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Regulatory Competition in European Company Law.

Where do we stand twenty years after Centros?

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May 2019

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Free University of Bozen/Bolzano, CRELE and ECGI

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I thank Peter Agstner and Federico M. Mucciarelli for helpful comments on a previous version of this article. I remain responsible for all possible mistakes.

Abstract

This article provides an overview of freedom of establishment and developments in the European market for corporate charters twenty years after the ECJ's important Centros decision of March 1999. Both for initial incorporations and reincorporations, ECJ case law has emerged as a key driver in providing the demand side the possibility to freely choose the applicable law. In fact, private limited companies in particular have reacted positively to the opportunities offered. From the supply side perspective, Member States have responded to the new challenges, particularly with respect to the relaxation of the minimal capital requirements of private limited liability companies. Nevertheless, the recent Kornhaas case of 2015 has complicated the picture of the European market for corporate charters, with the possible intersections between company law and insolvency law that may modify the incentives for a free choice of company law.

Keywords: EU company law, Centros, Freedom of establishment, Regulatory competition, Regulatory arbitrage

JEL Classifications: K20, K22

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1. Introduction

The twentieth anniversary of the important judgment of the European Court of Justice (ECJ) in the *Centros* case of 9 March 1999 is an opportunity to reassess this decision[1] and, more importantly, its impact on developments of freedom of establishment in the European Union.[2]

This article has an overview character, presenting the issue of freedom of establishment and mobility of companies from the beginning of the European "adventure" and the development of regulatory arbitrage and regulatory competition in company law in the EU in the last twenty years.[3] It then provides

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[1] Case C-212/97, of 9 March 1999. The Author started his Ph.D. in *Economic Analysis of Law* at the DFG Graduate College in *Law and Economics* of the University of Hamburg in October 1998 and decided from the outset to focus his dissertation on the topic of regulatory competition in company law in the European Community, presenting the dissertation topic in November 1998. The topic, ambitious but probably not so relevant, gained momentum precisely with the important decision of *Centros* of March 1999; see Stefano Lombardo, *Regulatory Competition in Company Law in the European Community*: *Prerequisites and Limits* (Peter Lang, 2002).

[2] In this article the terms company and company law and corporation and corporate law are used with the same meaning.

[3] The topic of freedom of establishment of companies in a context of possible regulatory arbitrage and regulatory competition has proved to be extensively studied in Europe with a burgeoning literature over the last twenty years. Limiting the overview to the literature in English and without any claims of exhaustiveness see e.g., Eva-Maria Kieninger, *The Legal Framework of Regulatory Competition Based on Company Mobility: EU and US Compared* 6 German Law Journal 741 (2004); John Armour, *Who Should Make Corporate Law? EC Legislation versus Regulatory Competition* ECGI Law WP 54/2005; Martin Gelter, *The*

a short assessment of the actual market for company law with a specific consideration of close corporations, taking ownership costs vs contracting costs as a paradigm of analysis.[4] Indeed, contrary to the US benchmark model, in Europe the phenomenon of mobility of companies has involved almost exclusively close corporations and in particular private limited liability companies, with some sporadic exemptions related to listed companies.[5] Given this pattern, the analysis will show that, twenty years after *Centros*, the situation in the EU differs considerably from the United States. A US style market for corporate charters for listed corporations with dispersed ownership will probably not develop in Europe in the future.[6]

Structure of Regulatory Competition in European Corporate Law 5 Journal of Corporate Law Studies 247 (2005); Wolfgang Schön, *The Mobility of Companies in Europe and the Organizational Freedom of Company Founders* 3 European Company and Financial Law Review 122 (2006); Marco Ventoruzzo, *Cost-Based and Rules-Based Regulatory Competition: Markets for Corporate Charters in the U.S. and in the E.U.* 3 New York University Journal of Law and Business 91 (2006); Luca Enriques and Marting Gelter, *How the Old World Encountered the New One: Regulatory Competition and Cooperation in European Corporate and Bankruptcy Law* 81 Tulane Law Review 577 (2007); Federico M. Mucciarelli, *The Function of Corporate Law and the Effects of Reincorporations in the U.S. and the E.U.* 20 Tulane Journal of International and Comparative Law 421 (2012).

[4] See already Lombardo, (fn. 1) and Section 3.

[5] They refer to the cases of FIAT-Chrysler, FCA (and Ferrari), which became Dutch companies, see Federico Pernazza, *Fiat Chrysler Automobiles and the New Face of Corporate Mobility in Europe* 14 European Company and Financial Law Review 37 (2017).

[6] A useful and complete overview of the legal situation in Europe and for the single Member States is provided by Carsten Gerner-Beuerle, Federico M. Mucciarelli, Edmund Schuster and Mathias Siems, *The Private International Law of Companies in Europe* (Beck, 2019).

The conclusion is that *Centros* had the positive effect of reconsidering the philosophy of harmonization of company law in Europe and making all the actors more aware of the *pro* and *contra* of such a device to reach the goal of an integrated internal market (Article 3.3 EU Treaty).[7] More importantly, *Centros* served as a very simple but at the same time very incisive device, decided by the ECJ as "motor of European integration",[8] (i) to eradicate the very deep fears anchored on and defended by the real seat theory followed by some Member States against "(EU)-foreign" companies, and as result (ii) to affirm the relevance of the country of origin principle and the mutual recognition principle, already applied in other areas of law, also in the field of company law.[9] The mentioned fears were exaggerated both with respect to the protection of shareholders and the protection of creditors and no longer justified in the European internal market context of Article 3.3 EU Treaty.[10] At the same time,

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[7] See Luca Enriques and Matteo Gatti, *The Uneasy Case for Top-Down Corporate Law Harmonization in the European Union* 27 U. Pa. Journal of International Economic Law 939 (2006); Luca Enriques, *EC Company Law Directives and Regulations: How Trivial Are?* 27 *U. Pa. Journal of International Economic Law* 1 (2006); more recently, Luca Enriques, *A Harmonized European Company Law: Are We There Already?* 66 International and Comparative Law Quarterly 763 (2017).

[8] Thomas Horsley, *Reflections on the Role of the Court of Justice as the "Motor" of European Integration:* Legal *Limits to Judicial Lawmaking* 50 Common Market Law Review 931 (2013).

[9] See Caspar Behme, *The Principle of Mutual Recognition in the European Internal Market With Special Regard to the Cross-Border Mobility of Companies* 13 European Company and Financial Law Review 31 (2016); Karsten Engsig Sørensen, *The Country-of-Origin Principle and Balancing Jurisdiction between Home Member States and Host Member States* 30 European Business Law Review 38 (2019).

[10] But see Karsten Engsig Sørensen, *The Fight against Letterbox Companies in the Internal Market* 52 Common Market Law Review 85 (2015), for an attempt to distinguish

more recently the issue of creditors' protection has gained new momentum with the *Kornhaas* case of the ECJ.[11] This case has reconsidered the relationship between company law and insolvency law, making the regulatory picture at the same time easier but more difficult to evaluate.[12] In this context, also the extent to which Brexit will impact on freedom of establishment (and on insolvency proceedings) is dependent on the way the exit will materialize.[13]

The liberal case law of the ECJ in the recent past accompanied by the economic and financial crisis after 2008 has led the European Commission to reconsider its action policy in the field of company law, which includes listed companies and close companies.[14] Probably for this reason, the recent "mobility package" of the European Commission is a minimal attempt to try to regulate only the issue of freedom of establishment in terms of reincorporations of private limited companies.[15]

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between compatible and incompatible letterbox companies in the context of freedom of establishment.

[11] Case C-594/14 of 10 December 2015.

[12] *Kornhass* concerned a UK limited liability company operating in Germany.

[13] The Brexit decision and its possible effects on freedom of establishment are discussed by John Armour, Holger Fleischer, Vanessa Knapp and Martin Winner, *Brexit and corporate Citizenship* ECGI Law WP 340/2017

[14] John Armour and Wolf-Georg Ringe, *European Company Law 1999-2010: Renaissance and Crisis* 48 Common Market Law Review 125 (2011).

[15] The recent Commission proposal for a Directive amending Directive 2017/1132 as regards cross-border conversions, mergers and divisions (Com(2018) 241 final of 25.4.2018) in the context of the so-called Company Law Package (together with the Commission's proposal for a Directive amending Directive 2017/1132 as regards the use of digital tools and processes in company law (Com(2018) 239 final of 25.4.2018)) also includes the possibility to transfer the registered office with change of applicable law and retention of legal personality. Nevertheless, the proposal applies only to limited liability companies. For a

The article in structured as follows. After providing in Section 2 a short overview of the relevant issues at stake in the case of freedom of establishment of companies in the European Community (Union), Section 3 briefly analyses the market for corporate charters for the United States for comparative purposes. Section 4 provides an overview of the development of the jurisprudence of the ECJ in the field of freedom of establishment and mobility of companies among Member States. Section 5 concentrates on a short assessment of the evolution of the European market for company law from the demand and supply side perspective. Section 6 concludes.

2. Freedom of establishment of companies in the EEC Treaty between incorporation theory and real seat theory

At the beginning of the European adventure, the relevant Articles in the area of freedom of establishment and mobility of companies were articles 52 and 58 of the EEC Treaty, Article 54(3)(g) EEC Treaty on harmonization of company law as well as Article 293(3) EEC Treaty on mutual recognition of companies, retention of legal personality and mergers between European companies.[16] While Article 52 EEC Treaty provided for freedom of establishment

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first assessment of the proposal, see Jessica Schmidt, *The Mobility Aspect of the EU Commission's Company Law Package: Or – 'The Good, the Bad and the Ugly'* 16 European Company Law 13 (2019). See also Carsten Gerner-Beuerle, Federico M. Mucciarelli, Edmund Schuster and Mathias Siems, *Cross-border reincorporations in the European Union: the case for comprehensive harmonization* 18 Journal of Corporate Law Studies 1 (2018).

[16] Article 293 EEC Treaty (Article 220 EC Treaty) is no longer present in the EU Treaties. For the early literature on the relevant Treaty Articles, see Y. Scholten, *Company Law in Europe* 4 Common Market Law Review 377 (1967); Marcus Lutter, *Die Angleichung des Gesellschaftsrechts nach dem EWG-Vertrag* 19 Neue Juristische Wochenschrift 277 (1966); Christian W.A. Timmermans, *Die europäische Rechtsangleichung im Gesellschaftsrecht. Eine*

for individuals, Article 58 EEC Treaty extended freedom of establishment also to companies (in terms of for-profit entities).[17]

Article 58 EEC Treaty, extending freedom of establishment also to companies that have their registered office, central administration or principal place of business within the Community, was interpreted according to national rules. In the field of private international law for companies, Member States have traditionally followed either the real seat theory or the incorporation theory. The real seat theory requires the (Member) State of the registered office and of the real seat (central administration or principal place of business) for formation and recognition purposes to coincide, while the incorporation theory allows for the registered office and real seat to be in two different (Member) States.[18]

In its essential terms, there was a compatibility problem between the real seat theory and Articles 52 and 58 EEC Treaty. Real seat Member States did not recognize a company with its registered office in a Member State that adopted the incorporation theory but which then moved its real seat to their territory. These real seat Member States for recognition purposes required that the real seat and registered office of the Member State of formation coincide, so

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integrations- und rechtspolitische Analyse 48 Rabels Zeitschrift für ausländ. und internat. Privatrecht 1 (1984); More recently, see Wolfgang Schön*, Mindestharmonisierung im europäischen Gesellschaftsrecht* 160 Zeitschrift für das gesamte Handels- und Wirtschaftsrecht 221 (1996); Jan Wouters, *European Company Law:* Quo Vadis? 37 Common Market Law Journal 257 (2000).

[17] See Stefano Lombardo, *Some Reflections on Freedom of Establishment of Non-profit Entities in the European Union* 14 European Business Organization Law Review 225 (2013).

[18] Günther Beitzke, *Anerkennung und Sitzverlegung von Gesellschaften und Juristischen Personen im EWG-Bereich* 127 Zeitschrift für das gesamte Handels- und Wirtschaftsrecht 1 (1964).

neglecting the issue of initial valid formation in the Member State of origin/formation (i.e. the one of incorporation).[19]

The problem of freedom of establishment and mobility of companies according to the relevant EEC Treaty Articles was furthermore complicated by the importance legal scholars were giving to Article 54(3)(g). This Article provides for coordination of the national company law provisions of Member States.[20] Under Article 54(3)(g), harmonization of company law was long considered functional and instrumental to the complete realization of freedom of establishment and mobility of companies needed to reach the goal of a single market. Indeed, as in other areas of law, *ex ante* harmonization was commonly considered to be a prerequisite to allow and realize the exercise of the rights established by the Treaty. Only after some decades, were doubts raised by some legal scholars about the paradigm of harmonization of company law as a mechanism to reach integration of the internal market and mobility of companies.[21]

3. The American market for corporate charters

[19] Peter Behrens, *Die grenzüberschreitende Sitzverlegung von Gesellschaften in der EWG* 9 Praxis des Internationalen Privat- und Verfahrensrechts 354 (1989).

[20] See Lutter (fn. 16).

[21] See Hein Kötz, *Rechtsvereinheitlichung – Nutzen, Kosten, Methoden, Ziele* 50 Rabels Zeitschrift für ausländ. und internat. Privatrecht 1 (1986); Peter Behrens, *Voraussetzungen und Grenzen der Rechtsfortbildung durch Rechtsvereinheitlichung* 50 Rabels Zeitschrift für ausländ. und internat. Privatrecht 19 (1986); Peter Behrens, *Krisensymptome in der Gesellschaftsrechtangleichung*, in Immenga, Möschel and Reuter (Hrsg.), *FS Mästmäcker*, 831 (Nomos, 1986); Klaus J. Hopt, *Company Law in the European Union: Harmonization or Subsidiarity*? Centro di studi e ricerche di diritto comparato e straniero (Roma, 1998).

The legal situation in Europe was for a long time different from the one in the United States, where the incorporation theory developed as the conflict of law rule for corporations applied by almost all States and where the predominance of Delaware as the State of (re)incorporation emerged quite early in time.[22] Delaware's predominance, possibly historically threatened by federal law,[23] was actually strongly criticized by some legal scholars in terms of "race to laxity" or "race to the bottom", but it was never the object of intervention by federal legislation that covered the entire spectrum of corporate law.[24] More recently, the predominance of Delaware was positively reassessed, after the findings of empirical studies on the possible positive effects of reincorporation of companies to Delaware.[25]

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[22] See Elvin R. Latty, *Pseudo-Foreign Corporations* 65 Yale Law Journal 137 (1955); P. John Kozyris, *Corporate Wars and Choice of Law*, 1 Duke Law Journal 1 (1985); Richard M. Buxbaum, *The Origins of the American >>Internal Affairs<< Rule in the Corporate Conflict of Laws*, in Musielak and Schurig (Hrsg.), *FS Kegel*, 55 (W. Kohlhammer, 1987). From a comparative perspective, see also Richard M. Buxbaum and Klaus J. Hopt, 1988, *Legal Harmonization and the Business Enterprise. Corporate and Capital Market Law Harmonization Policy in Europe and the U.S.A*. (de Gruyter, 1988).

[23] Mark J. Roe, *Delaware's Competition* 117 Harvard Law Review 588 (2003).

[24] See Horace LF. Wilgus, *Need of a National Incorporation Law* 2 Michigan Law Review 358 (1904); William L. Cary, *Federalism and Corporate Law: Reflections Upon Delaware* 83 Yale Law Journal 663 (1974); Note, *Federal Chartering of Corporations. A Proposal* 61 Georgetown Law Journal 89 (1972) and Note, *Federal Chartering of Corporations. Constitutional Challenge*s, 61 Georgetown Law Journal 123 (1972).

[25] See Roberta Romano, *Law as a Product: Some Pieces of the Incorporation Puzzle* 1 J. of Law, Econ., & Organization 225 (1985) and Roberta Romano, *The Genius of American Corporate Law* (AEI Press, 1993); see also Ralph K. Winter Jr., *State Law, Shareholder Protection, and the Theory of the Corporation* 6 Journal of Legal Studies 251 (1977).

To understand the major points of the more recent positive (re)evaluation of the Delaware predominance, it is useful to briefly describe the terms of the law and economics debate that developed in the United States.[26,27] Starting point for the analysis of the market for corporate charters is that the firm is an alternative mechanism for allocating resources than the market, owing to the different patterns of transaction costs that exist between the two mechanisms.[28] The corporation is considered to be a nexus of contracts between several parties (patrons) generating agency problems and agency costs.[29] In particular, according to a taxonomy of the different types of firms,[30] the transaction costs arising from the interaction of the different patrons (shareholders, creditors, employees, customers) using the firm are of two types: the costs of contracting and the costs of ownership.[31] More in particular, contracting costs include several types (due to classical market failures such as

[26] A complete analysis of the debate on regulatory competition in the US is outside the scope of this article. See Marcel Kahn, *The State of State Competition for Incorporation*, in ECGI Law WP 263/2014.

[27] Law and economics has characterized the development of US corporate scholarship in the last 40 years while in Europe this paradigm is comparatively less developed. For some considerations for the US, see Roberta Romano, *The Making of Contemporary Corporate Law Scholarship*, in Siekmann (Hrsg.), *FS Baums*, 991 (Mohr Siebeck, 2017).

[28] Ronald H. Coase, *The Nature of the Firm* 4 Economica 386 (1937).

[29] Armen Alchian and Harold Demstez, *Production, Information Costs, and Economic Organization* 62 American Economic Review 777 (1972) and Michael Jensen and William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure* 3 Journal of Financial Economics 305 (1976).

[30] Henry Hansmann, 1988, *The Ownership of the Firm*, 4 J. of Law, Econ. & Organization 267 (1988); see also Henry Hansmann, *The Ownership of Enterprise*, 11 (Harvard University Press, 1996).

[31] Hansmann, *Enterprise* (fn. 30), 18.

monopoly power, opportunistic behavior and asymmetric information) while ownership costs (meaning the residual right of control and the residual right of earning) include the costs of controlling managers, the costs of collective decision making and the costs of risk bearing.[32]

Ownership of the firm is efficiently assigned to a particular group of patrons in a way that "minimizes the total costs of transactions between the firm and all of its patrons".[33] The business corporation is characterized by the efficient assignment of ownership to shareholders because this reduces the total transaction costs of the entire nexus.[34]

In such a context, where the allocation of ownership to shareholders is justified in terms of better management control and common objective of shareholder value, the US market for corporate charters apparently reduces the costs of ownership and for this reason is efficient.[35] Indeed, the implicit logic of the US market for corporate charters is that a (re)incorporation to Delaware increases the value of the corporation, meaning that ownership costs are comparatively reduced.[36] At the same time, a (re)incorporation to Delaware does not increase the costs of credit, i.e. the second most important costs a

[32] Hansmann, *Enterprise* (fn. 30), 24 and 35, and 53 for the investor-owned firm. The relationship between the different agency costs a corporation creates and the possible legal instruments to deal with them is anaylsed in Reinier Kraakman, *The Anatomy of Corporate Law* (Oxford University Press, 2009).

[33] Hansmann, *Enterprise* (fn. 30), 21.

[34] Hansmann, *Enterprise* (fn. 30), 21.

[35] The extent to which regulatory competition is able or not to reach the *optimal* regulatory result is debated and doubted in a famous article by Lucian A. Bebchuck, *Federalism and the Corporation: The Desirable Limits on State Competition in Corporate Law* 105 Harvard Law Review 105 (1992).

[36] A complete overview of the empirical findings is provided by Kahn (fn. 26), 19.

corporation, as a firm, faces. This is the economic core of the American market for corporate charters in terms of ownership costs vs credit costs. Delaware law, by reducing the costs of ownership (particularly significant in large corporations with disperse ownership where the shareholders-managers agency problem dominates) and by not increasing the costs of credit, produces apparently a surplus in terms of share value that shareholders/investors are willing to pay.[37]

The reconstruction of the Delaware predominance in the market for corporate charters requires some qualifications for the limited purposes of this article; some of them belong to the realm of corporate law, while others are outside it and cover securities regulation and bankruptcy law. All these qualifications are essential for comparative purposes with the European market for corporate charters.

There are three points related to the nature of corporate law worth mentioning. The first is the central element that, given the theoretical model of reference, in the USA, corporate law is (considered to be only) the relationship between shareholders and managers.[38] There is no space, as in Europe, for the

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[37] The following example is useful. Imagine a corporation is incorporated in the State of Arizona with the total costs of $100: cost of ownership $80 and costs of credit $20. A reincorporation to Delaware means an increase in the stock value, because the costs of ownership become $76 (because of the better corporate law) while the costs of credit remains constant. The total costs of the Delaware incorporated firm are now $96 with an efficiency gain of $4.

[38] Romano, *The Genius* (fn. 25), 1, starts her book by simply stating "Corporate Law which is the relationship between shareholders and managers …". American corporate legal doctrine seems to be predominantly convinced that corporate law covers shareholders and managers and pursues an aim of shareholder value. For a comparative analysis of the two regulatory philosophies, see e.g. Mucciarelli, (fn. 3), *passim*; Martin Gelter, *Taming or Protecting the Modern Corporation – Shareholder-Stakeholder Debates in a Comparative Light* 7 New York University Journal of Law and Business 641 (2011). See also Günter H. Roth

consideration of other interests to be dealt with by corporate law. The second is that, given the concentration of corporate law on this single relationship, there is evidence that the surplus Delaware law provides predominantly comes from the quality of its judicial system.[39] The third point is that since the advantages of the Delaware corporate law are comparatively more useful in large corporations with dispersed ownership, closed corporations with a lower level of ownership costs are less interested in Delaware corporate law because the saving in ownership costs are less important. A consequence of this statement is that closed corporations (and limited liability companies) are less prone to (re)incorporate in Delaware.[40] On the same logic, concentrated ownership through institutional investors, as a self-enforcing mechanism to reduce ownership costs, as in closed corporations, has been qualified as a cause for the declaration of death of (Delaware) corporate law.[41]

There are two elements of this market for corporate law that have to be further considered for comparative purposes: bankruptcy law and securities regulation. Both areas of law are of federal competence in the United States and both areas of law are important in terms of transaction costs. This means that Delaware law reduces ownership costs for corporations with dispersed

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and Peter Kindler, *The Spirit of Corporate Law. Core Principles of Corporate Law in Continental Europe* (Beck, 2013).

[39] See William Savitt, *The Genius of the Modern Chancery System* Columbia Business Law Review 570 (2012); Holger Fleischer, *Gerichtsspezialisierung im Gesellschaftsrecht*, in Siekmann (Hrsg.), *FS Baums*, 417 (Mohr Siebeck, 2017).

[40] See Jens Dammann and Matthias Schündeln, *The Incorporation Choice of Privately Held Corporations* 27 J. of Law, Econ., & Organization 79 (2011) and Jens Dammann and Matthias Schündeln, *Where Are Limited Liability Companies Formed? An Empirical Analysis* 55 Journal of Law and Economics 741 (2012).

[41] See Zohar Goshen and Sharon Hannes, *The Death of Corporate Law*, in ECGI Law WP, 402/2018.

ownership (and does not increase credit costs) and that the market for corporate charters is (presumably) efficient inside this context of federal bankruptcy law and securities regulation. We do not know the extent to which the market for corporate charters would be efficient, were the two areas of law not of federal competence. Even though legal scholars have argued for competition also in these two areas, as yet we do not know the final word on this issue.[42]

4. The case law of the European Court of Justice

The relevant cases dealing with freedom of establishment and mobility of companies in the European Community/Union have focused mainly on private limited liability companies or partnerships. The ECJ in the last twenty years has developed a liberal jurisprudence towards both free choice of law for first incorporations and a general principle of permissibility for reincorporations of existing companies with retention of legal personality.

Given the general rule of permissibility, the Court has applied the so-called *Gebhard*-test,[43] according to which a possible limitation to freedom of establishment and mobility of companies has to be: (i) nondiscriminatory, (ii) justified by imperative requirements in the general interest, (iii) must be suitable for securing the attainment of the objective, (iv) must not go beyond what is necessary in order to attain it. This test is applied in any case, in very restrictive terms to avoid possible limitations of the granted freedom of establishment/mobility.

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[42] David A. Skeel, *Rethinking the Line Between Corporate Law and Bankruptcy*, 72 Texas Law Review 471 (1994); Roberta Romano, *Empowering Investors: A Market Approach to Securities Regulation* 107 Yale Law Journal 2359 (1998).

[43] Case C-55/94, of 30 November 1995.

The first relevant case in the jurisprudence of the ECJ was *Daily Mail* decided on September 1988.[44] Daily Mail was an English public limited liability company incorporated in the United Kingdom that wanted to transfer its central administration and control to the Netherlands in order to save taxes. The essential point of the four questions asked to the ECJ was whether Articles 52 and 58 EEC Treaty permit a company to transfer the central administration and control to another Member State by maintaining the registered office in the Member State of incorporation without the prior consent of tax authorities. The Court referred *Daily Mail* to a case of primary establishment and argued that "unlike natural persons, companies are creatures of the law and, in the present state of Community law, creatures of national law. They exist only by virtue of the varying national legislation which determines their incorporation and functioning".[45] The Court first described the diversity in the connecting factors required by the different Member States for the creation and recognition of companies and the absence of European legislation on mobility and recognition of companies. It then argued that, to date under existing Community law, Articles 52 and 58 EECT Treaty could not be interpreted as conferring to companies a right to transfer their central administration to another Member State while maintaining their status as companies of the original Member State. *Daily Mail* had significant reverberations in the field of European company law and was mainly interpreted as a barrier to freedom of establishment and mobility of companies in the European Union.

The predominant influence of *Daily Mail*, as interpreted by the majority of legal scholars in terms of limitation to freedom of establishment, rendered

[44] Case C-81/87, of 27 September 1988. On *Daily Mail*, see e.g. Jeremy Lever, *Note* 26 Common Market Law Review 327 (1989).

[45] *Daily Mail*, point 19.

the *Centros* decision of March 1999 a "revolution" in the European Union.[46] Centros was a mail-box private limited company incorporated in England and Wales by two Danish citizens that wished to register a branch in Denmark. The Danish authorities argued that the branch would have carried on the business activity and that Centros was established in the United Kingdom solely in order to circumvent mainly Danish rules on minimum capital requirements. The preliminary question referred to the ECJ by the Danish authority explicitly referred to the possibility to choose another Member State in order to register a company to do business in another Member State by way of a branch. The ECJ decided the case by covering the branch under the specific characteristics of freedom of establishment under the Treaty. Furthermore, the Court denied any importance to approximation of company law as instrumental to freedom of establishment and more importantly applied the proportionality *Gebhard*-test to the possible reasons that could limit the freedom of choosing a different Member State for incorporating a company in order to do business in another one.[47] The eco of *Centros* has been extremely significant for European company law and has opened the door to the possibility to choose a company of a Member State following the incorporation theory in order to do business in another Member State. *Centros* did in fact open up the way to regulatory

[46] On *Centros* see e.g., Peter Behrens, *International Company Law in View of the Centros Decision of the ECJ* 1 European Business Organization Law Review 125 (2000); Wulf-Henning Roth, *Note* 37 Common Market Law Review 143 (2000).

[47] Indeed, "national measures liable to hinder or make less attractive the exercise of fundamental freedoms guaranteed by the Treaty must fulfil four conditions: they must be applied in a non-discriminatory manner; they must be justified by imperative requirements in the general interest; they must be suitable for securing the attainment of the objective which they pursue; and they must not go beyond what is necessary in order to attain it", point 34 of *Centros*.

competition and regulatory arbitrage in European company law and legal doctrine began to analyze this phenomenon, which in fact changed the paradigm for European company law.

The third case was *Überseering* of November 2002 and was the first referring to a real seat Member State receiving a company from an incorporation theory Member State.[48] Überseering was a Dutch private limited liability company that shifted its central administration and principal place of business to Germany. The German BGH asked the ECJ the extent to which the recognition of the legal capacity of Überseering had to be granted by German authorities. The ECJ decided that Überseering's legal capacity be recognized as a Dutch company by German authorities. The Court referred to the *Daily Mail* decision for arguing the difference between the two cases. While *Daily Mail* concerned a case of permissibility of transfer from the Member State of departure, i.e. the extent to which the United Kingdom allowed its own companies to transfer the seat abroad, *Überseering* concerned the permissibility of the Member State of arrival to recognize a company validly incorporated in another Member State. Germany is not allowed under the freedom of establishment granted by the Treaty to deny recognition to a company validly incorporated in another Member State.

The fourth case was *Inspire Art* of September 2003,[49] a private limited liability company incorporated in the register of England and Wales; the case

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[48] Case C-208/00, of 5 November 2002. On *Überseering*, see e.g. Stefano Lombardo, *Conflict of Law Rules in Company Law after* Überseering: *An Economic and Comparative Analysis of the Allocation of Policy Competence in the European Union* 4 European Business Organization Law Review 301 (2003); Eddy Wymeersch, *The Transfer of the company seat in European company law* 40 Common Market Law Review 661 (2003).

[49] Case C-167/01, of 30 September 2003. See e.g. Werner F. Ebke, *The European Conflict-of-Corporate-Laws Revolutions:* Überseering*,* Insipire Art *and Beyond* 16

referred to the regularity and compatibility of Dutch provisions for the registration of branches according to European provisions and in particular with the Eleventh Directive. The ECJ was asked to assess the compatibility of those provisions, including the temporary joint and several liability of directors with European rules on freedom of establishment, checking in particular their proportionality in order to protect internal economic activity. The Court maintained the exhaustive nature of the Eleventh directive provisions and argued for the non-compatibility of the Dutch provision, integrating them by applying the proportionality test to assess their validity with respect to the protection of internal economic activity.

The fifth case, *Sevic* of December 2005,[50] regarded a merger between Sevic, a German public limited company and a Luxemburg limited company. The German authorities had refused to recognize the merger, because according to German law a merger was possible only between legal entities established in Germany. The ECJ was asked to assess to what extent mergers between companies of different Member States are included in the freedom of establishment. The Court recognized that mergers between companies are an essential instrument for the creation of the single market and that freedom of establishment includes also the possibility of merger.

The sixth case was *Cartesio* of 16 December 2008.[51] Cartesio was a Hungarian limited partnership that wanted to transfer its seat to Italy while

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European Business Law Review 9 (2005); Daniel Zimmer, *Note*, 41 Common Market Law Review 1127 (2004).

[50] Case C-411/03, of 13 December 2005. See e.g. Peter Behrens, *Note* 43 Common Market Law Review 1669 (2006); Mathias M. Siems, SEVIC: *Beyond Cross Border Mergers* 8 European Business Organization Law Review 307 (2007).

[51] Case C-210/06, of 16 December 2008. See for example Stefano Lombardo, *Regulatory Competition in Company Law in the European Union after* Cartesio 10 European

maintaining Hungarian legal status. The ECJ was asked to assess whether freedom of establishment includes the obligation for Hungary to permit such a transfer. The Court, mainly on the basis of *Daily Mail,* recognized that the Treaty does is not regulate the connecting factor Member States use to register/form their companies and that Cartesio was not permitted to move its seat to Italy while retaining Hungarian legal status. Furthermore, in *Cartesio* the Court with an *obiter dictum* opened the door to reincorporation with change of applicable law (conversion) as a possibility included in freedom of establishment.

The seventh case, of July 2012 is *Vale*,[52] which was an Italian limited liability company that wanted to convert into a Hungarian company. The ECJ was asked to assess whether conversion, like merger in the SEVIC case, is included in the freedom of establishment. The Court again recognized conversion between companies of different Member States as an important instrument for the realization of the internal market. The provisions of the Member State of arrival regulating the cross-border conversion can be applied, but the principles of equivalence and of effectiveness have to be respected in order to avoid discrimination between national and cross-border conversions.

Business Organization Law Review 627 (2009); Marek Szydło, *Note*, 46 Common Market Law Review 703 (2009).

[52] Case C-378/10, of 12 July 2012. See for example Stephan Rammeloo, *Freedom of Establishment: Cross-Border Transfer of Company Seat – The Last Piece of the Puzzle* 19 Maastricht Journal of European and Comparative Law 563 (2012); Thomas Biermeyer, *Shaping the space of cross-border conversions in the EU. Between right and autonomy:* VALE Építési Kft 50 Common Market Law Review 571 (2013).

The last case is *Polbud,* a Polish limited liability company that wanted to convert into a Luxemburg company of the same type.[53] The Court was asked to assess the compatibility of the liquidation procedure under Polish law required to cancel the company from the Polish register in order to register the company in Luxemburg. *Polbud* concerns the compatibility of material company law rules that require the liquidation of the company necessary for cancellation from the national register in turn needed to acquire the new legal status in the Member State of arrival. The ECJ ruled that liquidation is not proportional and reasonable to protect internal interests and that freedom of establishment covers the cross-border transformation with maintenance of legal personality.

5. The European market for company law in the last 20 years

When considering a market it is useful to differentiate firstly between the demand and supply sides. With respect to (company) law it is possible to differentiate between: (i) a possible regulatory arbitrage (demand side), where parties to a contractual agreement are free to choose the applicable law (of the Member State) of their (company) contract and (ii) a possible regulatory competition (supply side), where jurisdictions (Member States) possibly compete to attract contracts/companies.[54] Secondly, in the particular market for corporate charters, another difference has typically been made, in order to properly differentiate the various problems involved. It is the one between (i)

[53] Case C-106/16, of 25 October 2017. See Marek Szydło, *Cross-border conversion of companies under freedom of establishment:* Polbud and beyond 55 Common Market Law Review 1549 (2018).

[54] For an extreme of this paradigm and for the deconstruction of the different regulatory regimes a company could be subject to, see Stefano Lombardo and Piero Pasotti, *Disintegrating the Regulation of the Business Corporation as a Nexus of Contracts: Regulatory Competition vs Unification of Law* 10 European Business Organization Law Review 35 (2009).

first incorporation of a company (i.e. the formation of a new company in a Member State) and (ii) reincorporation of an existing company from one Member State to another one with change of applicable law, maintenance of legal personality and avoidance of a winding up of the company entity.[55]

Section 4 has shown that the legal conditions for the demand side have been progressively realized over the last twenty years by ECJ case law and are now open/ready to realize regulatory arbitrage, both in terms of first incorporations and re-incorporations. Essentially, the case law of the ECJ has extended also to company law an important principle typical of contract law, i.e. the one of freedom of choice of law.[56] The only limitation is the *Gebhard*-test, which is applied in very restrictive terms to avoid possible limitations to the granted freedom of establishment/mobility. Freedom of choice of law has been evaluated, from a law and economics perspective, as generally efficient in terms of giving contractual parties the possibility to gain from the choice of different substantive laws.[57]

This Section examines the equilibrium of the European market for corporate charters that has developed in the last twenty years. It takes into consideration the demand side in terms of first incorporation (i.e. formation of

[55] See e.g. Lombardo, (2), 145, 170; Schön, (3), 134, 137.

[56] See *Centros*, point 27. The dimension of the free choice of the most important contractual parties of the nexus, i.e. the shareholders who form the company has *de facto* equalized the company to those other types of contracts for whom freedom of choice of law was already granted. Abuse of law has been considered as absent in this free choice. On the point see Wolf-Georg Ringe, *Sparking Regulatory Competition in European Company Law: The Impact of the* Centros *Line of Case Law and its Concept of 'Abuse of Law'*, in de la Feira and Vogenauer (eds.*), Prohibition of Abuse of Law: A New Principle of EU Law*?, 107 (Hart Publishing, 2011).

[57] Francesco Parisi and Larry E. Ribstein, *Choice of Law*, in Newman (ed.), *The New Palgrave Dictionary of Economics and the Law*, 236 (Stockton Press, 1998).

a new company) and of reincorporation (i.e. change of applicable law of an existing company with retention of the legal personality), and the supply side.

5.1. The demand side

The demand side of the European market for corporate charters has mainly concerned in the last twenty years, first incorporations of private limited companies (or of closed corporations).[58] To analyze the possible efficiency gains of the European market for corporate charters, it is possible to scrutinize this result using the ownership costs vs contracting costs paradigm presented in Section 3.[59]

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[58] There are several empirical studies on the topic of first incorporation and reincorporation of existing companies. See e.g. Marco Becht, Colin Mayer and Hannes F. Wagner, *Where do firms incorporate? Deregulation and the cost of entry* 14 Journal of Corporate Finance 241 (2008); William W. Bratton, Joseph A. McCahrey and Erik P.M. Vermuelen, *How Does Corporate Mobility Affect Lawmaking?* 57 American Journal of Comparative Law 347 (2009); Reiner Braun, Horst Eidenmüller, Andreas Engert and Lars Hornuf, *Does Charter Competition Foster Entrepreneurship? A Difference-in-Difference Approach to European Company Law Reforms* 51 Journal of Common Market Studies 399 (2013); Wolf-Georg Ringe, *Corporate Mobility in the European Union – a Flash in the Pan? An empirical study on the success of lawmaking and regulatory competition* 10 European Company and Financial Law Review 230 (2013); Carsten Gerner-Beuerle, Federico M. Mucciarelli, Edmund Schuster and Mathias Siems, *Why do business incorporate in other Member States? An empirical analysis of the role of conflict of law rules* 56 International Review of Law and Economics 14 (2018).

[59] I do not take into consideration the operative costs of a first incorporation and a reincorporation in a Member State different from the hosting one. On this issue, see Marco Becht, Luca Enriques and Veronica Korom, Centros *and the Cost of Branching*, 9 Journal of Corporate Studies 171 (2009). Furthermore, I do not consider the costs of incorporation as analyzed by Ventoruzzo, (fn. 3).

(a) Ownership costs

It is a peculiar characteristic of private limited companies that their ownership costs are low in comparison to companies with dispersed ownership, being their ownership structure also usually extremely simple in terms of limited number of involved shareholders. From this perspective, we can also argue that private limited companies generally are companies where the level of trust/knowledge is comparatively higher and transaction costs relatively lower than listed companies with dispersed ownership.[60]

In exploiting the possibility of regulatory arbitrage, it can be presumed, as the *Centros* case law implicitly assumes and following the general principle of freedom of choice in contract law, that shareholders, having to decide where to incorporate a new company or to re-incorporate an existing company, can legitimately consider the company law of Member State A better (i.e. reducing ownership costs) than the company law of (their) hosting Member State B. This assumption can be argued both with reference to first incorporations and to re-incorporations with a change of applicable law and retention of legal personality.

This leads to the simple result that the company law of A is efficient in comparison to the company law of B, as regards solely ownership costs. By summing the (presumed) reduction in the ownership costs in the thousands of first incorporations (and some re-incorporations) carried out to exploit regulatory arbitrage of private limited companies that the EU has experienced

[60] For the typical agency problems of a close corporation like the private limited liability company, see Peter Agstner, *Shareholder conflicts in close corporations: Between theory and practice. Evidence from Italian private limited liability companies* forthcoming European Business Organization Law Review.

in these twenty years,[61] it can be presumably assumed that the European Union has gained in efficiency terms. This simply assumption is based on the elementary argument that the micro structure of the demand side of the ownership costs of (re)-incorporations has signaled this natural development.

A counter argument, rejecting this conclusion, should place the burden of proof of demonstrating, when choosing an alternative company law for (re)incorporations, shareholders of private limited companies would *intentionally* increase their ownership costs, so reducing the efficiency of their contractual agreement. Such an argument is of course difficult to sustain and would bring to the paternalistic policy conclusion that the hosting Member State B should impede the free choice of law of shareholders for Member State A.

Given this picture, we can reach a first, major comparative conclusion for differences in the structure of ownership costs between the US and the EU. In the US market for corporate charters, the predominance of Delaware is particularly relevant for hundreds of listed companies with dispersed ownership,[62] where the ownerships costs are much higher in comparison to private companies, and the Delaware predominance signals a (presumed) efficiency gain (because of the reduction of those ownership costs).[63] In Europe

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[61] According to Gerner-Beuerle et al, (fn. 58), 18 about 420.000 companies are incorporated in other Member States.

[62] According to Romano, *Law as a Product* (fn. 25), 244, 417 out of 515 companies reincorporated to Delaware.

[63] An example helps to understand the argument. Imagine that, for instance, the 1,000 corporations incorporated in Delaware have a single average ownership cost saving of $1,000: 1,000 corporations times $1,000 makes a total saving of $1,000,000, with the results that the product “Delaware corporate law” grants ownership cost savings for $1,000,000 to the US system.

on the contrary, it is the sum of thousands of cases of presumed savings in ownership costs of incorporations of new private limited companies (and some reincorporations) that characterizes the market for corporate charters.[64]

(b) Contracting costs

The costs of contracting include in particular the costs of contracts between the company and its creditors (or between the shareholders and the creditors taking the agency costs between shareholders and creditors)[65] and the costs of contracts between the company and its employees (or between the shareholders/creditors and the employees).[66] With respect to the second kind of costs, I will not treat the problem here because of the highly controversial nature of workers' codetermination.[67]

With respect to regulatory competition in company law and creditors, legal scholars have also typically distinguished between first incorporation and reincorporation with change of applicable law,[68] and have analyzed the pros

[64] In this case, for instance, the 20,000 private limited companies incorporated in a different Member State from the hosting one grants a single average ownership saving of €50: 20,000 companies times €50 makes a European savings in ownerships costs of € 1,000,000.

[65] Kraakman et al., (fn. 32), 115.

[66] Kraakman et al., (fn. 32), 100.

[67] See Martin Gelter, *Tilting the Balance Between Capital and Labor? The Effect of Regulatory Arbitrage in European Corporate Law on Employees* 33 Fordham International Law Journal 792 (2010). Apparently there are empirical data suggesting that where possible, German shareholders tend to escape the German codetermination system, see Sebastian Sick, 2015, *Der deutschen Mitebestimmung entzogen: Unternehmen mit ausländischer Rechstform nehmen zu. Umgehung der Mitbestimmung im Aufsichtsrat durch die Nutzung von ausländischen Rechtsformen*, Report, No. 8, (Hans-Böckler Stiftung, 2015).

[68] As stressed by Mucciarelli, (fn. 3), *passim*.

and cons of the market for corporate charters also by distinguishing between so-called adjusting creditors, i.e. those sophisticated creditors able to adjust the contractual conditions to a first incorporation or a reincorporation, and non-adjusting creditors.[69,70]

With regards to creditors, current ECJ case law is such that an efficient result is presumed in the case of both first incorporation and reincorporation. Adopting the paradigm of analysis used in this article, taking into account also contracting costs, implies adding to the presumed average decrease of the ownership costs, either (i) the possible invariance of the costs of credit (i.e. the costs of credit do not change in case of (re)incorporation in a Member State different from the one where business is carried out) or (ii) their possible increase (i.e. the costs of credit do increase).[71] Depending on the results of this exercise, the total possible benefits or costs for the complex of (re)incorporations in the European internal market should emerge.[72]

However, a complication in this exercise emerges because the regulatory arbitrage for saving in ownership costs has determined an apparent relaxation of legal capital rules for private limited companies in several Member States.[73] The extent to which this development has decreased or increased *per se* the costs of credit is nevertheless difficult to assess. The effects of regulatory

[69] See e.g. Armour (fn 3), 47.

[70] For an analysis of regulatory competition and creditors, see e.g. Ventoruzzo, (fn. 3), 107; Mucciarelli, (fn. 3), 454.

[71] I exclude the possibility of a decrease in the costs of contracting for credit.

[72] I stress that I am considering the issue from the perspective of theory without attempting here to provide an answer to the question.

[73] See the comparative experiences of some Member States as provided in the contributions in A. Jorge Viera González and Christoph Teichemann, *Private Company Law reform in Europe: The Race for Flexibility* (Thomson Reuters, 2015). See also Armour et al., (fn. 58), Table 1.

arbitrage on developments in the minimum legal capital rules of some Member States for private limited companies leads us to another more general consideration with respect to the relation between company law and insolvency law in terms of creditors' protection.[74] While EU Regulation 2015/848 on insolvency proceedings regulates cross-border insolvencies in a procedural way,[75] the possible tension between freedom of establishment and resulting applicable company law and insolvency law has been treated by the ECJ in the *Kornhass* case of December 2015.[76] The Court decided that the substantive insolvency law (rules on directors' liability) of the hosting Member State B (Germany) can be applied to a company incorporated in another Member State A (UK).[77] More in particular, as regards the possible tension arising between company law and insolvency law in the area of creditor protection, the ECJ judged that in the pathological phase of the business the insolvency law of the hosting Member State B should prevail, while in the physiological phase of the business (and the formation of the company) it should be the company law rules of the home Member State A freely chosen by shareholders and

[74] See Carsten Gerner-Beuerle and Edmund Schuster, *The Costs of Separation: Friction Between Company and Insolvency Law in the Single Market* 14 Journal of Corporate Law Studies 287 (2014).

[75] See Federico M. Mucciarelli, *Private International Law Rules in the Insolvency Regulation Recast: A reform or a Restatement of the* Status Quo? 13 European Company and Financial Law Review 1 (2016).

[76] See Gills Lindemans, *The Walls Have Fallen, Run for the Keep: Insolvency Law as the New Company Law for Third Parties* 24 European Review of Private Law 877 (2016); Marek Szydło, *Directors' duties and liability in insolvency and the freedom of establishment of companies after* Kornhaas 54 Common Market Law Review 1853 (2017).

[77] The extent to which the liability rule belongs to corporate law or insolvency law is discussed by Wolf-Georg Ringe, Kornhaas *and the Challenge of Applying* Keck *in Establishment* 42 European Law Review 270 (2017) who also criticizes the decision.

contractual creditors. The Court does not clarify all the possible consequences of integrating the company law of home Member State A with the insolvency law of hosting Member State B in terms of the substantive rules concerned, but simply assumes this possible integration as the basis for fruitful future collaboration.[78]

Here it is not possible to assess these consequences particularly in terms of the possible effects such a decision may have for the European market for corporate charters. The central question of *Kornhass* from the perspective of the demand side is whether the *ex ante* incentives of shareholders to choose a particular company law for the physiological phase of the business are modified by a possible *ex post* application of the insolvency rules for the pathological phase of the business to protect creditors of the hosting member State.[79]

5.2. The supply side

The supply side of the European market for corporate charters relates to the possible reaction of Member States to the regulatory arbitrage opened up by the case law of the ECJ, or in other words the extent to which regulatory arbitrage from the demand side generates a response from Member States, which having lost companies, decide to win back market position. While the public limited company has traditionally been harmonized more deeply,[80] the private limited company has proved to be more resistant to harmonization efforts probably both for political and practical reasons. Legal scholarship was

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[78] For a possible extension of *Kornhass* also to shareholders' liability, see Aleksandra Krawczyk-Giehsmann, *Shareholders' Liability for Ruining a Company in Light of the CCEU's Judgment in* Kornhaas forthcoming European Business Organization Law Review.

[79] On the point see also Lindemans (fn. 76), 888.

[80] Despite being argued in a trivial way by Enriques, *EC Company Law Directives*, (fn. 8).

initially uncertain about how Member States would react to the threat of regulatory arbitrage. After twenty years, it is possible to say that regulatory competition by Member States has been solely defensive as Member States do not appear to be actively competing in making their countries more attractive for companies.[81] The private limited company has been reformed in several Member States in response to regulatory arbitrage on the demand side by relaxing minimum capital requirements for private limited companies.[82] This development, though the object of conflicting evaluations, has characterized the market for corporate charters.[83] On the other hand, the European Union has created the European Company and the European Cooperative Company, which have proved to be in some way complementary to national companies and have increased the number of entities destined to business activity.[84]

6. Conclusions

This article has provided an overview of the issue of freedom of establishment and the main developments of the European market for corporate charters, following the jurisprudence of the ECJ in the field of

[81] Andrea Zorzi, *A European Nevada? Bad Enforcement as an Edge in State Competition for Incorporations* 18 European Business Organization Law Review 251 (2017).

[82] For the evolution of minimum capital requirements, see Armour et al., (fn. 58), Table 1.

[83] On the debate on legal capital, see Massimo Miola, *Legal Capital and Limited Liability Companies: The European Perspective* 2 European Company and Financial Law Review 413 (2006).

[84] For the new forms (in force and the possible new ones) see Holger Fleischer, *Supranational Corporate Forms in the European Union: Prolegomena to a Theory on Supranational Forms of Associations* 47 Common Market Law Review 1617 (2010); Riccardo Ghetti, 2018, *Unification, Harmonisation and Competition in European Company Forms* 29 European Business Law Review 813 (2018).

freedom of establishment and mobility of companies. Both for first incorporation and reincorporations of existing companies, the case law of the ECJ has proved to be essential in giving the demand side the possibility to freely choose the applicable law. The demand side has indeed reacted positively to the opportunities on offer, which has concerned mainly private limited companies. From the supply side perspective, Member States have responded to the new challenges, particularly with respect to the relaxation of minimal capital requirements of private limited liability companies. The *Kornhaas* case of 2015 has however complicated the picture of the European market for corporate charters with a paradoxical result. Indeed, twenty years after *Centros*, the real seat theory, which claimed the need for a single regulatory regime for ownership and contracting costs based in the hosting Member State, appears outdated. Nonetheless, the real seat theory has gained new momentum for the protection of creditors by switching from company law to insolvency law as the source of solutions to possible problems. Only the future will tell whether a frictionless coordination between company law and insolvency law is possible as implicitly assumed by the Court and whether this new regime will modify the incentives for a free choice of company law in a systematic way.

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