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Conflict of Law Rules in Company Law after *Überseering*: An Economic and Comparative Analysis of the Allocation of Policy Competence in the European Union

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Abstract

Starting from the latest decision of the European Court of Justice on the freedom of establishment for companies that are active in the European single market, this article develops an economic and comparative framework to answer the question which level (federal or national) should have competence to decide conflict of law rules for companies operating in the entire single market.

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1. Introduction

A recent article emphasised the past and recent tendency of the European Union to assert its power on conflict of law issues.[1] Historically, this power has resulted from the active devolution of this kind of competence from the Member States to the European Union or judicial intervention by the European Court of Justice, which regards conflict of law issues as essential to the realisation of the single market. This is not without reason. Conflict of law rules can form significant barriers to the entry and exit of parties active in the single market.

This article examines the economic criteria that should underlie the efficient allocation of policy competence for conflict of law rules for companies between the European Union (the 'federal' level) and the Member States (the national level).[2] Since conflict of law rules are regarded as a complementary or alternative means to harmonise/unify substantive law in order to achieve economic integration in a single market, the efficient allocation of the competence to make such rules is of extreme relevance. In the field of company law, a comparison of the situations in the European Union and the United States leads to puzzlement. In Europe, legal scholars have engaged in abstract, doctrinal debates on the freedom of establishment, the mutual recognition of companies and the harmonisation of company law as a means to achieve an integrated single market for more than forty years. In the United States, in contrast, the single market relies on a simple system based on freedom of incorporation and the mutual recognition of companies by states without the *ex ante* active harmonisation of company law.[3] This system boasts a GDP of approximately US$9 trillion per year, reaching a level of capitalist development and economic integration that Europeans can only dream about.[4]

More specifically, this article seeks to examine the issue of conflict of law rules for companies in the European Union from an economic perspective by

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[1] Basedow, 'The Communitarization of the Conflict of Laws under the Treaty of Amsterdam', 37 *CMLRev.* (2000) p. 687.

[2] The article is partly based on Lombardo, *Regulatory Competition in Company Law in the European Community. Prerequisites and Limits* (Frankfurt am Main 2002). The terms company (law) and corporation (law) are used as perfect synonyms. This article takes Germany as the European jurisdiction of major reference.

[3] On a comparative policy dimension, see Easterbrook, 'Federalism and European Business Law', 14 *Int. Rev. L. & Econ.* (1994) p. 125.

[4] In 1999, the GDP of the United States amounted to US$9,152,098 million. In the same year, the European Union had a GDP of US$8,390,233 million. World Bank, *World Development Indicators* (Washington DC, World Bank 2001) p. 198. Considering that the population of the United States is about 280 million and that of the European Union about 380 million, the GDP per capita in 1999 was about US$32,000 for the United States and US$22,000 in the European Union.

bringing the traditional European doctrinal debate into the economic paradigm.[5] In doing so, it follows the most recent contributions to the economic analysis of conflict of law rules by taking the company back to its original 'contractual dimension'.[6] This approach is suspicious of the role of general interests and concerns of state-sovereignty in conflict of law issues relating to contractual matters.[7] My impression is that legal scholars in Europe have placed too much emphasis on the importance of state sovereignty in matters relating to companies, thereby losing sight of the core of the problem. My claim is that this emphasis has complicated rather than clarified the framework of analysis.

The article is structured as follows. Section 2 provides an overview of the latest decision of the ECJ on conflict of law issues relating to companies in Europe. Section 3 presents a comparative analysis of the situation in the European Union and the United States. Section 4 provides an economic perspective on what is at stake in the debate on companies and conflict of law rules for companies. Section 5 provides a picture of the effects of the (non-) recognition of foreign companies and identifies the appropriate conflict of law rule. On the basis of the preceding analysis, Section 6 tries to provide a normative answer to the question whether the federal level or the national level should have policy competence for conflict of law rules for companies. Section 7 contains the article's final conclusions.

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[5] The economics of conflict of law rules is a relatively new development in law and economics. For an initial attempt to approach European conflict of law issues from this perspective, see Mankowski, 'Europäisches Internationales Privat- und Prozessrecht im Lichte der Ökonomischen Analyse', in Ott and Schäfer, eds., *Vereinheitlichung und Diversität des Zivilrechts in transnationalen Wirtschafträumen* (Tübingen 2002) p. 118.

[6] It is well known that the EC Convention on the Law Applicable to Contractual Obligations signed in Rome in June 1980 (Rome Convention) does not apply to company contracts as set forth in Article 1(2)(e). The Convention appears to consider a company as something intrinsically different from a normal contractual relationship. Zimmer, 'Private International Law of Business Organisations', 1 *EBOR* (2000) p. 585 at p. 588, clearly makes the point by stating that '[c]orporate law is fundamentally different from contract law for which the freedom of the choice of law is, at least in principle, undisputed'. To be sure, the perspective that a company is something different from a normal contract is not necessarily followed by common law jurisdictions that traditionally follow incorporation theory and grant shareholders free choice of law.

[7] See Parisi and Ribstein, 'Choice of Law', in Newman, ed., *The New Palgrave Dictionary of Economics and the Law* (New York 1999) p. 236; Guzman, 'Choice of Law: New Foundations', 90 *Georgetown LJ* (2002) p. 883.

2. The *Überseering* decision

The *Überseering* case[8] has clearly clarified the incompatibility of real seat theory as a conflict of law rule with the provisions on freedom of establishment as laid down in Articles 43 and 48 of the EC Treaty (EC). The case can be regarded as a natural development of and a complement to *Centros*.[9] In addition, it addresses two issues not covered in *Centros*, namely, the meaning of

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[8] ECJ, Case C-208/00 *Überseering* [2002] *ECR* nyr. For the English version of the decision and the conclusions of Advocate General Colomer, see <http://www.europa.eu.int/eur-lex>. Among the many articles in German on *Überseering*, see Behrens, 'Das Internationale Gesellschaftsrecht nach dem Überseering-Urteil des EuGH und den Sclussanträgen zu Inspire Art', 23 *IPRax* (2003) p. 193; Roth, 'Internationales Gesellschaftsrecht nach *Überseering*', 23 *IPRax* (2003) p. 117; von Halen, 'Das Internationale Gesellschaftsrecht im Gesellschafts-kollisionsrecht', 57 *WM* (2003) p. 571; Paefgen, 'Gezeitenwechsel im Gesellschaftskollisions-recht', 57 *WM* (2003) p. 661; Heidenhain, 'Ausländische Kapitalgesellschaften mit Verwaltungs-sitz in Deutschland', *NZG* (2002) p. 1141; Eidenmüller, 'Wettbewerb der Gesellschaftsrechte in Europa', 23 *ZIP* (2002) p. 2233; Wernicke, 'Anmerkung', 13 *EuZW* (2002) p. 758; Leible and Hoffmann, '"Überseering" und das (vermeintliche) Ende der Sitztheorie', 48 *RIW* (2002) p. 925; Schulz and Sester, 'Höchstrichterliche Harmonisierung der Kollisionsregeln im europäischen Gesellschaftsrecht: Durchbruch der Gründungstheorie nach "Überseering"', 13 *EWS* (2002) p. 545; Forsthoff, 'EuGH fördert Vielfalt im Gesellschaftsrecht', 55 *DB* (2002) p. 2471; Kallmeyer, 'Tragweite des Überseering-Urteils des EuGH vom 5.11.2002 zur grenzüberschreitenden Sitz-verlegung', 55 *DB* (2002) p. 2521; Ebke, 'Die Würfel sind gefallen: Die Sanktionen der Sitztheorie sind europarechtswidrig', 58 *BB* (2003) p. I; Zimmer, 'Wie es Euch gefällt? Offene Fragen nach dem Überseering-Urteil des EuGH', 58 *BB* (2003) p. 1; Lutter, '"Überseering" und die Folgen', 58 *BB* (2003) p. 7; Schanze and Jüttner, 'Anerkennung und Kontrolle ausländischer Gesellschaften – Rechtslage und Perspektiven nach der Überseering-Entscheidung des EuGH', 48 *AG* (2003) p. 30.

[9] ECJ, Case C-212/97 *Centros* [1999] *ECR* I-1459. The statement is true to the extent that *Centros* is interpreted – as has largely been the case – as a restriction of the application of real seat theory. In German, see Ebke, 'Das Schicksal der Sitztheorie nach dem Centros-Urteil des EuGH', 54 *JZ* (1999) p. 656; Ulmer, 'Schutzinstrumente gegen die Gefahren aus der Geschäftstätigkeit inländischer Zweigniederlassungen von Kapitalgesellschaften mit fiktiven Auslandsitz', 54 *JZ* (1999) p. 662; Behrens, 'Das Internationale Gesellschaftsrecht nach dem Centros-Urteil des EuGH', 19 *IPRax* (1999) p. 323; Roth, 'Gründungstheorie: Ist der Damm gebrochen?', 20 *ZIP* (1999) p. 861; Kindler, 'Niederlassungsfreiheit für Scheinauslandsgesellschaften? Die 'Centros'-Entscheidung des EuGH und das internationale Privatrecht', 52 *NJW* (1999) p. 1993; Kieninger, 'Niederlassungsfreiheit als Rechtswahlfreiheit', 28 *ZGR* (1999) p. 724; Werlauf, 'Ausländische Gesellschaft für inländische Aktivität', 20 *ZIP* (1999) p. 867; Sandrock, 'Centros: ein Etappensieg für die Überlagerungstheorie', 54 *BB* (1999) p. 1337; Zimmer, 'Mysterium "Centros". Von der schwierigen Suche nach der Bedeutung eines Urteils des Europäischen Gerichtshofes', 164 *ZHR* (2000) p. 23. In English, see Wymeersch, 'Centros: A Landmark decision in European Company Law', in Baums, Hopt and Horn, eds., *Corporations, Capital Markets and Business in the Law. Liber Amicorum Richard M. Buxbaum* (London 2000) p. 629; Behrens, 'Centros and the Proper Law of Companies', in Ferrarini, Hopt and Wymeersch, eds., *Capital Markets in the Age of the Euro* (The Hague 2002) p. 503; Wouters, 'Private International Law and Companies' Freedom of Establishment', 2 *EBOR* (2001) p. 101.

Daily Mail[10] and the meaning of Articles 293 and 44(2)(g) EC. The result is a robust and coherent legal argument in favour of the predominance of EC provisions on freedom of establishment and a strict limitation of the scope of application of real seat theory as a conflict of law rule in the European single market.

In brief, *Überseering* involved a Dutch limited liability company, validly incorporated in 1990 in the company registers of Amsterdam and Haarlem as a *besloten vennootschap met beperkte aansprakelijkheid (BV).* In 1995, two German nationals bought all of Überseering's shares and, according to the German courts, moved the company's centre of administration to Düsseldorf. In 1996, Überseering filed suit against Nordic Construction Company Baumanagement GmbH (NCC) concerning the non-fulfilment of a contract signed in 1992. The *Landgericht* dismissed the action, and the *Oberlandesgericht* upheld the decision of the *Landgericht*.[11] This was because neither court recognised Überseering's legal capacity or, consequently, its capacity to be a party to legal proceedings. They argued that since its centre of administration had been moved to Düsseldorf, the company had ceased to possess legal capacity under Dutch law, because the application of real seat theory imposed a change of applicable law on the company in favour of German law (*Statutenwechsel*).[12] Überseering appealed to the *Bundesgerichtshof* (Germany's Federal Supreme Court), which referred two questions to the European Court of Justice for a preliminary ruling on Article 234 EC.[13]

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[10] ECJ, Case C-81/87 *Daily Mail* [1988] ECR 5483. In German, see Behrens, 'Die Grenzüberschreitende Sitzverlegung von Gesellschaften in der EWG', 9 *IPRax* (1989) p. 354; Knobbe-Keuk, 'Umzug von Gesellschaften in Europa', 154 *ZHR* (1990) p. 325. In English, see Cerioni, 'The Barriers to the International Mobility of Companies within the European Community: A Rereading of the Case Law', *JBL* (1999) p. 59.

[11] The decision of the *Oberlandesgericht* appears in 55 *JZ* (2002) p. 203, with a comment by Ebke ('*Anmerkung*').

[12] Since § 50(1) of the *Zivilprozessordung* (German Code of Civil Procedure) requires legal capacity as a precondition to be a party to legal proceedings, the company could not have brought an action before a German court.

[13] The first question is basically whether Articles 43 and 48 EC preclude jurisdiction B from denying a company that is lawfully incorporated in jurisdiction A the recognition of its legal capacity and capacity to be a party in legal proceedings in jurisdiction B if it has moved its centre of administration there. The second question is whether Articles 43 and 48 EC explicitly provide that the recognition of legal capacity and capacity to be a party to legal proceedings has to be determined according to the law of the Member State where the company is incorporated. The decision by which the *Bundesgerichtshof* (BGH) referred the two questions to the ECJ is reported in 21 *ZIP* (2000) p. 967. For comments, see Walden, 'Niederlassungsfreiheit, Sitztheorie und der Vorlagebeschluss des VII Zivilsenates des BGH vom 30.3.2000', 12 *EWS* (2001) p. 256; Roth, 'Die Sitzverlegung vor dem EuGH', 21 *ZIP* (2000) p. 1597. The conclusions of Advocate General Colomer were presented on 4 December 2001. For comments, see Eidenmüller, 'Anmerkung', 23 *ZIP* (2002) p. 82; von Halen, 'Der Streit um die Sitztheorie vor der Entscheidung?', 13 *EWS* (2002) p. 107; Forsthoff, 'Abschied von der Sitztheorie', 57 *BB* (2002) p. 318.

The Court began its analysis by arguing that *Überseering* was a case in which the treaty provisions on freedom of establishment applied to national law para. 52). In this connection, the Court referred to national conflict of law rules as well as to national substantive company law. Paragraphs 53 to 60 contain a relativisation of the scope of the application of Articles 293 and 44(2)(g) EC. These articles should no longer be regarded as imperative provisions whose missed implementation causes a limitation of the freedoms granted, but should be understood, more modestly, as an incentive to Member States to act 'so far as is necessary'.[14]

The Court then referred to *Daily Mail*, interpreting it in favour of freedom of establishment (see paras. 61 to 72).[15] The Court noted that *Daily Mail* involved a company that was lawfully incorporated in one Member State and wanted to move its centre of administration to another without fully respecting the tax provisions of the Member State of incorporation. For this reason, *Daily Mail* should not be regarded as a case concerning freedom of establishment and recognition between *two* Member States but, more modestly, as a case concerning the compatibility of internal regulations with Articles 43 and 48 EC in relation to the transfer of the centre of administration out of a Member State.[16]

On the basis of a discussion of the relevant articles and past case law, the Court then examined whether the refusal by the German authorities to recognise the legal capacity and capacity to be a party to legal proceedings of a company that was validly incorporated under the law of another Member State violated treaty provisions on freedom of establishment. In paragraphs 79 to 82, the Court observed that this refusal was incompatible with Articles 43 and 48 EC. Paragraphs 83 to 93 analyse whether the restriction of freedom of establishment caused by the refusal to recognise legal capacity and capacity to be a party to

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[14] In other words, they are only an auxiliary means to exercise freedom of establishment and not an essential one. In Europe, companies have enjoyed freedom of establishment since the end of the transitional period on 31 December 1969 (see paras. 55 and 60 of the decision).

[15] Since *Centros* did not involve a discussion of *Daily Mail*, the interpretative relationship between the two decisions has been controversial. In this connection, a particularly relevant question is whether *Daily Mail* concerned a case of primary establishment and *Centros* a case of secondary establishment. On this point, see e.g. Ebke, loc. cit. n. 9, at p. 658, identifying in *Daily Mail* a case of primary establishment and in *Centros* a case of secondary establishment, thereby justifying the omission of the Court of the discussion of *Daily Mail* in *Centros*. Likewise, Zimmer, loc. cit. n. 9, at p. 37, considers *Daily Mail* a case of primary and *Centros* a case of secondary establishment. In contrast, Kieninger, loc. cit. n. 9, at pp. 729-730, appears to consider *Centros* a case of primary establishment. At any rate, the conformity and practicability of a possible distinction between primary and secondary establishment after *Centros* is questioned and doubted by Behrens, loc. cit. n. 9, at p. 327.

[16] See paras. 66 and 70 of the Court's decision.

legal proceedings was justified for the protection of the general interest.[17] This general interest is defined in terms of the protection of creditors, minority shareholders (also in a group of companies), internal taxation issues and employee participation in company decision making through the codetermination system. In this specific case, the Court determined that these interests, which real seat theory is meant to protect, did not include the limitation of the provisions of Articles 43 and 48 EC. In response to the first question of the *Bundesgerichtshof*, the Court noted that Articles 43 and 48 EC provide that legal capacity and capacity to be a party to legal proceedings must be respected by a Member State when a company validly incorporated in another Member State moves its centre of administration there. The Court also answered the second question (of the *Bundesgerichtshof*) in the affirmative, based on the same line of reasoning.[18]

On the basis of this decision, the *Bundesgerichtshof* has finally recognised Überseering's legal capacity and legal personality. In other words, it has recognised the company in accordance with the terms of its original Dutch company statute (*Gesellschaftsstatut*).[19] In doing so, the *Bundesgerichtshof* has also declined to pursue its recent attempt to rescue real seat theory by

[17] As applied in the decision in *Centros* on the basis of the decisions in *Kraus* (ECJ, Case C-19/92 [1993] *ECR* I-1663) and *Gebhard* (ECJ, Case C-55/94 [1995] *ECR* I-4165). The national provisions used in order to protect these interests shall respect the four conditions of non-discrimination, justification on the basis of imperative reasons, suitability and proportionality.

[18] It is interesting to note that the Court did not follow the opinion of Advocate General Colomer and that it resolved the problem on the basis of the reasons used to answer the first question. On 30 January 2003, Advocate General Alber presented his conclusions in a case dealing with the compatibility of the Dutch provisions that are applied when foreign incorporated companies wish to register an agency, branch or subsidiary in the Netherlands. ECJ, Case C-167/01, *Kamer van Koophandel en Fabrieken voor Amsterdam* v. *Inspire Art Ltd.* (hereinafter, *Inspire Art*). These conclusions confirm the liberal jurisprudence of *Centros* and *Überseering*, limiting the possibilities for the host jurisdiction to apply its regulations. The host jurisdiction has to respect the original statute of the company in relation to the liability of managers and the company's legal and capital rules. The conclusions are available at: <http://www.europa.eu.int/eur-lex>.

[19] BGH, *Urteil v.* 13.3.2003, VII *ZR* 370/98, available at: <http://www.bundesgerichtshof.de>. In the meantime, there have been some mixed reactions from lower courts in Germany. On 6 December 2002, the *Landgericht* of Frankental refused to register a branch of a British limited liability company. See 58 *BB* (2003) p. 542, with a comment by Leible and Hofmann, 'BB-Kommentar'. Behrens, loc. cit. n. 8, at p. 128, reports how the *Oberlandesgericht* of Celle accepted the registration of a branch of a British limited liability company on 19 December 2002, and the *Oberstes Landgericht* of Bayern has also recognised the legal capacity of a British limited liability company. Both events occurred irrespective of the fact that the headquarters of the companies were located in Germany. On 29 January 2003, the BGH also recognised the legal capacity and capacity to be a party to legal proceedings of a company incorporated in Florida, on the basis of the 1954 Friendship, Commerce and Navigation Treaty between Germany and the United States. The BGH explicitly referred to the ECJ's decision in *Überseering* (BGH, *Urteil v.* 29.1.2003, VII *ZR* 155/02, available at: <http://www.bundesgerichtshof.de>).

recharacterising foreign companies (*Requalifikation*) as German partnerships (*Personengesellschaften*).[20]

3. Conflict of law rules for companies in the European Union and the United States

The European Union and the United States are both confronted by issues relating to freedom of incorporation, freedom of establishment and the mutual recognition of companies by the jurisdictions that make up the federal system.[21]

[20] BGH, *Urteil v.* 1.7.2002, II *ZR* 380/00. To be sure, the two cases were decided by two different chambers. To the extent that the two decisions are incompatible, a final decision may be necessary. The 'recharacterisation' decision appears in 57 *BB* (2002) p. 2031, with a comment by Gronstedt, 'BB-Kommentar', at p. 2033. On this decision, see also Leible and Hofmann, 'Vom "Nullum" zur Personengesellschaft – Die Metamorphose der Scheinauslandsgesellschaft im deutschen Recht', 55 *DB* (2002) p. 2203. In the case in question, a company (the plaintiff) that was incorporated in 1966 in accordance with the laws of the island of Jersey transferred its centre of administration to Germany and, according to the defendant, lost its *Parteifähigkeit* in doing so. The BGH decided this case after Advocate General Colomer presented his conclusions on *Überseering*. The BGH recognised the active and passive *Parteifähigkeit* of the foreign company but recharacterised it as a German *Personengesellschaft* (a partnership). The company forms that are available for such recharacterisation in Germany are the *Gesellschaft bürgerlichen Rechts* (GbR) and the *Offene Handelsgesellschaft* (OHG). The BGH recognised the *Parteifähigkeitt* and the *Rechtsfähigkeit* of the *GbR* in an important decision of 29.1.2001, II *ZR* 331/00 (printed in 22 *ZIP* (2001) p. 330. For a comment, see Ulmer, 'Die Höchstrichterlich "enträtselte" Gesellschaft bürgerlichen Rechts', 22 *ZIP* (2001) p. 585. The *Parteifähigkeit* of the OHG follows directly from the law (§ 124 HGB). The problem of recharacterisation as a GbR or an OHG is that both companies are characterised by the fact that shareholders do not enjoy the privilege of limited liability so that they are sensibly constrained in their rights. It is worth mentioning that in its decision in *Überseering*, the ECJ referred to legal capacity (*Rechtsfähigkeit*) and capacity to be a party to legal proceedings (*Parteifähigkeit*) in its rulings on questions 1 and 2, but does not explicitly refer to legal personality (*Rechtspersönlichkeit*). Nevertheless, legal personality is mentioned in paras. 44, 76 and 80. The question is therefore whether *Überseering* also implies the recognition of legal personality. In favour of an interpretation of the Court's decision that also implies a recognition of legal personality or, in other words, the complete recognition of the foreign lawfully incorporated company and its original *Personalstatut*, see Leible and Hoffmann, loc. cit. n. 8, at p. 929; Eidenmüller, loc. cit. n. 8, at pp. 2240-2242; Forsthoff, loc. cit. n. 8, at pp. 2474-2475. Behrens, loc. cit. n. 8. *Contra*, see Wernike, loc. cit. n. 8, at pp. 759-760. In Inspire Art, Advocate General Alber finds in *Überseering* the recognition of the legal personality of the company (see para. 103 of his conclusions). The BGH ultimately also decided in favour of legal personality in its decisions of 13 March 2003 and 29 January 2003, see n. 19 *supra*.

[21] To be sure, the European Union is not a federal system. I use this term just for the sake of simplicity. In addition, despite not being strictly synonymous, the terms Union and Community are also used as synonyms for the sake of simplicity. On terminological issues relating to the true character of the European Union/European Community, see Hirsch, 'EG: Kein Staat, aber eine Verfassung?', 53 *NJW* (2000) p. 46.

This section briefly compares the development of the two systems, both on the level of conflict of law rules and on the level of substantive company law.

In the European Union, the relevant provisions concerning mutual recognition and freedom of establishment for companies operating in the single market are Articles 43 and 48 EC. Article 43 EC provides that natural persons who are nationals of a Member State shall enjoy freedom of establishment (in terms of primary and secondary establishment) in the territory of another Member State. Article 43 also refers to Article 48, which provides that companies also enjoy this freedom.[22] In the case of a company, however, freedom of establishment presumes recognition of that company's existence in the host jurisdiction. This is the point where incorporation theory and real seat theory diverge in their compatibility with Articles 43 and 48 EC. Member States that follow incorporation theory recognise the existence of a company based on the law of the jurisdiction where the company is lawfully incorporated and generally ensure freedom of establishment for companies in their territory.[23]

In contrast, Member States that follow real seat theory for purposes of recognition require that the company's statutory seat (registered office) and its centre of administration coincide. This means that, in the case of the transfer of a company's centre of administration to its territory, the Member State in question effects a change in the *Personalstatut* of the company (*Statutenwechsel*).[24] This means that the company is no longer eligible to exercise its right to freedom of establishment on the basis of its *original* identity. Real seat theory is therefore regarded as a protection theory,[25] as the shareholders' choice of law is curtailed in order to protect the interests of local (minority) shareholders, creditors, third parties, general interest and so forth. Real seat theory relies on the strict coincidence of the statutory seat and the real seat of companies. However, this raises the problem of identifying the real seat of business, because it is difficult – and increasingly so in a globalised and technologically advanced economy – to ascertain with certainty where a company's

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[22] Article 48 EC sets two conditions on the enjoyment of such a right by companies. Companies (or firms) have to (i) be formed in accordance with the law of a Member State and (ii) have their registered office, central administration or principal place of business in the Community.

[23] Even if this does not necessarily imply that the same jurisdiction completely avoids the responsibility of regulating the recognised company.

[24] Depending on the substantive company law of the host jurisdiction, the company may be able to keep its identity (though not necessarily the original one) by adapting the company contract to local company law requirements or may be regarded as non-existent. As a result, the lawfully incorporated foreign company is either (i) completely unrecognised because it is materially unable to adapt its company contract or (ii) recognised only as a result of the adaptation of its company contract

[25] See Wiedemann, *Gesellschaftsrecht*, Band I (München 1980) p. 782.

principal place of business is located.[26] Incorporation theory, in contrast, ensures certainty of law once it has been verified that a company is incorporated in accordance with the law of a particular jurisdiction. This is normally the law of the jurisdiction where the company is registered and has its statutory seat.[27]

In its decisions in *Centros* and *Überseering*, the European Court of Justice sensibly limited the effect of real seat theory as a conflict of law rule that limits or denies the recognition and, consequently, the freedom of establishment of lawfully incorporated foreign companies. In doing so, the Court not only directly addressed the issue of freedom of establishment in accordance with Articles 43 and 48 EC, but also indirectly addressed the recognition of foreign companies. The Court has consequently opposed the use of real seat theory as a conflict of law rule (i.e. as a basis for recognition). As a matter of law, it is therefore possible to do business in jurisdiction A, which follows real seat theory, while using a company form recognised in jurisdiction B, which follows incorporation theory. This applies to both primary establishments (e.g. Überseering) and secondary establishments (e.g. Centros).[28]

To be sure, the compatibility of real seat theory with the treaty provisions on mutual recognition and freedom of establishment has been debated by scholars for many years.[29] Nevertheless, the dominant opinion was that Articles 43 and 48 EC did not establish a European conflict of law rule and that Member States were free to adopt the preferred rule.[30] It is also worth mentioning that Articles 43 and 48 EC were interpreted in connection with the provisions set forth in Articles 293 and 44(2)(g) EC. According to Article 293 EC, Member States shall enter into negotiations for the mutual recognition of companies. An

[26] Or where its centre of administration is located or where important decisions are taken.

[27] The point is also made and developed by Zimmer, loc. cit. n. 6, at pp. 590-593.

[28] It is important to stress that *Centros* and *Überseering* do not constrain Member States from applying real seat theory to locally incorporated companies. On the situation after *Centros*, see Behrens, loc. cit. n. 9, at p. 331. On the situation after *Überseering*, see Leible and Hofmann, loc. cit. n. 8, at p. 932. See also Eidenmüller, loc. cit. n. 8, at pp. 2242-2243.

[29] See e.g. Beitzke, 'Anerkennung und Sitzverlegung von Gesellschaften und juristischen Personen im EWG-Bereich', 127 *ZHR* (1965) p. 1; Stein, 'Conflict-of-Laws Rules by Treaty: Recognition of Companies in a Regional Market', 68 *Michigan LR* (1970) p. 1327. For a more recent discussion, see the literature mentioned in relation to *Daily Mail* at n. 10 *supra*, *Centro*s at n. 9 *supra* and *Überseering* at n. 8 *supra*.

[30] For the majority opinion, see e.g. Santa Maria, *EC Commercial Law* (The Hague 1996) p. 25, who notes on the basis of Article 58 EC (now Article 48 EC): 'Article 58 contains no rule of private international law, since it presumes that any conflict regarding the existence and functioning of companies is already determined and resolved by the competent rule of private international law as enacted under the legal system of each Member State in the Community. Therefore, Article 58, *per se*, does not serve to eliminate conflicts arising between legal systems which follow differing criteria in specifying the law regulating companies'. For the minority opinion, arguing for the incompatibility of real seat theory with Articles 43 and 48 EC, see Behrens, 'Niederlassungsfreiheit und Internationales Gesellschaftsrecht', 52 *RabelsZ* (1988) p. 498.

agreement was concluded in this regard in 1968, but it never entered into force.[31] Article 44(2)(g) EC provides for the coordination of national company laws 'for the protection of the interests of members and other'.[32] From this perspective, the harmonisation of company law under Article 44(2)(g) EC was considered a functional element that facilitated freedom of establishment and the realisation of the single market. However, the meaning of harmonisation and the extent to which it has been realised are much more complex issues.

In the early years of the European Community, two schools of thought developed on this issue. One was devoted to a strict interpretation of Article 44(2)(g) EC, favouring limited coordination of national company laws, while the other called for a wider interpretation of the provision.[33] The European Commission initially favoured broad intervention to achieve something approaching unification rather than just coordination.[34] This strategy was replaced in the 1980s by a more pragmatic approach based on minimum standards and mutual recognition. The subsidiarity principle, which was introduced by the Maastricht Treaty in 1992, also encouraged a more cautious approach and a partial reconsideration of the benefits of decentralisation.[35] In 1989, in *Daily Mail*, the European Court of Justice opted for a substantial limitation of the freedoms granted under Articles 43 and 48 EC, due to the partial harmonisation in accordance with Article 44(2)(g) EC and the absence of a conflict of law rules agreement in accordance with Article 293 EC. In doing so, the Court reaffirmed the basic correlation between the coordination of national provisions, on the one hand, and freedom of establishment and mutual recogni-

[31] Convention on the Mutual Recognition of Companies and Legal Persons of 29 February 1968 (Brussels Convention). The Convention followed the theory of incorporation (Article 6) but allowed Member States to apply real seat theory to questions of company law other than the recognition of companies (Article 4). On the Convention, see Santa Maria, op. cit. n. 30, at p. 51. See also Stein, loc. cit. n. 29, at p. 1337.

[32] Article 44(2)(g) EC was introduced in order to prevent the abuse of treaty provisions on freedom of establishment by incorporating companies in Member States with a lesser degree of protection. On this point, see Timmermans, 'Die Europäische Rechtsangleichung im Gesellschaftsrecht. Eine integrations- und rechtspolitische Analyse', 48 *RabelsZ* (1984) p. 1 at p. 12. France, in particular, was suspicious about the level of protection provided by Dutch company law. The Netherlands switched to incorporation theory in 1959. On this point, see Stein, loc. cit. n. 29, at p. 1131.

[33] See Scholten, 'Company Law in Europe', 4 *CMLRev.* (1967) p. 377.

[34] For the different stages of the European Commission's approach to the harmonisation of company law, see Wouters, 'European Company Law: *Quo Vadis*?', 37 *CMLRev.* (2000) p. 257 at p. 269.

[35] See Schön, 'Mindestharmonisierung im Gesellschaftsrecht', 160 *ZHR* (1996) p. 221; Merkt, 'Europäische Rechtsetzung und strengeres autonomes Recht. Zur Auslegung von Gemeinschaftsnormen als Mindeststandards', 61 *RabelsZ* (1997) p. 647.

tion, on the other.[36] Only recently, after more than forty years, the Court eliminated this functional connection by means of *Centros* and *Überseering*, by recognising that companies that are active in the single market have a 'constitutional' right to freedom of establishment and mutual recognition deriving directly from the treaty provisions.

In the United States, the problem of mutual recognition of corporate entities also arose in the early days of the political union.[37] In this federal system, incorporation theory emerged as the general conflict of law rule for determining the internal affairs doctrine[38] of corporations that were active in the entire single market. This rule is based on case law, as explicit legislative provisions are generally absent.[39] This is particularly true at the federal constitutional level, where several clauses regulate interstate activity but do not specify which conflict of law rule should be applied to corporations. These constitutional principles have nevertheless been interpreted so as to grant shareholders free choice in relation to the state of incorporation and corporations free activity in the entire single market.[40]

Incorporation theory has survived as an exception to the 'conflict of law revolution' that shifted the general balance in favour of the application of the *lex fori*, particularly in contract and tort cases.[41] More recently, incorporation theory may even have gained constitutional protection by virtue of two Supreme Court decisions on the constitutionality of state takeover regulations.[42] Incorporation theory is thus the general rule, even if so-called outreach statutes

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[36] See, in particular, paras. 21 to 24 of the decision.

[37] For the early days, as well as for the entire development, see Buxbaum and Hopt, *Legal Harmonization and the Business Enterprise* (Berlin 1988) p. 28. On the survival of incorporation theory, see Note, 'The Internal Affairs Doctrine: Theoretical Justifications and Tentative Explanations for its Continued Primacy', 115 *Harvard LR* (2002) p. 1480.

[38] The 'internal affairs' of a corporation basically include the contractual relations between shareholders and between shareholders and managers. A definition of internal affairs appears in the *Restatement (Second) of the Conflict of Laws*, § 302 et seq.

[39] For exceptions, see Kozyris, 'Corporate Wars and Choice of Law', *Duke LJ* (1985) p. 1 at p. 26.

[40] Ibid., at p. 30. See also Buxbaum and Hopt, op. cit. n. 37, at p. 28. The relevant constitutional provisions are, in particular, the Privileges and Immunities Clause of Article IV(2)(1), the Commerce Clause of Article I (8)(1) and the Full Faith and Credit Clause of Article IV (1).

[41] See Kozyris, loc. cit. n. 39, at p. 15; Schulz, *Verfassungsrechtliche Vorgaben für das Kollisionsrecht in einem Gemeinsamen Markt* (Frankfurt am Main 2000) pp. 1-103.

[42] The first case was *Edgar* v. *MITE Corp.*, 457 US 624 (1982), in which the Supreme Court found that the Minnesota takeover statute was incompatible with the Williamson Act and the commerce clause. The second case was *CTS Corp.* v. *Dynamics Corp. of America*, 481 US 69 (1987), in which the Supreme Court confirmed the validity of the Indiana takeover statute. On the first case, see Kozyris, loc. cit. n. 39, at p. 35. On both cases, see Buxbaum, 'The Threatened Constitutionalization of the Internal Affairs Doctrine in Corporation Law', *California LR* (1987) p. 29; Schulz, op. cit. n. 41, at p. 84.

in some states provide for the application of *lex fori*.[43] A corporation incorporated in State A (typically Delaware) nevertheless has to qualify (register) in other states in order to conduct business there. State qualification statutes are basically registration statutes and regulate the disclosure requirements that corporations have to meet, which are similar to those required under the First and Eleventh European Company Law Directives,[44] and the procedural rules for the appointment of an agent upon whom process may be served.[45] With regard to substantive law, harmonisation of state company laws has never been actively pursued on the basis of federal legislation. A form of soft coordination has been pursued in the Model Business Corporation Act, but it is fair to say that, given its predominance in the incorporation business, Delaware law is in fact the standard national corporation law.

In conclusion, after *Centros* and *Überseering*, companies in Europe enjoy freedom of establishment and mutual recognition as rights that derive directly from the 'constitutional' provisions of Articles 43 and 48 EC. This situation is more advanced than in the United States, where the relevant constitutional provisions are less determinate, even if the same rights have essentially been guaranteed on a practical level.[46] In the future, the European Court of Justice will increasingly be confronted with the question of the compatibility of internal substantive law for the regulation of foreign companies, on the one hand, and EC provisions,

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[43] In particular, the codes of California and New York provide for the application of local law where the corporation has substantial contacts with the State (but both codes exempt corporations listed on a stock exchange). See Kozyris, loc. cit. n. 39, at p. 46; Kersting, 'Corporate Choice of Law. A Comparison of the United States and European Systems and a Proposal for a European Directive', 28(1) *Brookl. J. Int. L* (2002) p. 25. See also Beveridge, 'The Internal Affairs Doctrine: The Proper Law of a Corporation', 44 *Business Lawyer* (1989) p. 693 at p. 702.

[44] Respectively, Council Directive 68/151, *OJ* L 65/8 and Council Directive 89/666, *OJ* L 395/36. See Kersting, loc. cit. n. 43, at p. 44. Kersting's article refers to the situation before the *Überseering* decision and affirms the substantial similarity between the information required from companies under the qualification statutes and under the above-mentioned European directives. Nevertheless, it should be emphasised that *Überseering* does not register a branch according to the Eleventh Directive and is active in Germany only according to the original incorporation act, which is harmonised at the European level on the basis of the First Directive. The ECJ has decided in favour of the recognition and exercise of the right of (primary) establishment on the basis of the original incorporation act (which is harmonised by the First Directive), but without the registration of a branch (which is harmonised by the Eleventh Directive).

[45] On qualification statutes, see Kersting, loc. cit. n. 43, at p. 16.

[46] I would like to stress again that, after *Überseering*, a company can exercise its right of primary establishment without registration in the host jurisdiction. The company has to be recognised according to the personal statute in the jurisdiction of incorporation. In the United States, as mentioned earlier, qualification statutes serve as registration statutes. In Europe, the 'constitutional' right deriving from Articles 43 and 48 EC includes primary establishment without a formal act of qualification of the US kind. A qualification act continues to apply for secondary establishment in the form of a branch and is regulated by the Eleventh Directive.

on the other, as the US Supreme Court has been in relation to the constitutionality of the content of qualification and outreach statutes.[47]

4. The economic theory of the company

In economic theory, a company is defined as a nexus of contracts.[48] Shareholders, managers, creditors, employees and customers (the stakeholders or patrons of the nexus)[49] interact on a permanent basis through the company by means of contracts to achieve their various goals. These goals are defined and structured in economic terms in such a way that their simultaneous realisation results in an *efficient* nexus of contracts.[50] Company ownership is only allocated to shareholders on the basis of efficiency criteria.[51] Ownership by shareholders is efficient, given that the costs of contracting are prohibitively high and that,

[47] The *Inspire Art* case is probably just the beginning of a body of case law that establishes limits and principles of internal substantive regulation. Following *Centros*, the Danish authorities have introduced new provisions on capital requirements in the form of tax law. See Hansen, 'From C 212 to L 212 – *Centros* Revisited', 2 *EBOR* (2001) p. 141.

[48] This theory developed on the basis of the seminal 1937 article by Coase, 'The Nature of the Firm', reprinted in Coase, *The Firm, the Market, and the Law* (Chicago 1988). See Alchian and Demsetz, 'Production, Information Costs, and Economic Organization', 62 *AER* (1972) p. 777; Jensen and Meckling, 'Theory of the Firm: Managerial Behaviour, Agency Costs and Ownership Structure', 3 *J. Fin. Econ.* (1976) p. 305. It is the mainstream paradigm, even if it is not the only one. For the impact of Coase's paper on the theory of the firm, see Ulen, 'The Coasean Firm in Law and Economic*s*', 18 *J. Corpor. L* (1993) p. 301.

[49] I rely on the systematic treatment provided by Hansmann, *The Ownership of Enterprise* (Cambridge, MA 1996).

[50] That is, in a way that maximises the aggregate value of *all* contracts – nobody can be better off without making somebody worse off.

[51] See Hansmann, op. cit. n. 49, at pp. 11-49 and 53-65. Ownership is an essential element of the nexus of contracts. There are actually several types of firms, according to the various forms of assignment or non-assignment of ownership. A company is just a certain type of firm. Ownership includes two formal residual rights: the right to control the company (by voting on particular issues) and the right to its earnings (dividends). Ownership is assigned according to efficiency criteria in a way that reduces the total transaction costs arising in the nexus. Such transaction costs are defined in terms of the costs of contracting (defined by Hansmann in terms of *ex ante* and *ex post* monopoly power, opportunistic behaviour in case of transaction-specific investments, asymmetric information, strategic bargaining and a relative degree of homogeneity among different classes of patrons, p. 24) and the costs of ownership (defined by Hansmann in terms of costs arising from residual control, i.e. controlling managers, decision-making costs and costs arising from residual earnings, i.e. risk-bearing costs, p. 35). In this context, the efficient allocation of ownership to a particular class of patrons instead of another is the one 'that minimizes the total costs of transactions between the firm and all of its patrons' (Hansmann, p. 21) or, more precisely, in a way that minimises 'the sum of (1) the costs of market contracting for those classes of patrons that are not owners and (2) the costs of ownership for the class of patrons who own the firm' (Hansmann, p. 22). As mentioned, there are different kinds of firms according to the assignment of ownership among patrons in different eco-

for this particular group of patrons, ownership costs (or the agency costs of ownership), are still comparatively lower than they would be for any other group of patrons.[52] A key explanation why shareholders are the most efficient class of patrons for maintaining company ownership is their uniformity in terms of the achievement of one simple goal – profit maximisation.[53] In fact, this common goal reduces both kinds of ownership costs: controlling costs and risk-bearing costs.[54] Apart from shareholders, no other class of patrons enjoys company ownership (i.e. *residual* rights in the company). They join the nexus of contracts on the basis of contractual rights and obligations that are *fixed* and specified *ex ante*.[55] This reliance on fixed claims that are specified *ex ante* makes all other classes of patrons creditors of the company. To comply with such contractual claims, the company needs assets that prove that it is committed to satisfying its obligations.

Legal personality and limited liability play an important role in providing the company with the assets it needs,[56] as they structure assets in such a way that some are pledged to the shareholders' personal creditors and some to company

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nomic sectors and time periods. It is important to emphasise that we are only able to argue and compare the *relative* efficiency of the different types of firms and not the *absolute* efficiency. Nevertheless, there is a general tendency in the long run towards natural selection on the basis of efficiency among the various types of firm, so that only more efficient types of firm survive. On the survival thesis, see Hansmann (p. 22). Alchian, 'Uncertainty, Evolution, and Economic Theory', 58 *J. Pol. Econ.* (1950) p. 211, already proposed a theory based on the survival of firms as proof of their relatively superior organisational efficiency.

[52] For the development of this point, see Hansmann, op. cit. n. 49, at p. 53.

[53] In the discipline of corporate finance, managers are said to maximise net present value, i.e. equity price. This efficiently permits shareholders to freely choose the patterns of consumption and saving they prefer at different times. On this point, see Brealey and Myers, *Principles of Corporate Finance* (New York 1996) p. 24. On shareholder value from a corporate finance perspective, see Zingales, 'In Search of New Foundations', 55 *J. Finance* (2000) p. 1623 at p. 1630; Jensen, 'Value Maximization, Stakeholder Theory, and the Corporate Objective Function', 14 *J. Applied Corp. Fin.* (2001) p. 8.

[54] The costs of controlling include, as mentioned, the costs of monitoring managers and decision-making costs. The former may be substantial, given the separation between ownership and control, but are sensibly reduced because managers have only one clear line of conduct (profit maximisation). The latter are also sensibly reduced because, despite collective action problems in decision making, all the decisions try to reach the single goal of profit maximisation. The costs of risk bearing are also reduced because investors can typically diversify their investments between several companies, thereby reducing risk.

[55] On this point, see also Williamson, 'Corporate Governance', 93 *Yale LJ* (1984) p. 1197. This is obviously not true for tort creditors.

[56] See Hansmann and Kraakman, 'The Essential Role of Organizational Law', 110 *Yale LJ* (2000) p. 387 at pp. 391-394.

creditors.[57] With regard to standard company forms – such as a business corporation, AG, private limited liability company or GmbH – the general rule is that company creditors have a priority claim to company assets, meaning that they enjoy priority over the claims of the shareholders' personal creditors. This also applies in the case of the liquidation of the company.[58] This arrangement is the result of affirmative asset partitioning by means of legal personality (i.e. company assets are exclusively pledged to company creditors) and defensive asset partitioning by means of limited liability (i.e. the shareholders' personal assets are exclusively pledged to the shareholders' personal creditors). It is the role of organisational law to provide for affirmative asset partitioning that is not reachable and enforceable only by means of contract. This is because transaction costs are prohibitively high.[59]

Affirmative asset partitioning also has some key advantages that reduce the costs of credit, essentially by reducing monitoring costs.[60] First, in the case of a separation of assets across business lines, affirmative asset partitioning generally enables business creditors to better monitor those individual lines of business. Second, it reduces the monitoring costs of business creditors, because they only need to concentrate on monitoring the profitability of specific company assets.[61] Third, business creditors are able to diversify credit risk by splitting resources between companies and caring only about the risks specifically associated with each of them. Finally, liquidation protection against claims by the shareholders' personal creditors may increase the creditworthiness of the company.

Defensive asset partitioning, in contrast, can be established by means of contracts.[62] Although they can be high, the transaction costs of such contractual

[57] For the sake of simplicity, I have omitted the analysis of managers that are also involved in asset partitioning. On this point, see Hansmann and Kraakman, loc. cit. n. 56, at pp. 393 and 398. In the present context, the relevance of asset partitioning for managers nevertheless arises, if one considers that the Dutch provisions in *Inspire Art* directly affected the liability of managers, i.e. their status in a well-defined asset partitioning structure.

[58] For the American business corporation, see Hansmann and Kraakman, loc. cit. n. 56, at p. 397. For the *Aktiengesellschaft* (AG) and the *Gesellschaft mit beschränkter Haftung* (GmbH) this follows from the limited liability rule. For the AG this appears in § 1 Abs. 1 Satz 2, § 268 Abs. 1. Satz 1 and § 271 Abs. 1 of the AktG and for the GmbH this appears in § 13 Abs. 2, § 70 Satz 1 and § 72 Satz 1 of the GmbHG.

[59] See Hansmann and Kraakman, loc. cit. n. 56, at pp. 408-409 and 410-411.

[60] Ibid., at p. 399.

[61] Ibid., at p. 401. Company creditors do not have to care about the creditworthiness of the single shareholder whose personal assets are pledged to his or her personal creditors.

[62] For this reason, the role played by organisational law is not essential. See Hansmann and Kraakman, loc. cit. n. 56, at p. 427.

agreements are nevertheless manageable.[63] In this connection, it is worth mentioning the advantages and disadvantages of limited liability, as a contractually viable legal institution, from an economic perspective.[64] The first advantage of limited liability is that it makes it possible to monitor companies in two ways: the shareholders' personal creditors focus only on the shareholders' personal assets and the shareholders themselves do not need to monitor the personal assets and liabilities of other shareholders. Limited liability also reduces the costs of governance by reducing decision-making costs, as shareholders have a shared interest in profit maximisation. A third benefit of limited liability is that it shifts part of the cost of monitoring managers from shareholders to creditors. A fourth important benefit is that limited liability facilitates the transferability of shares by separating the value of the shares from the shareholders' other personal assets. Another benefit, finally, is that it permits risk sharing between shareholders and creditors according to the preferred equity/debt ratio and between shareholders according to their preferred amount of equity claims.

The main disadvantage of limited liability are the well-known agency costs of credit. This includes the exploitation that company creditors are potentially exposed to after conceding credit to the company. Contractual company creditors are faced with two kind of risk: an *ex ante* contract risk relating to the possibility that a debtor will default because of unfavourable business opportunities and an *ex post* contract risk relating to the possibility that shareholders will divert company assets financed by credit to riskier projects. In the case of insolvency, shareholders bear only part of the costs, which are basically passed on to company creditors. In terms of the first risk, contractual creditors face a problem of information. In terms of the second risk, they face a problem of

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[63] In the case of a partnership, it would be sufficient to convince all the partnership creditors to limit their contractual claims to the partnership's assets and exempt the partners' personal assets. See Hansmann and Kraakman, loc. cit. n. 56, at pp. 429-430.

[64] The economic advantages and disadvantages of limited liability as a form of defensive asset partitioning are well documented in the literature. For more details, see, in particular, Halpern, Trebilcock and Turnbul, 'An Economic Analysis of Limited Liability in Corporate Law', 30 *U. Toronto LJ* (1980) p. 117; Woodward, 'Limited Liability in the Theory of the Firm', 141 *JITE* (1985) p. 601; Easterbrook and Fischel, 'Limited Liability and the Corporation', 52 *U. Chicago LR* (1985) p. 89; Ribstein, 'Limited Liability and Theories of the Corporation', 50 *Maryland LR* (1991) p. 80. For a survey, see Hansmann and Kraakman, loc. cit. n. 56, at pp. 423-427.

supervision.[65] From a theoretical,[66] practical[67] and historical[68] perspective, it is true that contractual creditors are ready and able to contract for limited liability and manage its potential costs, because the transaction costs are affordable and the benefits preponderant.[69] On balance, this means that the disadvantage of limited liability (i.e. the agency costs of credit) is more than outweighed by its various advantages. It may therefore be concluded that limited liability is an

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[65] This categorisation is made by Posner, 'The Rights of Creditors of Affiliated Corporations', *U. Chicago LR* (1976) pp. 507-506.

[66] The basic problem in the debtor-creditor contractual relationship is one of asymmetric information. Nevertheless, the problem is not necessarily a market failure and does not necessarily require state intervention. In fact, it is solvable on a *contractual* basis. Two elements are at the basis of this contractual solution. The first element is that *all* contractual creditors are *repeat players* (this implies the impossibility of systematic exploitation, as this would imply systematic irrationality). The second element is the *contractual*, i.e. free and voluntary, nature of the relationship. This means that the Coasean bargaining process takes place without sensible limitations. In this context, with regard to the effects of limited liability, Posner, loc. cit. n. 65, at p. 505, already argued: 'An important implication of the foregoing analysis is that specific doctrines of corporation law should not be expected, in general, to have a profound impact on the credit system or to alter the balance of advantage between debtor and creditor'. Ekelund and Tollison, 'Mercantilist origins of the corporation', 11 *Bell J. Econ*. (1980) p. 715 at p. 719, make the same point: 'Bargaining in capital markets typically takes the form of negotiated, face-to-face transactions, so that the costs of bargaining is independent of the liability provisions. The interest rate is not an impersonally established price in a (Coasian) world wherein instruments are personally negotiated. The capital market will pierce the veil of limited liability in such a way as to internalize the costs of capital to a given firm'. In addition, Hansmann and Kraakman, loc. cit. n. 56, at p. 429, point out the contractual nature of the arrangement leads to limited liability. For a discussion of the way in which *all* classes of contractual creditors (from banks to trade creditors and employees) are able to limit the negative impact of limited liability on a contractual basis, see Lombardo, op. cit. n. 2, at pp. 119 and 152; Macey and Enriques, 'Creditors versus Capital Formation: The Case against the European Legal Capital Rules', 86 *Cornell LR* (2001) p. 1165.

[67] For the American experience, see Manning and Hanks, *Legal Capital* (Westbury, NY 1990).

[68] See Hansmann and Kraakman, loc. cit. n. 56, at p. 429; Andersen and Tollison, 'The Myth of the Corporation as a Creation of the State', 3 *Int. R. L&E* (1983) p. 107. See also Ekelund and Tollison, loc. cit. n. 66.

[69] I will take this statement as read. In order to avoid misunderstandings, I would like to stress that the *contractual* solution of the limited liability problem does not necessarily exclude state intervention. My main point is that contractual solutions are able to impede systematic creditor exploitation even without state intervention. They can cause an increase in the costs of debt, but are able to exclude systematic exploitation. In this context, state regulation could be introduced to allow parties to reach contractual agreements cheaply and quickly on the basis of standard form contracts. Nevertheless, to argue in favour of state intervention in the form of *strict mandatory regulation* in order to solve the problem caused by limited liability does not take theory or practice into consideration. For this reason, the common argument that real seat theory is a protection theory for *contractual* creditors is unconvincing, and its application can consequently not be invoked in order to limit the right of establishment of foreign incorporated companies.

efficient contractual form of asset partitioning between shareholders and contractual company creditors.[70]

5. Conflict of law rules, transfer of seat and the company form

The economic theory that describes the incentive structure of the company as a nexus of contracts between several classes of patrons can now be applied to the case of a limited liability company (AG or GmbH) that is incorporated in jurisdiction A, which applies incorporation theory (e.g. the United Kingdom), and transfers its centre of administration to jurisdiction B, which follows real seat theory (e.g. Germany) – in other words, a typical case of *Sitzverlegung*.[71] Before *Centros* and *Überseering*, a company of this kind would not have been recognised.[72] It is now possible to analyse a case of *Sitzverlegung* in terms of economic efficiency. Supporters of real seat theory as a protection theory generally argue that such a foreign company may present a danger to minority shareholders, local company contractual and tort creditors and the general interest. In this section, I will attempt to show that the arguments advanced to

[70] The question, of course, is whether limited liability is also efficient on a social level with respect to tort creditors. The answer is probably not. One might think, for example, of a nuclear power plant accident of really tremendous impact (e.g. 4 million dead and €600 billion in damages) that is not covered by insurance. As Woodward, loc. cit. n. 64, has meaningfully pointed out: 'To a lesser degree the problem of the socially optimal amount of limited liability insurance remains with extended liability. Even in the most insured of worlds, the possibility remains of an accident of such magnitude that the assets of the firm as well as its insurance company are exhausted. *There is no such thing as unlimited liability*'. [emphasis added] What would real seat theory as a protection theory protect in such a situation? What would a the piercing of the corporate veil bring? Who should be responsible for €600 billion in damages? Maybe the company managing the power plant and its shareholders?

[71] I use the term *Sitzverlegung* to refer to the transfer of the centre of administration or principal place of business while maintaining the registered office in the original jurisdiction. *Sitzverlegung* may also be used to describe the transfer of the centre of administration and the registered office. For such a case of *Sitzverlegung* from Luxembourg to Germany, see Behrens, 'Identitätswahrende Sitzverlegung einer Kapitalgesellschaft von Luxemburg in die Bundesrepublik Deutschland', 32 *RIW* (1986) p. 590. I will not discuss here a change of registered office as the result of a merger or by means of a regulation of the kind contained in the proposal for a Fourteenth European Directive. For this, see Lombardo, op. cit. n. 2, at p. 170.

[72] In other words, it would have been considered a *Nullum*, as Leible and Hofmann, loc. cit. n. 20, put it. According to the case law of the BGH, it could have been recharacterised as a *Personengesellschaft*. Generally speaking, the ECJ will have to examine whether company may be subject to outreach statutes. To be sure, the second European Company Law Directive has harmonised capital rules, but only with respect to companies of the AG type. Member States like the United Kingdom and Ireland do not apply minimal capital requirements or the machinery of the Second Directive to private limited liability companies.

justify real seat theory as a protection theory do not stand up to analysis in terms of efficiency. The focus will be on shareholders, contractual creditors[73] and the general interest.

5.1 Shareholders

In a federal system, shareholders may be tempted to choose the legal form of a limited liability company under jurisdiction A, with or without the intention of also doing business in jurisdiction B – exclusively or otherwise – in the future. In other words, majority and minority shareholders can freely choose to enter into contracts amongst themselves[74] according to the law of jurisdiction A. Such a free and voluntary choice should be regarded as efficient and should therefore be recognised by jurisdiction B. Any claim to the contrary would be paternalistic and ultimately unjustified.[75] By means of this free choice of law, shareholders organise a system for allocating (property) rights and obligations amongst themselves that they consider better than the system offered by jurisdiction B.[76] In economic terms, they choose a legal system that regulates the

[73] This article does do not cover tort creditors, because the conflict of law rule that needs to be applied is different from the one for companies. Generally speaking, competence is given to the court and to the law of the country of injury (for Germany, see § 40 Abs. 1 Satz 1 of the EGBGB). With respect to tort creditors, the case for real seat theory is weak. It needs to be demonstrated that a minimal capital requirement is able to solve the problem of cost externalisation. This is generally not the case, as insurance is a more efficient way of dealing with this problem. For a comparative analysis of tort creditors, see Haar, 'Piercing the Corporate Veil and Shareholders' Product and Environmental Liability in American Law as Remedies for Capital Market Failures – New Developments and Implications for European and German Law after 'Centros'', 2 *EBOR* (2000) p. 317.

[74] That is, the corporate contract, or the set of contracts that form the nexus of the contracts of the corporation that regulate its contractual relationships or internal affairs.

[75] In a similar vein, see Knobbe-Keuk, loc. cit. n. 10, at p. 346; Schulz and Sester, loc. cit. n. 8, at p. 551 and Behrens, loc. cit. n. 8, at p. 112. That point was also already made by Ulmer, loc. cit. n. 9, at p. 662, who speaks of *Innenbeziehungen* (the contractual relationships between shareholders). He refers to the already harmonised regulation in accordance with Article 44(2)(g) EC as a guarantee of the sufficient protection of shareholders. The point is maybe misguided, at least in relation to closed corporations, if one considers that, in general contract law, the choice of a foreign jurisdiction by parties in order to regulate the terms of their contract (i.e. their contractual relationship) without such an *ex ante* harmonisation of substantive law is allowed in Europe and the United States and is considered efficient.

[76] This is now commonly known as the 'law as a product' paradigm. See Romano, 'Law as a Product. Some Pieces of the Incorporation Puzzle', 1 *J. L. Econ. Org*. (1985) p. 225. The system includes the content of the corporate contract as provided by statutory law and judicial review. I have intentionally omitted the discussion of the contents of the regulation of the agency costs of ownership as provided by corporate law, i.e. the limits and scope of regulation, particularly with respect to the distinction between mandatory v. default contract terms. On this topic, see Lombardo, op. cit. n. 2, at p. 107. For a German perspective, see Bak, *Aktienrecht zwischen Markt und Staat. Eine ökonomische Kritik des Prinzips der Satzungsstrenge* (Wiesbaden 2003).

agency costs of ownership (controlling costs and risk-bearing costs) in a way that is probably different from the way they are regulated in jurisdiction B. In a small company, the effects of this difference may be negligible. In large corporations with dispersed ownership, however, the costs of ownership are enormous, and different regulations offer alternative solutions. A free choice between different regulations thus becomes efficient.[77]

A free choice of law made voluntarily by minority or majority shareholders in order to regulate their internal affairs should be regarded as efficient *per se*, as is generally the case in relation to contract law.[78] This is true both in closed companies and in listed companies with dispersed ownership. In the case of closed companies, all shareholders have sufficient incentive to acquaint themselves with the contents of the contract they are entering into. If they contractually (i.e. freely and voluntarily) enter into the contract, every protection argument under real seat theory is paternalistic. In the case of listed companies with dispersed ownership, small shareholders are generally not aware of substantive company law and conflict of law issues. They have to hitch a free ride on the price of the corporate contract terms, which are determined on the

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[77] Following this line of reasoning, at least implicitly, are Romano, loc. cit. n. 76; Romano, *The Genius of American Corporate Law* (Washington, DC 1993); Daines, 'Does Delaware law improve firm value?', 62 *J. Fin. Econ*. (2001) p. 525. In a similar vein, see Romano, *The Advantage of Competitive Federalism for Securities Regulation* (Washington, DC 2002). Having only a single law regulating the set of contracts between shareholders and managers ensures certainty of law and reduces the transaction costs of dealing with different, possibly incompatible regulations. This is true both for company law and for securities regulation. Easterbrook and Fischel, *The Economic Structure of Corporation Law* (Cambridge, MA 1991), have discussed the topic of multiple regulation of securities disclosures from the perspective of several regulating jurisdictions. They refer to the several forum laws of the shareholders and not to the single one of the issuer (pp. 285-286 and 300-302). It is interesting to note that this approach naturally leads towards an increase in transaction costs, because, in a single market consisting of 51 or 15 jurisdictions, shareholders of large companies with dispersed ownership can be located all over the place. In *The Advantage of Competitive Federalism for Securities Regulation*, Romano recognises the problem and proposes a free choice of law for issuers. Regardless of the results (the race to the top or the bottom), the point is that the certainty, predictability and integrity of law is only guaranteed by this unique and clear choice of law rule.

[78] See Reimann, 'Savigny's Triumph? Choice of Law in Contracts Cases at the Close of the Twentieth Century', 39 *Virginia J. Internat. L* (1999) p. 571. See also Parisi and Ribstein, loc. cit. n. 7.

capital market by informed investors.[79] Limited liability should also be respected, particularly in the case of large companies with dispersed ownership, where its benefits are great because hundreds or thousands of shareholders are not able to monitor managers and each other closely.

5.2 **Contractual creditors**

The final consideration relates to creditors' interests. By choosing jurisdiction A and, in particular, the form of a limited liability company, shareholders opt for a double system of asset partitioning of the kind described above. This section argues that, in the case of the transfer of the centre of administration or part of the business activity of a company to jurisdiction B, the non-recognition of the asset partitioning permitted under jurisdiction A simply results in an *ex post* inefficient partition of assets between pre- and post-transfer creditors (both company creditors and the shareholders' personal creditors).[80] In other words, it is highly doubtful that the law of jurisdiction B will be able to offer a more efficient asset partitioning system, by means of (i) non-recognition; (ii) recharacterisation as a *Personengesellschaft*; or (iii) stricter capital regulation, than the one offered by jurisdiction A (which is chosen by shareholders and is freely joined by all contractual creditors in both jurisdictions). To illustrate this

[79] This is the traditional argument used to justify the choice of law for corporations. See both works by Romano, op. cit. n. 77; Easterbrook and Fischel, op. cit. n. 77, at p. 1. Bebchuk, 'Federalism and the Corporation: the Desirable Limits on State Competition in Corporate Law', 105 *Harvard LR* (1992) p. 1435 at p. 1472, argues that small shareholders may be not perfectly informed. This point refers directly to the efficiency of the capital market and the reliance on it of small shareholders. Nevertheless, in a system of (perfect) worldwide capital mobility, small shareholders move their savings to different companies independently of the place of incorporation of the companies. This means that, in a system of capital mobility, real seat theory and incorporation theory become equivalent. The mobility of capital permits the formation of a pricing system for the different corporate governance systems. For instance, does a German small shareholder who holds shares in Siemens, Fiat and General Electric, directly or through a fund, know that General Electric is a company incorporated in New York State? In such a system, in order to avoid possible dangers for small shareholders, the German authorities, which may be tempted to consider German company law as better than its counterparts, should forbid the export of capital or require a worldwide unification of company law. To be sure, such a solution has costs as well as benefits.

[80] Behrens, loc. cit. n. 8, at p. 112, has pointed out that, in general, legal doctrine only concentrates on local company creditors, completely overlooking shareholders' personal creditors (who may also be local and may also rely on the limited liability provided by jurisdiction A from a contractual point of view). An incidental reference to shareholders' personal creditors, albeit from a different perspective, was made by Advocate General Van Gerven in his conclusions (paras. 16 and 17) in the *Marleasing* case. See ECJ, Case C-106/89 *Marleasing* [1990] *ECR* I-4135.

point, this section examines the situation with respect to defensive asset partitioning and then with respect to affirmative asset partitioning.

After the transfer of its centre of administration or part of its economic activity to jurisdiction B, a company starts to do business by entering contracts with local parties. In jurisdiction A, it remains a limited liability company, but in jurisdiction B its destiny is unclear.[81] In jurisdiction A, the potential transfer of the centre of administration or part of the business activity of the company to jurisdiction B may be regarded as an eventuality and may therefore be anticipated by the shareholders' personal creditors as well as by company creditors. In order to protect their respective claims, as structured by the asset partitioning under jurisdictions A and B, the shareholders' personal creditors and company creditors can enter into contracts. Nevertheless, only the shareholders' personal creditors may be able to protect themselves by means of contracts. Indeed, the company/partnership could insert a clause in its credit agreements with business creditors that asks such creditors to respect limited liability in jurisdiction B. Despite not being cheap, because of the transaction costs involved, such an agreement is nevertheless achievable by means of a contract, as mentioned in the description of defensive asset partitioning.[82] To the extent that such a contractual agreement is recognised by jurisdiction B, the shareholders' personal creditors are not exploited by business creditors in jurisdiction B.

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[81] The company may be not recognised, recharacterised or subject to more restrictive capital requirements. I use the term company-partnership to describe the unclear legal character of the resulting legal body.

[82] Transaction costs may arise because every single company-partnership creditor should individually accept this rule by means of contractual agreement, given that a company-partnership statute clause limitation may be not possible. In Germany, for instance, the principle that the partnership agreement cannot limit liability is mandatory, and any agreement between shareholders to the contrary has no effect on third parties. See § 128 Satz 2 of the HGB. Creditors can only agree to limit partners' liability explicitly, as in the case of the example above, in which the partnership contracts with each business creditor limit liability to partnership assets. On the German OHG, see Grunewald, *Gesellschaftsrecht* (Tübingen 2002) p. 103. A recent decision by the BGH has confirmed that the principle of unlimited liability in a *Personengesellschaft* cannot be limited by simple reference to standard terms like *limited liability* (*beschränkte Haftung*) but only through an explicit contractual agreement with each partnership creditor. See BGH, *Urteil v.* 27.9.1999, II *ZR* 371/98, published in 20 *ZIP* (1999) p. 1755, with a comment by Holger ('*Anmerkung*'). Transaction costs may also increase in the shareholding status, as company-partnerships should be able to credibly convince each shareholder that limited liability will also be respected in jurisdiction B. In the case of a closed company-partnership, transaction costs may be small, but they are likely to be large in a company-partnership with hundreds or thousands of shareholders. Indeed, shareholders may feel the need to monitor managers more closely in order to ensure that limited liability is respected. This distorts the passivity rule granted by limited liability. In addition, share transferability could be damaged because more (potential) wealthy shareholders fear modification of the liability rule to their detriment.

In the absence of limited liability,[83] the company can present itself with limited liability in jurisdiction A but not in jurisdiction B. The result of this is that company/partnership creditors in jurisdiction B are able to exploit the shareholders' personal creditors in jurisdiction A. In fact, they also have the right to ask for the shareholders' assets as compensation for business liabilities. Whatever the measures adopted by jurisdiction B, the legal result is inefficient compared to the legal result achieved by the partitioning of assets offered by jurisdiction A and freely joined by contractual company/partnership creditors in jurisdiction B.[84]

The position of company creditors in jurisdiction A is more complex and depends on the type of measures adopted in jurisdiction B. In the case of the complete non-recognition of a company, for example, company creditors would be unable to protect themselves contractually against the shareholders' personal creditors. Contractual transaction costs would be prohibitively high, as mentioned above. In this case, the shareholders' personal creditors in jurisdiction A and jurisdiction B could exploit company creditors in jurisdiction B, as they would have free access to the company's assets.[85] In the case of the recharacterisation of the company as a *Personengesellschaft*, affirmative asset partitioning is respected in jurisdiction B.[86] In the case of stricter capital requirements, rational company creditors in jurisdiction A would *ex ante* discount the different protection offered to company creditors in jurisdiction B by modifying the contractual terms of debt. This would imply an increase or decrease in the costs of debt in jurisdiction A, which would probably be compensated by a inversely corresponding modification in jurisdiction B.

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[83] Because of non-recognition or compulsory recharacterisation by jurisdiction B or non-provision by contractual agreement.

[84] It is inefficient in the sense that it does not maximise the aggregate value of all contracts. Generally, the inefficiency created by the alteration of liability rule will be positively correlated to the number of shareholders and creditors.

[85] At the same time, however, company creditors in jurisdiction B would not only have access to company assets (which company creditors in jurisdiction A do not, because limited liability is still granted by law) but also to shareholders' personal assets.

[86] It is an essential characteristic of the *Gesellschaft*, as well as of the *Personengesellschaft*, to provide an asset partitioning structure that ensures partnership creditors a prior claim, even if it is less pronounced, to partnership assets in relation to partners' personal creditors. This is the case for an OHG or a GbR in Germany. In the case of the OHG, affirmative asset partitioning is provided by § 124 Abs. 2, § 131 and § 135 of the HGB. In the case of the GbR, affirmative asset partitioning is less pronounced but still existent and is provided by § 725 Abs. 1 and § 728 Abs. 2 of the BGB. In the case of the liquidation of the partnership, partnership creditors enjoy a priority claim to partnership assets in relation to partners' personal creditors. Hansmann and Kraakman, loc. cit. n. 56, describe these forms as weak forms of affirmative asset partitioning, because they do not ensure liquidation protection as granted to the AG or the GmbH.

In sum, the sanction of non-recognition, recharacterisation or stricter capital regulation, which is justified in order to protect *local* company/partnership creditors, jeopardises the distribution of property rights that *all* contractual creditors are able to deal with. This contractual ability essentially relies on affirmative asset partitioning, which is created by incorporation.[87] So far, the argument has been based on a simple example involving only two jurisdictions. It is nevertheless plausible – and will become increasingly common in the European single market, as it is in the single market of the United States – that a company incorporated in jurisdiction A (with shareholders, company creditors and shareholders' personal creditors dispersed over several jurisdictions) will do business in different jurisdictions, solely on the basis of its original incorporation.[88] Exposing the company to different legal and capital requirements or different degrees of liability according to the laws of the individual jurisdictions only complicates and jeopardises the rights of *all* contractual creditors at the European level. It increases the contractual costs of credit instead of decreasing them, due to the possibility of opportunistic creditors exploiting other creditors and shareholders by means of different legal regimes. A system in which *all* contractual creditors at the European level rely only on the capital requirements and liability regime of the jurisdiction of incorporation is superior to a system of simultaneous multiple regulations. It improves certainty of law, as all contractual creditors react and discount their risks *ex ante*.[89]

In fact, in dealing with a European system in which different jurisdictions offer different degrees of creditor protection, contractual creditors are cheaper cost avoiders than the Member States. This is because contractual creditors discount the (increased) risk *ex ante* by simply adjusting the contractual terms

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[87] See section 4.

[88] Thus far, it has been common for companies incorporated in one jurisdiction to incorporate subsidiary companies in each jurisdiction where it does business. This system of parent-subsidiaries has led to costs of approximately €30 billion. See European Commission, *Enhancing European Competitiveness*, Report of Ciampi Group on Competitiveness Advisory Group, (Luxembourg 1995) p. 9.

[89] In other words, it is efficient, which means that it maximises the value of the contracts of *all* creditors. In relation to creditors, I have reached the same conclusion that I reached in relation to the regulation of the set of contracts related to shareholders and their agency costs of ownership.

of credit.[90] For this reason, attempts by Member States, such as the Netherlands and Denmark, to further burden foreign companies with internal regulation should not find judicial support within the European Court of Justice. Furthermore, it is highly unlikely that the Court would be able to identify better general principles leading to coherent rules of risk allocation among contractual creditors that would be superior to those established by all creditors on a *voluntary* basis.[91]

5.3 General interest and state sovereignty concerns

The company has been described as a nexus of contracts between different classes of patrons. It has also been argued that one class of patrons (shareholders) is the owner of the company and maintains *residual* rights in the company. All other classes (financial creditors, customers, employees and trade creditors) join the nexus on the basis of voluntary contractual terms specified *ex ante* by means of *fixed* claims. Only a particular class of creditors (tort creditors) joins the nexus on an involuntary basis. This is a useful economic framework for trying to define what, in the context of conflict of law issues for companies, is normally referred to as the general interest (or public policy or public interest) in the literature. The general interest argument is normally advanced and defended in terms of the sovereignty concerns of the forum state. The issue is not without real and practical implications for the topic this article deals with. Indeed, Article 44(2)(g) EC refers to *members* and *other*.[92] If one can reasonably argue that *members* are shareholders, one may have problems determining exactly who the *other* are.

In strict economic terms, it is not reasonable to assume that the general interest coincides with the interests of contractual creditors. They join the nexus

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[90] Each of the company creditors will have to answer a clear and simple question. In my position as a contractual creditor, do I want to participate in an allocation of property rights (basically, an allocation of risk) that is different from the allocation granted by my local legal order? Once the contractual creditor is informed (via the First Directive or the Eleventh Directive) that it is dealing with a foreign company, it will ask itself this question and discount the risk *ex ante*, adjusting or refusing the contractual agreement in question. If minimal capital requirements are really necessary for protecting company creditors, we should see an increase in the number of incorporations in jurisdictions that impose such requirements, because companies want to reduce the costs of credit. However, comparative analysis demonstrates that minimal capital requirements are not a necessary form of creditor protection and persist in Europe because of path dependency resulting from mandatory regulation.

[91] From this perspective, the considerations advanced by Advocate General Alber in para. 151 in *Inspire Art* are completely correct. No regulator is able to establish the optimal amount of business risk between jurisdictions to protect local company creditors *ex ante* by statute or *ex post* by judicial review.

[92] The pre-Amsterdam English version of the EC Treaty contained the plural *others*.

by means of *voluntary* contractual agreements, which means that freedom of contract should be granted. Generally speaking, freedom of contract has been limited in cases involving standard form contracts on the basis of severe asymmetric information problems. For instance, in the case of contracts of adhesion, this has occurred because of consumer protection concerns. The free choice of law for standard form contracts has consequently been limited by forum states for the same reason.[93] Section 4 explained that, with respect to the capital provisions of a company, customers lack real protection because insurance and general regulation of the economic activity in question (basically through safety and health regulations for products or services) are a more efficient means of protection. All other creditors do not really require substantive regulation to identify the optimal amount of risk to which they are subject.[94] In sum, contractual creditors are not candidates for the general interest status that state sovereignty concerns attempt to protect. Instead, general interest status may be fruitfully identified with the economic concept of externalities.[95] A third party that comes into contact with the nexus of contracts on an involuntary basis may be a party that needs special protection. Tort creditors could thus be identified as eligible for general interest status, and a form of protection could be found to protect their interests.[96]

However, the picture is more complex than this. In fact, it has so far been assumed that the particular incentive structure of the nexus, which is based on residual *versus* fixed claims, is always respected. The picture would be complicated if the framework was modified by allowing a particular class of patrons, other than shareholders, to decide matters related to the contractual agreements between shareholders (i.e. matters related to contracts or the internal affairs of the company).[97] In other words, the peculiar incentive structure of the company

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[93] For a comparison between Germany and Great Britain, see Knöfel, 'Mandatory Rules and Choice of Law: A Comparative Approach to Article 7(2) of the Rome Convention', *JBL* (1999) p. 239.

[94] More specifically, they would require it if somebody were able to identify it for them. Unfortunately, nobody is able to identify the optimal amount and allocation of risk by means of a regulation.

[95] Broadly speaking, an externality is a modification of a property right on the basis of an involuntary non-contractual choice. A negative externality generally occurs because of the simultaneous, involuntary and non-compatible use of the same resource by two or more subjects.

[96] In this case, the question is whether real seat theory and minimal capital requirements actually protect tort creditors, or whether (mandatory) insurance (which is independent of real seat theory and incorporation theory) forms a more efficient way of protecting tort creditors.

[97] Or by allowing different classes of creditors to make decisions not only with regard to their own claims but also with regard to the claims of other classes. This would imply a modification of the free incentive structure of the contracts to which each different class of creditors generally agrees voluntarily. In fact, given the low transaction costs, all creditors would *ex ante* discount the new incentive system by modifying the debt conditions.

as a particular type of nexus of contracts between several classes of patrons would be modified as a result of the mandatory regulation of the ownership incentive structure.

To understand this point, imagine a hypothetical community, like the European Community, that has fifteen jurisdictions, is governed by a treaty that contains articles like Articles 43, 48 and 44(2)(g) EC and exhibits the following pattern. Jurisdictions 1, 2 and 3 require the presence and proportional voting power of shareholder representatives and customer representatives on the board of directors.[98] Customer representatives are chosen by the national association for consumer protection and make up half of the board of directors. The aim of such mandatory legislation is assumed to be the better protection that all customers will enjoy because their representatives on the board of directors will care about the safety and the health of the products! The other jurisdictions apply different mandatory requirements for similar social reasons.[99] Jurisdictions 4 and 5 require the presence of employee representatives on the board of directors. Jurisdictions 6, 7, 8 and 9 grant shareholders the freedom to compose the board of directors as they see fit. Jurisdiction 10 requires the presence of representatives of trade creditors (e.g. representatives chosen by the local chamber of commerce). Jurisdiction 11 requires the presence of employee and customer representatives. Jurisdiction 12 requires the presence of financial creditors and customer representatives. Jurisdiction 13 requires the presence of financial creditor representatives. Finally, jurisdictions 14 and 15 require the presence of tort creditor representatives (chosen by the national association of insurance companies) and employee representatives.

Economic theory tells us that in each of these cases, with the exception of jurisdictions 6 to 9 (where shareholders will not rationally choose to hand over power to other patrons), the costs of ownership will increase because the incentive structure of the residual claimants (owners) is modified.[100] In a system of free incorporation, rational shareholders in search of efficient solutions for decreasing the costs of ownership could escape inefficient regulation by incorporating the company in jurisdictions 6 to 9. To prevent avoidance of internal

[98] The example given is not as hazardous as it appears. In fact, intellectual forces in the United States and Europe have argued in favour of a 'democratisation' of the corporation by means of a democratisation of corporate boards. See Romano, 'Metapolitics and Corporate Law Reform', 36 *Stanford LR* (1984) p. 923; Clark, *Corporate Law* (Boston 1986) p. 675; Mitchel, ed., *Progressive Corporate Law* (Boulder 1995). With regard to Germany, the European country in which the *communitarian* view of the company has been debated most, Pistor, 'Codetermination: A Sociopolitical Model with Governance Externalities', in Blair and Roe, eds., *Employees and Corporate Governance* (Washington, DC 1999) p. 163, reports several strange proposals that were made during the 1970s on how to compose the supervisory boards of large companies.

[99] The examples that follow are based on several hypothetical combinations.

[100] See n. 51 *supra* and accompanying text.

regulations, some jurisdictions (e.g. jurisdictions 12 and 14) could impose real seat theory on the grounds of general interest, in other words, by trying to impose state sovereignty concerns. Alternatively, jurisdictions 12 and 14 could launch political negotiations to reach an agreement about a common federal composition of the board of directors that could be imposed by federal regulation.[101] In the absence of political agreement in a case concerning mutual recognition,[102] the Federal Court of Justice of this hypothetical community would have to decide to what extent the general interest cited in defence of internal regulation conflicted with treaty provisions on freedom of establishment and the mutual recognition of companies.[103]

In a federal system, however, the general interest argument, which extends to state sovereignty concerns, can be advanced to justify all kinds of restrictions to free contracting and free choice of law among parties that are active in a single market comprised of several jurisdictions.[104] In the company context, the general interest argument cannot be justified. Indeed, economic theory tells us that it would not be rational for patrons to increase the costs of ownership contractually, as this would quite simply imply a reduction in the value of all the contracts of the nexus.[105] The general interest argument assumes the necessity of a *political* decision concerning the mandatory allocation of property rights to

[101] According to the relative contracting power of each jurisdiction, several results are possible. One of them could be that the board of directors is composed of ten members (four elected by shareholders, two by customers, three by employees and one by tort creditors).

[102] For instance, shareholders could choose jurisdiction 8 to incorporate a company to do business in jurisdiction 1, where the national organisation of consumers could bring an action before a local court against this incorporation, arguing that public policy is being violated and national regulation circumvented by means of a fraudulent incorporation. In addition, jurisdiction 1 could argue that a company in jurisdiction 1 is regarded as a contract, implicit or explicitly, between shareholders and customers, so that the issue of *Qualifikation* (characterisation) could also come into play.

[103] I have intentionally avoided public choice analysis to explain how single groups of patrons in the different jurisdictions could hijack the legislature to impose inefficient regulation. On this point, see section 6.

[104] On this point, Stephan, 'The Political Economy of Choice of Law', 90 *Georgetown LJ* (2002) p. 957 at p. 958, correctly states that 'the protean nature of the sovereignty concept means that it can be made to work for almost any cause'. Schulz, op. cit. n. 41, at p. 179, concludes his comparative analysis by arguing that, since the 'conflict revolution', the US Supreme Court has basically refused to establish federal constitutional common law criteria for dealing with problems deriving from conflict of law issues between the states. States are basically free to decide without strict constitutional supervision (the only exception to this general rule being the supremacy of incorporation theory in corporate law). The ECJ has developed a more coherent and precise framework to deal with the compatibility of national conflict of law rules with EC treaty provisions (i.e. the proportionality test).

[105] It is worth recalling that all the patrons are rational and discount prices *ex ante*, meaning that they will rationally react to a reduction of their claims by offering less.

efficiently regulate the nexus of contracts. In general, *political* decisions (which are normally adopted by a simple or qualified majority) are necessary in the field of tax law in order to finance public goods because of the well-known free-rider problem. In contrast, in the case of a set of contractual arrangements, mediation by a political body is not necessary and generally inefficient. Patrons are *private* utility-maximising actors that enter into contractual agreements on the basis of *private* utility functions without the need for political mediation. Furthermore, a political decision concerning the mandatory allocation of (property) rights to a class of patrons in the context of company law can give rise to a conflict between various classes of patrons in terms of externality problems.

To understand this point, imagine a situation in which, in order to avoid inefficient mandatory regulation, shareholders in jurisdiction 1 choose to incorporate a company in jurisdiction 8. This constitutes an indirect externality for jurisdiction 1 and a direct externality for consumers in jurisdiction 1, who are deprived of their (inefficient) right to co-determine company decisions.[106]

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[106] The externality argument was already made by Bebchuk, loc. cit. n. 79, at p. 1485. In this case, the externality is created by the simultaneous and incompatible use of the resource or right of 'ownership of the company' granted by jurisdiction 1 by two different classes of patrons. It should be noted, however, that there is an asymmetry between the reactions of the two classes of patrons to inefficient mandatory regulation that assigns property rights in a way that creates an externality that reduces efficiency. Given free mobility of capital, shareholders, even as a dispersed group, will simply discount the inefficient regulation *ex ante* by lowering the price of shares (using the efficiency of the capital markets to price their claims). To the extent that the political system permits capital mobility, they are not exploited and react to the externality because of the very low transaction costs of organising their opposition. They simply react in the same way that creditors react in the example provided in n. 97 *supra*.

Customers, [in contrast, are a more dispersed group of patrons and have a smaller degree of homogeneity of interests than shareholders, who only care about profit maximisation and for this reason maintain efficient ownership of the company. In addition, customers do not have a pricing system like shareholders, who have the capital market. For this reason, they require the *political* enforcement of the law to ensure that their claims are respected. In other words, they are not able to react directly – by means of their involvement in the nexus of contracts – to the supposed externality, because of the free-rider problem and problems associated with collective action. For this reason, they are more likely than shareholders to lobby the national regulator to ensure that their claims are respected, for instance, by impeding exit by means of real seat theory or by trying to unify the relevant legislation at the federal level. Then again, given the free worldwide mobility of capital, shareholders at the federal level could simply react by discounting the price of equities *ex ante*. The final solution should therefore be a worldwide imposition of the regulation that favours customers: shareholders should be obliged to bear the costs of the inefficient regulation they would like to escape in order to ensure that *all* classes of patrons are better off.

5.4 Conclusions

The above analysis indicates that the key factor for deciding the relative efficiency of foreign incorporation *versus* internal incorporation is a comparison of savings in ownership costs and (a possible increase in) the costs of credit. If the savings in ownership costs outweigh the increase in the costs of credit, a foreign incorporated company will be more efficient than a locally incorporated one.[107] This is particularly true in the case of large (listed) companies with dispersed ownership, in which the efficiency of different regulations in relation to the agency costs of ownership can actually be compared. The corollary of this conclusion is that real seat theory is an inefficient conflict of law rule, because it precludes *ex ante* the possibility of using foreign regulations for efficient purposes and leads to an inefficient asset partitioning between creditors. Furthermore, the preceding arguments also show that, even in the case of small mail-box companies (like Centros and Überseering), real seat theory should not be applied to *contractual* creditors.

6. The efficient allocation of policy competence

The analysis presented so far favours the following approach. In the market for property rights, one should grant free choice of law to the class of patrons that values it most (i.e. shareholders) and allow it to choose the jurisdiction it considers more efficient to regulate its contractual arrangements, in order to minimise ownership costs. All other classes of patrons will also benefit from such a free choice by joining a nexus of contracts that is, relatively speaking, more efficient than others. In a federal system composed of several jurisdictions offering different regulatory devices for the minimisation of the agency costs of ownership, the ideal conflict of law rule is the one that ensures free choice of law for shareholders. Unfortunately, decisions concerning conflict of law rules are not directly in the hands of shareholders. They are made at the national level or at the federal level (in accordance with the relevant constitutional provisions). At the federal level, however, the constitution has to be written. In other

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[107] This thesis has already appeared in Lombardo, op. cit. n. 2, at p. 154, arguing that Delaware corporate law is more efficient than the corporate law of others US states in dealing with ownership costs and that the costs of credit did not increase. Comparatively speaking, it may be concluded that, in the absence of federal regulation on the protection of creditors, contractual creditors are not exposed to systematic exploitation. See Manning and Hanks, op. cit. n. 67. For comparative purposes, see Macey and Enriques, loc. cit. n. 66. Moreover, my conclusion is also compatible and in line with the conclusion reached by law and economics scholars, namely, that the benefits of limited liability are very large in companies with dispersed ownership. See Halpern, Trebilcock and Turnbull, loc. cit. n. 64, at p. 147.

words, competence has to be allocated explicitly. The question now is which level (federal or national) should have competence (the property right) regarding the choice of law rule.

The Coase theorem suggests that, in a world without transaction costs between parties, the efficient solution is independent of the allocation of property rights. In other words, if the property right concerning the decision were at the national level and the federal level valued it more, the federal level would buy it from the national level by means of a mutually beneficial agreement. Likewise, if the property right were at the federal level and the national level valued it more, the national level would buy it from the federal level.[108] Assuming, however, that both levels consist of efficiency-oriented policy makers that ascribe the same value to the property right in question, the only solution would be a choice of law rule granting shareholders free choice of law, that is, the efficiency-oriented solution. Unfortunately, the real world is characterised by transaction costs. In the economics of politics, these transaction costs are identified in terms of political decision-making costs and political economy costs (i.e. political costs).[109] In the case of a federal system, the framework of analysis is more complicated, because political costs derive from the horizontal level (the interaction between the jurisdictions that make up the federal system) as well as from the vertical level (the interaction between the federal jurisdiction and the lower jurisdictions).[110]

In the company law context, a federal system is confronted with political costs in two areas: the harmonisation/unification of substantive law and conflict of law issues. At both levels, there is a general tendency by jurisdictions to

[108] It is worth noting that, if shareholders participated in this game, they would get the decision concerning conflict of law and would choose a conflict of law rule that permits exit, because they value it most. However, they are not even allowed to participate in this game directly. In addition, they are a dispersed class of patrons, so their decision-making mechanism is extremely difficult to organise.

[109] For the sake of simplicity, I refer to these kinds of transaction costs as political costs. The reference is to public economics and public choice. Obviously, the literature on these topics is abundant. In general, see Atkinson and Stiglitz, *Lectures on Public Economics* (Maidenhead 1980) p. 294 (in particular); Mueller, *Public Choice II* (Cambridge 1989); Buchanan and Tullock, *The Calculus of Consent. Legal Foundations of Constitutional Democracy* (Ann Arbor 1965).

[110] The economics of federalism deals with these topics. Once again, the literature in this are is abundant. For a survey, see Inman and Rubinfeld, 'Rethinking Federalism', 11 *J. Econ. Persp.* (1997) p. 43.

protect claims that should not be protected in efficiency terms.[111] Small interest groups are capable of organising themselves more effectively than shareholders to lobby regulators to impose inefficient regulation.[112] Lobbying takes place at the national or federal level depending on the allocation of competence and the relative probability of success.[113]

With regard to the focus of this article, it appears that the EC Treaty does not opt for a particular choice of law rule in Articles 43 and 48 EC. In practice, there is a general statement in favour of freedom of establishment but not a clear

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[111] On the creation of the externality problem, see n. 106 *supra* and accompanying text. In the economics of federalism, the problem of externalities between jurisdictions is one of the most important. In the company law context, my analysis has nevertheless eliminated the problem *ab origine*, because I have argued on the basis of an ideal company based on an efficient nexus of contracts. To be sure, the gravity of the externality problem between jurisdictions has also been relativised in the classic context of the public aggregation of preferences as conducted in environmental matters. See Revesz, 'Rehabilitating Interstate Competition: Rethinking the 'Race-to-the-Bottom' Rationale for Federal Environmental Regulation', 67 *New York U. LR* (1992) p. 1210.

[112] In the very extensive (US) literature on the political economy of regulation, this case has been made by Carney, 'The Production of Corporate Law', 71 *South. Cal. LR* (1998) p. 715, with respect to the takeover regulations of single states, and by Macey and Enriques, loc. cit. n. 66, at p. 1202, with respect to those that profited from the inefficient regulation of the Second European Company Law Directive. European scholars are generally less interested in the theory of political economy than US scholars, so European studies in this area are basically non-existent. Nevertheless, it is common knowledge that the legislative *iter* of several European legislative acts (e.g. the European Company Regulation, the Takeover Directive and the Structure Directive) has been and continues to be the object of intense rent-seeking activity by interest groups. Whatever can be said about the efficiency and necessity of such acts, it is worth noting that the first was enacted after many years of discussion and that the second and third acts have still not been enacted.

[113] For a theoretical model, see Noam, 'The Choice of Governmental Level in Regulation', 35 *Kyklos* (1982) p. 278. For an application in corporate law with respect to the federal disclosure requirements in the case of takeovers, see Kostel, 'A Public Choice Perspective on the Debate over Federal versus State Corporate Law', 79 *Virginia LR* (1993) p. 2129. Stressing the point that federal regulation should generally not be expected to be less of an object of lobbying activity than state regulation, see Choi and Guzman, 'Choice and Federal Intervention in Corporate Law', 87 *Virginia LR* (2001) p. 87. On this issue, see also Mahoney, 'The Political Economy of the Securities Act of 1933', 30 *J. Leg. Stud.* (2001) p. 1. For a political economy of the conflict of law issue, see Stephan, loc. cit. n. 104. Romano (2002), op. cit. n. 77, at pp. 112 and 120, has proposed a federal mandatory act of Congress as a better way to implement a system of free choice of law for issuers. To be sure, incorporation theory has developed spontaneously without mandatory federal regulation (see Note, loc. cit. n. 37). Romano's proposal rests on the assumption that direct federal intervention would be more effective than the free choice of states.

conflict of law rule.[114] However, since all six of the original Member States followed real seat theory at the time of the adoption of the Treaty, it is reasonable to assume that the delegations that negotiated the Treaty had real seat theory in mind as the relevant conflict of law rule.[115] Furthermore, agreements in the European Community have generally resulted in the safeguarding of real seat theory. Without a specific analysis of the legislative *iter* of individual agreements, it is fair to assume that national delegations have generally tried to impose their own domestic solutions.[116] This is true for the Brussels Convention

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[114] This is actually confirmed by Advocate General Colomer in his considerations regarding *Überseering* (see paras. 39 to 41). Due to the absence of an explicit reference of the ECJ on this point, the extent to which the Court implicitly follows Colomer's conclusions is difficult to establish. In fact, some scholars claim to have detected a non unconstrained possibility for Member States (that follow real seat theory as well as incorporation theory) to limit exit and/or entry opportunities in the decision. Articles 43 and 48 EC would be from that prospective constitutional conflict of law rules directly granting exit and/or entry to companies in relation to which both national conflict of law rules and substantive law rules should be examined for compatibility. See Eidenmüller, loc. cit. n. 8, at p. 2243; Zimmer, loc. cit. n. 8, at p. 3.

[115] Nevertheless, this statement has to be taken as a working hypothesis, as there is no clear historical proof (see section 3, also with regard to the functional link between Articles 43 and 48 EC and Articles 44(2)(g) and 293 EC). The Netherlands switched to incorporation theory in 1959 (see Stein, loc. cit. n. 29, at p. 1330). When Great Britain, Ireland and Denmark (all followers of incorporation theory) joined the Community in 1973, the conflict of law issue suddenly became more concrete. This is because Article 48 EC requires that a company (a) has to be formed in accordance with the law of a Member State and (b) has to have its (i) registered office, (ii) central administration or (iii) principal place of business within the Community. For a Member State like the United Kingdom, for example, conditions (a) and (i) essentially coincide. A company is formed in accordance with the law of the United Kingdom if it is domiciled in the United Kingdom, that is, has its registered office there but not necessarily its principal place of business or central administration – 'a company formed under the Companies Act 1985 has an English domicile if it is registered in England and a Scottish domicile if it is registered in Scotland'. See Collins, *Dicey and Morris on the Conflict of Laws* (London 1993) p. 1104. As already explained by Behrens, loc. cit. n. 30, if a company moves its centre of administration to Germany, it is still validly constituted in Great Britain. For this reason, the company enjoys freedom of establishment under EC treaty provisions and has to be recognised in Germany. It is interesting to note that, if all Member States followed real seat theory (an eventuality not forbidden by the EC Treaty, which does not impose a particular conflict of law rule in this regard), the transfer of the centre of administration or principal place of business of a company would not be possible in Europe without reincorporation.

[116] By trying to develop a political economy of the harmonisation of company law, I have argued that a substantial difference between the European single market and the single market of the United States is that of the language. US lawyers (both university professors and attorneys) do not really care about the Delaware regulation, because it is still regulation in *English*. In Europe, the human capital of a professor or lawyer is generally invested in only one jurisdiction and one language, so a free market for legal services may jeopardise this human capital and challenge this linguistic limitation. For an attempt to construct a political economy of the harmonisation of company law in Europe, see Lombardo, op. cit. n. 2, at p. 193.

on the Mutual Recognition of Companies,[117] the Regulation on the Statute for a European Company[118] and the draft proposal for a Fourteenth Directive on the Transfer of Registered or Head Offices.[119]

Historical evidence seems to suggest that the political costs (political decision making costs and political economy costs) of the allocation of policy competence have favoured the national level and that the general rule has been the one that forbids exit, namely, real seat theory.[120] It is true that the subsidiarity principle, as introduced by the Maastricht Treaty, favours the allocation of policy competence to the lowest possible level, but with respect to conflict of law rules the issue is more complex and delicate. In fact, conflict of law rules can be used to forbid entry and exit options to contractual parties that are active in the entire single market. They can limit choice opportunities and represent a vigorous and dangerous barrier to the efficient allocation of resources as required by Article 98 EC. Furthermore, from a public choice perspective, they are the best means to impose rent-seeking regulations by simply forbidding exit or entry opportunities. In short, neither the federal nor the national level has been able to develop a system of conflict of laws rules permitting a real implementation of the 'constitutional' freedoms granted by the spirit of the EC Treaty. The only actor that has sensibly tried to implement the spirit of the Treaty has been the European Court of Justice. This actor has been identified in the literature as the 'motor of integration', because, through its case law, it has

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[117] See n. 31 *supra*.

[118] Council Regulation of 8 October 2001 on the Statute for a European Company (SE), *OJ* 2001 L 294/1. The conflict of law rule is determined in Article 7 and is also the real seat theory for Member States that follow incorporation theory. The extent to which this mandatory choice of real seat theory conflicts with treaty provisions has been briefly analysed by Schindler, ''Überseering' und Societas Europea: Vereinbar oder nicht vereinbar, das ist die Frage', 21 *RdW* (2003) p. 122. The Regulation on the European Economic Interest Grouping (EEIG) specifies in Article 12 that the legal seat of the EEIG has to be in the same place as the centre of administration. See Council Regulation 2137/85, *OJ* 1985 L 191/1.

[119] This is explicitly referred to in point A(VII)(2) of the preamble of the draft proposal, which appears in 28 *ZGR* (1999) p. 157. Di Marco, 'Der Vorschlag der Kommission für eine 14. Richtlinie', 28 *ZGR* (1999) p. 3 at p. 6, points out that the proposed directive refuses to take a clear position on choice of law rule. He argues on the basis of the subsidiarity principle, as does the preamble (see point V). It is not clear to what extent the draft proposal will be modified to take into account the new judicial results of *Centros* and *Überseering*.

[120] Stephan, 'Regulatory Cooperation and Competition: The Search for Virtue', (1999), available at: <http://www.ssrn.com>, has proposed the concept of *cooperative competition*, that is, cooperation between jurisdictions at the conflict of law level to achieve freedom of choice of law and forum law in order to make competition between jurisdictions work. In this context, historical European evidence appears to suggest that jurisdictions do not cooperate. Some Member States have changed their conflict of law rule, as the Netherlands did in 1959. Italy has formally followed incorporation theory since 1995, but applies internal regulation in the case of the transfer of the centre of administration or principal place of business to its territory.

created a 'constitutional' framework that ensures the exercise of the freedoms granted by the Treaty against national, parochial interests that are defended by means of substantive law or conflict of law regulations.[121]

7. Conclusions

This article has tried to provide an economic analysis of the conflict of law issues that apply to companies that are active in the European single market. It has been argued that, in an ideal world without transaction costs, the efficient allocation of policy competence would be directly in the hands of shareholders and would favour freedom of incorporation and mutual recognition between jurisdictions. Unfortunately, political costs make this solution impossible. So far, only the European Court of Justice has tried to implement such a solution.

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[121] It would be beyond the scope of this article even to try to provide a possible explanation for the role of the ECJ as a (political) actor on behalf of the European integration. For an introduction to this topic, see Weiler, *The Constitution of Europe* (Cambridge 1999) p. 188. On the extent to which the ECJ continues to qualify as the 'motor of integration', see Hirsch, 'Der EuGH im Spannungsverhältnis zwischen Gemeinschaftsrecht und nationalem Recht', 53 *NJW* (2000) p. 1817 at p. 1820; Hirsch, 'Das Rechtsgespräch im Europäischen Gerichtshof', 31 *ZGR* (2002) p. 1, also with regard to conflict of law rules for companies.

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