

# Freedom of establishment

## EU Company Law

### Exam question

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Examine how the freedom of establishment applies to companies.

### Introduction

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#### EU law

- Art. 12
  - General freedom of movement
  - “Within the scope of application of this Treaty, and without prejudice to any special provisions contained therein, **any discrimination on grounds of nationality shall be prohibited.**”
    - Direct applicability + vertical & horizontal application
    - Imposes duties on companies
  - Freedom of establishment = absolute central basic rights under EC Treaty and EEA agreement.
- Principle laid down in Articles 43 and 48 EC Treaty:
  - Any restrictions on the freedom of establishment of a company in the territory of another Member State shall be prohibited.
    - If formed in accordance with the law of a Member State
      - and having its registered office, central administration or principal place of business within the Community.
  - The prohibition applies also to restrictions on the setting-up of agencies, branches or subsidiaries by companies established in the territory of any Member State.
- Reasons for a state to oppose the emigration (udvandre) of a company:
  - Tax reasons,
  - Change of the *lex societatis* (= the law applicable to a company) and therefore change of the legal rights of the shareholders, creditors and employees of the company,
- Reasons for a state to oppose the immigration (indvandre) of a company:
  - Avoidance / circumvention of mandatory company law rules (minimum capital requirements, directors liability, ...)
  - Consumer and creditor protection
- Choice of law rules:
  - Real seat doctrine vs. Incorporation doctrine
    - Greater obstacles in case of the application of the real seat doctrine.

#### Legal personality

- Legal personality refers to the ability of an organization to enter into legal transactions
  - such as holding property or entering into debt.
  - A company is a legal entity with distinct legal personality separate to that of the owners, members, or shareholders.
  - Form of business
    - Trading in one's Personal Capacity.
    - Trading through an incorporated entity.

- EC law definition:
  - The grouping of undertakings from the date of its registration will acquire the capacity in its own name to have rights and obligations of all kinds (i.e. legal capacity), to make contracts or accomplish other legal acts (i.e. the contractual capacity) and to sue and be sued (i.e. the capacity to be a party in legal proceedings).

## Incorporation

- Meaning:
  - The creation of a corporation .
  - by *incorporation* is understood the act by which a corporation is created
  - by *corporation* is meant the body thus created.
- Requirements for incorporation:
  - May vary acc. to the different categories of legal persons
  - Companies: either by registration or by notarial deed
- Two conflicting doctrines
  - Real seat theory v. Incorporation theory

## Real Seat Theory

- Requires a company to be subject to the law of the country in which its effective center of administration is situated.
- E.g., a company is incorporated in England, but the company's headquarters or central administration is in Germany:
  - Germany follows the real seat theory.
    - France, another country which follows the real seat theory would recognize this company as subject to German law, while the UK would consider it as subject to its own laws
  - However, as the company is not incorporated in Germany, German law does not recognize it as a legal personality, therefore nor would French law.
- Companies' "seat" is its place of management – its real or effective seat, rather than the seat that is memorialized in the company's articles of incorporation.
- The principle underlying the seat theory is a desire to impose the host state's company law standards.
- The theory is based on the conviction that a company should abide by the laws of the state where it carries on its principal business and should not be able to escape the "legal, economic, and social values" of that country.

## Incorporation theory

- The legal systems refer instead to the place where a company is entered in the register that exists for the purpose, or to the place in which it was incorporated (e.g., UK, IRL).
- Thus, allows a company freedom to choose the law applicable to them.

## Primary establishment

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### In general

Art. 43

- Every **natural person** has the right of primary and secondary establishment.

Art. 48

- Companies have the same rights as natural persons. (Under certain conditions)
  - Company must be correctly incorporated in a MS etc. - Case law interpretation.

## Case of Factortame I - C -221/89

- Among its efforts to prevent **Spanish fishing** interests from taking part of the UK catch quota under the Common Fisheries Policy, the UK in 1988 amended its regulation of fishing vessels.
  - The fishing vessel must be British-owned
  - It must be managed and controlled from within the UK
  - If the owner is a company, then
    - It must be incorporated in the UK
    - Have its principal place of business in the UK
    - Have 75% of shares in the hands of UK citizens
    - 75% of directors must be UK citizens
- ECJ Held:
  - “The concept of establishment
    - ... involves the actual pursuit of an economic activity through a fixed establishment in another member state for an indefinite period”.
  - “Where the vessel constitutes an instrument for pursuing an economic activity which involves a fixed establishment in the member state concerned, the registration of the vessel cannot be disassociated from the exercise of the freedom of establishment”.
- The question:
  - Are the conditions for registration of a vessel constituting an obstacle to the freedom of establishment?
    - Each member state must comply with the prohibition against discrimination against nationals of member states on grounds of their nationality.
- Therefore:
  - The requirement that the vessel is owned by a natural person of a particular nationality is contrary to the right of establishment.
  - The requirement that managers and shareholders of the company owning the vessel be of a particular nationality is also contrary to freedom of establishment.
  - BUT:
    - **the requirement that it must be managed and controlled from within the UK is okay.**

## Daily Mail - C-81/87

- A tax-law case.
  - Daily Mail limited liability company wanted to move its de facto head office (tax residence) to the Netherlands because of the more favorable tax regime there, while at the same time it planned to remain a company subject to UK company law.
  - Such a transfer required consent from the UK Treasury Department.
    - The UK Treasury Department refused permission for the transfer of seat.
- EC law implications
  - Daily Mail referred the question to the ECJ, whether Articles 43 and 48 EC Treaty preclude a member state from obstructing the transfer of the de facto head office from a member state.
- Decision of the court
  - The ECJ concluded that this issue falls outside the scope of the Treaty provisions on freedom of establishment.
  - Companies are creatures of (national) law, and exist only by virtue of this legislation.
  - Art. 43 and 48 does not (in present state) give any right to transfer registered office outside the MS.
  - The Daily Mail judgment was recently confirmed by the Cartesio decision (see below).

- Daily Mail: outstanding questions
  - Uncertainty surrounding the case law
  - Is the judgment (and arguments) in Daily Mail, stating that the freedom of establishment can not be relied upon against restrictions imposed by the law of the “home state”, still valid,
    - or is it in fact overruled by the new case law (Sevic) and legislative initiatives (international merger directive) ? (criticism on the exit – entry division)
  - In case of a transfer of a company retaining its status of company governed by the law of the member state of incorporation, what are the limits of the freedom of establishment?
    - What are the restrictions a state can impose based on the “general interest”?
  - In case of transfer of a company which voluntarily adopts the status of company governed by the law of the host member state: can the home state impose any restrictions on leaving the state?

## Answers in Cartesio? - C-210/06

- Facts: a Daily Mail situation
- Judgment:
  - confirmation of Daily Mail:
    - home state may impose restrictions on the transfer of the seat, if the company retains the status of company governed by the home state
  - BUT: obiter dictum:
    - The home state may NOT impose any restrictions on the transfer of the seat if the company does not retain the status of company governed by the law of its home state, but voluntarily adopt the status of company governed by the law of the host state.
- Arguments of the ECJ
  - If status of company governed by the law of the home member state is retained:
    - Companies = creatures of national law (Daily Mail),
    - No single connecting factor determining the national law applicable to a company
      - therefore a state “has the power to define both the connecting factor required of a company if it is to be regarded as incorporated under the law of that Member State and, as such, capable of enjoying the right of establishment, and that required if the company is to be able subsequently to maintain that status.”
      - ”That power includes the possibility for that Member State not to permit a company governed by its law to retain that status if the company intends to reorganise itself in another Member State by moving its seat to the territory of the latter, thereby breaking the connecting factor required under the national law of the Member State of incorporation”
- Arguments of the ECJ
  - If status of company governed by the law of the home member state is not retained:
    - Any barrier (such as the prior winding-up or liquidation) to the actual conversion of such a company into a company governed by the law of the Member State to which it wishes to relocate constitutes a prohibited restriction on the freedom of establishment of the company,
      - unless it serves overriding requirements in the public interest

## Secondary establishment

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### In general

Art. 43

- Secondary establishment is protected.
- Branches, subsidiaries, etc.

## **Centros (1999) - C-212/97**

- Centros Ltd, a private limited company formed under English law (“Centros”), applied for the registration of a branch in Denmark. Centros’ share capital was held by Danish nationals residing in Denmark. Centros had never traded since its formation in the UK and was in fact seeking to establish in Denmark not a branch, but a principal place of business, by circumventing the national rules concerning the paying-up of minimum share capital
- The registration authorities refused the registration of the branch based on the grounds that the establishment of a branch in Denmark would be a way of avoiding the national rules on paying-up of minimum share capital
- According to the ECJ, it was contrary to Articles 43 and 48 of the Treaty for a Member State to refuse to register a branch of a company formed in accordance with the law of another Member State in which it has its registered office
- Establishment of a branch in another Member State - Registration refused.
- Landmark decision: real seat theory and freedom of establishment.
- The Centros case caused a debate about whether the real seat theory constitutes a restriction on the freedom of establishment.
- Ruling:
  - It is contrary to Article 52 (now Article 432) and Article 58 (now Article 48) of the EC Treaty for the authorities of a MS (here: Denmark) to refuse to register a branch of a company formed under the law of another MS (here: the UK) in which it has its registered office, even if the company concerned has never conducted any business in the latter State and intends to carry out its entire business in the State in which the branch is to be set up.
- Company – registered in MS A and formed in accordance with law of MS A:
- MS B
- Cannot refuse to recognize that company;
- Cannot deny legal capacity;
- Cannot impose disclosure requirements;
- Cannot impose conditions on that company provided for in domestic company law relating to a min. Capital and director’s liability.

## **Überseering (2002) - C-208/00**

- Überseering BV established in 1990 in the Netherlands, acquired land and buildings in Germany and ordered construction work; all its shares acquired by two German nationals residing in Germany.
- Action brought by Überseering on construction contract dismissed because the company had its actual center of administration in Germany and thus (under German law) had no legal capacity in Germany.
- German position supported before ECJ by Spain and Italy; Überseering supported by Netherlands, UK, EU Commission and EFTA Surveillance Authority.
- Decision of the ECJ expands the scope of the freedom of establishment and prohibits member states from refusing to recognize companies that move their headquarters from one state to another.

## **Inspire Art (2003) - C-167/01**

- Inspire Art incorporated in England as a private company limited by shares and registered a branch in the Netherlands.
- Dutch authorities ordered Inspire Art to register as a “formally foreign company” and comply with requirements as to minimum capital (€18,000; directors are personally liable if capital falls below minimum).
- Dutch position supported before ECJ by Germany, Italy and Austria; Inspire Art supported by UK and the EU Commission.
- A "pseudo-foreign corporation" is a corporation that is incorporated in another jurisdiction but has no significant contacts with that other jurisdiction.

- National legislation which provides for the application of domestic company law rules to foreign companies constitutes a restriction on the freedom of establishment.

## Überseering, Centros, Inspire Art

- Not about the transfer of seat:
  - The companies were created in one MS to operate through a head office located in another MS
  - Not about transfer of head office but about recognition and acceptance without further requirements of the existence of head office of a Co legally constituted in another MS
- Company – re-registered in MS A and formed accordance with law of MS A:
  - MS B:
    - Cannot refuse to recognize that company
    - Cannot deny legal capacity
    - Cannot impose extensive disclosure requirements
    - Cannot impose conditions on that company provided for in domestic company law relating to a min. capital and director's liability.

## Is the real seat doctrine dead?

Different interpretation of Centros

- There is an unconditional requirement for all MS to recognize any company which is validly incorporated in a MS as a legal person,
  - even though the company's actual head office (real seat) was relocated to another MS.
    - the real seat doctrine could no longer be used to deny recognition of a company, which is covered by the Treaty rules on freedom of establishment.
- The real seat doctrine is compatible with Community law.

Arguments for Maintaining the Real Seat Doctrine

- The Centros case Involved two 'Incorporation Doctrine' States
  - It should be possible for a company from one incorporation state (fx. UK) to move its real seat to a branch in another incorporation state (fx. DK).
- Argument: Centros did not affect MS whose international company law is based on the real seat doctrine.

## ECJ Case Law and Right of Establishment

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- Can companies on the basis of the existing case law move around in the EU their registered seat or head office?
- Daily Mail jurisprudence untouched:
  - MS are not forbidden to impose restrictions on the transfer to another MS of the real seat of a company incorporated under their law (if restrictions proportionate and based on public interest)

## Alternatives

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- Harmonization – the 14<sup>th</sup> directive
- SE company (Societas Europaea)
- Cross-border merger directive (10<sup>th</sup> directive) / Sevic-case

## How does companies exercise free movement?

- By setting up **branches** and **subsidiaries**
  - Possible although there may be discrimination (tax)

- By **mergers** and fissions
  - National rules does not always allow for cross border transaction
  - 10th Company Law Directive and SE/SCE Statutes makes mergers possible
- By *transfer* of **registered office**
  - National law does not always allow for this
  - Proposed 14th Company Law Directive abandoned
- By *transfer* of **real seat**
  - Problems with Real Seat theory
  - Other problems with national company law

## **Regulatory competition within the EU**

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- ECJ decisions have strengthened freedom of establishment as well as the application of mutual recognition of national company laws – harmonised rules play an important role in the protection of shareholders and savers – tension between two forces
- Regulatory competition: quality of national rules and judiciary in adjudication of controversies and bankruptcy law important in influencing incorporation seat
- Regulatory harmonisation creating common platform of protection: stronger effects on listed companies, subject to harder rules for investor protection