. According to the letter of the listing rules, the midstream introduction of loyalty shares is currently not allowed in the United States. *But see* the argument below in the text.

153. Berger *et al*., above n. 138.

154. *See* R.J. Gilson, 'Evaluating Dual Class Common Stock: The Relevance of Substitutes', 73 *Virginia Law Review* 807 (1987) for a critical discussion of the argument.

made such worries much less compelling. Therefore, dual-class recaps could be allowed subject to a majority of minority (MOM) vote. This solution would not only provide sufficient guarantees to minority shareholders; it would also screen for situations in which dual-class shares are efficient from the perspective of conflict of entrepreneurship. Managers and controlling shareholders are naturally inclined to curb shareholder powers, particularly in the midstream, when investors cannot collectively withdraw equity. However, a MOM vote requires the proponent to signal that the restriction is value-increasing in order to gain the approval by minority shareholders.

The one-share-one-vote regime (1S1V) should not be a constraint on the flexibility of established listed companies, but rather become a 'sticky default', as Professor Ayres put it.[155] A sticky default is a quasi-mandatory rule that, by design, is expensive to alter for the average person or company. The purpose of sticky defaults is to enable opt-out *only* by those parties for which the default rule would be inefficient, because otherwise the cost of opting out would outweigh the benefits. If the management wants to introduce dual-class shares to take advantage of minority shareholders, the latter will not consent unless they are paid the full expected value of expropriation. Conversely, the management of a company with a project that could take too long for the market to appreciate may derive net benefits from persuading institutional investors to enter into a dual-class recapitalisation. Because institutional investors will typically have a policy against dual-class shares, management will have to commit to a value-increasing strategy. The key question is, then, what commitment is likely to persuade institutional investors to accept the deal.

The baseline to compare this hypothetical contract is a going private transaction, which could likewise enable a dual-class recapitalisation.[156] Going private requires the management to find a financier, for which they will have to commit their personal wealth and offer sufficient guarantees to outside investors. As founders commit their private wealth when they go public with a dual-class voting structure, by investing sufficient capital in Class-A shares, so could the management or the dominant shareholders of an already listed company. In the midstream, additional guarantees may be needed to persuade institutional investors, thereby saving on the cost of taking the company private. First, controllers will want to commit against self-dealing for as long as they retain extra voting rights. Minority board representation is a credible signal for this, because by sitting on the board, investors' representatives can stop expropriation in most western jurisdictions.[157] Minority board seats, however, are not enough to undermine long-term strategies. Second, in order to commit against a never-ending long-term, which investors would not accept, the restriction to protect insiders' entrepreneurship could be time-bound. Dual-class shares could be set to expire in a horizon agreed upon, during which the goals of the project are realised or clearly become unattainable.[158] This would commit prospective controllers against empire building and similar conflicts of interest.

This reasoning reveals that the combination of a 1S1V default with a MOM rule for altering it provides an advantage that loyalty shares only have in theory: the temporary character of control enhancement.[159] It is often argued that because loyalty shares confer benefits depending on a holding period, eventually there will be no disproportionality between ownership and voting rights among loyal shareholders. In practice, this never leads to the elimination of control enhancement because, as explained, institutional investors cannot commit to the same loyalty as a controlling shareholder. On the contrary, having to negotiate with institutional investors the midstream introduction of dual-class shares, managers and dominant shareholders must likely commit to sunsetting disproportional voting structures.

A major disadvantage of dual-class shares and entrenched control structures in general is that they are difficult to remove once they are established. This may lead to inefficiency because the same company that once benefited from entrenched control may suffer from it later on. The need for controllers to offer investors a sunset arrangement to enable a dual-class recapitalisation overcomes this problem. As the recent U.S. experience with the poison pill suggests, institutional investors can be talked into accepting control enhancements only when these are temporary.[160] So if, within a limited period, the entrepreneurial project succeeded, both controlling and non-controlling shareholders would make their profits and the dual-class structure could be collapsed. If, instead, the project failed, the expiration of the dual-class structure would make it easier to reallocate control of the company's assets, with or without the intervention of activists or hostile bidders. Therefore, the sticky default approach to 1S1V proposed here supports not only the selection of voice restrictions by the companies for which this is efficient ex-ante, but also the removal of these restrictions when they become inefficient ex post.

155. *See* Ayres, above n. 34, at 2032, 2084-88 on 'Impeding altering rules'.
156. Another way to do it is by reincorporation, which is comparable to the solution being advocated in this article, because it requires a favourable vote by minority shareholders.
157. On the role of minority-appointed directors to curb self-dealing, *see* A.M. Pacces, 'Controlling the Corporate Controller's Misbehaviour', 11 *Journal of Corporate Law Studies* 177 (2011) (assuming that courts are sufficiently reliable to enforce the appointment of minority directors).
158. On the theoretical advantages of such sunset clauses, *see* L.A. Bebchuk, 'Why Firms Adopt Antitakeover Arrangements', 152 *University of Pennsylvania Law Review* 713 (2003). For an application to the takeover context, *see* Enriques and others, above n. 32, at 126.
159. Dallas and Barry, above n. 138, claim the temporary character of the disparity between classes of shareholders and argue, on this basis, that loyalty shares are intermediate between dual-class shares and 1S1V.
160. *See* Gilson and Gordon, above n. 16, at 910-11.

5 Conclusion

In this article, I have discussed the policy responses to hedge funds activism in corporate governance. The analysis has been based on Hirschman's classic, *Exit, Voice and Loyalty*. Although Hirschman wrote before the re-concentration of ownership in the hands of institutional investors, which nurtured entrepreneurial activism by hedge funds, his framework can be adapted to the new situation. Contrary to the received wisdom, hedge funds do not pose problems of loyalty because the arbiters of their activism are typically quasi-indexers, which cannot exit strategically. What we can still learn from Hirschman, though, is that voice can be excessive for a particular company.

From this perspective, I have discussed hedge funds activism both empirically and in theory. This analysis reveals that, while the claim that the gains from hedge funds activism are short-lived is not borne out by the empirical evidence, the latter can tell us neither whether the existence of hedge funds activism leads to short-termism in corporate governance nor whether this is efficient across the board. The real issue with activism is a conflict of entrepreneurship, namely a conflict between two views about the right time horizon for the target company to maximise uncertain profit – the view of the activist as opposed to the view of the incumbent management. Leaving the choice between these views to institutional investors is not efficient for every company at every point in time.

In order to cope with this problem, this article has argued that regulation should refrain from curbing the power of activists. Rather, regulation should enable individual companies to limit the impact of activism when this is efficient for them. Reviewing the recent European experience with loyalty shares, this article contends that they operate as dual-class shares in disguise, sometimes allowing their midstream introduction without the approval by institutional investors. It is preferable for efficiency to allow dual-class recapitalisations explicitly, subject to a majority of minority vote conferring an effective veto power upon institutional investors. This 'sticky default' solution would screen the companies for which limiting the influence of activists is efficient, and induce these companies to negotiate time-bound restrictions (for instance, sunset clauses) with institutional investors.