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## Companies in the European Community: Are the Conflict-of-Law Rules Ready for 1992?

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# COMPANIES IN THE EUROPEAN COMMUNITY: ARE THE CONFLICT-OF-LAW RULES READY FOR 1992?

Andreas Reindl\*

## I. INTRODUCTION

In a modern economy, companies are an important form for pursuing business activities. When states purport to create an integrated market system, the ability of companies to do business within this market with a minimum of restrictions becomes essential in order to achieve a better allocation of resources. For this purpose, a company must be able to acquire property, access the courts, organize branches or subsidiaries and generally do business at any place it deems most favorable. In order to operate, the company must be recognized as a legal entity in the courts regardless of whether it has conformed with the host country's law of business organization or the home country's provisions on location of its activities.<sup>1</sup> Thus, in an efficient, integrated system of states, the traditional concept that a state, on the basis of its internal law or international comity,<sup>2</sup> may or may not recognize a foreign company whose existence and legal character is derived from a

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I am most grateful to Professor Eric Stein for encouraging me to write this article, and for criticizing earlier drafts.

1. In the European discussion on the compatibility of conflict-of-law rules with the EEC Treaty, "recognition" in the first place refers to the question whether the legal existence — i.e., the capacity to hold rights and bear duties — of a company which has been created by a foreign law is accepted at all. If a foreign company is viewed as legally non-existent, any further question as to the position resulting from the recognition cannot arise. Thus, the extent and possible effects of a recognition (whether, e.g., a foreign company has the same capacity as in its home state, is subject to any restrictions in its business activities or must conform with local company laws concerning internal affairs) are not primarily discussed. For the European position see generally, Beitzge, *Anerkennung und Sitzverlegung von Juristischen Personen im EWG-Bereich*, 127 ZEITSCHRIFT FÜR DAS GESAMTE HANDELSRECHT UND WIRTSCHAFTSRECHT [ZHR] 1, 3 (1965); and Diephuis, *The Concept of Recognition*, 27 NETH. INT'L L. REV. 347 (1980). Besides legal personality and capacity, recognition includes the limited liability of its members, segregation of the private property of members from that of the entity, and the constitution of the company, including the distribution of powers amongst its organs. *Id.* at 349.

2. During a highly protectionist period in Europe in the 19th century which featured strict control over all business activities, legal personality was conferred upon an association by a grant of the sovereign. Later, states developed a more liberal attitude. Today, in general they automatically recognize the legal personality conferred upon a company by a foreign state. See H. WIEDEMANN, 1 GESELLSCHAFTSRECHT 777 (1980); Diephuis, *supra* note 1, at 349.

foreign state will gradually be replaced by a duty imposed on the states by the "federal" order.

This article describes the current situation in the emerging integrated system of the European Community, focusing on the potential conflict between Community rules on the freedom of establishment and national conflict-of-law rules relating to companies. In the first part, I shall outline the relevant provisions of EC law and the two conflict-of-law concepts presently exhibited in the national laws of the Member States. In the second part, I shall discuss three cases in which the European Court of Justice recently addressed this subject. In the third part, I shall analyze the impact of the Court's opinions, and finally outline options for future legislative and other action.

### COMMUNITY LAW AND NATIONAL CONFLICT-OF-LAW RULES

The founders of the European Community saw in unrestricted transborder activities of companies an important tool for the creation of a common market. The freedom of establishment,<sup>3</sup> granted to both natural persons and companies, is one of the "basic" freedoms provided by the Treaty.<sup>4</sup> It is laid down in article 52's guarantee of this right to all Community companies;<sup>5</sup> paragraph 1 mentions both "primary" and "secondary" establishment.<sup>6</sup> Article 58 specifies that all

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3. No clear definition of the term "establishment" exists, in particular regarding the distinction to the providing of services. It consists of the conduct of an economic activity from a fixed base, if not on a permanent basis, at least from a durable one; it usually involves the occupation of premises there.

4. Treaty Establishing the European Economic Community, *opened for signature* March 25, 1957, 298 U.N.T.S. 11. The other basic freedoms are the free movement of goods (arts. 9-37), workers (arts. 48-51), services (arts. 59-66) and capital (arts. 67-73).

5. Article 52 states:

Within the framework of the provisions set out below, restrictions on the freedom of establishment of nationals of a Member State in the territory of another Member State shall be abolished by progressive stages in the course of the transitional period. Such progressive abolition shall also apply to restrictions on the setting up of agencies, branches or subsidiaries by nationals of any Member State established in the territory of any Member State.

Freedom of establishment shall include the right . . . to set up and manage undertakings, in particular companies or firms within the meaning of the second paragraph of Article 58, under the conditions laid down for its own nationals by the law of the country where such an establishment is effected, subject to the provisions of the Chapter relating to capital.

The transitional period, mentioned in the first paragraph, ended in 1970. This provision is directly applicable. See *Reyners v. Belgium*, 1974 E.C.R. 631.

6. "Primary establishment" means the setting up of the principal place of business in a territory; it includes the case of a transfer of the company headquarters. "Secondary establishment" means setting up a subsidiary, agency or branch. While in the first case the principal place of business does not remain in the originating state, in the second case the center of the enterprise is not removed; only an additional, subordinate place of business is created.

The right of secondary establishment requires an already existing link to the economy of a Member State. See Behrens, *Niederlassungsfreiheit und Internationales Gesellschaftsrecht*, 52 *RABELS ZEITSCHRIFT FÜR AUSLÄNDISCHES UND INTERNATIONALES PRIVATRECHT* [RABELSZ] 498, 499 (1988); Timmermans, *The Convention of 29 February 1968 on the Mutual Recognition of Companies and Firms*, 27 *NETH. INT'L L. REV.* 357, 359 (1980). The additional

companies formed in accordance with the law of a Member State which have their registered office, central administration or principal place of business in a Member State enjoy this right.<sup>7</sup> The recognition of a company in the state where the company decides to do business is necessary for the exercise of the right of establishment.<sup>8</sup> Thus, one should expect that a Member State can no longer decide on the basis of nationality<sup>9</sup> which "foreign" company of another Member State to recognize and grant free establishment.

Finally, one has to mention article 220, which addresses the situation where a company transfers its management to another Member State. Article 220 stipulates that the Member States shall enter into negotiations on the "retention of legal personality [of companies] in the event of a transfer of their seat from one country to another."<sup>10</sup>

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requirement of an economic link is inferred from the different wording of the first and second sentence of article 52(1). The first sentence gives a general right to freedom of establishment to any national of a Member State which can be exercised by founding a principal place of business in a Member State ("primary establishment"). The second sentence provides the right to set up a branch, agency or subsidiary only under the additional requirement that the company is already established in a Member State ("secondary establishment"). This difference also is expressed in Part I of the General Programme on Establishment, 5 J.O. COMM. EUR. (No. C2) 36 (1962).

7. Article 58 states:

Companies or firms formed in accordance with the law of a Member State and having their registered office, central administration or principal place of business within the Community shall, for the purposes of this Chapter, be treated in the same way as natural persons who are nationals of Member States.

"Companies or firms" means companies or firms constituted under civil or commercial law, including cooperative societies, and other legal persons governed by public or private law, save for those which are non-profit-making.

8. See H. WIEDEMANN, *supra* note 2, at 793, who affirms that the permission to conduct business activities in the form of an establishment always includes the recognition of the foreign entity. By granting the right of establishment, recognition as a legal personality is decided at the same time. See also Steindorff, *Gemeinsamer Markt als Binnenmarkt*, 150 ZHR 687, 694 (1986), who speaks of the affirmative effect of the freedoms under Community law. The exercise of these rights must in fact be possible; thus, the legal existence must be assured in every Community State.

9. For a discussion of the "nationality" of a company, see F. BURROWS, *FREE MOVEMENT IN EUROPEAN COMMUNITY LAW* 182-83 (1987). Burrows suggests that article 58 specifies the sole test for nationality, requiring only that a company is formed in accordance with the law of a Member State or alternatively has either its registered office, seat of management or principal place of business within the Community. Once the requirements of article 58 are met, the company would become a "Community national" and enjoy the right of establishment.

Two of these elements — the territory where a company is incorporated and the place of its registered office, specified in the company's charter — will normally coincide since the place of the registered office will determine the jurisdiction of the registering authority. Behrens, *supra* note 6, at 499; Kozyris, *Corporate Wars and Coice of Law*, 1985 DUKE L.J. 1, 50.

10. Article 220 states:

Member States shall, so far as is necessary, enter into negotiations with each other with a view to securing for the benefit of their nationals . . . the mutual recognition of companies or firms within the meaning of the second paragraph of Article 58, the retention of legal personality in the event of transfer of their seat from one country to another.

It is recognized by many authors that article 220 requires Member States to enter into negotiations, if necessary, rather than simply granting them an option to negotiate. The latter interpretation would render article 220 redundant, for it is in the original competence of each Member

A company incorporated in a Member State that decides to transfer its seat<sup>11</sup> to another Member State without changing its incorporation still faces a problem in the EC. Most of the Member States do not automatically recognize the legal personality of a transferring company; rather, they require the formation of a new company in compliance with the company laws of the receiving state and its incorporation there. This results from national conflict-of-law rules regarding the recognition of foreign companies and the law governing its internal relationships.<sup>12</sup> These rules are based on the "headquarters theory," which states that the law of the place of the management — the real seat of a company — provides the law governing all aspects of the company, including its legal personality and internal regime.<sup>13</sup>

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State to enter into negotiations and to conclude agreements with other Member States. Hence, article 220 can only have the purpose of constituting a duty of the Member States. See Schwarz, *Verhandlungen der Mitgliedstaaten*, in 2 KOMMENTAR ZUM EWG VERTRAG 972-74 (H. von der Groeben, H. von Boeckh, J. Thiesing & C.-D. Ehlermann 3d ed. 1983).

11. The terms "management," "seat" and "headquarters" are used indiscriminately to describe the company's real seat (*siège réel*), the place where the "brain" or "nerve center" are located, where decisions are made and control over the company is exercised. The statutory seat of registration, specified in the company's charter, will be called the "registered office."

12. It is the prevailing view in the European discussion that the distinction between the law determining the company's legal capacity and the law regulating other aspects has become unnecessary. "Recognition" of a foreign company's legal existence was used in the early days of transnational corporate activities as a tool to protect a state against foreign "tramp companies." Today, with the international standard of an automatic recognition, the conflict-of-law rule would point only to one law which then is applied to all aspects of a company; it would also decide the legal existence. See Ebenroth & Sura, *Das Problem der Anerkennung im internationalen Gesellschaftsrecht*, 43 RABELSZ 315, 317 (1979); Drobnig, *Kritische Bemerkungen zum Vorentwurf eines EWG-Übereinkommens über die Anerkennung von Gesellschaften*, 129 ZHR 93 (1966).

But see Grossfeld, *Internationales Gesellschaftsrecht*, in KOMMENTAR ZUM BÜRGERLICHES GESETZBUCH (Staudinger ed. 1981), who insists that "recognition" — meaning the recognition as a legal entity — still has its own value as a separate issue. He points to the fact that in various fields recognition remains a separate issue, and some national laws would still acknowledge a separate act of recognition. He mentions also the specific character — in particular social aspects — of a company that would justify a different treatment of natural and legal persons, and a separate use of this concept regarding companies.

One could further add that the term is repeatedly used in international agreements and the EEC Treaty. It seems therefore justified to discuss separately the recognition aspect although it has no particular legal significance.

13. Since the local law also determines the legal existence, the company must be incorporated where the company's real seat is located. This is significantly different from the U.S. concept where the legal existence of a corporation created by another state is never questioned; the discussion only focuses on the problem of the extent to which local law may be imposed on the internal affairs of a company. See Buxbaum, *The Origins of the American "Internal Affairs" Rule in the Corporate Conflict of Laws* in Festschrift für Gerhard Kegel zum 75. Geburtstag 75, 86 (H.-J. Musiak & K. Schurig eds. 1987), who provides a historical explanation: in the 19th century, U.S. companies incorporated in Northwestern states were active in Southern states less for the purpose of mobilizing local capital than for conducting local business on the basis of their home capital; host states did not have to exercise control over investment (and thus over the internal affairs), but over business activities. On the other hand, European states already suffered from pseudo-foreign corporate distortion and local capital claiming foreign status; for an effective control of this phenomenon, they developed the headquarters theory.

Under this conflict-of-law rule, a company must always be incorporated in the country where it has its real seat; it must be "created" by local law.<sup>14</sup> If the company attempts to transfer its seat to another state without incorporation in its new host state, it loses its legal personality.<sup>15</sup>

Under the so-called "incorporation theory," on the other hand, the law of the state where a corporation is incorporated and has its registered office should always govern legal personality and other related questions. Even if the corporation moves its management and activities into another territory, the law of the state of incorporation should still govern the company. A transfer of the management to another state would not change the law governing the company and affect the company's legal personality.<sup>16</sup>

Therefore, there is potential conflict between article 220 and arti-

14. The incorporation in the new host state is only possible if the company's structure conforms with the host state's company laws. This is the very purpose of the headquarters theory, a reaction to transborder mobility of companies: the state seeks to enforce local laws — in particular concerning employee co-determination and creditor protection — against any organization with its real seat in the state's territory that claims to derive its existence, legal character and governing law from a foreign state. Non-compliance with local law is sanctioned with non-existence for the lack of incorporation. See E. RABEL, 2 *THE CONFLICT OF LAWS* 39 (2d ed. 1960); Buxbaum, *supra* note 13, at 85; for further comment, see *infra* note 15.

15. E. RABEL, *supra* note 14, at 38; Behrens, *Identitätswahrende Sitzverlegung einer Kapitalgesellschaft von Luxemburg in die Bundesrepublik Deutschland*, 32 *RECHT DER INTERNATIONALEN WIRTSCHAFT* [RIW] 590, 591 (1986), speaks of an act of suicide if a company transfers only the management without a concurrent incorporation in the receiving state.

A company may attempt to transfer only its management for several reasons. In doing so, it would be able to transfer the operational center to newly emerging markets without the delay of a liquidation in the first and subsequent incorporation in the second state; Sandroock, *Sitztheorie, Überlagerungstheorie und der EWG-Vertrag: Wasser, Öund Feuer*, 35 *RIW* 505, 512 (1989). It might want to act in a more attractive market without being subject to local company laws requiring high capital resources or employee co-determination. Besides, the company may have fiscal reasons: if it transfers its seat it might no longer be liable for taxes in the originating state and could reduce tax payments; Ebenroth & Eyles, *Die innereuropäische Verlegung des Gesellschaftssitzes als Ausfluss der Niederlassungsfreiheit*, 42 *DER BETRIEB* 363, 364 (1989).

There exists no precise definition of the legal consequences of such a denial. Grossfeld, *supra* note 12, at 331, assumes that the headquarters theory has such a strong preventive effect that only in rare cases do legal disputes arise before the courts.

Some of the effects can be summarized as follows. First, the law of the place of the central management would determine that no registration exists in the relevant legal system, and the company would become a "non-existent legal person." As such, it could not acquire property rights. In this context, German courts held that a company, incorporated under foreign law, cannot become the general partner in a limited partnership after the shareholders decided to transfer the company's seat to Germany. Judgment of June 7, 1984, OLG, Nürnberg, 5 *PRAXIS DES INTERNATIONALEN PRIVAT- UND VERFAHRENSRECHTS* [IPRax] 342 (1985).

Those who act in the name of the company become liable but acquire no rights under contracts purportedly concluded in the name of the company. See Grossfeld, *supra* note 12, at 344. The company also has no active standing. According to Grossfeld, *id.* at 346, and OLG, Nürnberg, *supra*, at 342, however, the foreign entity has passive standing together with the persons who acted in its name.

Finally, the domestic mandatory rules on employee co-determination would apply to the company.

16. Among the EC Member States, the Netherlands and probably Denmark are the only

cles 52 and 58 concerning the right of establishment. The resolution of this conflict also affects the compatibility of the national conflict-of-law rules with the Treaty. Does the right of establishment under articles 52 and 58 include the right of a company, once incorporated in a Member State, to have its personality recognized after transferring its management to another state? Or does article 220 indicate that the right of establishment provisions in articles 52 and 58 are narrower and do not cover the transfer situation? To phrase it differently: Can Member States still lawfully adhere to the headquarters theory and require a company that transfers its management to incorporate as a new company in the receiving state? Or do articles 52 and 58 impose the incorporation theory as a Community-wide, uniform conflict-of-law rule upon the Member States, so that the receiving Member States are duty-bound to recognize the "immigrating" foreign company's legal existence and grant it the same rights as enjoyed by domestic companies, even if the structure of the "migrant" company does not fit into the scheme of domestic company law?

## II. THE TRIAD OF CASES

The debate about the relationship between article 220 and articles 52 and 58 started soon after the formation of the EEC. For a long time the problem was only the subject of an academic discussion that failed to lead to a generally accepted solution. Only recently did the European Court of Justice decide three cases which dealt with the scope of articles 52 and 58 and their relation to article 220. The first two cases included important statements on articles 52 and 58, although the Court referred only to the right of secondary establishment.<sup>17</sup> In the third case, the *Daily Case*, the Court had to address directly the impact of article 220 on article 58.

### A. *Commission v. France*<sup>18</sup>

This case involved provisions of French tax law designed to avoid the double taxation of corporate dividends, first as income of the company, then as income of the shareholders. It granted the shareholders a tax credit of 50% of the taxes paid by the company on the amount

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civil-law countries that — together with the United Kingdom and the Republic of Ireland — follow the incorporation theory. See Ebenroth & Eyles, *supra* note 15, at 366.

For an overview on the development of the two theories, see Grossfeld, *Die Entwicklung der Anerkennungstheorien im Internationalen Gesellschaftsrecht*, in Festschrift für Harry Westermann 199, 200 (W. Hefermehl, R. Gmör & H. Brox eds. 1974).

17. See *supra* note 6.

18. 1986 E.C.R. 273.



distributed.<sup>19</sup> This concession, however, was available only to shareholders with a habitual residence or registered office in France. Companies incorporated in France, including French subsidiaries of foreign companies, could therefore profit from this advantage if they owned shares of other companies. But agencies or branches of companies incorporated outside France could not claim the credit, although they were liable to taxation on profits in France.

The Commission brought an action under article 169<sup>20</sup> against France asserting that this situation would violate article 52 for two reasons. First, the distinction between the agency or branch of a domestic company on the one hand, and of a foreign company on the other, discriminated against the foreign company. Second, since foreign companies were likely to be induced to establish a subsidiary instead of a branch or agency in order to benefit from the French tax provisions, the free choice between the forms of establishment was disproportionately restricted.<sup>21</sup>

As to article 52, the Court held that a discrimination against agencies or branches of Member State companies or any indirect restriction on the freedom of establishment was prohibited.<sup>22</sup> The Court referred to article 58, under which a company, formed under the law of a Member State, and having its registered office, central administration or principal place of business in a Member State, would have a right to pursue activities in another Member State through a branch or agency. To deny a company equal treatment "solely by reason of the fact that its registered office was in another Member State would deprive that provision of all meaning."<sup>23</sup> The Court also rejected the French argument that foreign companies were still free to set up subsidiaries that would enjoy the tax concession. Article 52 expressly preserves a company's free choice of the legal form in which to do business in another state and that freedom of choice must not be limited by discriminatory tax provisions.<sup>24</sup>

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19. General Tax Code, arts. 205-06, fixing a 50% income tax on company income, and art. 158, providing for the tax credit (*avoir fiscal*).

20. Article 169 regulates the supervision by the Commission over the acts of Member States. In the ultimate stage, the Commission may bring an action before the Court if it is of the opinion that a Member State is infringing Community law.

21. In its application, the Commission referred only to insurance companies because complaints were brought only from this business branch. Both the Commission and the Court stated, however, that the case would equally apply to any other industry. 1986 E.C.R. 273, 301.

22. *Id.* at 303 permits this conclusion; the Court stated that the two allegations of the Commission were related and therefore should be considered together.

23. *Id.* at 304. The Court stated that with regard to companies it is the "registered office . . . that serves as the connecting factor with the legal system of a particular state, like nationality in the case of natural persons." *Id.*

24. *Id.* at 305.

**B. *Segers v. K. Bedrijfsvereniging voor Bank en Verzekeringwezen, Groothandel en Vrije Beropen***<sup>25</sup>

This case emerged from a litigation between Mr. Segers, a Dutch national, and the Dutch authorities which administered the national health insurance scheme. Initially, Mr. Segers was the sole proprietor of a Dutch enterprise that provided investment services in the Netherlands. He then founded a British company and transformed his enterprise in the Netherlands into a subsidiary of the British limited company. Mr. Segers became the major shareholder and director of the British company. He maintained his residence in the Netherlands and conducted all business activities through the Dutch subsidiary. The Dutch social security plan providing for health benefits permitted company directors to participate in the insurance plan even if they held more than 50% of the shares of the company. In the case of Mr. Segers, however, the Dutch insurance authority denied him the benefits on the ground that he was director of a company registered outside, but pursuing virtually all its activities inside, the Netherlands; the denial was necessary in order to prevent fraud against national rules.<sup>26</sup> On Mr. Segers' appeal, the Dutch court requested the European Court to determine whether the distinction in the social security law between directors or major shareholders of companies incorporated in the Netherlands and those incorporated in another Member State violated articles 52 and 58.<sup>27</sup>

In the course of the proceeding before the European Court, the Dutch authorities repeated that the conversion of an undertaking into a subsidiary of a company incorporated in another Member State could have a fraudulent purpose. The Advocate General responded that taking advantage of the benefits of a national system was a logical consequence of the right of free movement, and specifically of the freedom of establishment. It was the objective of that freedom that a national of a Member State should be able to use the advantages provided by the law of another Member State. This included the right to take advantage of the flexibility of British company law which permitted the Segers arrangement and made it possible to exploit its attractions.<sup>28</sup>

The Court followed the Advocate General's opinion. It stated that,

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25. 1986 E.C.R. 2375.

26. See point 6 of the opinion of the Advocate General, *Id.* at 2380.

27. Under article 177, a national court is entitled, and in the highest instance even obliged, to ask the European Court of Justice for a preliminary ruling on the interpretation of the Treaty if it considers that the decision on such a question is necessary to enable it to give judgment.

28. 1986 E.C.R. at 2380.

under article 58, a company formed in accordance with the law of a Member State must be free to conduct its business in another Member State in whatever form it elects. Therefore, the location of the company's registered office could not be the basis for differentiation, and the fact that Mr. Segers, who lived in the Netherlands, was director of a British company could not justify the denial of benefits.<sup>29</sup>

C. *Regina v. H.M. Treasury and Commissioners of Inland Revenue ex parte Daily Mail and General Trust plc*<sup>30</sup>

The Daily Mail and General Trust plc, a company incorporated in the United Kingdom, decided to transfer its headquarters to the Netherlands while maintaining its British incorporation. Under British company law, consistent with the incorporation theory, a company may do so without losing its legal personality. However, according to British tax law, a company needs the approval of the transfer by the tax authorities; without such an approval, the company would lose its legal personality and be subject to winding-up-like procedures.<sup>31</sup> Daily Mail made the appropriate applications, but, without waiting for the decision, proceeded with the transfer and commenced rendering services to clients in the Netherlands. The British tax authorities denied their approval unless at least parts of the company's assets were sold before the company moved its management to the Netherlands and ceased to be taxable in the United Kingdom. When protracted negotiations with the British tax authorities brought no solution, Daily Mail initiated proceedings before the High Court, Queen's Bench Division. It claimed that the application of the tax provisions was contrary to EC law, since the right of free establishment of companies under article 58 included an unconditional right to move its headquarters without any prior authorization of the tax authorities. The British court stayed the action and referred to the European Court of Justice the question whether the British tax statute prohibiting a corporation with its headquarters in the United Kingdom from moving its management to another Member State without prior approval of the tax authorities would violate articles 52 and 58 of the EEC Treaty.<sup>32</sup>

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29. *Id.* at 2387-88.

30. [1988] Recueil 5483; 53 Comm. Mkt. L.R. 713 (1988).

31. Income and Corporation Taxes Act of 1970 § 482(1)(a).

32. Again, the reference was based on article 177; see *supra* note 27. The question was restricted to the fact that such an approval was required when tax upon profits should be avoided or other already chargeable taxes circumvented. The Court, however, contrary to the Advocate General, did not limit itself to the tax issue. Cf. the suggested ruling by the Advocate General, 53 Comm. Mkt. L.R. at 721, and the Court's statements in paras. 23-24, *id.* at 726. See *infra* note 50 and accompanying text.

Before the Court, Daily Mail was opposed by both the Advocate General and the Commission. The Advocate General seemed to acknowledge that such a transfer would fall under the term "establishment."<sup>33</sup> He stated, however, that the Treaty allowed a Member State to restrict the right to transfer the central administration of a company in order to prevent an abuse of rights granted under the Treaty. He would deny Daily Mail's application on the ground that the requirement to settle its fiscal position prior to a transfer did not violate Community law as it presently stands. Therefore, Member States could lawfully attach fiscal consequences to such a transfer similar to a liquidation of a company.<sup>34</sup>

The Court agreed with the Advocate General in upholding the British statute, but adopted a broader language than was necessary for deciding the case. It stated that a company could exercise its right of establishment in another Member State either by setting up an agency, a branch or a subsidiary or by winding up and incorporating as a new company there.<sup>35</sup> However, in the current state of Community law, companies were creatures of national law and the legislation in the Member States differed widely both as regards the connecting factors<sup>36</sup> for the applicable company law, and the question whether a company incorporated in one Member State could change the connecting factor.<sup>37</sup> At present, neither Community directives on harmonization of company laws<sup>38</sup> nor the conventions envisaged by article 220 have dealt with this issue. Thus, the right to retain the status of a company after a transfer of its headquarters from one Member State to another is not guaranteed by Community law. It is not possible to claim a right

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33. 53 Comm. Mkt. L.R. at 719-20.

34. *Id.*

35. *Id.* at 725. For criticism of the Court's statement that winding up and re-incorporation in a new Member State would also satisfy the freedom of movement right, see Sandrock & Austmann, *Das Internationale Gesellschaftsrecht nach der Daily Mail-Entscheidung des Europäischen Gerichtshofs: Quo vadis?*, 35 RIW 249, 250 (1989).

36. The "connecting factor" is the element which determines the substantive law that is applicable in a conflict-of-law case. For companies, it may either be the place of incorporation or the seat of the company; see *supra*, text following note 12.

37. The Court cites article 58 placing the incorporation, the seat and the place of principal business on equal footing. 53 Comm. Mkt. L.R. at 726. This would indicate that Member States can choose between these three for the connecting factor. It seems, however, that article 58 provides exactly the opposite; it grants companies a right to choose. This right is effective against the Member States, so they must recognize every alternative.

38. These directives are based on article 54, which provides that the Council shall issue directives to implement the freedom of establishment. With regard to companies, para. (3)(g) specifies that the Council shall co-ordinate

to the necessary extent the safeguards which, for the protection of the interests of members and others, are required by Member States of companies or firms within the meaning of the second paragraph of Article 58 with a view to making such safeguards equivalent throughout the Community.

under articles 52 and 58 to transfer the central management and control to another Member State; national law is not preempted by the provisions of the EEC Treaty.<sup>39</sup>

### III. POSSIBLE RECONCILIATIONS

The three decisions concurred in the proposition that article 58 contains directly applicable law.<sup>40</sup> Therefore, the contention that articles 52 and 58 include only a general program and are not directly applicable to companies can no longer be maintained.<sup>41</sup>

It is difficult, however, to reconcile the three decisions and determine the exact scope of the right protected by articles 52 and 58. On the one hand, *Commission v. France* lays down a sweeping prohibition of any restriction on the freedom of establishment for companies. More specifically, in *Daily* the Court declares that an attempt to restrict a company from moving its seat to another Member State would violate articles 52 and 58.<sup>42</sup> *Segers* provides another argument that the

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39. 53 Comm. Mkt. L.R. at 726.

40. For natural persons, the Court has held article 52 directly applicable in *Reyners v. Belgium*, 1974 E.C.R. 631.

"Directly applicable" means that individuals can invoke their right under Community law before national courts even if national laws contradict the Community law. *Van Gend & Loos*, 1963 E.C.R. 1.

See Timmermans, *supra* note 6, at 357-58, who argues for the direct applicability for companies and concludes that the law of the receiving state may apply only to the extent that it would not hinder the actual exercise of the right of establishment.

41. Initially, the direct applicability of articles 52 and 58 to a company's right of establishment was denied. Although the principle of establishment was included in the Treaty, it was too diffuse and general with regard to companies and did not confer directly invocable rights. Thus, national conflict-of-law rules were not preempted under Community Law. See Grossfeld, *supra* note 12, at 92, arguing that articles 52 and 58 contain at present only general programmatic ideas. See also Grossfeld, *Die Sitztheorie des Internationalen Privatrechts in der Europäischen Gemeinschaft*, 6 IPRA 145, 146 (1986), speaking of an "interpreting away" of the wording of article 220 when he defends the compatibility of the headquarters theory with the Treaty.

However, considering the legal history of article 220, one may counter-argue that this article was never meant to justify the headquarters theory. Article 220 was finalized only at the very end of the negotiations on the EEC Treaty in 1957. One can argue that it is only a subsidiary provision which neither replaces, nor limits or specifies other Treaty provisions but has only a complementary function. The clause "as far as necessary" was only included because the Contracting Parties did not know with certainty in which areas additional measures were still necessary. Although article 220 speaks of an agreement between Member States on mutual recognition, it does not exclude the possibility that mutual recognition is already required by other provisions of the Treaty. For the legal history of article 220, see Schwarz, *supra* note 10, at 976-77.

42. 53 Comm. Mkt. L.R. at 724 states "... prohibit the member-State of origin from hindering the establishment in another member-State of one of its nationals or of a company incorporated under its legislation ..." Arguably, this language would include both discrimination and disproportionate restriction.

Ebenroth & Eyles, *supra* note 15, at 372, think the Court could have easily avoided this statement on articles 52 and 58 by referring to an earlier decision in *Robert Fearon & Co. v. Irish Land Comm'n*, 1984 E.C.R. 3677. There the Court had held that an Irish company could not invoke the right of free establishment under article 58 in order to challenge provisions of Irish law because nationals were not protected against restrictions imposed by the law of their home

freedom of establishment should prevail over state interests. Under articles 52 and 58, the Court granted Mr. Segers the right to choose the legal regime governing his enterprise although its location does not change. This choice is exactly what the headquarters theory tries to prevent.<sup>43</sup> The Court also held that the freedom of establishment of a company cannot be restricted solely on the ground that its office is registered in another Member State.<sup>44</sup> The fact that the company did not pursue any activities in the state in which it was incorporated could not justify a restriction on the freedom of establishment.<sup>45</sup> These statements suggested that the headquarters theory could not survive, once challenged directly before the Court.<sup>46</sup>

On the other hand, the Court upheld the British tax law that — in keeping with the headquarters theory — imposed the loss of legal existence on a domestic company transferring its management to another state.

#### A. *A Narrow Reading of the Third Case — Confining Daily Mail to its Fiscal Aspects*

The most obvious way to reconcile the three decisions is to restrict the reading of the *Daily Mail* decision to the holding on the facts of the case. Under this interpretation, the Court's holding is confined to the proposition that the home state is free to protect its tax interests by

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state. *Id.* at 3685. In *Daily Mail*, the Court discussed the freedom of establishment in the context of a British law that restricted a company which was registered in the United Kingdom.

The cases seem, however, to be distinguishable because in *Fearon* the Irish company itself did not seek a transfer into another Member State; thus, article 58 could not govern the case. In *Daily Mail*, on the other hand, the intention of the British company to move to another state created the connection to another Member State and was sufficient to invoke a right under article 58.

43. See *supra* notes 13-15 and accompanying text. By Mr. Segers' transaction the enterprise, initially owned by Mr. Segers and governed by Dutch law, became the property of a company incorporated under British law without changing its place of business. The Court mentions only the right of secondary establishment; in economic terms, however, the situation is similar to a transborder merger. See Ebenroth & Eyles, *supra* note 15, at 371. They criticize this decision and argue that transborder mergers are not regulated by Community law and national provisions restricting such activities should not be limited by articles 52 and 58.

44. 1986 E.C.R. at 2387, citing *Commission v. France*; see also Cath, *Freedom of Establishment of Companies: A New Step Towards Completion of the Internal Market*, 6 Y.B. EUR. L. 247, 259 (1987).

45. 1986 E.C.R. at 2388; see Cath, *supra* note 44, at 259, stating that "the Court refused to look behind the veil of the company."

46. Cath, *supra* note 44, at 261, states that "it may be inferred that a two-century old discussion with regard to the doctrines of '*siège réel*' and 'incorporation' has been (implicitly) decided in favor of the latter in so far as intra-Community cross-border establishment of companies is concerned."

See also Ebenroth & Eyles, *supra* note 15, at 371. They particularly refer to the *Segers* case and concede that this decision provided the strongest argument against the compatibility of the headquarters theory with Community law.

imposing winding-up procedures if the migrating company has not cleared its financial position. The effective enforcement of tax provisions legitimizes restrictions on the freedom of movement.<sup>47</sup> In previous cases the Court has repeatedly confirmed the broad power of Member States in the fiscal field, including the authorization to impose criminal sanctions aimed at preventing tax fraud.<sup>48</sup>

*Commission v. France*, then, could be distinguished: while the British tax law in *Daily Mail* was permissible as the only way to secure the effective enforcement of national tax rules, the French law discriminated against foreign companies and thus violated Community law. If one takes this view, the question whether a receiving state could lawfully apply the headquarters theory in other circumstances and require a formation and incorporation of a new company was not reached by the Court and the debate between "headquarterists" and "incorporationists" would remain undecided.<sup>49</sup>

### B. A Narrow Reading of "Establishment" - The Language of the Court

The second way to explain, if not reconcile, the cases points to the Court's narrow definition of the term "establishment." When the Court spoke of the right of establishment in the *Daily Mail* case, it had in mind only the second sentence of article 52(1),<sup>50</sup> which discusses

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47. *Rewe-Zentral AG v. Bundesmonopolverwaltung für Branntwein*, 1979 E.C.R. 649, 662.

48. Such national measures were held permissible even if no fraudulent intent was proven. See *Carcianti*, 1980 E.C.R. 2773, and *Abbink*, 1984 E.C.R. 4097. In these cases the Court upheld prohibitions for persons residing in the importation state to use cars which were registered in another Member State, imported for temporary use and therefore exempt from the payment of value added tax (VAT). The provisions, including criminal sanctions, potentially restrict free movement but were held permissible because they prevent the circumvention of national tax laws on VAT.

In *Italy v. Rainer Drexl*, 55 Comm. Mkt. L.R. 241 (1989), the Court pointed out that criminal sanctions must be proportionate to the gravity of the offense. Although Member States are still responsible for fiscal regulations, Community law sets the limit that national laws may not have the effect of jeopardizing the freedom of movement. Confiscation of a car for which the value added tax had not been paid upon importation is disproportionate.

49. *Sandrock*, *supra* note 15, at 512 n.59, emphasizes that by its facts the case was limited to tax provisions, that and a greater autonomy in fiscal matters has always been recognized by the Court. He also points out that the decision involved two states that apply the incorporation theory, and thus the headquarters theory was not an issue before the Court. He doubts whether all the arguments that could be made against the headquarters theory were brought up.

50. *Daily Mail*, 53 Comm. Mkt. L.R. at 725. The statements of the Court seem to be contradictory. First, it affirms the right of unrestricted secondary establishment and states that this "is the form of establishment in which the applicant engaged in this case." *Id.* It continues that the British law would not restrict this right, but finally finds that there are restrictions imposed by the tax law which are, however, permissible. *Id.*

Apparently the Court's statement that the *Daily Mail* wanted to exercise the right of secondary establishment is incorrect. Rather, the company attempted to remove its principal place of business, and thus to exercise the right of primary establishment. See *supra* note 6.

the right of secondary establishment, or the right to choose between setting up a subsidiary or acting through an agency or branch.<sup>51</sup> It is only this right that national laws must not limit.

The recognition of a company's legal existence in the event of a transfer of its headquarters, however, raises a problem of the right of primary establishment.<sup>52</sup> Due to article 220, this area remains subject to limitations based on national conflict-of-law rules. National laws which require an incorporation of a new company in the event of a transfer of the management into another Member State and, by the same token, limit the right of establishment would prevail, by virtue of article 220.

According to this interpretation, the Court grants the Member States wide discretion to deny the legal existence of a moving company.<sup>53</sup> This would correspond to the view that the headquarters theory is still compatible with the Treaty.<sup>54</sup> For several reasons, it is proposed that this interpretation indeed expresses the Court's opinion. First, there is significant difference between the Advocate General's opinion and the language of the Court in the *Daily Mail* case.<sup>55</sup> The proposed ruling of the Advocate General was limited to the fiscal aspects. The Court easily could have adopted this proposal; the result would have been the same. But the language actually adopted by the Court was significantly broader and also covered the right of the receiving state to decide upon the legal existence of an immigrating company.<sup>56</sup>

Second, apart from this contextual argument, one can also refer to the arguments of supporters of the headquarters theory. It was pointed out that the prohibition of indirect restrictions on free movement of goods has never been extended explicitly to the establishment of companies.<sup>57</sup> Only discrimination was prohibited, and the headquarters

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51. The limit the Court imposes on national laws means only that foreign and domestic companies must be treated equally. Different treatment of agencies and subsidiaries is permissible as long as it affects indistinctly all companies.

52. See *supra* note 6, on article 52's distinction between primary and secondary establishment.

53. Ebenroth & Eyles, *supra* note 15, at 372, emphasize that the *Daily Mail* decision is relevant beyond its fiscal aspects and applicable to a receiving state as well.

54. Although even advocates of this theory admit that it represents a protective and restrictive concept. See Ebenroth & Eyles, *supra* note 15, at 365, who state that one can simply say that the headquarters theory largely thwarts the company's right of primary establishment.

55. See *supra* note 32.

56. 53 Comm. Mkt. L.R. at 726; see *supra* note 39 and accompanying text.

57. The Court has developed the principle that non-discriminatory but unreasonable restrictions were prohibited in the area of goods as well as of services, but never clearly extended it to the right of establishment, not even for natural persons. See, e.g., *Procureur du Roi v. Das-*



theory could be applied in a non-discriminatory way.<sup>58</sup> But even if articles 52 and 58 extended to the prohibition of disproportionate restrictions, restrictions based on the headquarters theory were permissible since they were: (1) based on compelling reasons; (2) necessary to protect legitimate local interests; and (3) reasonably related to their objective and equally applied to all companies.<sup>59</sup>

The rationale for this position derives from the differences between national company laws of the Member States, differences which are apparently more substantial and of a different quality than in other areas. European company laws tend to be highly regulatory and express social and political factors.<sup>60</sup> The most frequently cited examples are the rules on employee co-determination in the company management and structures of company boards.<sup>61</sup> National company laws in-

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sonville, 1974 E.C.R. 837; De Peijper, 1976 E.C.R. 613. For further references, see F. BURROWS, *supra* note 9, at 39-43.

See also Ebke, "Ausländische Kapitalgesellschaft & Co. KG" und das europäische Gemeinschaftsrecht, 151 ZEITSCHRIFT FÜR UNTERNEHMENS-UND GESELLSCHAFTSRECHT [ZGR] 245, 257-58 (1988). Even Behrens, *supra* note 6, at 512, an advocate of the incorporation theory, is cautiously extending that second element, the prohibition of a non-discriminatory restriction, to a company's right of establishment. He states that the case law of the Court "at least shows a first sign of going beyond a mere prohibition of discrimination." See also *Ordre des Avocats au Barreau de Paris v. Klopp*, 1984 E.C.R. 2971, discussed *infra*, note 82.

58. See Ebke, *supra* note 57, at 253, arguing that it is applicable to companies with a domestic seat and foreign incorporation as well as companies incorporated abroad with domestic headquarters. He concedes that a different result is possible when the company has a foreign seat. Then the conflict-of-law rules would lead to the applicability of the foreign law. If under that legal system the incorporation theory were applied, the company could retain its legal personality. A company with a domestic seat would always lose that status. He justifies that result by arguing that the domestic conflict-of-law rules are non-discriminatory, and only the foreign law caused that distinction.

It is debatable whether this standard of comparison is correct. Advocates of the incorporation theory would compare two companies which both have a domestic seat; one is incorporated abroad, the other in the same country. Only the latter would be recognized under the headquarters theory and the non-domestically incorporated company would be discriminated against because of the place of incorporation; see Behrens, *supra* note 6, at 518-20.

59. See Ebke, *supra* note 57, at 259, 265, where he applies these principles as they were formulated by the Court in *Commission v. Germany*, 1986 E.C.R. 3755, to the headquarters theory.

60. Stein, *Uses, Misuses and Nonuses of Comparative Law*, 72 N.W. UNIV. L. REV. 198, 208 (1977); Buxbaum, *supra* note 13, at 76. The idea to regulate the social impact of companies is also reflected in the development of "enterprise law" in the European discussion. It focuses on the social impact which a company — regardless of its legal structure — has on its constituents, such as employees, creditors or shareholders. The law should reach all these effects; regulations of traditional corporate law would be insufficient for this task.

61. See, e.g., Hopt, *New Ways in Corporate Governance: European Experiments with Labor Representation on Corporate Boards*, 82 MICH. L. REV. 1338, 1345 (1984).

For example, German companies always have a two-tier board system with a managing and an independent supervising board. Co-determination is based on the representation of employees on the supervisory board. It would be almost impossible for a company with one uniform board that transfers its management to Germany to provide an adequate place for employees' representatives.

See also *infra* note 72, for the different attitudes in the area of "industrial democracy."

corporate solutions reached through complex political debates involving not only political parties but also other interests, particularly those of industry representatives and labor unions.<sup>62</sup>

The headquarters theory, "protected" under article 220, severely limits a company's right under article 58. As the Advocate General in *Daily Mail* pointed out, the incorporation theory is more consistent with the free movement of companies called for by the EEC Treaty.<sup>63</sup> On the other hand, because of the differences between company laws and the modest progress in the harmonization process, the headquarters theory appears to be the only way to protect national interests. Any other result would impose a duty on Member States to acquiesce in the establishment of companies in their territories, formed under a foreign law, even if they were unable to provide the same level of protection for the company's constituencies, in particular for worker representation within the corporate structure.<sup>64</sup> Arguably, it is not politically feasible to deprive the Member States of their right of national protection of public interest.

#### IV. FUTURE OPTIONS

The current situation allowing Member States to continue to apply restrictive conflict-of-law rules to moving companies is unsatisfactory and raises the problem of uncertainty concerning the limits of national discretion.<sup>65</sup> In the last part of this essay I propose ways of escaping

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62. See, e.g., Ebke, *supra* note 57, at 203; Hopt, *supra* note 61, at 1348-50.

63. 53 Comm. Mkt. L.R. at 720. See also H. WIEDEMANN, *supra* note 2, at 791, who describes the headquarter theory as a "protection-theory," and seems to assume that it is contrary to the ideas of the EEC Treaty.

We find the obligation of the Member States to accept the control and supervision of another Member State also in the current efforts to overcome differences in national technical standards. The new Community approach, based on the Council Resolution of 7 May 1985, 28 O.J. EUR. COMM. (No. C 136) 1 (1985) on a new approach to technical harmonization and standards relies on the idea of mutual recognition. What is good enough for the consumers in one Member State must also be sufficient for the rest of the Community, even if that means the introduction of a lower standard on the domestic market. This approach is reflected in the incorporation theory rather than the headquarters theory.

64. Had the Court interpreted article 58 as a mandatory conflict-of-law rule, only the incorporation theory would be permissible. That would lead to a "harmonized participation model through the back door," a conflict-of-law rule would have broader consequences than any measure taken by a Community institution.

Grossfeld & Luttermann, *Comment on Daily Mail*, 44 JURISTENZEITUNG [JZ] 386, 387 (1989), state that national interests, presently protected under state laws, would have been sacrificed on the altar of the freedom of establishment. Similarly, Ebenroth & Eyles, *supra* note 15, at 414, emphasize that no extensive interpretation of article 58 should anticipate present harmonization efforts.

65. This is due to the two above-mentioned reasons: first, if *Daily Mail* is reduced to a tax case, it would not at all address the headquarters theory; secondly, even if the Member States retained their power in this area, fundamental principles of Community law would still apply to national rules. *Robert Fearon & Co. v. Irish Land Comm'n*, 1984 E.C.R. 3677, 3685. The effect

the dilemma. First, I shall describe possible Community solutions including both harmonization of national company laws and a genuine Community company law. I shall then discuss options available to the Member States on a national level.

### A. Community Measures

There are two ways for the EC to improve the current situation and remove obstacles on the free movement of companies. The first is harmonizing national company laws by directives based on article 54.<sup>66</sup> With lesser variation between national laws, protection by conflict-of-law rules would become unnecessary. The harmonization directives adopted within the past 20 years cover various aspects of enterprise control, such as the formation of corporations, capital requirements, mergers within a state and accounting rules.<sup>67</sup> So far, however, the Community has been unable to adopt measures with an impact on the most sensitive areas — company structure, worker co-determination and taxation — the same issues which are cited as a justification for the continued application of the headquarters theory. Two proposals by the Commission are currently affected by this deadlock, the 5th Directive on the structure of companies and the 10th Directive on transborder mergers.<sup>68</sup>

The second way is to avoid reliance on national company laws by creating a body of "EEC company law" through regulations based primarily on article 235.<sup>69</sup> Here, the Commission's plan for a European company is most important.<sup>70</sup> It is based on the concept of a company

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of these fundamental principles on the headquarters theory is discussed *infra* note 80 and accompanying text.

66. For the text of article 54, see *supra* note 38.

67. For a more detailed description, see Ebenroth & Eyles, *supra* note 15, at 414.

68. The Commission itself apparently doubts whether the two directives will be adopted in the near future; see *Statute for a European Company*, BULL. EC, Supp. 3/88, at 6 (1988).

69. This article is the "necessary and proper clause" of the EC Treaty. It provides that [i]f action by the Community should prove necessary to attain, in the course of the operation of the common market, one of the objectives of the Community and this Treaty has not provided the necessary powers, the Council shall, acting unanimously on a proposal from the Commission and after consulting the Assembly, take the appropriate measures.

In the most recent proposal for a statute of a European company, the Commission claims authority to regulate the creation and operation of the European company except rules dealing with employee co-determination by a Regulation based on article 100A. *Proposal for a Council Regulation on the Statute for a European Company*, E.C. COMM'N DOCS., COM (89) 268 final at 62. Article 100A provides for the adoption of measures for the approximation of national laws necessary for the establishment of the internal market. The Council can adopt such measures by a qualified majority. The parallel Directive dealing with employee co-determination is based on article 54, *id.*, at 140.

70. The first proposal dates back to 1970, 13 J.O. COMM. EUR. (No. C 124) 1 (1970), and was amended in 1975, *Proposal for a Council Regulation on the Statute for European Companies*, BULL. EC, Supp. 4/75 (1975). Recently, the Commission has put forward a new proposal. See

chartered under EEC law. It would be registered in a Member State but would be a "Community national," not subject to national restrictions. Accordingly, it could transfer its seat to any place in the Community without losing its legal personality.

For two reasons, however, this plan will not completely solve the current problems. First, the same reluctance exists on the part of the Member States to give up their national standards of worker co-determination. The most recent proposal provides for three substantially different formulas and gives the Member States the opportunity to choose one of the options for "European companies" incorporated in their territory.<sup>71</sup> But the possibility that companies could be formed under an option that provides less protection and subsequently "immigrate" into other Member States has thus far prevented a breakthrough of this ambitious plan.<sup>72</sup>

Besides, even if the European company comes into existence, it will have a limited scope. Only legal entities may form such a company; natural persons are excluded. Moreover, incorporation of a company under a national regime will remain possible and thus the existence of various types of companies will continue.<sup>73</sup>

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BULL. EC, Supp. 3/88 (1988), for the memorandum of the Commission and E.C. COMM'N DOCS. COM (89) 268 FINAL FOR THE PROPOSED MEASURES.

ONE REGULATION ALREADY HAS BEEN ADOPTED. SINCE JULY 1, 1989, THE EUROPEAN ECONOMIC INTEREST GROUPING, EEIG, HAVE EXISTED UNDER COMMUNITY LAW. 28 O.J. EUR. COMM. (No. L 199) 1 (1985). It permits a greater cooperation between small and medium-sized companies. There are limits, such as the number of employees and the fact that the EEIG itself is prohibited from making profits and has no access to capital markets. Hence there exist doubts whether it will provide a successful way for a cooperation on a Community level. See Ebenroth & Eyles, *supra* note 15, at 414.

71. Article 3 of the *Proposal for a Council Directive Complementing the Statute for a European Company*, E.C. COMM'N DOCS., COM(89) 268 final, at 142-43. The three options permit participation on the supervisory board (art. 4; German system); through a body separate from the company organs (art. 5); and through collectively agreed systems, agreed upon within the company (art. 6). See also BULL. EC, Supp. 3/88, at 14 (1988).

72. A similar phenomenon can be observed in the area of "industrial democracy" determining the fate of the "Vredeling" Directive, 23 O.J. EUR. COMM. (No. C 297) 3 (1980), amended in 26 O.J. EUR. COMM. (No. C 217) 3 (1983), dealing with information and consulting procedures for employees. The proposal was never adopted.

For the role of unions in the collective bargaining process, see Nelson, *The Vredeling Directive: The EEC's Failed Attempt to Regulate Multinational Enterprises and Organize Collective Bargaining*, 20 N.Y.U. J. INT'L L. & POL. 967, 979-82 (1988). See also Westermann, *Tendenzen der gegenwärtigen Mitbestimmungsdiskussion in der EG*, 48 RABELSZ 123, 128 (1984). He describes various attitudes currently existing in the Member States. As to the role of labor unions, there is first the British approach of collective bargaining which is "hardly understandable for a spectator from the European continent." *Id.* at 129. The situation also differs widely as to the degree of centralization of the union's decision making process. Italy and France represent a more decentralized system with powerful representation on a plant level, while in the Benelux countries national centralized labor councils have a strong political influence.

73. The third way, an international agreement pursuant to article 220, appears to be a dead end. The Convention on the Mutual Recognition of Companies, negotiated among the original six Member States, never came into force because the Netherlands refused its ratification. Negoti-

## B. National Measures

Two approaches utilizing national measures could be undertaken — splitting applicable laws or changing the company's legal form without a loss of legal identity. In the first approach, Member States would accept a "derivative" of the incorporation theory, the so-called "theory of super-addition" (*Überlagerungstheorie*).<sup>74</sup> According to this concept, incorporation in one state determines the "personal law" of a company, which retains its legal personality wherever it acts. The state where the management is domiciled, however, selectively may impose its imperative company law to protect the interests of the local constituencies of the company. Then, creditors, shareholders or employees' representatives could invoke the local law that is more favorable for them.

Advocates of this theory argue that the model already works successfully in the United States, a federal system.<sup>75</sup> Critics, however, doubt whether the model can be transplanted to Europe where state company laws are more diverse than in the U.S. As a result of structural and functional differences, state laws would often not create and utilize parallel institutions. Arguably, the model could work where dif-

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ations with the next three Member States—the United Kingdom, the Republic of Ireland and Denmark—as mandated in the Acts of Accession, were terminated without a result; Timmermanns, *Die europäische Rechtsangleichung im Gesellschaftsrecht*, 48 RABELSZ 1, 39-40 (1984). Ebenroth & Eyles, *supra* note 15, at 414, report preparatory works on an agreement on the transfer of the seat of a company, but do not indicate a chance for a realization in the near future.

74. This theory, based on American models, has been introduced by Sandrock to the European discussion. See Sandrock, *Ein amerikanisches Lehrstück für das Kollisionsrecht der Kapitalgesellschaften*, 42 RABELSZ 227 (1978).

75. Under the Full Faith and Credit Clause of article IV of the Constitution, the states have to recognize the legal personality of a company incorporated in a sister state; but they are still entitled to impose regulations on companies acting in their territories.

See RESTATEMENT (SECOND) OF CONFLICT OF LAWS §§ 296-97 (1971). A corporation, formed in compliance with the law of one State is governed by this law as to its legal personality and corporate structure even if its decisions are made and its business is performed in another state. Sections 311-12 contain limitations on this concept, arising from a state's power to regulate business activities in its own territory.

On the development of the common law view that the internal affairs of a company were to be governed by the law of the state of incorporation, see Buxbaum, *supra* note 13. It has been proposed that a state should be permitted to protect itself against "pseudo-foreign companies" by applying local law to the internal affairs of foreign corporations. See Latty, *Pseudo-Foreign Corporations*, 65 YALE L.J. 137 (1955). The theory had significant influence only in two states, New York and California. See, N.Y. BUS. CORP. LAW §§ 1301-1320 (1962); CAL. CORP. CODE §§ 2100-2116 (1977); as to case law, see, e.g., *Western Airlines, Inc. v. Sobieski*, 191 Cal. App. 2d 399, 412, 12 Cal. Rptr. 719, 727-28 (1961). According to a recent analysis, the traditional concept still prevails in the U.S.; the law of the state of incorporation almost always governs the internal affairs. See Kozyris, *supra* note 9.

For a detailed description of both the role of choice-of-law rules in U.S. company law and the impact of provisions of the U.S. Constitution, see R. BUXBAUM & K. HOPT, *LEGAL HARMONIZATION AND THE BUSINESS ENTERPRISE* 62 (Integration through Law: Europe and the American Federal Experience No. 2.4, M. Cappelletti, M. Seccombe & J. Weiler eds. 1988).

ferences between foreign law imported by the migrating company and domestic law imposed upon the company are less significant.<sup>76</sup> While in the U.S. "splitting" the law applicable to a company may provide a sufficient remedy to protect local interests, in Europe the differences between national laws appear to create insurmountable problems for a meaningful application of this theory.<sup>77</sup>

The second approach is based on the headquarters theory, but attempts to avoid the rigid consequence of death for a company moving its seat to another state. This approach utilizes a principle of substantive company law, an "identity-preserving change of the legal form."<sup>78</sup> National laws permit such a change of legal form in a domestic context, for example, between a stock company and a limited liability company. Generally, these laws require a qualified majority of shareholders to approve the necessary amendment of the charter and a change of the company's form. With the registration of the decision the corporation continues to exist in a new form but as the same legal person;<sup>79</sup> neither a winding-up procedure nor an incorporation of a new, different company is necessary. The concept requires an incorporation in the new host state but guarantees the company's continued legal existence.

The same idea could be transposed to the transnational Community level and applied to a foreign company that moves its management into another Member State. In fact, this has already occurred on

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76. Information rights of shareholders or the availability of a derivative action might be an example. See BUXBAUM & HOPT, *supra* note 75, at 92-103, who discuss possible conflicts of interests. These rights would fall into a minimum burden group. They also refer to fiduciary duties of the management or cumulative voting rights where the conflict between the interests of the incorporating and the receiving state may become more serious.

77. It is significant that authors who favor this theory do not provide a satisfactory answer to the crucial problems. Behrens, *supra* note 6, at 514, acknowledges that conflict-of-law rules cannot resolve the differences. Sandrock, *Die multinationalen Korporationen in internationalen Privatrecht*, in INTERNATIONALE PROBLEME MULTINATIONALER KORPORATIONEN 208 (1978), admits the existence of serious problems but shows no feasible way for a solution. On the issue of worker co-determination, he proposes that a foreign corporation does not have to adopt its legal structure but that every decision of the board that could have come out differently if employees had been represented in accordance with German law should be void. For a justified criticism see Ebenroth & Sura, *supra* note 12, at 335-36.

In addition, it has been argued that the extent to which the company's constituents may legitimately be protected remains too uncertain. See Ebenroth & Sura, *id.* at 334.

78. In the German literature the model was proposed, e.g., by Behrens, *supra* note 15, at 591; see also Grossfeld & Jasper, *Identitätswahrende Fusion von Kapitalgesellschaften in die Bundesrepublik Deutschland*, 53 RABELSZ 52-62 (1989).

79. Aktiengesetz, arts. 362-93 (W. Ger.) [German Stock Corporation Act]; Codice Civile, art. 2498 (Italy).

One of the major advantages over a complete liquidation derives from the fact that one can avoid a taxation of the corporation's entire assets; rights and obligations would automatically be transferred, as well as the ownership in assets.

an international level.<sup>80</sup> An argument could be made that Member States have a duty to apply this model. First, as the Court has repeatedly stated, in the absence of Community measures non-discrimination is still a fundamental principle for state legislation.<sup>81</sup> Thus, one could argue that if a country offers this opportunity to domestic companies, it must also offer the same rights to companies from other Member States.

An argument that goes beyond the non-discrimination aspect of the problem is based on the concept of "least restrictive measures." Where states are permitted to maintain national legislation in order to protect public interests, their measures must not be disproportionate.<sup>82</sup> Consequently, they must take into account the regulatory procedures

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80. See Judgment of Nov. 12, 1965, Cass., Belg., 20 REVUE CRITIQUE DE JURISPRUDENCE BELGE 392 (1966), cited by Grossfeld & Jasper, *supra* note 78, at 58, where the court held that an originally British company became a Belgian company after transferring its seat and restructuring in accordance with Belgian law. Behrens, *supra* note 15, at 591, reports a case where a company wanted to move from Luxemburg to Germany. Timmermans, *supra* note 6, at 358, refers to this possibility under Belgian and Italian law.

Ebenroth & Eyles, *supra* note 15, at 366, give an overview on the current situation in the Member States. In most countries, no definite answer exists whether national laws at present permit such a transaction. It appears that Germany and Greece have the most rigid rules: a new company must be formed in the receiving state. Other countries, such as Italy, Portugal, and probably France, permit the adaptation of the company to domestic law and in that case recognize the identity of the company.

81. See *Van Binsbergen v. Bedrijfsvereniging voor de Metaalnijverheid*, 1974 E.C.R. 1299, regarding services, and *Reyners v. Belgium*, 1974 E.C.R. 631 regarding the establishment of natural persons. Such statements exist also in the cases discussed above. See the Commission's position in *Commission v. France*, 1986 E.C.R. 273, 293-94, and the corresponding opinion of the Court at para. 24, both rejecting the French contention that in the absence of uniform tax laws Member States could apply their national laws without restriction.

82. On the "least-restrictive" principle, see, e.g., for the free movement of goods, *Commission v. Denmark*, 56 Comm. Mkt. L.R. 619 (1989). There the Court accepted the argument that no Community standard existed for the recycling of beverage containers. It also acknowledged that the protection of the environment could justify national measures with a negative impact on Community trade. Nevertheless, it held that the Danish "recycling law" was in some aspects too restrictive and disproportionate to its goal.

This principle was extended to the freedom to provide services in *Webb*, 1981 E.C.R. 3305, 3319-20, 3325-26. Recently, the Court affirmed that Member States must not unduly restrict insurance companies established in another Member State from providing their services. See *Commission v. Germany*, 1986 E.C.R. 3755. In the Court's view, Member States were prohibited from duplicating the requirements which had already been fulfilled in another state.

Although articles 59 and 60, referring to services, and article 52 contain similar language, it is uncertain whether the Court has ever extended the "least restrictive" principle to the freedom of establishment. In *Klopp*, 1984 E.C.R. 2971, the Court found a violation of Community law although the challenged provision applied equally to foreign and domestic lawyers. Everling, *Vertragsverhandlungen und Vertragspraxis 1957, dargestellt an den Kapiteln Niederlassungsrecht und Dienstleistungsfreiheit des EWG Vertrages*, in *EINE ORDNUNGSPOLITIK FÜR EUROPA — FESTSCHRIFT FÜR HANS VON DER GROEBEN* 111, 116-17 (E. Mestmäcker, H. Möller & H. Schasse eds. 1987), admits that the Court went very far in this direction but still sees only an extended application of the non-discrimination principle. But see Steindorff, *Reichweite der Niederlassungsfreiheit*, 23 *EUROPARECHT* 19, 22-23 (1988), who thinks that the Court went beyond the non-discrimination principle; see also Behrens, *supra* note 6, 510-11, who shares Steindorff's interpretation of the Court's practice; see also *supra*, note 42, for the interpretation that *Daily Mail* seems to adopt the latter position.

of the state where the transferring company was initially incorporated, which are designed to assure the preservation of corresponding public interests.<sup>83</sup> This principle, already acknowledged in the area of the right to provide services, would, if applied to company laws, oblige Member States to recognize procedures and acts in another Member State which were taken in the course of the formation or auditing of companies.<sup>84</sup> To require an immigrating company to liquidate and form a new legal person would duplicate procedures and constitute an arbitrary and disproportionate measure that would violate the Treaty.

It has been stated that the receiving state can apply this concept only if the law of the originating state also would permit such a transaction.<sup>85</sup> One can argue, however, that the prohibition of disproportionate measures applies equally to the originating state. Only restrictions which are necessary to protect a public interest may be maintained.<sup>86</sup> Otherwise there could be no justification for a national law to prevent such a transfer; national laws would have to permit such a transfer from their territory.<sup>87</sup>

Since this approach is still based on the headquarters theory, it requires the incorporation of the company in the receiving state. This is certainly not an easy procedure since complex restructuring is necessary; it is time-consuming and more restrictive than the present American doctrine. It makes the transfer easier, however, and presents a feasible option for Community countries that desire more flexibility than is provided by the original headquarters theory.<sup>88</sup>

## V. SUMMARY

This article has discussed the free establishment problem that arises when a company within the EC attempts to transfer its headquarters to another Member State without changing its incorpora-

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83. *Webb*, 1981 E.C.R. at 3325-26.

84. Behrens, *supra* note 15, at 593, states that the controlling procedure in the course of formation of a company should not be duplicated.

85. See Behrens, *supra* note 15, at 591; Grossfeld & Jasper, *supra* note 78, at 53.

86. *Daily Mail* shows a possible application of the concept of least restrictive measures — tax duties that have arisen in the past. In that case, the threat of liquidation is probably the only means to secure the payment. Beitzge, *supra* note 1, at 41-43, mentions the protection of shareholders and, in particular, creditors.

87. One might regret that the Court used such broad language, which seems to permit the application of the headquarters theory without any qualification. Still, one could argue that a national court should refer an adequate case in order to provide an opportunity to the Court to consider a different solution. See Sandrock, *supra* note 15, at 512 n.59.

88. But see Timmermanns, *supra* note 6, who argues that even this modified form would still violate the Treaty.



tion.<sup>89</sup> The Treaty gives no definite answer to the question whether the receiving state may refuse to recognize the legal personality of a moving company. It provides for the free establishment of companies but also calls for negotiations among Member States on the recognition of companies which transfer their seat.

Three recent decisions by the Court on this issue leave uncertainty as to whether the Member States may still apply the restrictive headquarters theory which requires that a company be incorporated in the state where its real seat is located. It is possible to confine the third case, *Daily Mail*, to its fiscal aspects and to argue that the conflict-of-law question is yet unanswered. It is argued, however, that the Court indeed accepted the fact that a majority of the Member States currently apply the headquarters theory. Due to significant differences between national company laws, this theory appears permissible in order to protect national interests, despite its restrictive effect on the free allocation of resources. Member States cannot be required to apply the incorporation theory necessary for a complete realization of the freedom of establishment of companies prior to the creation of Community-wide solutions in the politically sensitive areas of taxation, company structure and employee co-determination.<sup>90</sup>

It is difficult to predict the impact of the *Daily Mail* decision on the development of company law in Europe. By deferring to national conflict-of-law rules, the Court has indirectly put some pressure on both the Community and Member States to harmonize national company

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89. I found no statistics regarding how often such a problem does in fact arise. P. Cecchini mentions the access to new geographical markets as a main goal for 1992, but provides no empirical data. P. CECCHINI, *THE EUROPEAN CHALLENGE 1992: THE BENEFITS OF A SINGLE MARKET* 86 (1988). The limited number of cases reported in the doctrinal debate seems to indicate that at least in the past the problem had no great practical importance. Arguably, the present legal situation has a deterring effect. Grossfeld, *supra* note 12, at 331. Major parts of the debate and the case law are limited to Germany, probably because it provides on the one hand an economic environment attractive for foreign companies, but on the other hand comprehensive rules on employee co-determination.

There is, however, agreement that transborder activities are an important factor in the course of the creation of the single market. See, e.g., the position of the Commission in BULL. EC, Supp. 3/88, at 8-9 (1988); P. CECCHINI, *supra*, at 53-54. One can thus assume that such transfers will occur more frequently in the future.

90. See also Meier-Schatz, *Europäische Harmonisierung des Gesellschafts- und Kapitalmarktrechts*, 41 RECHT UND WIRTSCHAFT 84, 106, 109 (1989): areas which include political values, such as employee co-determination, require a centralized, Community wide solution before the incorporation theory can be applied in all Member States.

Chances for rapid progress in sensitive areas on a Community level are, it seems, rather small. There, any harmonization at the Community level might not take place without comprehensive democratic representation. As long as Community decisions lack the necessary legitimacy, without representation of all interest groups, a uniform answer to this politically sensitive problem can hardly be found. See Memorandum on a statute for a European company, PE DOC A 2-405/88, February 24, 1989, where such a representation on Community level is seen as a major requirement.

laws. Currently, it is unlikely that Community measures will soon create a fairly uniform body of company laws; the *Daily* case, however, might revitalize the process of company law harmonization.

At present, only modified national conflict-of-law rules will improve the situation. Here, the technique of "splitting" the law which governs the company is of limited applicability in Europe due to the significant differences between national company laws.

Member States should, however, adopt another possible approach which acknowledges their right to apply the headquarters theory, but at the same time takes into account the prohibition on applying disproportionate measures.<sup>91</sup> This solution requires that Member States permit a company to retain its legal identity although it must adjust its structure to the law of the receiving state. It satisfies the interests of the Member States and, at the same time, takes into account the need to develop a less restrictive legal environment for companies in the European Market.

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91. For the discussion whether articles 52 and 58 include such a prohibition, see *supra* note 82.