

**PASCHALIS PASCHALIDIS**

**DPHIL THESIS**

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**THE IMPACT OF FREEDOM OF ESTABLISHMENT  
ON PRIVATE INTERNATIONAL LAW  
FOR CORPORATIONS**

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## **ABSTRACT**

Title: The Impact of Freedom of Establishment on Private International Law for Corporations

Name: Paschalis Paschalidis

College: Harris Manchester College

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The present thesis is concerned with private international law for corporate and insolvency disputes in the context of freedom of establishment. First, it presents the traditional rules of conflict applicable to corporate disputes that have been implemented in some major jurisdictions. Second, it analyses the relevant leading judgments of the European Court of Justice and it demonstrates the way in which, contrary to popular belief, the real seat theory has not been held contrary to freedom of establishment. The thesis then deals with the concept of letter-box companies and examines the limitations that are being placed to the use of freedom of establishment. This is followed by a juxtaposition of the factors that have lead and could lead to regulatory competition for corporate law in the USA and the EU respectively. A modest approach is taken towards the possibility of the latter occurring in the EU. Third, the thesis examines the treatment of insolvency disputes in this context. A substantial part of it is dedicated to the definition of the basis for international jurisdiction for the opening of insolvency proceedings, namely the centre of main interests. It argues in favour of an objective test for the

identification of the centre of main interests (COMI) and the allocations of certain burdens on both the debtor and the creditors. It then focuses on the treatment of forum shopping in the context on international insolvencies. Based on considerations of consent and economic efficiency, it suggests a definition, according to which certain transfers of the COMI should not amount to forum shopping. Finally, the thesis examines the possibility of a regulatory competition for insolvencies in the EU and seeks to demonstrate that the conditions for such a competition are more analogous between US corporate law and EU insolvency, rather than company, law.

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## TABLE OF ABBREVIATIONS

|                 |                                                                 |
|-----------------|-----------------------------------------------------------------|
| Azd             | Atlantic Reporter Second                                        |
| AEI             | American Enterprise Institute for Public<br>Policy Research     |
| ALER            | American Law & Economics Review                                 |
| AG              | <i>Aktiengesellschaft</i><br><i>Amtsgericht</i>                 |
| <i>AktG</i>     | <i>Aktiengesetz</i>                                             |
| AJCL            | American Journal of Comparative Law                             |
| Am Bankr Inst J | American Bankruptcy Institute Journal                           |
| ATF             | <i>Arrêts du Tribunal Fédéral</i>                               |
| BR              | Bankruptcy Reporter                                             |
| BCC             | British Company Cases                                           |
| BCLC            | Butterworths Company Law Cases                                  |
| BCL Rev         | Boston College Law Review                                       |
| BGB             | <i>Bürgerliches Gesetzbuch</i>                                  |
| BGH             | <i>Bundesgerichtshof</i>                                        |
| BGHZ            | <i>Entscheidungen des Bundesgerichtshofs<br/>in Zivilsachen</i> |
| Bkrtcy          | Bankruptcy Court                                                |
| Brook J Intl L  | Brooklyn Journal of International Law                           |
| BTR             | British Tax Review                                              |
| Buff L Rev      | Buffalo Law Review                                              |

|                  |                                                    |
|------------------|----------------------------------------------------|
| BYIL             | British Yearbook of International Law              |
| CA               | Court of Appeal                                    |
|                  | Court of Appeals                                   |
| Cal              | California                                         |
| CalRptr          | Californian Reporter                               |
| <i>Cass Ass</i>  | <i>Cour de cassation, Assemblée Plénière</i>       |
| <i>Cass civ</i>  | <i>Cour de cassation, chambre civile</i>           |
|                  | <i>Corte Suprema di cassazione, Udienza civile</i> |
| <i>Cass comm</i> | <i>Cour de cassation, chambre commerciale</i>      |
| <i>Cass crim</i> | <i>Cour de cassation, chambre criminelle</i>       |
| <i>Cass soc</i>  | <i>Cour de cassation, chambre sociale</i>          |
| <i>Cass SU</i>   | <i>Corte Suprema di cassazione, Sezione Unite</i>  |
| <i>Cass</i>      | <i>Cour de cassation</i>                           |
| CBM Directive    | Cross-border Mergers Directive                     |
| CC               | Civil Code                                         |
|                  | <i>Code Civil</i>                                  |
| CCom             | <i>Code de commerce</i>                            |
| CCP              | Code of Civil Procedure                            |
| CD               | Central District                                   |
| CDIP             | <i>Code de Droit International Privé</i>           |
| CE               | <i>Conseil d'État</i>                              |
| Ch               | Chancery Court                                     |
|                  | <i>chambre</i>                                     |
| CILR             | Cayman Islands Law Reports                         |

|               |                                                        |
|---------------|--------------------------------------------------------|
| Cir           | Circuit                                                |
| CLC           | Commercial Law Cases                                   |
| CLR           | California Law Review                                  |
|               | Commonwealth Law Reports                               |
| CJJO          | Civil Jurisdiction and Judgments Order                 |
| CLC           | Commercial Law Cases                                   |
| Co Law        | Company Lawyer                                         |
| Colum J Eur L | Columbia Law Journal of European Law                   |
| COMI          | centre of main interests                               |
| Comm          | Commercial Court                                       |
|               | <i>Tribunal de commerce</i>                            |
| Cong          | US Congress                                            |
| CVA           | company voluntary arrangement                          |
| CYELS         | Cambridge Yearbook of European Legal<br>Studies        |
| D             | <i>Décret</i>                                          |
|               | Digest                                                 |
|               | District                                               |
| Del           | Delaware                                               |
| Del J Corp L  | Delaware Journal of Corporate Law                      |
| Den LJ        | Denver Law Journal                                     |
| Dir fall      | Il diritto fallimentare e delle società<br>commerciali |
| EBLR          | European Business Law Reports                          |

|              |                                                      |
|--------------|------------------------------------------------------|
| EBL Rev      | European Business Law Review                         |
| EBOR         | European Business Organization Law Review            |
| ECFLR        | European Company & Financial Law Review              |
| ED           | Eastern District                                     |
| EEA          | European Economic Area                               |
| ELJ          | European Law Journal                                 |
| EL Rev       | European Law Review                                  |
| EGBGB        | <i>Einführungsgesetz zum Bürgerlichen Gesetzbuch</i> |
| Eq           | Equity                                               |
| ERPL         | European Review of Public Law                        |
| ETUC         | European Trade Union Confederation                   |
| F2d          | Federal Reports Second                               |
| FSupp        | Federal Supplement                                   |
| FSupp2d      | Federal Supplement Second                            |
| GA           | General Assembly                                     |
| GbR          | <i>Gesellschaft bürgerlichen Rechts</i>              |
| German LJ    | German Law Journal                                   |
| GmbH         | <i>Gesellschaft mit beschränkter Haftung</i>         |
| Harv Intl LJ | Harvard International Law Journal                    |
| Harv L Rev   | Harvard Law Review                                   |
| HCA          | High Court of Australia                              |

|                |                                                                             |
|----------------|-----------------------------------------------------------------------------|
| HL             | House of Lords                                                              |
| HMRC           | Her Majesty's Revenue & Customs                                             |
| HR Rep         | House of Representatives Report                                             |
| IBC            | International Business Company                                              |
| ICCLR          | International Company & Commercial Law<br>Review                            |
| ILC            | International Law Commission                                                |
| ILPr           | International Litigation Procedure                                          |
| Insolv Int     | Insolvency Intelligence                                                     |
| Intl Law       | International Lawyer                                                        |
| IPRax          | Praxis des Internationalen Privat- und<br>Verfahrensrechts                  |
| J              | Justice<br><br>Institutes of Emperor Justinian                              |
| JBL            | Journal of Business Law                                                     |
| JCLS           | Journal of Corporate Law Studies                                            |
| J Corp Fin     | Journal of Corporate Finance                                                |
| JCP G          | <i>La Semaine Juridique: Juris Classeur<br/>périodique édition générale</i> |
| J Fin          | Journal of Finance                                                          |
| J Fin Econ     | Journal of Financial Economics                                              |
| J L Econ & Org | Journal of Law, Economics & Organization                                    |
| JLE            | Journal of Law & Economics                                                  |
| JLS            | Journal of Legal Studies                                                    |

|                   |                                                                       |
|-------------------|-----------------------------------------------------------------------|
| JDI               | <i>Journal du Droit International</i>                                 |
| JZ                | <i>Juristenzeitung</i>                                                |
| JO                | <i>Journal officiel de la République française</i>                    |
| KG                | <i>Kommanditgesellschaft</i>                                          |
| LDIP              | <i>Loi fédéral sur le droit international privé</i>                   |
| LD Raym           | Lord Raymond                                                          |
| LLC               | Limited Liability Company                                             |
| LR                | Law Reports                                                           |
| Mass              | Massachussets                                                         |
| Mich L Rev        | Michigan Law Review                                                   |
| MJ                | Maastricht Journal of European &<br>Comparative Law                   |
| NDIll             | United States District Court for the<br>Northern District of Illinois |
| NE                | North Eastern Reporter                                                |
| NE2d              | North Eastern Reporter Second                                         |
| NJ                | New Jersey                                                            |
| NW2d              | North Western Reporter Second                                         |
| Nw J Intl L & Bus | Northwestern Journal of International Law<br>& Business               |
| NYCA              | New York Court of Appeals                                             |
| NYU L Rev         | New York University Law Review                                        |
| OHG               | <i>Offene Handelsgesellschaft</i>                                     |
| OLG               | <i>Oberlandesgericht</i>                                              |

|         |                                                                                 |
|---------|---------------------------------------------------------------------------------|
| Ont     | Ontario                                                                         |
| P2d     | Pacific Reporter Second                                                         |
| Pub L   | Public Law                                                                      |
| PUF     | <i>Presses Universitaires de France</i>                                         |
| RabelsZ | <i>Rabels Zeitschrift für Ausländisches und<br/>Internationales Privatrecht</i> |
| RCDIP   | <i>Revue Critique de Droit International Privé</i>                              |
| RDIPP   | <i>Revista di Diritto Internazionale Privato e<br/>Processuale</i>              |
| Res     | Resolution                                                                      |
| RHDI    | <i>Revue Hellenique de Droit International</i>                                  |
| RS      | <i>Recueil systématique du droit fédéral</i>                                    |
| RTD eur | <i>Revue Trimestrielle de Droit Européen</i>                                    |
| SA      | <i>Société Anonyme</i>                                                          |
| SARL    | <i>Société à responsabilité limitée</i>                                         |
| SE2d    | South Eastern Reporter Second                                                   |
| SDNY    | United States District Court for the<br>Southern District of New York           |
| SE      | Societas Europaea                                                               |
| Sess    | session                                                                         |
| Sez     | <i>sezione</i>                                                                  |
| SME     | small and medium sized enterprises                                              |
| Soc     | <i>société</i>                                                                  |
| SpA     | <i>società per azioni</i>                                                       |

|                     |                                                                     |
|---------------------|---------------------------------------------------------------------|
| Srl                 | <i>società a responsabilità limitata</i>                            |
| Stan L Rev          | Stanford Law Review                                                 |
| Super               | Superior Court                                                      |
| Supr                | Supreme Court                                                       |
| Supr J Ct           | Supreme Judicial Court                                              |
| SW2d                | South Western Reporter Second                                       |
| Tex L Rev           | Texas Law Review                                                    |
| TF                  | <i>Tribunal Fédéral</i>                                             |
| Trib                | <i>Tribunal</i>                                                     |
|                     | <i>Tribunale</i>                                                    |
| Trib civ            | <i>Tribunal civil</i>                                               |
| Trib corr           | <i>Tribunal correctionnel</i>                                       |
| Tul J Intl & Comp L | Tulane Journal of International &<br>Comparative Law                |
| Tul L Rev           | Tulane Law Review                                                   |
| U Chi L Rev         | University of Chicago Law Review                                    |
| UNCITRAL            | United Nations Commission on<br>International Trade Law             |
| UN Doc              | United Nations Documents                                            |
| U Pa J Intl Econ L  | University of Pennsylvania Journal of<br>International Economic Law |
| US                  | United States Reports                                               |
| USCA                | United States Court of Appeals                                      |
|                     | United States Code Annotated                                        |

|               |                                                                 |
|---------------|-----------------------------------------------------------------|
| Va            | Virginia                                                        |
| Vand L Rev    | Vanderbilt Law Review                                           |
| VULR          | Victoria University of Wellington Law<br>Review                 |
| Wash U L Q    | Washington University Law Quarterly                             |
| WFBV          | <i>Wet op de Formeel Buitenlandse<br/>Vennootschappen</i>       |
| WL            | Westlaw                                                         |
| Yale J Intl L | Yale Journal of International Law                               |
| YEL           | Yearbook of European Law                                        |
| ZIP           | <i>Zeitschrift für Wirtschaftsrecht und<br/>Insolvenzpraxis</i> |

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| UNCITRAL, 'Legislative Guide on Insolvency Law' (2005) .....                                                                                                                       | 289                          |
| UNCITRAL, 'Legislative Guide on Insolvency Law' (2005) New York p 10, recommended for due consideration to all States by UNGA Res 59/40 (2 December 2004) UN Doc A/RES/59/40 ..... | 394                          |
| UNCITRAL, 'Report of the Working Group V (Insolvency Law) on the work of its thirty-sixth session' (New York, 18-22 May 2009) UN Doc A/CN.9/671                                    | 305                          |
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| UNCITRAL, 'Treatment of corporate groups in insolvency' (New York, 14-18 May 2007) UN Doc A/CN.9/WG.V/WP.76/Add.2.....                                                             | 304, 305                     |
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## **1. Introduction**

The present thesis will seek to sustain one main argument. Freedom of establishment is not universal. Although the European Community has taken active steps to encourage corporate mobility, the initial enthusiasm for it has been replaced by a more cautious approach. In the middle of a financial crisis, the international environment for letter-box and offshore companies is becoming increasingly intolerant. As such companies and their directors become all the more vilified in popular perception and as the need for safeguarding State revenue through taxation becomes more acute, the ECJ as well as national courts are less willing to uphold the benefits that such structures have enjoyed so far under freedom of establishment.

Cross-border activity in Europe has so far required the use of letter-box companies as a cheap means of selecting the company law of a Member State other than the one where the company conducts its activities. This is not to say that letter-box companies have been the only means implemented in corporate mobility. However, they have clearly dominated the field of small and medium sized enterprises. As States are eager to preserve their revenue from corporate taxation in order to fund their schemes to reheat the economy, such corporate schemes will become less tolerated.

The present thesis will highlight the recent developments in the field of freedom of establishment for corporations. It will seek to narrate the way in which debate has shifted from traditional private international law rules (law of the place of incorporation- law of the place of the real seat) to the possibility and desirability of a regulatory competition for corporate and

insolvency laws. It will be argued that the emergence of a regulatory competition in both fields would be desirable as competition is more likely to increase the quality of the law than not. However, the case for regulatory competition in insolvency law is probably stronger than in corporate law.

One way or the other, one should realise that in both the fields of corporate and insolvency law, harmonisation is not the appropriate course of action. Entrepreneurship in Europe has a lot to gain from diversity in tax, insolvency and corporate law. It is also good for the state of the law. Regulatory competition is desirable only if States engage in it with a view to devise the best possible law. This is positive both for the law and for the development of business. Member States and European institutions should be discouraged from any kind of harmonisation that could put an end to polyphony amongst national laws.

The present thesis will address these issues in the following order:

Part I deals with the traditional choice of law rules that have been developed in order to identify the *lex causae* in corporate affairs. Chapter 2 consists of a brief introduction to Part I. Chapter 3 presents and analyses the theory of incorporation as choice of law for corporations in the UK, the USA and Switzerland, which is then followed by the presentation and analysis of the real seat theory as the traditional choice of law for corporations in France and Germany and the principal place of business as part of the Italian choice of law rule. Chapter 4 will address the advantages and disadvantages of the two theories and Chapter 5 will set them in the context of the procedural and

substantive law in which they operate. Chapter 6 provides a short conclusion to Part I.

Part II examines the interaction between freedom of establishment and choice of law for corporations in the European Union. Chapter 7 provides the reader with a brief introduction. Chapter 8 provides a detailed survey of the leading judgments of the European Court of Justice (hereinafter ECJ) in the area of freedom of establishment for corporations, starting with *Daily Mail* and ending with *Cartesio*. Chapter 9 deals with the treatment of letter-box companies in the context of freedom of establishment. It presents and analyses the new regime created under the Services Directive and its consequences on letter-box companies. It also considers the refinement of the doctrine of abuse in relation to such companies. Chapter 10 is concerned with regulatory competition for corporate charters. It examines the way in which regulatory competition is structured in the US and considers the arguments for and against such competition taking place in the European Union. Chapter 11 contains some concluding remarks for Part II.

Part III deals with the scheme of insolvency proceedings in Europe and its interaction with freedom of establishment. Chapter 12 provides a brief introduction to the scheme of international jurisdiction and choice of law for insolvency in Europe. Chapter 13 dwells upon the notion of the centre of main interests (hereinafter COMI) in ECJ and domestic case-law as the basis for both international jurisdiction and applicable law. Chapter 14 is concerned with the anti-forum shopping policy that the Insolvency Regulation is meant to implement. It examines all the various ways in which the centre of main

interests can be transferred from one Member State to another and tries to identify the dividing line between transfers that constitute forum shopping and transfers that do not.

Chapter 15 is concerned with the compatibility of the centre of main interests with freedom of establishment. It argues that the possibility to reverse the presumption that exists in favour of the place of incorporation is not contrary to freedom of establishment. Chapter 16 assesses the possibility for a regulatory competition for insolvency laws in Europe. It seeks to examine the reasons for, and conditions under which the Member States could engage in, such a competition. Chapter 17 makes some concluding remarks on Part III of the thesis. Finally, Chapter 18 provides the conclusions that can be drawn from the entire thesis.

## **PART I**

### **Private international law for corporations**

## 2. Introduction

Part I deals with the traditional choice of law rules that the two main Western legal families have employed in order to identify the applicable law in corporate affairs. The theory of incorporation has prevailed in the common law, whereas the real seat theory has prevailed in most of the civilian jurisdictions. The first part of this thesis will present and analyse the way in which the incorporation theory has been implemented at common law in England, the US<sup>1</sup> and by the civil law in Switzerland. It will also present and analyse the functioning of the real seat theory in French, German and Italian private international law. As far as the latter is concerned, particular attention is paid to the *sui generis* conflict rule which employs the principal place of business as a connecting factor.

This Part omits any reference to the influence that EU law, and in particular freedom of establishment, has had on conflict of laws for corporate affairs. Its purpose is to set the scene in which the ECJ has shaped its case-law on freedom of establishment. For this reason a full survey of the justifications behind these two theories is examined<sup>2</sup> and a juxtaposition of these theories with national procedural and substantive law<sup>3</sup> is arranged in the chapters below.

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<sup>1</sup> Although the US is not a Member State of the EU, any reference to the incorporation theory would be incomplete without reference to the manner in which it is implemented in the US. Despite the existing differences, the way these private international law issues are treated in the US can always constitute a useful point of reference or inspiration for EU law.

<sup>2</sup> See pp 52 *et seq.*

<sup>3</sup> See pp 57 *et seq.*

### 3. National choice of law for corporations

#### *I. Common law: the theory of incorporation*

The theory of incorporation has prevailed in all common law jurisdictions and has recently expanded in the sphere of civilian systems. In English law the *lex incorporationis* has been traced<sup>4</sup> back to 18<sup>th</sup> century case-law,<sup>5</sup> contrary to the view of some authors.<sup>6</sup> Be that as it may, its predominance in English law is uncontroversial.<sup>7</sup> It is also by and large followed in the Commonwealth,<sup>8</sup> as well as in the United States.<sup>9</sup> It has also been adopted by some civilian systems, like the Netherlands,<sup>10</sup> Switzerland<sup>11</sup> and Russia.<sup>12</sup>

According to this theory, ‘all matters concerning the constitution of a corporation are governed by the law of the place of incorporation’<sup>13</sup>

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<sup>4</sup> *Lazard Bros v Midland Bank* [1933] AC 289 (HL) 297.

<sup>5</sup> *Henriques v Dutch West India Co* (1728) 2 LD Raym 1532, 92 ER 494.

<sup>6</sup> S Rammeloo, *Corporations in Private International Law: A European Perspective* (1<sup>st</sup> edn OUP, Oxford 2001) 129.

<sup>7</sup> Dicey, Morris & Collins, *The Conflict of Laws* (14<sup>th</sup> edn Sweet and Maxwell, London 2006) paras 30R-020 *et seq*; *Bank of Ethiopia v National Bank of Egypt and Liguori* [1937] 3 All ER 8 (Ch); *Banco de Bilbao v Sancha and Rey* [1938] 2 KB 176 (CA); *Sierra Leone Telecommunications Co Ltd v Barclays Bank plc* [1998] 2 All ER 821 (QB); *Grupo Torras SA v Al-Sabah* [2001] CLC 221 (CA); *Base Metal Trading Ltd v Shamurin* [2004] EWCA Civ 1316, [2005] 1 WLR 1157.

<sup>8</sup> *Re Macks; Ex parte Saint* (2000) 204 CLR 158 (HCA) 227-228; *Technip SA v SMS Holdings (Pvt) Ltd* < <http://www.sebi.gov.in/courtorders/technip.html> > (India Supr) accessed on 13 December 2009; *National Trust Co v Ebro Irrigation & Power Ltd* [1954] Ont L Rep 463 (Ont Supr) 476-479.

<sup>9</sup> WLM Reese & EM Kaufmann, ‘The law governing the corporate affairs: choice of law and the impact of full faith and credit’ (1958) 58 Colum L Rev 1118, 1125-1126.

<sup>10</sup> Rammeloo (n6) 98-100.

<sup>11</sup> See pp 44 *et seq*.

<sup>12</sup> Articles 1202-1203 CC.

<sup>13</sup> Rule 162(2) in Dicey, Morris & Collins (n7) para 30R-020.

(hereinafter *lex incorporationis*). Under the American approach, the *lex incorporationis* governs the existence and the subsequent dissolution of a corporation,<sup>14</sup> as well as issues involving corporate powers and liabilities,<sup>15</sup> shareholders, directors and officers.<sup>16</sup>

### **A. Choice of law for corporations in England**

In England,<sup>17</sup> it has been well established that the following seven main issues are all matters to be governed by the *lex incorporationis*: (1) the beginning or the end of the legal personality of a corporation;<sup>18</sup> (2) the validity of the appointment of directors;<sup>19</sup> (3) the authority of individuals to act on behalf of the corporation;<sup>20</sup> (4) the existence or not of liability of the corporation members for corporate debts;<sup>21</sup> (5) the capacity of the corporation to enter in certain agreements;<sup>22</sup> (6) contracts of membership to a corporation;<sup>23</sup> and (7) the amalgamation of corporations resulting in the establishment of a new

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<sup>14</sup> Restatement Second, Conflict of Laws, para 297 (1971).

<sup>15</sup> *ibid* paras 301-302.

<sup>16</sup> *ibid* paras 303-310.

<sup>17</sup> Dicey, Morris & Collins (n7) para 30-024.

<sup>18</sup> *Lazard Bros* (n7); *Presentaciones Musicales SA v Secunda* [1994] Ch 271 (CA); *The Kommunar No 2* [1997] 1 Lloyd's Rep 8 (QB) 11.

<sup>19</sup> *Sierra Leone Telecommunications* (n7).

<sup>20</sup> *Banco de Bilbao* (n7); *Presentaciones Musicales* (n18) 277[B], 283[F]-[G].

<sup>21</sup> *JH Rayner(Mincing Lane) Ltd v Department of Trade and Industry* [1990] 2 AC 418 (HL) 509[A]&[B].

<sup>22</sup> *Baccus SRL v Servicio Nacional del Trigo* [1957] 1 QB 438 (CA); *Janred Properties Ltd v ENIT* [1989] 2 All ER 444 (CA). This issue is also governed by the *lex contractus* (cf Rule 162(1) in Dicey, Morris & Collins).

<sup>23</sup> *Pickering v Stephenson* (1872) LR 14 Eq 322 (Ch); *Spiller v Turner* [1897] 1 Ch 911 (Ch).

corporation and the *successio universalis* of the new corporation to the rights and obligations of the old ones.<sup>24</sup>

## **B. Choice of law for corporations in the USA**

American legal theory had initially taken the view that corporations are creatures of law that do not exist beyond the borders of the state of incorporation.<sup>25</sup> However, by the end of the 19<sup>th</sup> century it had been accepted that recognition of a corporation will depend on whether the requirements of the *lex incorporationis* had been fulfilled.<sup>26</sup> States though would not be allowed to impose special requirements on companies incorporated in other US jurisdictions in order to grant them permission to conduct business in their territory.<sup>27</sup>

For a long time federal courts had also declined to adjudicate disputes concerning the internal affairs of foreign corporations.<sup>28</sup> However, the Supreme Court reversed the position in *Williams v Green Bay & Wisconsin Railroad Co*,<sup>29</sup> where it endorsed the opinion of the minority in *Rogers v Guaranty Trust Co of New York*.<sup>30</sup> It held that federal courts may hear cases

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<sup>24</sup> *National Bank of Greece and Athens SA v Metliss* [1958] AC 509 (HL); *Eurosteel Ltd v Stinnes AG* [2000] 1 All ER (Comm) 964 (QB) 969[D].

<sup>25</sup> *Bank of Augusta v Earle* 38 US 519 (1839); M Rosenberg, P Hay & RJ Weintraub, *Conflict of Laws: Cases and Materials* (10<sup>th</sup> edn The Foundation Press Inc, 1996) 983.

<sup>26</sup> *Lancaster v Amsterdam Improvement Co* 35 NE 964, 967, col. 2 (NYCA 1894); *Montgomery v Forbes* 19 NE 342, 343 (Massachusetts SuprCt 1889).

<sup>27</sup> *Paul v Virginia* 75 US 168 (1868).

<sup>28</sup> *Rogers v Guaranty Trust Co of New York et al* 288 US 123, 130[2,3] (Butler J); see Stone J dissent at 144 (1933).

<sup>29</sup> 326 US 549, 553 (1946).

<sup>30</sup> *ibid* 144 (Stone J).

involving in a sense internal affairs of a corporation foreign to the state where the federal court sits.

The Supreme Court has established that the internal affairs of corporations should be governed by the *lex incorporationis*.<sup>31</sup> In fact it has been argued that this choice of law<sup>32</sup> has been elevated to a constitutional mandate.<sup>33</sup> These rules also apply in international corporate disputes, namely in cases where one party is alien,<sup>34</sup> i.e. a company incorporated abroad. However, it is rare that US federal courts will establish jurisdiction in such cases.<sup>35</sup>

Deviating from the position of English law, some US States recognise an exception to the theory of incorporation and adhere to the doctrine of pseudo-foreign corporations. A corporation is pseudo-foreign if it has no connection with the State of incorporation other than the act of incorporation, while its centre of management and activities lies elsewhere. The rules of this latter place will be entitled to apply as part of the *lex fori*.<sup>36</sup> In order to determine whether a corporation is pseudo-foreign, it is necessary to

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<sup>31</sup> *Edgar v MITE Corp* 457 US 624, 645 (1982).

<sup>32</sup> *CTS Corp v Dynamics Corp of America* 481 US 69, 87-94 (1987).

<sup>33</sup> EF Scoles and others, *Conflict of Laws* (4<sup>th</sup> edn West Group, St Paul, Minnesota 2004) 1229-1230, whereas Ph J Kozyris, 'Corporate Wars and Choice of Law' [1985] *Duke LJ* 1, 49 argues that it does not clearly establish it.

<sup>34</sup> *ITEL Containers International Corp. v Atlantrafik Express Service Ltd* Not Reported in FSupp, 1988 WL 75262 (SDNY).

<sup>35</sup> See pp 69 *et seq.*

<sup>36</sup> *Mansfield Hardwood Lumber Co v Johnson* 268 F2d 317 (US CA 5<sup>th</sup> Cir 1959); *Western Air Lines, Inc v Sobieski* 12 CalRptr 719 (California CA 1961); *Gries Sports v Modell* 473 NE2d 807, 810 (Ohio Supr 1984); *Yates v Bridge Trading Co* 844 SW2d 56 (Missouri CA 1992).

examine, *inter alia*, various factors, such as the place of substantial business, the domicile of a substantial number of shareholders,<sup>37</sup> the residence of the parties and actors, the *situs* of property, *lex loci delicti vel contractus*, or the sole or main location of the corporation carrying business.<sup>38</sup>

This doctrine was first conceived by Latty<sup>39</sup> but was initially adopted only in California and New York.<sup>40</sup> However, it has always enjoyed support from eminent authors.<sup>41</sup> It has been developed to tackle one of the main disadvantages of the incorporation theory, namely the fact that it may result in the application of a law with which the corporation has in fact no true connection. However, both federal and some State courts had declined to adopt it and applied the *lex incorporationis*, even in cases where there was no genuine link between the corporation and the place of incorporation, provided that the litigation concerned take-over battles, derivative suits, and a variety of other internal matters.<sup>42</sup>

By the 1980s the pseudo-foreign doctrine had gained almost universal acceptance in the USA.<sup>43</sup> It was argued that State courts should abstain though from directly regulating the constitution of a foreign corporation,

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<sup>37</sup> *Western Air Lines* (n36).

<sup>38</sup> *Mansfield* (n36).

<sup>39</sup> ER Latty, 'Pseudo-Foreign Corporations' (1955) 65 Yale LJ 137.

<sup>40</sup> Kozyris (n33).

<sup>41</sup> Restatement Second, Conflict of Laws, para 302(g) (1971); EF Scoles (n33) 1232; AW Vestal, 'Choice of Law and the Fiduciary Duties of Partners Under the Revised Partnership Act' [1994] Iowa L Rev 219, 268.

<sup>42</sup> Kozyris (n33) 18-24.

<sup>43</sup> *ibid* 96.

because in doing so it would impose excessive burdens on interstate commerce.<sup>44</sup> Full faith and credit demands the application of any law, which happens to be the *lex incorporationis*.<sup>45</sup> Even Delaware, which has attracted most incorporations in the US,<sup>46</sup> eventually recognised the existence of such an exception, but only on very rare occasions, where national policy is outweighed by the interests of the *forum* state in the company and its shareholders.<sup>47</sup>

### C. Choice of law for corporations in Switzerland

Switzerland adheres to the incorporation theory. According to article 154(1) of the *Loi fédérale sur le droit international privé* (hereinafter ‘LDIP’) of 18.12.1987,<sup>48</sup> corporations are governed by the *lex incorporationis*, if the registration and publicity requirements of the latter have been met. In the event that such requirements have not been met, the *lex incorporationis* is replaced by the law of the place where the corporation is ‘actually administered’ under article 154(2) LDIP.

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<sup>44</sup> *ibid* 33.

<sup>45</sup> *Order of United Commercial Travellers v Wolfe* 331 US 586 (1947).

<sup>46</sup> There are approximately 695,000 active entities registered in Delaware, including about 50% of the corporations publicly traded on the US stock exchange. See —, ‘Third Mutual Evaluation Report on Anti-Money Laundering and Combating Terrorism: United States of America, prepared by the FATF in Paris 23 June 2006’ <[http://www.fatf-gafi.org/document/23/o,2340,en\\_32250379\\_32237217\\_37101591\\_1\\_1\\_1\\_1,00.html](http://www.fatf-gafi.org/document/23/o,2340,en_32250379_32237217_37101591_1_1_1_1,00.html)> p 231 accessed on 13 December 2009; John Armour, ‘Who should make corporate law? EC legislation versus regulatory competition’ (2005) 58 CLP 369, 376n24.

<sup>47</sup> *McDermott Inc v Harry Lewis* 531 A2d 206, 218 (Del Supr 1987); followed by *Draper v Gardner* 625 A2d 859 (Del Supr 1993), where the court drew attention to *Kamen v Kemper Financial Services Inc* 500 US 90 (1991), where the US Supreme Court had held that it was the law of the state of incorporation which governed the substantive legal issues of corporate governance.

<sup>48</sup> RS 291.

The theory of incorporation constituted the Swiss choice of law even before the enactment of the LDIP in the sense that the Swiss courts would apply the law of the place of the statutory seat and not of the real seat. However, it had been held by the Swiss *Tribunal Fédéral* (hereinafter ‘TF’) that the law of the real seat would replace the *lex incorporationis*, if the statutory seat was fictitious.<sup>49</sup> This was held to be the case with regard to a foundation established in Liechtenstein that had ‘no activity, real seat or even a letter box’ in the Principality. There was strong academic debate whether this *fraus legis* exception survived the enactment of the LDIP. The TF reached the conclusion that the ‘fictitious seat’ theory was incompatible with the spirit and letter of the LDIP.<sup>50</sup>

## ***II. Civil law: the real seat theory***

The majority of civilian systems have opted for the real seat theory.<sup>51</sup> The content of this theory is more or less uniform throughout the jurisdictions that have adopted it, subject to minor variations that will be examined on a State by State basis. According to this theory, a corporation is governed by the law of the place where the central management and control is located.<sup>52</sup>

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<sup>49</sup> ATF 108 II 398 (1982).

<sup>50</sup> ATF 117 II 494, para 5b (1991).

<sup>51</sup> Article 110(1) of the Belgian *Code de Droit International Privé*; article 10 of the Austrian *Gesetz über das internationale Privatrecht* and *Oberster Gerichtshof*, 14.07.1993, (1998) 125 JDI 993; article 10 of the Greek CC; article 158 of the Law of 10.08.1915 of Luxembourg; article 11(2) of the United Arab Emirates CC.

<sup>52</sup> Rammeloo (n6) 11-13.

## A. Choice of law for corporations in France

In France, due to the key role that nationality plays in the private international law syllabus, the aim has been to identify the *lex patriae* of the corporation. It remained to be decided what the criterion of nationality should be. Several incoherencies in the jurisprudence,<sup>53</sup> lead the *Cour de Cassation* to adopt the *siège social* criterion.<sup>54</sup> The latter defined the *siège social* as the real seat, namely the location where the corporation has its main legal, financial, administrative and technical management. The *Conseil d'Etat* has also adopted the same theory.<sup>55</sup>

Since then the *Cour de Cassation* has confirmed the validity of the real seat theory and has recognised one exception to the rule,<sup>56</sup> namely the case where, due to a change of sovereignty over the territory where the real seat of the company is situated, the latter moves its real seat to the territory of its original State of incorporation. Two requirements were put in place for the satisfaction of the exception. First, the company had to be controlled by French nationals and, second, the transfer of seat had to be lawfully decided by the competent corporate body.<sup>57</sup> However, the nationality of such

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<sup>53</sup> H Batiffol & P Lagarde, *Traité de Droit International Privé* (8<sup>th</sup> edn LGDJ, Paris 1993) vol. 1, 334-335 ; Y Loussouarn & P Bourel, *Droit International Privé* (6th edn Dalloz, Paris 1999) 751-753.

<sup>54</sup> *Cass civ*, 07.07.1947, *Compagnie du Cambodge c Administration de l'Enregistrement* (1949) 38 RCDIP 78.

<sup>55</sup> *CE*, 22.02.1960, *Société Mayol, Arbona et Cie* (1960) 49 RCDIP 335.

<sup>56</sup> *Cass civ*, 30.03.1971, *Caisse Centrale de reassurance des mutuelles agricoles c Mutuelle centrale d'assurances et de reassurance des mutuelles agricoles et Société générale* (1971) 60 RCDIP 451; Bertrand Ancel & Yves Lequette, *Les grands arrêts de la jurisprudence française de droit international privé* (5<sup>th</sup> edn Dalloz, Paris 2006) 458.

<sup>57</sup> *ibid* 462.

corporations will normally be governed by the agreement or treaty of independence.<sup>58</sup>

The next issue to be decided had to do with the identification of the real seat on a factual level. It was addressed in a series of cases which were summed up by the legislator and enacted as law.<sup>59</sup> The French courts have held that in order to determine the *siège social*, one should refer to the place where the General Assemblies are summoned, the board of directors has its offices and the superior organs of management and control can be found. It treated the Banque, which had been incorporated in Denmark, as a French corporation.<sup>60</sup> The *siège social* is, therefore, not to be understood as the *siège statutaire*, but as the *siège réel*. That test has been consistently followed ever since.<sup>61</sup> In the case of *sociétés anonymes* it has been ruled that one should look for the location of the board of directors and not for that of the general assembly.<sup>62</sup>

In general, the *siège réel* is held to be located in the place where effective management is exercised, that is not only the place where the general assembly is convened, but also the place where the board of directors

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<sup>58</sup> *ibid.*

<sup>59</sup> B Audit, *Droit International Privé* (4<sup>th</sup> edn Economica, Paris 2006) 874.

<sup>60</sup> *Cour d'appel de Paris*, 21.05.1957, *Banque Franco-serbe c Danske-Landmarndsbank* (1958) 47 RCDIP 128.

<sup>61</sup> P Kahn, *Cass comm*, 19.05.1992, *Banque Worms c Grindlay's Bank* (case note) (1992) 119 JDI 954; M Menjucq, *Cass comm*, 08.12.1998, *Soc General Accident c Banque Nationale de Paris et autres* (case note) (1999) 88 RCDIP 284.

<sup>62</sup> *Compagnie du Cambodge* (n54); although this case concerned the transfer of the place where the General Assembly was held, it has been generally alleged that central management and control lies within the Administrating Council (cf. Batiffol & Lagarde (n53) 339).

holds its meetings and the place where the major contracts concerning the corporation are signed.<sup>63</sup> This jurisprudential approach now stands as positive law by virtue of article 1837(1) CC.

In order to facilitate the process before the French courts, the *Cour de Cassation* has established a rebuttable presumption that the *siège réel* coincides with the *siège statutaire*.<sup>64</sup> This requires the litigant wishing to overturn the presumption to prove that the central management is not located in the statutory seat.<sup>65</sup> In doing so, facts such as the ownership of the company in question, the existence of registered branches in France, the domicile of the chairman of the board of directors, and the location of the premises of the company in which decisions are made will become extremely relevant.<sup>66</sup>

In cases of multi-national corporations or corporations having various administrative organs in various States, the court will have to take into account the location of the organs of the very central management and control and not of the management of secondary character or exploitation.<sup>67</sup>

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<sup>63</sup> *Cass soc*, 03.03.2004, *Mme X c Soc Ural Hudson Ltd* at (Official website of the French Republic for the Diffusion of Law) <<http://www.legifrance.gouv.fr/>> accessed on 13 December 2009.

<sup>64</sup> *Cass Ass*, 21.12.1990, *Directeur general des impots c Soc Roval* (1992) 81 RCDIP 70-72. *Siège statutaire* (statutory seat) is the place named as seat in the corporate charter and corresponds best to the registered office in English company law.

<sup>65</sup> *Cass comm*, 18.10.1994, *Paul Guez c Soc Emerson Europe SA* at (Official website of the French Republic for the Diffusion of Law) <<http://www.legifrance.gouv.fr/>> accessed on 13 December 2009.

<sup>66</sup> *Cass crim*, 31.01.2007, *La Soc Elf Aquitaine* at (Official website of the French Republic for the Diffusion of Law) <<http://www.legifrance.gouv.fr/>> accessed on 13 December 2009.

<sup>67</sup> Batiffol & Lagarde (n53) 338.

In cases of foreign companies setting up a subsidiary in France, the position of the law nowadays is that the central management and control of a French subsidiary is located in France.<sup>68</sup>

## **B. Choice of law for corporations in Germany**

Despite the fact that the German BGB does not provide for a choice of law for corporations, the real seat theory has been long established in case-law.<sup>69</sup>

According to the latter, the real seat is the place of central management and control.<sup>70</sup> The *Bundesgerichtshof* (hereinafter 'BGH') construed central management to mean the place where 'the fundamental business decisions by the managers are being implemented effectively into day-to-day business activities'.<sup>71</sup>

Furthermore, *renvoi* plays a significant role in the German rule of conflict for corporations. Under paragraph 4(1) of the Introductory Law to the Civil Code (*Einführungsgesetz zum Bürgerlichen Gesetzbuch- EGBGB*) the reference made by German law to the *lex sedis* includes a reference to the private international law rules of the latter. Thus questions concerning the corporation will be resolved according to the substantive law of the country

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<sup>68</sup> Cass civ, 08.02.1972, *Epelbaum c Société Shell Berre* (1973) 100 JDI 218; Ancel & Lequette (n56) 460-461.

<sup>69</sup> WF Ebke, 'The "Real Seat" Doctrine in the Conflict of Corporate Laws' [Fall 2002] Intl Law 1015, 1021-1022; for a list of German cases endorsing the rule of the seat theory see G Hertel, 'La loi nationale face aux structures patrimoniales étrangères: la loi allemande' [2001] RHDI 189, 201, 202n47.

<sup>70</sup> Hertel (n69) 201-204.

<sup>71</sup> Ebke (n69) 1022, citing Judgment of 21.03.1986, (1986) 97 BGHZ 269 (German Federal Court of Cassation).

chosen by the private international law rules of the country pointed to by the *lex sedis*.<sup>72</sup> Thus, the *lex incorporationis* might apply only by renvoi.

### **C. Choice of law for corporations in Italy**

The choice of law for corporations in Italy is *sui generis*. Article 25(1) of Law No 218/31.05.1995 on the reform of the Italian system of private international law<sup>73</sup> adheres *prima facie* to the incorporation theory. However, the same article further stipulates that Italian law will apply if the *sede dell'amministrazione* (seat of the administration) or the *oggetto principale dell'impresa* (principal place of business) is located in Italy. The interpretation of these terms has been left to the courts. It requires the finding of an actual relationship with the Italian legal order by discarding formalities.<sup>74</sup> This requirement will be satisfied if the place where the acts forming the will of the company (*volontà sociale*) take place<sup>75</sup> in Italy or the activity of the company is predominantly in Italy.<sup>76</sup> In all other cases the *lex incorporationis* will apply, which includes renvoi under article 13 of Law No 218.

The *sui generis* link of *oggetto principale dell'impresa* does not get applied frequently. It has been adopted in order to tackle a specific type of

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<sup>72</sup> T Koller, 'The English Limited Company- Ready to Invade Germany' (2004) 15 ICCLR 334, 335-336.

<sup>73</sup> A Montanari & VA Narasi, *Conflict of Laws in Italy: The Text and an English translation of Italian Law No 218 of May 31, 1995* (1st edn Kluwer Law International, The Hague 1997) 36-37.

<sup>74</sup> T Ballarino, *Diritto Internazionale Privato* (3<sup>rd</sup> edn Cedam, Padova 1999) 365-366; Cass civ, sez III, 10.12.1974, n 4172 (Italian Court of Cassation) reported in G Bellagamba & G Cariti, *Il sistema Italiano del diritto internazionale privato: Rassegna della giurisprudenza* (1<sup>st</sup> edn Giuffrè, Milano 2000) 145-146.

<sup>75</sup> Simonetto, *Trasformazione e fusione delle società: Società costituite all'estero* (2<sup>nd</sup> edn Zanichelli, Bologna- Roma 1976) 389.

<sup>76</sup> Ballarino (n74).

cross-border entrepreneurship, namely the Liechtenstein *Anstalten*, which Italians were increasingly using in Italy.<sup>77</sup> It is now settled that in cases where an *Anstalt* does not have its *oggetto principale* in Italy the lack of plurality of shareholders does not conflict with Italian public order.<sup>78</sup>

According to article 25(2) of Law No 218, the scope of article 25(1) covers the legal status of the entity, its name, its incorporation, transformation and dissolution, its capacity, its establishment and the powers of its organs, agency, acquisition or loss of membership of the company as well as rights and obligations resulting thereof, liability for its obligations and consequences of breach of the law of the memorandum of association.

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<sup>77</sup> *ibid* 365.

<sup>78</sup> *Cass SU*, 16.11.2000, n 14870 (2002) 38 RDIPP 193 (Italian Court of Cassation).

#### **4. Incorporation and real seat theories: advantages and disadvantages**

It is necessary to examine the two theories in question within their legal context in order to identify their respective advantages and disadvantages. This will ensure a better understanding of their functioning.

##### ***I. Advantages and disadvantages of the incorporation theory***

With regard to the incorporation theory, it is said that it is fairly reasonable that the legal order that created the corporation should also govern it.<sup>79</sup> No other state has a greater interest than the State of incorporation in regulating a corporation's internal affairs.<sup>80</sup> Arguments based on legal certainty,<sup>81</sup> predictability<sup>82</sup>, party autonomy<sup>83</sup> and security of transactions are also in its favour. This theory facilitates any potential litigant in identifying *ex ante* the law applicable to a possible dispute with a corporation. Last but not least, a considerable advantage of the incorporation theory is that it has promoted the economic development of the countries that have adopted it. The

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<sup>79</sup> TC Drucker, 'Companies in Private International Law' [1968] ICLQ 28.

<sup>80</sup> *Soviet Pan Am Travel Effort v Travel Comm Inc* 756 FSupp 126, 131 (1991) (SDNY).

<sup>81</sup> *Yates v Bridge Trading Co* 844 SW2d 56, 62 (1992) (Missouri CA).

<sup>82</sup> Y Hadari, 'The Choice of National Law Applicable to the Multinational Enterprise and the Nationality of such Enterprises' [1974] Duke LJ 1, 10; JT Oldham, 'Regulating Regulators: Limitations Upon a State's Ability to Regulate Corporations with Multi-State Contacts' (1980) 57 DenLJ 345, 350.

<sup>83</sup> B Audit, *Droit International Privé* (4<sup>th</sup> edn Economica, Paris 2006) 870-871.

Netherlands<sup>84</sup> and Switzerland are good examples of civilian jurisdictions that adopted the incorporation theory in order to encourage foreign investment.

However, *fraus legis* and tolerance, if not promotion, of sham corporate formations are the most well-known disadvantages of this theory.<sup>85</sup> It allows for the founders to establish the corporation in a jurisdiction with lax company law and simultaneously circumvent the rules of the State in which they conduct business and in which one might expect them to incorporate. Practice has shown that jurisdictions with very lenient rules of corporate governance, which also adopt the theory of incorporation, have attracted huge numbers of corporations. Delaware especially has attracted thousands of corporations, which has led commentators to describe this flow as a ‘law beauty competition’.<sup>86</sup> However, as will be argued below, in the case of Delaware at least, it is not possible to speak of lenient or lax corporate law, but of corporate law which is thought to be regulating the relations between managers and shareholders in an efficient manner.<sup>87</sup>

The common law response to this alleged defect of the incorporation theory has been the pseudo-foreign company doctrine.<sup>88</sup> The urge to guarantee the financial stability of corporations operating within their

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<sup>84</sup> D Charny, ‘Competition among Jurisdiction in Formulating Corporate Law Rules: An American Perspective on the “Race to the Bottom” in the European Communities’ (1991) 32 Harv Intl LJ 423, 429.

<sup>85</sup> S Rammeloo, *Corporations in Private International Law: A European Perspective* (1<sup>st</sup> edn OUP, Oxford 2001) 17-18.

<sup>86</sup> R Drury, ‘The regulation of foreign corporations: Responses to the “Delaware syndrome”’ (1998) 57 CLJ 165.

<sup>87</sup> See pp 223 *et seq.*

<sup>88</sup> See pp 43 *et seq.*

jurisdiction and to protect shareholders and creditors from fraudulent practices has motivated the propagation of this theory.<sup>89</sup> It was, therefore, anti-*fraus legis* policies that lead to the promulgation of such laws in various States, the most prominent of which are California and New York, in the USA, and the Netherlands, in Europe.

## ***II. Anti-fraus legis considerations: the advantage of the real seat theory***

The advantages of the real seat theory have been efficiently summarised in the following statement:

This theory, which is a protective one, is still supported by the better arguments. It ensures that in general the law of the state that is most affected will be implemented; it has the advantage of being appropriate to the issues arising, it makes effective state supervision possible, and offers the greatest possible protection for creditors. A state which, out of concern for its own national economy, is wary of the encroachment of the interests of the founders of the company and the state of incorporation will in principle choose a connecting factor independent of the statutory seat and place of registration and concentrate on the law of the place from which the company is actually controlled.<sup>90</sup>

The assumption behind the theory is that no law is more closely connected with the corporation than the law of the country where the central management is located. Although in most countries it is always possible for a corporation to transfer its seat abroad without prior dissolution,<sup>91</sup> this

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<sup>89</sup> Oldham (n82) 378.

<sup>90</sup> *Re Expatriation of A German Company* [1993] 2 CMLR 801 (Bavarian Oberstes Landesgericht) [7].

<sup>91</sup> Article 112 of the Belgian *CDIP*; Y Loussouarn, *Belgian Cass*, 12.11.1965, *Soc Lamot Ltd c Willy Lamot* (case note) (1967) 56 RCDIP 506, 510. In Germany though dissolution of the corporation was a prerequisite for the transfer of the seat abroad: C Kersting, 'Corporate Choice of Law – A Comparison of the United States and European Systems and a Proposal for a European Directive' (2002) 28 *Brook J Intl L* 1, 39 n207; WF Ebke, 'The "Real Seat" Doctrine

decision is not as easy as it sounds. It is a very hard and often not cost-effective decision. Setting aside these advantages, the real seat theory restricts the extent of party autonomy of entrepreneurs in selecting to establish a company under a specific national law.

On the other hand, the real seat theory may lead to more equitable solutions than the incorporation theory by facilitating a kind of extraterritorial application of the law. The best example is that of the Elf scandal that shook France in 1994. The giant French oil company, Elf Aquitaine, had actually become a private bank for executives who defrauded at least 3 billion French francs from the Elf Group through the establishment of several offshore companies and the opening of several bank accounts abroad and spent it on political favours, mistresses, jewellery, fine art, villas and apartments.

In relation to fraudulent activities undertaken by a manager of Elf Gabon, a company incorporated in Port-Gentil, Gabon, the manager in question tried to evade liability for '*complicité de recel et recel d'abus de biens sociaux*' by arguing that the relevant French corporate law provisions could not apply to the director of a Gabonese company. In upholding the judgment of the Paris *Cour d'appel*, the *Cour de Cassation* held that Elf Gabon was a French company, because the French parent company, Elf Aquitaine, held 58.28% of the shares of Elf Gabon, the latter retained an establishment registered in the Commercial Registry of Nanterre, the president of the board

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in the Conflict of Corporate Laws' [Fall 2002] Intl Law 1015, 1036 n151&152, citing relevant German case-law.

of directors was domiciled in Paris and the decisions to perform all the relevant fraudulent activities were taken in the premises of the *Tour Elf* in *La Défense*, Paris. It was thus proved to the satisfaction of the *Cour de cassation* that the real seat of Elf Gabon was in France and that French law should apply to its directors.<sup>92</sup>

In any event, the criticism that the real seat theory negates the legitimate expectation of the founders that the *lex incorporationis* will govern all corporate affairs ignores the fact that the real seat in fact does not envisage the exclusion of the law of incorporation. It merely suggests as an *optimum* that the central management is located *in* the country of incorporation.

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<sup>92</sup> *Cass crim*, 31.01.2007, *La Soc Elf Aquitaine et al* at (Official website of the French Republic for the Diffusion of Law) <<http://www.legifrance.gouv.fr/>> accessed on 13 December 2009.

## **5. Incorporation and real seat theory in context**

Having considered all the above, one may now assess these two theories in the legal framework in which they exist, to see how the rules of conflict for corporations match with the provisions of jurisdiction and corporate law.

### ***I. Choice of law for corporations and rules on jurisdiction***

#### **A. Choice of law for corporations and rules on jurisdiction in Europe**

International jurisdiction on civil and commercial matters is governed by Regulation 44/2001 (hereinafter 'Brussels Regulation').<sup>93</sup> Article 22(2) confers exclusive jurisdiction on the courts of the seat for disputes concerning the validity of the constitution, the nullity or the dissolution of companies, or of the validity of the decisions of their organs. According to the same proviso, it is for the court where the claim is filed to apply its own private international law rules and determine whether the seat of the company is located within its jurisdiction.

##### ***i) The interpretation of article 22(2) of the Brussels Regulation in the UK***

Article 22(2) allows for a certain degree of inconsistency as it allows for both the place of incorporation and the real seat rules to be applied. In the UK, jurisdiction concerning issues related to the constitution of a corporation is regulated by article 22(2) of the Brussels Regulation and Schedule 1, paragraph 10 of the Civil Jurisdiction and Judgments Order 2001 (hereinafter 'CJJO 2001'). Article 22(2) confers exclusive jurisdiction on the courts of the seat and

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<sup>93</sup> Council Regulation (EC) 44/2001 of 22 December 2000 on jurisdiction and the recognition and enforcement of judgments in civil and commercial matters [2001] OJ L12/1, 8.

Schedule 1, paragraph 10 provides that the seat is located in the UK only if incorporation has taken place in the UK, or the central management is exercised in the UK.<sup>94</sup>

The following examples will illustrate three possibilities that the CJJO 2001 allows. If a limited liability company is incorporated in Greece and the central management is exercised in the UK, then the UK courts will have exclusive jurisdiction,<sup>95</sup> but they will have to apply Greek law. If it is incorporated in the UK and has its central management in Greece, then the UK courts will consider that they have exclusive jurisdiction,<sup>96</sup> but so too will the Greek courts.<sup>97</sup> If the company is incorporated in a non Member State and its central management is exercised in the UK, then the UK courts will again enjoy exclusive jurisdiction,<sup>98</sup> but will have to apply the law of that non Member State.

Concerning the second example, both national courts will consider that under article 22(2) of the Brussels Regulation they enjoy exclusive jurisdiction. Article 29 of the Regulation is there to ensure that the court with exclusive jurisdiction but second seized will decline jurisdiction in favour of

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<sup>94</sup> A Briggs & P Rees, *Civil Jurisdiction and Judgments* (4<sup>th</sup> edn LLP, London- Hong Kong 2005) para 2.52; *The Deichland* [1990] 1 QB 361 (CA); *The Rewia* [1991] 2 Lloyd's Rep 325 (CA) 334-336.

<sup>95</sup> Para 10(4)(b) CJJO 2001: because under Greek law the company is domiciled in the UK where lies its actual seat (Article 25(2) CCP), provided that the formalities for transfer of seat to the UK and change of nationality have been fulfilled otherwise the company will be deemed to be domiciled in Greece, as a matter of Greek law.

<sup>96</sup> Para 10(4)(a) CJJO 2001.

<sup>97</sup> Article 25(2) CCP. See further, text to n101.

<sup>98</sup> Para 10(2)(b) CJJO 2001.

the court with exclusive jurisdiction and first seized. In the unlikely event that conflicting judgments will be delivered, it is debatable whether their recognition will be refused under article 34(3) or 35(1) of the Regulation. It would seem *prima facie* reasonable to apply article 34(3). However the wording of article 29, especially in the rest of the official languages, supports the argument that the court second seized does not stay proceedings but dismisses them on the ground of lack of international jurisdiction. This implies that under articles 22(2) and 29 only one court has exclusive jurisdiction in the end and the court second seized having heard the case has issued a judgment in conflict with article 22(2) in the sense of article 35(1).

Concerning the third example, the choice of central management as the basis of jurisdiction appears strange. Given that the *lex incorporationis* is the English choice of law for corporations and that article 22(2) of the Regulation refers to national private international law rules, it was not necessary for the legislator to define the seat, even alternatively, as the location of the central management.<sup>99</sup> In cases such as this the outcome will be that the *lex causae* will be different from the *lex fori*, despite the tendency of English courts not to admit claims unless English law is applicable.<sup>100</sup> One

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<sup>99</sup> Had the seat been defined only as the place of incorporation, English courts would not be hearing disputes relating to foreign companies, as is the case outside the scope of the Regulation. See A Briggs, 'Decisions of British Courts During 2004 Involving Questions Of Private International Law' (2005) 75 BYIL 537, 545.

<sup>100</sup> It is a very sensible assumption that every judge is much more suited and trusted to interpret the *lex fori* than any other law: A Briggs, *The Conflict of Laws* (2<sup>nd</sup> edn OUP, Oxford 2008) 6. It must be noted that some take the view that English courts might have the possibility of staying proceedings based on the reflexive effect of article 22, which seems to be a possibility not excluded by the ECJ in Case C-281/02 *Owusu* [2005] ECR I-1383 [48]. See Georges Droz, 'La Convention de San Sebastian alignant la Convention de Bruxelles sur la

plausible explanation might be that companies that are not incorporated in the UK but have their central management in the UK are thought to be resident for tax purposes in the UK. One might reasonably think that this adoption of the real seat approach in relation to jurisdiction emanates from tax law and the wish, or need, to establish jurisdiction over companies that are liable to UK tax.

***ii) The interpretation of article 22(2) of the Brussels Regulation in civilian jurisdictions***

By contrast, civilian rules of competence match in a far simpler way with the actual seat. In all civilian systems, the Civil Procedure Codes have adopted the rule that the defendant corporation is amenable before the courts of its seat, which is interpreted to mean the real seat.<sup>101</sup> This rule also applies in the Brussels Regulation context under articles 22(2) and 60 of the Regulation.<sup>102</sup> At the same time, in cases falling outside the scope of the Brussels Regulation, civilian courts will refuse recognition of judgments obtained against companies having their real seat within their territorial jurisdiction.<sup>103</sup>

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Convention de Lugano' (1990) 79 RCDIP 1, 14. However, cf. Case C-420/07 *Apostolides v Orams* [2009] ECR (not yet reported).

<sup>101</sup> Articles 42 and 43 of the French *Code de procedure civile*; §17(1) of the German *Zivilprozessordnung*; article 19 of the Italian *Codice di procedura civile*; article 109 of the Belgian *Code de Droit International Privé*; article 25(2) of the Greek CCP.

<sup>102</sup> *Cass soc*, 03.03.2004, *Mme X c Soc Ural Hudson Ltd* at (Official website of the French Republic for the Diffusion of Law) <<http://www.legifrance.gouv.fr/>> accessed on 13 December 2009.

<sup>103</sup> Article 905(3) of the Greek CCP; article 109 of the Belgian *Code de Droit International Privé*.

## **B. *Hassett & Doherty*: the place of corporate claims in the scheme of the Brussels Regulation**

The European Court of Justice (hereinafter the ECJ) has interpreted article 22(2) in a way that excludes any other corporate claim that does not fall under the exclusive enumeration of claims contained in the said article. Consequently, the rest of the company law claims will either have to be covered by the jurisdictional rules on contractual obligations, contained in article 5(1), or the rules on tort, delict and quasi-delict, contained in article 5(3). At all times, the claimant can have recourse to article 2 which elevates domicile to the general rule of jurisdiction.<sup>104</sup> This appears to be the conclusion of the Court in *Hassett & Doherty*, which constitutes the first case where the ECJ dealt with the place of corporate actions in the scheme of the Brussels Regulation.

### ***i) The facts of the case***

Nicole Hassett and Cheryl Doherty, both Irish nationals, brought a claim against two Irish health boards for serious personal injuries allegedly caused through the professional negligence of the doctors who were employed by those health boards. The health boards in question applied to have the doctors joined as a third party in each case, in order to claim an indemnity or a contribution from them.

The doctors, in turn, sought an indemnity and/or a contribution from the Medical Defence Union Ltd (hereinafter 'MDU'), a company incorporated in England, and of which they were both members, in respect of any sum

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<sup>104</sup> M Gelter, 'The structure of regulatory competition in European corporate law' (2005) 5 JCLS 247, 257-258.

which either of them might be required to pay by way of indemnity to the relevant health board. The doctors alleged that the MDU breached its duties under the articles of association in refusing to pay the indemnities.<sup>105</sup> The MDU responded by challenging the jurisdiction of the Irish courts. The Irish Supreme Court submitted a reference for a preliminary ruling to the ECJ asking whether the doctors' claim fell within the scope of article 22(2) of the Brussels Regulation.

***ii) The judgment of the ECJ***

AG Bot advised the Court to proceed without an Opinion from his side. The Court held that the claim did not fall within the scope of article 22(2). Although both obscure and laconic, it is possible to discern the Court's line of reasoning.

On the one hand, the Court accepted that article 22(2) must be interpreted as covering only disputes in which a party is challenging the validity of a decision of an organ of a company under the company law applicable or under the provisions governing the functioning of its organs, as laid down in its articles of association.<sup>106</sup> On the other, it noted that the doctors did not in any way challenge the fact that the board of management was empowered under the articles of association to adopt the decision rejecting their claim for indemnity, but only the way in which this power was exercised.<sup>107</sup>

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<sup>105</sup> Case C-372/07 *Hassett & Doherty* [2008] ECR I-7403 [8]-[11] .

<sup>106</sup> *ibid* [26].

<sup>107</sup> *ibid* [28]-[29].

***iii) Where should company law claims be placed in the Brussels Regulation scheme?***

It is clear that the Court believes only questions of formal validity to fall under the scope of article 22(2). This, of course, begs the question of what is the appropriate legal basis for an action challenging the material validity of board decisions and of company law claims in general. The answer seems to be that the doctors, the Irish courts and the ECJ contemplated them as arguments in contract arising out of the articles of association.<sup>108</sup> After all, article 22(2) comprises of few issues which are rather rare in litigation, i.e. the validity of the constitution, the nullity or the dissolution of companies and the validity of the decisions of their organs.

Is this, however, a sound decision? The answer is probably negative, but nonetheless inevitable. Article 22(2) does not cover every kind of company law claim.<sup>109</sup> Even if article 22 needs to be interpreted in a narrow manner by virtue of its very nature as a ground of exclusive jurisdiction,<sup>110</sup> company law claims do require a separate basis from claims in tort or contract. The nature and objectives of company law are no doubt different to those of general contract law or even tort law.

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<sup>108</sup> *ibid* [14].

<sup>109</sup> DI Evrigenis & KD Kerameus, 'Report on the accession of the Hellenic Republic to the Community Convention on jurisdiction and the enforcement of judgments in civil and commercial matters' [1986] OJ C298/1, 16; *Grupo Torras SA v Sheikh Fahad Mohammed Al-Sabah* [1996] 1 Lloyd's Rep 7 (CA) 15; *Phillips v Symes* [2002] 1 WLR 853 (Ch) [50]-[51]; *Speed Investments Ltd v Formula One Holdings Ltd (No 2)* [2004] EWCA Civ 1512, [2005] 1 WLR 1936; *Cass SU*, 12.01.2005, n 385 (2005) RDIPP 801 (Italian Court of Cassation); *FKI Engineering Ltd v Dewind Holdings Limited* [2007] EWHC 72 (Comm), [2007] ILPr 17 [26]; *JPMorgan Chase Bank v Berliner Verkehrsbetriebe* [2009] EWHC 1627 (Comm).

<sup>110</sup> Case C-73/77 *Sanders* [1977] ECR 2383 [17]-[18]; Case C-8/98 *Dansommer* [2000] ECR I-393 [21]; Case C-343/04 *ČEZ* [2006] ECR I-4557 [26].

One should start though by having reference to the Reports that have been drafted to supplement the 1968 Brussels Convention, before being superseded by the Brussels Regulation.<sup>111</sup> The purpose of granting exclusive jurisdiction to the courts of the seat was to avoid conflicting judgments, since it is in the Member State of the seat that information about the company is available and made public.<sup>112</sup> This was thought to be in conformity with the doctrine of *actor sequitur forum rei*.<sup>113</sup>

However, apart from the very fact that the Brussels Convention did not provide a definition of the term ‘seat’, the committee of experts agreed that, in deciding where the seat of a company is located, each Member State should apply its own private international law rules.<sup>114</sup> When contemplating the possibility of several courts enjoying exclusive jurisdiction, the committee concluded that article 28(1) of the Brussels Convention on recognition of judgements could be relied upon to prevent recognition.<sup>115</sup> This was perhaps an erroneous statement, given that article 23 of the said Convention was the one that required that in such cases any court other than the court first seized shall decline jurisdiction in favour of that court.

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<sup>111</sup> P Jenard, ‘Report on the Convention on jurisdiction and the enforcement of judgments in civil and commercial matters (Signed at Brussels, 27 September 1968)’ [1979] OJ C59/1; P Schlosser, ‘Report on the Convention on the Association of the Kingdom of Denmark, Ireland and the United Kingdom of Great Britain and Northern Ireland to the Convention on jurisdiction and the enforcement of judgments in civil and commercial matters and to the Protocol on its interpretation by the Court of Justice (Signed at Luxembourg, 9 October 1978)’ [1979] OJ C59/71.

<sup>112</sup> *ibid* 35; *Hassett & Doherty* (n105) [20].

<sup>113</sup> Jenard Report (n111).

<sup>114</sup> *ibid* 57.

<sup>115</sup> *ibid*.

It may be the case that in 1968 to leave the interpretation of the term ‘seat’ to national courts was a rational choice. All Member States, perhaps with the exception of the Netherlands, adhered to the real seat theory. However, this is probably not so any more. One of the main reasons that dictated this choice back in 1968 no longer exists. At that time, ‘the [c]ommittee did not wish to encroach upon the work on company law which is now being carried out within the Community.’<sup>116</sup> However, the 1968 Brussels Convention on the mutual recognition of companies never entered into force as the Netherlands refused to ratify it. Thus it no longer makes as much sense as it did in 1968 to allow each national court to apply its own private international law rules.

In dealing with the same issues, the Schlosser Report pointed out that positive conflicts of jurisdiction could be overcome by the provisions on *lis pendens* and related actions.<sup>117</sup> If a company has more than one seat, it is for the plaintiff to choose the forum where he will bring his action.<sup>118</sup>

The consequences are clear. Under the Brussels Regulation there is exclusive jurisdiction over a small range of corporate issues, which are rather rare in litigation. Other more significant corporate disputes, such as derivative actions, will have to be based on the general or special rules of jurisdiction contained in the Regulation.

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<sup>116</sup> *ibid.*

<sup>117</sup> Schlosser Report (1991) 97.

<sup>118</sup> *ibid* 120.

An example may help clarify things. Let it be supposed that X Ltd is incorporated in England, where it maintains only a registered office. The majority of the assets of X are located in Jersey and Switzerland. Y Ltd, incorporated in England, is the controlling shareholder and has, among others, appointed A, who is domiciled in France, and B, who is domiciled in Belgium, to the board of managers. Y's head office is in Luxembourg. Let it be further supposed that A and B misappropriate funds of X either for their own benefit or for the benefit of Y through a complex scheme of financial transactions that take place in England, Jersey and the Cayman Islands.

If the minority shareholders wish to sue A, B and Y, they are confronted with the following possibilities. Under article 2 of the Brussels Regulation, A can be sued in France, B in Belgium and Y in England or in Luxembourg. Article 6(1) allows for claims against multiple defendants to be brought together against all defendants in any of these countries, provided that there is a connection among the claims 'of such a kind that it is expedient to determine the actions together in order to avoid the risk of irreconcilable judgments resulting from separate proceedings.'<sup>119</sup> Consequently, if the action is brought in France, Belgium or Luxembourg, it is very likely that Luxembourgian company law might be applied, as Luxembourg adheres to the real seat theory. If the action is brought in England, English company law will apply.

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<sup>119</sup> Case C-189/87 *Kalfelis* [1988] ECR 5565 [12]; Case C-539/03 *Roche Nederland* [2006] ECR I-6535 [36]-[40].

If reliance is placed on article 5(1) of the Regulation, alleging breach of contract by the managers, it will be hard to see where the performance of the obligation is due. The managers owe a negative obligation not to misappropriate assets of the company. One might think that the term ‘obligation’ in article 5(1) is meant to capture obligations in the proper sense of the term.<sup>120</sup> However, there is authority to support the proposition that all obligations in the ordinary sense of the term, i.e. mere duties, are covered by article 5(1).<sup>121</sup>

If it is thought that a derivative action falls outside the scope of contractual claims, reliance could be placed on article 5(3) of the Brussels Regulation. Damage is sustained in Jersey and Switzerland, whereas the acts giving rise to it,<sup>122</sup> i.e. the transactions, take place in various jurisdictions outside the Community and in England.

Thus, establishing the jurisdiction of the English courts might be possible in such circumstances. A and B can be sued in England by virtue of article 5(3) and Y by virtue of article 2. These scenarios show that it is possible for the dispute to be litigated in a forum, in this case Belgium or France, that would not apply its own company law. Bearing in mind that the multiplicity of connecting factors in article 60 and the renvoi to national private

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<sup>120</sup> See J.3.13 pr: ‘obligatio est iuris vinculum, quo necessitate adstringimur alicuius solvendae rei, secundum nostrae civitatis iura.’; JB Moyle (tr), *The Institutes of Justinian* (5th edn Oxford 1913): ‘An obligation is a legal bond, with which we are bound by a necessity of performing some act according to the laws of our State’.

<sup>121</sup> *Agnew v Länsförsäkringsbolagens AB* [2001] 1 AC 223 (HL); Adrian Briggs, *The Conflict of Laws* (2nd edn Clarendon Law Series OUP, Oxford 2008) 77.

<sup>122</sup> On the interpretation of article 5(3) see Case C-21/76 *Bier* [1976] ECR 1735.

international law rules in article 22(2), one may wonder what sort of uniformity in jurisdiction the Brussels Regulation is seeking to establish.

This point is best illustrated by the example of an action to declare the nullity of a company brought before the courts of the real seat, which will apply the law of the real seat. When recognition is sought in the Member State of incorporation, the courts of the latter will be unable to rely on article 35(1) to refuse recognition. The reason is twofold. First, there is no breach of article 22(2). Second, article 29 requires that any other court that enjoys exclusive jurisdiction should decline it in favour of the court first seized.

Company law should fall within the scope of a single basis of jurisdiction. It is truly more convenient that claims requiring the application of foreign company law are adjudicated before a court that claims to have a connection with the company rather than with the contract or tort. The judges of these countries whose law is likely to be applied will in any event be more qualified to apply their company law than any other judge, no matter how well informed the latter may be.

It should be borne in mind that there are acute differences between the same doctrines in company law and general contract law, tort law or equity. For instance, fiduciary duties that directors owe to shareholders in common law jurisdictions are construed differently from fiduciary duties in the general law of equity. In civil law jurisdictions, the duty of loyalty that directors owe to the company does not exist in contract law.

It is for these reasons that two steps should be made. First, article 22(2) should be revised to exclude any reference to national private international

law rules. It should be for the courts of the place of incorporation, where a company is registered, to decide the specific issues addressed by article 22(2).<sup>123</sup> Second, there should be a new basis of jurisdiction for company law claims, which could potentially allow reference to national private international law rules, given that no connecting factor *per se* can conflict with freedom of establishment. Whether this is in a position to upset regulatory competition for corporate charters will be examined below.<sup>124</sup>

### **C. Choice of law for corporations and rules on jurisdiction in the USA**

Unlike English courts, in US law a distinction has to be drawn between corporations incorporated in another State (foreign) and corporations incorporated outside the USA (alien). State courts have jurisdiction over foreign corporations for a variety of grounds ranging from consent to ownership, use or possession of tangible things in the state.<sup>125</sup> The most important of them is ‘doing business in the State’, which is interpreted to include any act of a lucrative nature, or otherwise accomplishing an object.<sup>126</sup> Many States of the US felt though that ‘doing business’ limits their courts’ jurisdiction and they have replaced it by ‘transacting business’.<sup>127</sup>

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<sup>123</sup> MV Benedettelli, ‘Conflicts of Jurisdiction and Conflicts of Law in Company Law: Matters Within the EU “Market for Corporate Models”: Brussels I and Rome I after *Centros*’ [2005] EBLR 55, 75.

<sup>124</sup> See pp 251 *et seq.*

<sup>125</sup> Restatement Second, Conflict of Laws paras 43-52 (1971).

<sup>126</sup> *ibid* para 47; *Davenport Machine & Foundry Co v Adolph Coors Co* 314 NW2d 432 (Iowa Supr 1982).

<sup>127</sup> *Ketcham v Charles R Lister International Inc* 400 A2d 487, 489 (NJ Super 1979); *Labbe v Nissen Corp* 404 A2d 564, 570 (Maine Supr)Ct 1979); *Davenport v Coors* (n126) 435.

Jurisdiction for corporate claims is based on the doctrine of *forum non conveniens*. The leading authority on this point is *Koster*, where it was held, in connection with companies that do not maintain any presence in the State of incorporation other than the bare minimum, that '[p]lace of corporate domicile in such circumstances might be entitled to little consideration under the doctrine of *forum non conveniens*, which resists formalization and looks to the realities that make for doing justice.'<sup>128</sup> In Delaware, the State that attracts most incorporation, the doctrine of *forum non conveniens* has been recently interpreted in a manner to facilitate Delaware's jurisdiction over companies incorporated within its territory. Although it refuses to stay proceedings in cases where parallel proceedings are subsequently opened elsewhere save for cases of 'overwhelming hardship',<sup>129</sup> it also refuses to stay proceedings when Delaware proceedings are commenced subsequently to the foreign proceedings.<sup>130</sup>

In *Re Topps* the Delaware Court of Chancery refused to take a strict approach to the opening of proceedings. The subsequent Delaware proceedings were admitted as proceedings opened contemporaneously. It has also increasingly refused to grant a stay when it thinks that the complaint before it is better drafted.<sup>131</sup>

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<sup>128</sup> *Koster v (American) Lumbermens Mutual Casualty Co* 330 US 518, 527-528 (1947).

<sup>129</sup> *Berger v Intelligent Solutions Inc* 906 A2d 134 (Del Ch 2006).

<sup>130</sup> *In re The Topps Co Shareholders Litigation* 924 A2d 951 (Del Ch 2007), distinguishing *McWane Cast Iron Pipe Corp v McDowell-Wellmann Eng'g Co* 263 A2d 281 (Del Supr 1970) and its progeny which establish a presumption of favouring the stay of Delaware proceedings in such cases.

<sup>131</sup> *Biondi v Scrushy* 820 A2d 1148, 1153-1154 (Del Ch 2003).

More significantly, it has held that Delaware courts should take precedence over other courts when Delaware corporate law is called for application, especially when novel issues arise,<sup>132</sup> even if the contract in connection with which the dispute arose contains a prorogation agreement in favour of a foreign court, as was the case in *Re Topps*. In favour of this approach, the Court of Chancery has advanced two reasons. First, Delaware incorporation mandates a Delaware forum, because Delaware courts can apply their own law better than any other court. Second, Delaware adjudication ‘foster[s] optimal clarity and coherence in Delaware corporate law... which will benefit investors’, while adjudication in a foreign court will ‘increase doctrinal uncertainty and incoherence, and thus increase economic inefficiency harmful to investors.’<sup>133</sup>

Both lines of reasoning have been criticised.<sup>134</sup> Both the ‘ein Recht, ein Forum’ approach and the efficiency analysis employed by the Court of Chancery are not entirely persuasive. ‘Widespread variation in other tribunal’s adjudication of Delaware corporate law could reduce the indentifiability of Delaware’s brand of corporate law, which also might reduce an out-of-state firm’s incentive to charter in Delaware’.<sup>135</sup> Therefore, this whole analysis can be perceived as an effort to safeguard Delaware’s supremacy in regulatory competition for corporate charters.

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<sup>132</sup> *In re Topps* (n130).

<sup>133</sup> F Stevelman, ‘Regulatory Competition, Choice of Forum, and Delaware’s Stake in Corporate Law’ (2009) 34 Del J Corp L 57, 122; *In re Topps* (n130) 958-959.

<sup>134</sup> Stevelman (n133).

<sup>135</sup> *ibid* 124.

Even though federal courts have jurisdiction to hear claims between citizens of a State and citizens or subjects of a foreign State,<sup>136</sup> if both parties are aliens, 'diversity' jurisdiction cannot be established.<sup>137</sup> Therefore, the traditional self-restraining approach that US courts will not adjudicate disputes concerning the internal affairs of foreign corporations has partly survived.<sup>138</sup> However, a corporation is deemed to be a citizen of any State in which it has been incorporated and of the State where it has its principal place of business.<sup>139</sup> Just as the CJO 2001 adopted the place of central management and control in addition to the place of incorporation, the USCA has adopted both the place of incorporation and the place of business. This is easily explained if one bears in mind the understanding of US courts' jurisdiction over aliens. US courts will not take cognizance of the case if justice would be as well done by remitting the parties to their home forum.<sup>140</sup>

The last important element to be considered is that after the last War the USA also made sure that the actual seat theory may never be applied to US corporations by civilian courts by contracting conventions with civil law

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<sup>136</sup> 28 USCA §1332(a)(2).

<sup>137</sup> *HTL Sp ZOO v Nissho Corporation* 538 SE2d 525 (Georgia CA 2001). However, if the alien company has its worldwide principal place of business in the USA, diversity jurisdiction exists: EF Scoles and others, *Conflict of Laws* (4<sup>th</sup> edn West Group, St Paul, Minnesota 2004) 1223n1.

<sup>138</sup> *Caisse Nationale de Credit Agricole v Chameleon Finance Co BV* 1995 WL 76877 (NDIll); *Rouhi v Harza Eng'g Co* 785 FSupp 1290 (NDIll 1992); *RW Sawant & Co v Ben Kozloff Inc* 507 FSupp 614, 615-16 (NDIll 1981).

<sup>139</sup> 28 USCA §1332(c).

<sup>140</sup> *Piper Aircraft Co v Reyno* 454 US 235, 262 (1981).

countries. These conventions provide for the mutual recognition of companies incorporated in the Contracting States.<sup>141</sup>

## ***II. Choice of law for corporations and substantive rules of company law***

The next issue to be examined is the way in which the actual seat and incorporation theories interact with the corporate law provisions of their legal order.

### **A. Choice of law for corporations and substantive rules of company law in common law jurisdictions**

The theory of incorporation in combination with ‘advanced and flexible business formation’<sup>142</sup> legislation has been used by certain States in order to increase their revenue from charter taxes by attracting large numbers of companies either to incorporate or move their registered office to their territory. For example, s 62 of Act No 18 of 1992<sup>143</sup> of the Bahamas provides immunity to the shareholders of a corporation formed in the Bahamas with regard to the acts or omissions of the corporation; s 101(1) provides for the possibility of a telephone participation of directors in board meetings; Schedule 3 also imposes extremely low fees for incorporation expenses and annual contributions ranging from \$30 to \$1,000. Delaware has equally lenient

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<sup>141</sup> Article XXIV(3) of the 1951 Treaty of Friendship, Commerce and Navigation (USA – Greece); Article XXV(5) of the 1954 Treaty of Friendship, Commerce and Navigation (USA – Germany); Article XIV(5) of the 1959 Convention of Establishment (USA – France).

<sup>142</sup> —, (Delaware Department of State: Division of Corporations) <<http://www.state.de.us/corp/faqs.shtml#numcorps>> accessed 13 December 2009.

<sup>143</sup> —, (Official website of the Bahamian Online Legal Resource Centre: Act No 18 of 1992 As amended by Act No 24 of 1993, Act No 28 of 1994 and Act No 30 of 1995).

provisions, which has led US courts from time to time to seek to escape its allegedly inequitable corporate governance rules.<sup>144</sup>

These provisions gave rise to extensive litigation before State and Federal courts in the USA. Delaware law was discarded in various cases because it imposed no fiduciary duty on the part of officers or directors or majority stockholders in buying stock from the minority or individual stockholders;<sup>145</sup> or it provided less strict rules in matters of reclassification of the corporation's stock structure;<sup>146</sup> or it had no statutory provision authorising inspection of the books and records of a corporation by its shareholders.<sup>147</sup>

Since federal authorities remained inert before Delaware's success in attracting incorporations, some other States reacted in order to tackle the so-called 'Delaware' syndrome. In enacting its pseudo-foreign corporation legislation, California considered a number of different links between the corporations and California, even including the location where the shareholders' and directors' meetings take place.<sup>148</sup> However, both

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<sup>144</sup> *Mansfield Hardwood Lumber Co v Johnson* 268 F2d 317, 322 (US CA 5<sup>th</sup> Cir 1959).

<sup>145</sup> *ibid* 320.

<sup>146</sup> *State of Iowa ex rel Weedy v Bechtel* 31 NW2d 853 (Iowa Supr 1948).

<sup>147</sup> *Toklan Royalty Corp. v Tiffany* 141 P2d 571 (Oklahoma Supr 1943).

<sup>148</sup> *Wilson v Louisiana-Pacific Resources, Inc* 187 CalRptr 852, 854-855 (Cal CA 1982) citing s 2115 of the California Corporations Code, which applies also to pseudo-foreign corporations, namely to corporations that had more than 50% of property, sales and payroll in California and more than 50% of its shareholders in California; JT Oldham, 'Regulating Regulators: Limitations Upon a State's Ability to Regulate Corporations with Multi-State Contacts' (1980) 57 Den LJ 345, 390.

Californian<sup>149</sup> and New York law have excluded corporations with shares listed on national securities exchanges from the *ratione materiae* of the pseudo-foreign doctrine,<sup>150</sup> an exception which excludes most of the US leading firms. They were probably afraid that the absence of this exception might provoke a federal reaction, as the rule would be seen to violate the full faith and credit clause.

Other favourable jurisdictions have reached the point of allowing the founders of a corporation to include foreign suffixes indicating limited liability, like the French *SA* and *SARL* or the German *GmbH*, *AG* and extending to any type of corporate vehicle established by any European legal order.<sup>151</sup> The actual status of the corporation as International Business Company (hereinafter 'IBC') is revealed only after the name and the fake suffix indicating limited liability and foreign nationality. The additional requirement that the IBCs are not allowed to do business in their State of incorporation<sup>152</sup> can only add suspicion about the inclusion of such suffixes. Even under English law, nothing in Part 5 of Companies Act 2006 seems to

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<sup>149</sup> California Corporations Code s 2115(e).

<sup>150</sup> WJ Carney, 'The Political Economy of Competition for Corporate Charters' (1997) 26 JLS 303, 314-315; —, 'The Internal Affairs Doctrine: Theoretical Justifications And Tentative Explanations For its Continued Primacy' (2002) 115 Harv L Rev 1480, 1497.

<sup>151</sup> s 11 and Schedule Part 3 Seychelles International Business Companies Act 1994; s 10 St Vincent and the Grenadines International Business Companies Act 1996; s 5 Anguilla International Business Companies Act 2000; s 11 Anguilla Companies Act 2000.

<sup>152</sup> s 5 of the Seychelles International Business Companies Act 1994; s 5 St Vincent and the Grenadines International Business Companies Act 1996; s 3 Anguilla International Business Companies Act 2000.

prevent the founders of a corporation from including foreign initials of limited liability.<sup>153</sup>

## **B. Choice of law for corporations and substantive rules of company law in civil law jurisdictions**

Civil law systems that adopt the actual seat theory have adopted provisions of corporate law of an interventionist character in order to avoid potential *fraus legis*. The traditional company law rules affirm that the statutory and actual seat should coincide,<sup>154</sup> otherwise acts of management done outside the statutory seat are rendered null and void.<sup>155</sup>

In France, article L225-36-1 CComm and article 83 D No 67-236 of 23.03.1967 provide that the statute of the corporation will determine the rules that are relevant to the conduct of meetings of the board of directors. However, due to article 1837(2) CC, a corporation having its *siège statutaire* and its *siège réel* in different countries cannot rely on corporate law provisions of the state of its *siège statutaire* against third parties. By contrast, third parties can invoke against the corporation corporate law provisions of the *siège statutaire*, if they are beneficial to them.<sup>156</sup>

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<sup>153</sup> E.g. Delta (AG) Ltd, POSITRON GmbH Ltd and Kampmann (GmbH) Ltd incorporated in the UK and Wires & Fabriks (SA) Ltd incorporated in India.

<sup>154</sup> §5 AktG; Y Hadari, 'The Choice of National Law Applicable to the Multinational Enterprise and the Nationality of such Enterprises' [1974] Duke LJ 1, 9n40.

<sup>155</sup> Article 20(1) Law 2190/1920 (Greek statute on *Sociétés Anonymes*) prior to 1995 mandated that for a board meeting to take place outside of Greece, a special leave from the Minister of Trade was required; H Xanthaki, *The establishment of foreign corporations in Greece with particular reference to the compliance of Greece with the law of the EU*, (1<sup>st</sup> edn Sakkoulas Publisher, Athens 1996) 19.

<sup>156</sup> Article 1837(2) CC ; Cass comm, 12.12.2006, *Soc Dreamhouse Ltd* at (Official website of the French Republic for the Diffusion of Law) <<http://www.legifrance.gouv.fr/>> accessed on 13 December 2009.

It is impossible for a French *Société Anonyme* to have its *siège social* outside the European Economic Area (hereinafter EEA) and at the same time retain its French nationality, as it would fail to abide by the formalities imposed on it by French corporate law.<sup>157</sup> Such a corporation is confronted with nullity because the formalities of French law for the creation of corporations have not been observed and French courts will treat it as a French *de facto* corporation.<sup>158</sup> Nor is it possible for a French corporation to evade the application of French law by moving its central management outside the EEA, unless the formalities imposed by French law are observed, namely that the decision is taken unanimously by the general assembly of the shareholders and France has ratified a convention with the receiving state allowing such a transfer, which has never yet occurred.<sup>159</sup>

Exactly the same treatment was reserved for such corporations under German law. The leading case on this issue had been rendered by the German *Reichsgericht* in 1904.<sup>160</sup> It refused to recognise as a corporation a stock company incorporated in the USA for the purpose of exploiting mines in Mexico, yet having its headquarters in Germany, on the basis that it had failed

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<sup>157</sup> A Moreau, *La Société Anonyme; Traité Pratique* (2<sup>nd</sup> edn Librairie de Journal des Notaires et des Avocats, Paris 1966) vol. II, 1215.

<sup>158</sup> *Cour d'appel de Paris*, 19.3.1992, Bulletin July 1992, 759. The most significant consequence of such a characterisation is that the partners of a *de facto* corporation are considered jointly and severally liable towards the creditors and that the corporation itself does not have a *jus standi in judicio*.

<sup>159</sup> H Batiffol & P Lagarde, *Traité de Droit International Privé* (8<sup>th</sup> edn LGDJ, Paris 1993) vol. 1, 346-347; S Rammeloo, *Corporations in Private International Law: A European Perspective* (1<sup>st</sup> edn OUP, Oxford 2001) 214-215.

<sup>160</sup> Judgment of 09.03.1904 (1905) 1 RCDIP 364 (German Imperial Court of Cassation).

to comply with the requirements of German law. It consequently was treated as a German *de facto* corporation.

However, according to the very recent jurisprudence of the German BGH, such corporations are German and are equated to a German commercial or civil partnership (OGH or GbR), which have legal personality but its members can be held jointly and severally liable for the debts of the company.<sup>161</sup> Additionally, the enactment of the *Gesetz zur Modernisierung des GmbH-Rechts und zur Bekämpfung von Missbräuchen* as of 1 November 2008 has suspended the requirement, according to which the statutory and real seat of all GmbHs and AGs incorporated under German law must be located in Germany.

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<sup>161</sup> Judgment of 29.01.2001 (2001) 146 BGHZ 341 (German Federal Court of Cassation).

## **6. Concluding remarks**

Part I has demonstrated the way in which the incorporation and the real seat theory have operated in private international law. The incorporation theory appears to be more business oriented, whereas the real seat theory appears to attribute more weight to State interests. Courts in civilian jurisdictions have been more willing to bring upon businessmen the grave consequences of denial of legal personality and joint and several liability for the debts of the company for the mere reason that a company that had been incorporated in another State happened to have its real seat within the jurisdiction. On the other hand, the incorporation theory has proved to be one of the factors that are necessary, but not sufficient, for money laundering and other unlawful activities to be performed. In any event, regardless of their respective advantages and disadvantages, both theories appear to match with the procedural and substantive rules that the said jurisdictions have adopted.

Having examined the two choice of law rules that have prevailed in some major European jurisdictions, the next Part will focus on the influence that freedom of establishment has had on private international law for corporate affairs. As one may have imagined, the real seat theory has been challenged as regards its compatibility with freedom of establishment. To many it appeared that the denial of legal personality, the application of a law other than that of the place of incorporation etc., are all good reasons to deny its validity vis-à-vis the Treaty establishing the European Community. Whether they were right or not, will be demonstrated in Part II.

## **PART II**

### **Corporate affairs in the context of freedom of establishment**

## 7. Introduction

The Treaty Establishing the European Community<sup>162</sup> (hereinafter 'EC') provides for the creation of a Single Market which shall be based primarily on four fundamental freedoms, among which is the freedom of establishment. Article 48 EC provides for the right of establishment of corporations, other partnerships of civil and commercial law and other legal persons established under private or public law, so long as they are not non-profit making and confers upon them the same rights that the natural persons enjoy under article 43 EC. The privileges of the freedom in question are accorded to corporations which are 'nationals' of a Member State.

Due to the diverse rules of conflict adopted by the various jurisdictions of the Member States for defining the nationality of corporations, article 48 EC adopts all three of those used. The registered office is the essence of the *lex incorporationis* adopted mainly by the common law jurisdictions, the central administration is the connecting factor of the majority of civilian traditions and the principal place of business (*oggetto principale dell'impresa*)<sup>163</sup> is the *sui generis* Italian rule of conflict.<sup>164</sup>

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<sup>162</sup> [2002] OJ C325/1.

<sup>163</sup> T Ballarino, *Diritto Internazionale Privato* (3<sup>rd</sup> edn Cedam, Padova 1999) 350-388.

<sup>164</sup> S Rammello, *Corporations in Private International Law: A European Perspective* (1<sup>st</sup> edn OUP, Oxford 2001) 29, n100; V Edwards, *EC Company Law* (1<sup>st</sup> edn Clarendon Press, Oxford 1999) 340.

The structure of articles 43 and 48 EC has provoked among authors a distinction between primary and secondary establishment.<sup>165</sup> The former implies the location of the establishment of the head office, whereas the latter refers to any establishment of an agency, branch or subsidiary that corporations might wish to create under article 43 EC.

This distinction no longer serves a purpose.<sup>166</sup> It had been suggested that the Treaty guarantees only the latter, since the transfer of the head office would require a treaty between Member States<sup>167</sup> which had never been adopted.<sup>168</sup> On this view, the freedom of primary establishment had the sole purpose of allowing EU nationals to choose any Member State in order to incorporate and activate in that specific jurisdiction.<sup>169</sup> However, this distinction is no more plausible since the ECJ has acknowledged that articles 43 and 48 extend to the transfer of the real seat.<sup>170</sup> The significance of the primary establishment remains in the fact that it is only the Member State of

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<sup>165</sup> Rammeloo (n164) 31-34; WH Roth, 'Case C-212/97, *Centros Ltd v Erhvervs-og Selskabsstyrelsen*' (2000) 37 CML Rev 147, 151-152; WF Ebke, '*Centros* -- Some Realities and Some Mysteries' (2000) 48 AJCL 623-660; Edwards (n164) 342.

<sup>166</sup> E Vaccaro, 'Transfer of Seat and Freedom of Establishment in European Company Law' (2005) 16 EBL Rev 1348, 1363.

<sup>167</sup> Article 293 EC.

<sup>168</sup> WF Ebke reports these views in (n165) 623-633.

<sup>169</sup> *ibid.*

<sup>170</sup> Case C-208/00 *Überseering v Nordic Construction Company Baumanagement GmbH (NCC)* [2002] ECR I-9919.

incorporation that on certain occasions can prevent a company from transferring its real seat to another Member State.<sup>171</sup>

Part II will demonstrate the evolution of the ECJ jurisprudence on freedom of establishment from an all-out freedom of establishment to the recognition of an interest to restrict access to the benefits of freedom of establishment by letter-box companies. The enactment of the Services Directive and the refinement of the doctrine of abuse will affect the nature of cross-border corporate mobility in Europe. The possibility of a regulatory competition for corporate law in Europe is far from eradicated. However, as it will be shown in the chapters below, regulatory competition can no longer take place in the same way as it was contemplated initially and it may well shift from small and medium sized enterprises to larger corporations.

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<sup>171</sup> Case C-81/87 *R v HM Treasury and Commissioners of Inland Revenue, ex parte Daily Mail and General Trust plc* [1988] ECR 5483 [24]; Case C-210/06 *Cartesio* [2008] ECR (not published yet); [2009] 1 CMLR 50.

## 8. The Normative Content of Freedom of Establishment

A series of ECJ judgments has created the context in which private international and corporate and insolvency law has been faced with a new dynamic that has sought to encourage cross-border corporate mobility. The first set of cases that reached the ECJ concerned unlawful restrictions of a fiscal nature on the establishment of agencies, branches or subsidiaries.<sup>172</sup>

In *Commission v France* the ECJ ruled that France could not deny tax benefits to branches and agencies established in France by insurance companies incorporated in another Member State.<sup>173</sup> It has been argued that the finding of the ECJ in *Commission v France* that the nationality of a company is dependent upon the location of the registered office paved the way for the full endorsement of the incorporation theory in *Segers*.<sup>174</sup> In *Segers* the ECJ held that social benefits available to the directors of companies incorporated in the Netherlands should also be available to the directors of companies registered in another Member State.<sup>175</sup>

It was on the background of these two cases that the ECJ delivered seven additional cases, starting with *Daily Mail*, having a close link with private international law and which can be considered to be leading cases in

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<sup>172</sup> V Edwards, *EC Company Law* (1<sup>st</sup> edn Clarendon Press, Oxford 1999) 343.

<sup>173</sup> Case C-270/83 *Commission v France* [1986] ECR 273.

<sup>174</sup> T Tridimas, 'The Case-Law of the European Court of Justice on Corporate Entities' (1993) 13 YEL 335, 338-339.

<sup>175</sup> Case C-79/85 *Segers v Bedrijfsvereniging voor Bank- en Verzekeringswezen, Groothandel en Vrije Beroepen* [1986] 2375.

this field. The jurisprudence of ECJ in this field is rich. This thesis will concentrate only the cases which are perceived to have a degree of connection with private international law for corporations.

## ***I. Daily Mail case***

### **A. The facts of the case and the ruling of the ECJ**

*Daily Mail*<sup>176</sup> concerned the application of Daily Mail and General Trust plc to the Treasury for leave to transfer their central management to the Netherlands. They wished to move to the Netherlands in order to sell a significant part of their non permanent assets and use the profits derived from the sale to purchase their own shares without paying the UK tax that would normally be due thereon. They would also cease to be liable for UK corporation tax but only for tax on their income arising in the UK. The Treasury did not consent to the transfer of seat insisting that they said companies should at least sell part of their non permanent assets before moving to the Netherlands.<sup>177</sup>

Daily Mail and General Trust filed a lawsuit before the English courts that stayed proceedings and submitted a reference for a preliminary ruling to the ECJ. The Court rejected the claim of the companies' that the Treasury's refusal amounted to an unlawful restriction on their freedom of establishment. Rather, it held that companies are 'creatures of the law' of the Member State of origin, which can determine 'their incorporation and

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<sup>176</sup> Case C-81/87 *R v HM Treasury and Commissioners of Inland Revenue, ex parte Daily Mail and General Trust plc* [1988] ECR 5483.

<sup>177</sup> For these background details to *Daily Mail* see Opinion of AG Maduro in Case C-210/06 *Cartesio* [2008] ECR (not yet published); [2009] 1 CMLR 50 [26].

functioning'.<sup>178</sup> The ECJ consequently ruled that a company does not have a right to transfer its real seat from its State of incorporation to another Member State and at the same time retain the nationality of the former.<sup>179</sup>

## **B. The reaction of commentators**

*Daily Mail* provoked rather diverse reactions among authors. Cath -following Timmermans- argued that the right of freedom of primary establishment thereby ceased to exist, at least in relation to the exit of companies from the Member State of incorporation.<sup>180</sup>

For many commentators *Daily Mail* was received as the guarantee of the real seat theory in EC Company law, despite the fact that neither of the countries involved adhered to it.<sup>181</sup> In their eyes, *Daily Mail* came as a relief after *Segers*, which had seemed to endorse the incorporation theory.<sup>182</sup> However, one of the most eminent German authors openly disagreed with this conclusion and argued that Member States are at liberty to choose either of the two rules of conflict.<sup>183</sup> In 1988 he had argued that the real seat rule clearly violates the EEC Treaty as discriminatory and unjustifiably restrictive

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<sup>178</sup> *Daily Mail* (n176) [19].

<sup>179</sup> *ibid* [24].

<sup>180</sup> IGF Cath, 'Free Movement of Legal Persons' in HG Schermers and others (eds) *Free Movement of Persons in Europe* (Martinus Nijhoff Publishers, Dordrecht 1993) 464.

<sup>181</sup> M Andenas, 'Free Movement of Companies' (2003) 119 LQR 221, 222; H Halbhuber, 'National Doctrinal Structures and European Company Law' (2001) 38 CML Rev 1385, 1390-1395.

<sup>182</sup> Tridimas (n174).

<sup>183</sup> P Behrens, 'Die grenzüberschreitende Sitzverlegung von Gesellschaften in der EWG' [1989] IPRax 354.

in both cases of companies wishing to transfer their central administration both in and out of Germany.<sup>184</sup>

Loussouarn did not follow Behrens to this extreme position. Instead he argued that *Daily Mail* marked the end of the predominance of the real seat theory.<sup>185</sup> In his view *Daily Mail* was justified on grounds of equal treatment. The ECJ was making sure that EU law provisions would not be used to succeed in tax evasion.<sup>186</sup> He tried to explain the case by drawing a distinction between the right of establishment and the freedom of establishment.<sup>187</sup> No such undeniable right existed, whereas the freedom of establishment could be restricted in order to attain equality in establishment. Rammeloo also reacted to the German appraisal of *Daily Mail* by arguing that it is 'an exercise in futility' to contest the admissibility of the incorporation theory as it is 'far more appropriate' to promote the Single Market than the real seat theory.<sup>188</sup> However, it has been argued that the latter point does not justify a claim that that the real seat theory is contrary to EU law.<sup>189</sup>

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<sup>184</sup> P Behrens, '*Niederlassungsfreiheit und Internationales Gesellschaftsrecht*' (1988) 52 *RabelsZ* 489, 524-525.

<sup>185</sup> Y Loussouarn, '*Le droit d'établissement des sociétés*' (1990) 26 *RTD eur* 229, 235-236.

<sup>186</sup> P Dyrberg, '*Full Free Movement of Companies in the European Community At Last*' (2003) 28 *EL Rev* 528, 536.

<sup>187</sup> Loussouarn (n185) 238.

<sup>188</sup> S Rammeloo, '*Recognition of Foreign Companies in Incorporation Countries: A Dutch Perspective*' in Jan Wouters & H Schneider (eds) *Current Issues of Cross-Border Establishment of Companies in the European Union* (Maklu, Antwerpen/ Apeldoorn 1995) 47, 52.

<sup>189</sup> T Ballarino, '*Les règles de conflit sur les sociétés commerciales à l'épreuve du droit communautaire d'établissement. Remarques sur deux arrêts récents de la Cour de Justice des Communautés Européennes*' (2003) 92 *RCDIP* 373, 386.

Viewing the debate *ex post facto* it is easy to conclude that neither *Segers* nor *Daily Mail* opted for one of the two rules of conflict, as in both cases the countries involved adhered to the incorporation theory. What is different in the two cases is the perspective of the Court. In *Segers* the case is examined from the host Member State's point of view, whereas in *Daily Mail* from the point of view of the Member State of origin (the 'home' Member State).<sup>190</sup> This reading of *Daily Mail* was subsequently confirmed by the ECJ in *Überseering*.<sup>191</sup>

## ***II. Centros case: 'Something is rotten in the state of Denmark' Hamlet (I, iv, 90)***

### **A. The facts of the case and the ruling of the ECJ**

The second leading case came almost a decade after *Daily Mail*. In *Centros*<sup>192</sup> two Danish nationals had set up a limited company in the UK and sought to exercise the management and control of the company through a branch that they would establish in Denmark. Nordic scholars had always disagreed on whether a doctrine of abuse or circumvention existed in Nordic law, but the Danish Trade and Companies Board had established a practice of refusing to register companies incorporated abroad for the purpose of evading the Danish minimum capital requirements.<sup>193</sup> In refusing to register the

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<sup>190</sup> Edwards (n172) 381-382; Dyberg (n186) 531-532.

<sup>191</sup> Case C-208/00 *Überseering v Nordic Construction Company Baumanagement GmbH (NCC)* [2002] ECR I-9919 [70].

<sup>192</sup> Case C-212/97 *Centros Ltd v Erhvervs- og Selskabsstyrelsen* [1999] ECR I-1459.

<sup>193</sup> PK Anderse & KE Søre, 'Free Movement of Companies from a Nordic Perspective' (1999) 6 MJ 47, 58-59.

company's branch, it argued that the EC provisions cannot be used to circumvent national legislation which is in conformity with EU law.

The ECJ ruled, first, that it is irrelevant that a company has been created in one Member State with a view to establish itself in another Member State<sup>194</sup> and, second, that the creation of a corporation under the less restrictive company law of another Member State cannot amount *per se* to an abuse of the right of establishment, even if the sole aim is to set up a branch in another Member State, because this would be incompatible with the establishment of a single market.<sup>195</sup>

Finally, the ECJ examined whether the Danish measure could be justified by public interest<sup>196</sup> under the *Gebhard* test.<sup>197</sup> Under this test a measure restricting the freedom of establishment may nevertheless be upheld if it applies in a non-discriminatory manner, it is justified by imperative requirements of public interest and is proportionate. The Danish restriction failed as disproportionate. In the Court's opinion, it was not a suitable measure to ensure the protection of creditors and, in any event, less onerous measures could have been adopted to attain this goal.<sup>198</sup>

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<sup>194</sup> *Centros* (n192) [17].

<sup>195</sup> *ibid* [27].

<sup>196</sup> *ibid* [32]-[38].

<sup>197</sup> Case C-55/94 *Gebhard v Consiglio dell'Ordine degli Avvocati e Procuratori di Milano* [1995] ECR I-4165 [37].

<sup>198</sup> *Centros* (n192) [35]-[37].

## B. The reaction of commentators

The judgment in *Centros* provoked volumes of literature particularly among German authors and divided them in various camps. Ebke classified them into four main groups.<sup>199</sup>

The first group argued that *Centros* effectively banned the real seat theory.<sup>200</sup> This view was adopted by the Austrian Court of Cassation (*Oberste Gerichtshof*), which ruled that ‘the real seat theory... conflicts with the secondary freedom of establishment’.<sup>201</sup> Although the Austrian judgment has been based on a false assumption, namely that ‘Denmark, like Austria, follows the [real] seat theory’,<sup>202</sup> and the judgment was heavily criticised for assuming that the ECJ had ruled on choice of law rules,<sup>203</sup> the case was correctly decided as the refusal to register the branch of a company established in another Member State is an unlawful restriction of the freedom of establishment, even if the company is a pseudo-foreign one.<sup>204</sup>

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<sup>199</sup> WF Ebke, ‘*Centros* – Some Realities and Mysteries’ (2000) 48 AJCL 623, 627-628.

<sup>200</sup> *ibid* 627-628; GS Gravir, ‘Conflict of Laws Rules for Norwegian Companies after the *Centros* Judgment’ (2001) 12 EBL Rev 146, 151; P Behrens, ‘International Company Law in View of the *Centros* Decision of the ECJ’ (2000) 1 EBOR 125.

<sup>201</sup> *Re Registration in Austria of a Branch of an English Company S v Companies Registrar, Graz* (Case number 6Ob 124/99z) [2001] 1 CMLR 38.

<sup>202</sup> *ibid* [22], n24. Denmark follows the Nordic theory of registration, namely that a company is governed by the law of the place of registration, which coincides with the place of incorporation: Anderse & Sørei (n193) 55.

<sup>203</sup> Ebke (n199) 657.

<sup>204</sup> E Werlauff, ‘The Main Seat Criterion in a New Disguise - An Acceptable Version of the Classic Main Seat Criterion?’ (2001) 12 EBL Rev 2, 3; M Siems, ‘Convergence, competition, *Centros* and conflicts of law: European company law in the 21<sup>st</sup> century’ (2002) 27 EL Rev 47, 50; P Behrens, ‘Reactions of Member State Courts to the *Centros* Ruling by the ECJ’ (2001) 2 EBOR 159, 165.

This stance provoked a reaction in the opposite direction. It was argued that *Centros* dealt with a matter of substantive law whereas the German real seat theory is a conflicts rule and as such would escape review under the right of establishment.<sup>205</sup> Others tried to isolate the impact of *Centros* by arguing that both England and Denmark adhered to some version of the incorporation theory and, thus, the real seat theory had not been touched upon.<sup>206</sup> German lower courts were untroubled by doubts about the status of the real seat theory and continued applying it.<sup>207</sup> The Danish reaction was to circumvent *Centros* by enacting legislation that required foreign and Danish corporations wishing to register in Denmark either to have a minimum capital requirement of DKK125,000 or to deposit this amount to the Danish Tax Authorities.<sup>208</sup> Werlauff argued that the provisions requiring the deposit have no chance of being upheld by the ECJ, if such a case is brought before it.<sup>209</sup>

The second school of thought was formed by authors who thought that the real seat theory could not be used to obstruct the transfer of central

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<sup>205</sup> WH Roth, 'Case C-212/97, *Centros Ltd v Erhvervs-og Selskabsstyrelsen*' (2000) 37 CML Rev 147, 147-155.

<sup>206</sup> WH Roth, 'From *Centros* to *Überseering*: Free Movement of Companies, Private International Law, and Community Law' (2003) 52 ICLQ 177, 188; O Sandrock & JJ du Plessis, 'The German Corporate Governance Model in the Wake of Company Law Harmonisation in the European Union' (2005) 26 Co Law 88, 89.

<sup>207</sup> Ebke (n199) 650-651 citing the relevant German case-law.

<sup>208</sup> Werlauff (n204) 4-5; C Frost, 'Transfer of Company's Seat – An Unfolding Story in Europe' (2005) 36 VULR 359, 380.

<sup>209</sup> Werlauff (n204) 5.

management from one Member State to another.<sup>210</sup> The third group considered that the judgment in *Centros* is the foundation of an EU conflicts rule that would consist of the *lex incorporationis* but would be supplemented by the *ordre public* rules of the *forum*.<sup>211</sup> The last group took the view that the whole impact of *Centros* could be restricted to freedom of secondary establishment and did not affect the choice of law for corporations or the freedom of primary establishment.<sup>212</sup>

Although it is thought that *Centros* had little impact in English law,<sup>213</sup> it was also commented upon in English literature. With few exceptions,<sup>214</sup> commentators were not concerned with the survival of the real seat theory but with the relation between *Centros* and *Daily Mail*, the doctrine of abuse and with the prospect of a regulatory competition<sup>215</sup> or a Delaware effect in

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<sup>210</sup> Ebke (n199) 627-628.

<sup>211</sup> *ibid.*

<sup>212</sup> *ibid* 628.

<sup>213</sup> D Prentice, 'The Incorporation Theory – The United Kingdom' (2003) 14 EBL Rev 631, 640.

<sup>214</sup> E Xanthaki, 'Centros: is this really the end for the theory of the siège réel?' (2001) 22 Co Law 2-7, where she argued that *Centros* did not choose between two theories but it merely applied the theory prevailing 'in Denmark in a case involving the interpretation of EU law as applied in Danish law'; HS Birkmose, 'A Market for Company Incorporations in the European Union? – Is *Überseering* the Beginning of the End?' (2005) 13 Tul J Intl & Comp L 55, 79-81, accepting that *Centros* narrowed substantially the scope of the real seat theory.

<sup>215</sup> Some authors draw a distinction between regulatory competition and regulatory arbitrage. The former is used to describe the case when States actively compete to attract incorporations. The latter is used for cases where the States remain indifferent, but companies appear to prefer to incorporate in one specific jurisdiction more than in any other. Although there appears to be some merit in this theoretical distinction, the result in both cases is that one specific State has an advantage over the others. The lack of practical difference between the two terms is also manifested by the fact that a race to the top or bottom remains possible under both approaches. This thesis will use the term 'regulatory competition' for both instances. The pejorative connotations of the term 'arbitrage' might justify the use of other terms to draw this distinction where necessary, such as active and passive regulatory competition or State and non-State driven regulatory competition.

the EU.<sup>216</sup> Despite the ECJ's mysterious silence in relation to the judgment in *Daily Mail*, it was generally agreed that the latter was still good law.<sup>217</sup>

*Centros* has also been considered to be a significant contribution to the doctrine of abuse of EU law. The concept of abuse would apply exceptionally only on an *ad hoc* basis.<sup>218</sup> The ECJ did not provide any particular guidance other than a comparison between the objective pursued by the individual and the objective pursued by the EC Treaty provision in question.<sup>219</sup> The concept of abuse had been stated rather broadly in *Van Binsbergen*:<sup>220</sup> circumvention of national law constituting abuse could exist in cases where a person established in a Member State moved to another Member State thereby avoiding the law of the former Member State. In a later case, the ECJ abandoned the requirement of moving the establishment from one Member State to another.<sup>221</sup>

This doctrine was narrowed subsequently by *Centros* where setting up a company in another Member State in order to benefit from its corporate legislation<sup>222</sup> or lower taxation<sup>223</sup> did not constitute in and of itself an abuse.<sup>224</sup>

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<sup>216</sup> S Deakin, 'Legal Diversity and Regulatory Competition: Which Model for Europe?' (2006) 12 ELJ 440.

<sup>217</sup> M Siems (n204) 52; Ebke (n199) 640; KE Sørensen, 'Prospects for European Company Law After the Judgment of the European Court of Justice in *Centros Ltd*' (1999) 2 CYELS 203, 221.

<sup>218</sup> Sørensen (n217) 210-211.

<sup>219</sup> *Centros* (n192) [25].

<sup>220</sup> Case C-33/74 *Van Binsbergen v Bedrijfsvereniging voor de Metaalnijverheid* [1974] ECR 1299 [13].

<sup>221</sup> Case C-23/93 *TV 10 SA v Commissariaat voor de Media* [1994] ECR I-4795 [15].

<sup>222</sup> *Centros* (n192) [29].

Centros Ltd was carrying on the activity which was the primary aim of the right of establishment and this was not likely to be viewed as circumvention.<sup>225</sup> The fact that Centros Ltd was not avoiding rules ‘concerning the carrying on of certain trades, professions or businesses’ counted also against the finding of an abuse.<sup>226</sup> On the other hand, it would have been more likely for an abuse to be found where incorporation in a specific Member State is performed with the intention of defrauding the company itself or its members.<sup>227</sup> Case-law also appeared to suggest that it is likely for an abuse to be found in cases of artificial arrangements and pro-forma transactions.<sup>228</sup> Such transactions are performed for a purpose other than the exercise of the freedom of establishment in good faith.<sup>229</sup>

Two recent cases<sup>230</sup> have helped to clarify two criteria, one objective and one subjective, that will help to establish an abuse.<sup>231</sup> The ECJ will first

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<sup>223</sup> Case C-294/97 *Eurowings Luftverkehr* [1999] ECR I-7447 [44]; Case C-315/02 *Lenz* [2004] ECR I-7063 [41] & [43].

<sup>224</sup> KE Sørensen, ‘Abuse of rights in Community Law: A Principle of Substance or Merely Rhetoric!’ (2006) 43 CML Rev 423, 443-444.

<sup>225</sup> *ibid* 445; Case C-147/03 *Commission v Austria* [2005] ECR I-5969 [70]; Case C-264/96 *ICI v Colmer* [1998] ECR I-4695 [26]; Case C-397 & 410/98 *Metallgesellschaft* [2001] ECR I-1727 [57]; Case C-9/02 *de Lasteyrie du Saillant* [2004] ECR I-2409 [51]; Case C-436/00 *X & Y* [2002] ECR I-10829 [44].

<sup>226</sup> *Centros* (n222) [26].

<sup>227</sup> Sørensen (n224) 445-447; *Centros* (n222) [38].

<sup>228</sup> Sørensen (n227); Case C-324/00 *Lankhorst-Hohorst* [2002] ECR I-11779; *Lasteyrie du Saillant* (n225) [50].

<sup>229</sup> Sørensen (n224) 447.

<sup>230</sup> Case C-373/97 *Diamantis* [2000] ECR I-1705 [33]-[34]; Case C-110/99 *Emsland-Stärke* [2000] ECR I-11569 [52]-[53].

<sup>231</sup> Sørensen (n224) 447-452.

examine whether the purpose of the EU law provision has not been achieved and second whether there was an intention to obtain an advantage by creating artificially the requirements of application of the provision in question. In the freedom of establishment of companies it is difficult to see the kind of cases where the first criterion will be satisfied. Incorporation in a Member State so as to benefit from its less restrictive legislation is consistent with freedom of establishment.<sup>232</sup> Nonetheless, the doctrine of abuse has been expanded to any right provided by EU law other than the freedoms but at the same time is narrowed by the requirement of an artificial arrangement.<sup>233</sup>

### ***III. Überseering case: The real seat theory: ‘To be or not to be’ Hamlet (V, i)***

#### **A. The facts of the case and proceedings before German courts**

At the eve of *Centros* there was still doubt about the compatibility of the real seat theory with the freedom of establishment,<sup>234</sup> although it had been suggested, even before the pronouncement of *Centros*, that, once a case was brought before the ECJ, the consequences of the German real seat theory would be considered an unlawful restriction of the freedom of establishment.<sup>235</sup>

German nationals acquired the shares of Überseering BV, a company incorporated in the Netherlands, and thus became its sole directors. At all

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<sup>232</sup> *Centros* (n222) [29]; S Chertok, ‘Jurisdictional Competition in the European Community’ (2006) U Pa J Intl Econ L 465, 513.

<sup>233</sup> Sørensen (n231).

<sup>234</sup> DE Robertson, ‘Überseering: Nailing the Coffin on Sitztheorie’ (2003) 24 Co Law 184.

<sup>235</sup> Tridimas (n174) 344.

relevant times, they resided in Germany and exercised the central management and control thereof. Überseering brought a contractual claim against a German company and the German courts held that the former did not enjoy *jus standi in judicio*.<sup>236</sup> The German courts applying the real seat theory concluded that Überseering was putatively a German company, which having failed to abide by the incorporation and registration process imposed by German company law was thus deprived of legal personality.

The case was brought before the BGH which submitted a reference for a preliminary ruling. The BGH must have realised the imminent ‘danger’ for the real seat and analysed the advantages of and the public policy behind the real seat theory.<sup>237</sup> It acknowledged that some German authors have argued against the real seat theory,<sup>238</sup> but it deemed it ‘preferable’ to uphold it, despite its consequences for three main reasons: first, there should be one governing law for corporations in order to avoid legal uncertainty;<sup>239</sup> second, that the incorporation theory fails to provide for the interest of third parties and of the State where the company has its central management;<sup>240</sup> and third that the real seat theory tends to safeguard ‘certain vital interests, from being

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<sup>236</sup> Judgment of 10.09.1998 [2000] JZ 203 (Düsseldorf CA, Germany).

<sup>237</sup> *Überseering* (n191) [13]-[20]; PS Ryan, ‘Case C-167/01 *Kamer Van Koophandel en Fabrieken voor Amsterdam v Inspire Art Ltd* (ECJ September 23, 2003)’ (2005) 11 Colum J Eur L 187, 193.

<sup>238</sup> *Überseering* (n191) [13].

<sup>239</sup> *ibid* [14].

<sup>240</sup> *ibid* [15].

circumvented', namely the interests of creditors, minority shareholders and employees.<sup>241</sup>

It then went on to state that the reference for a preliminary ruling was submitted because ECJ case-law on the matter was not clear.<sup>242</sup> There was confusion about the exact meaning and relation of *Daily Mail* and *Centros*.<sup>243</sup> The BGH concluded the reference by asking, first, whether the consequence of denying legal personality to *Überseering* as a result of applying the real seat theory amounted to a restriction of the freedom of establishment and, second, whether the legal capacity and the *jus standi in judicio* of *Überseering* had to be decided according to the law of the Member State of incorporation.

### **B. The ruling of the ECJ: the relationship between *Daily Mail* and *Centros***

The ECJ overruled the arguments of the German, Italian and Spanish Governments that due to the lack of a multilateral convention envisaged by article 293 EC, the real seat theory could not be reviewed in relation to freedom of establishment.<sup>244</sup> It held that it is not possible to subject the effectiveness of freedom of establishment to the failure of negotiations among Member State for the adoption of a treaty regulating the transfer of seat under article 293 EC.<sup>245</sup>

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<sup>241</sup> *ibid* [16].

<sup>242</sup> *ibid* [17].

<sup>243</sup> *ibid* [18]-[20].

<sup>244</sup> *Überseering* (n191) [26]-[28].

<sup>245</sup> *ibid* [52]-[55].

The ECJ also dismissed the arguments presented by the German, Italian and Spanish Government based on *Daily Mail*,<sup>246</sup> namely that the genuine link that existed between England and Daily Mail had shifted in the case at hand from the State of incorporation to the State of central management and that, in any event, the choice of law rules fell squarely within the domain of national law. According to the ECJ's reasoning, *Daily Mail* could apply only to the relations between the company and the State of incorporation.<sup>247</sup> The ECJ also seized the opportunity to clarify that the term 'connecting factor' in *Daily Mail* had not been used as a term of private international law, as had been assumed and relied upon by the German Government,<sup>248</sup> but as an exclusive reference to the law of incorporation.<sup>249</sup>

The great contribution of *Centros* was the implementation of the *Gebhard* test in the freedom of establishment of companies.<sup>250</sup> Despite the ECJ's affirmation of *Daily Mail*, it was suggested that this case was irreconcilable with *Überseering* because, first, it created logical problems by distinguishing between ingoing and outgoing corporations; second, its interpretation of article 293 EC<sup>251</sup> did not match with the one provided by the ECJ in *Überseering*; and third, *Überseering*, unlike *Daily Mail*, allowed for

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<sup>246</sup> *ibid* [30]-[32].

<sup>247</sup> *ibid* [65]-[66], [70]-[73]. This has been described as a disappointment in Roth (n206) 207.

<sup>248</sup> *Überseering* (n191) [29]-[30].

<sup>249</sup> *ibid* [68]; T Bachner, 'Freedom of Establishment for Companies: A Great Leap Forward' (2003) 62 CLJ 47-50.

<sup>250</sup> Opinion of AG Colomer in *Überseering* (n191) [41].

<sup>251</sup> *Daily Mail* (n176) [19].

reverse discrimination in the sense that foreign corporations receive better treatment than their counterparts who are nationals of the host Member State.<sup>252</sup>

### **C. The Opinion of AG Colomer: the relationship between *Daily Mail* and *Centros***

Advocate General Colomer had also extrapolated on *Daily Mail* and its relation with *Centros* and he identified three possible interpretations.

One possible way would be to say that *Centros* concerned the establishment of a branch whereas *Daily Mail* the transfer of seat.<sup>253</sup> He rejected it noting that it creates a false impression about the distinction between the establishment of a branch and the transfer of seat.<sup>254</sup> The second explanation he suggested was that *Centros* referred to the relations between corporations and the host State (inbound cases) whereas *Daily Mail* concerned their relations with the State of origin (outbound cases), which he also rejected as ‘artificial’.<sup>255</sup> The ECJ however adopted this approach.<sup>256</sup> His third alternative explanation was that *Centros* superseded ‘the practical legal consequences’ of *Daily Mail* by allowing a transfer of seat to take place in the form of establishing a branch.<sup>257</sup> His personal view was that *Centros*

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<sup>252</sup> WG Ringe, ‘No freedom of Emigration for Companies?’ (2005) 16 EBL Rev 621, 631-640.

<sup>253</sup> Opinion of AG Colomer in *Überseering* (n237) [36].

<sup>254</sup> PJ Omar, ‘*Centros* Redux: Conflict at the Heart of European Company Law’ (2002) 13 ICCLR 448, 452.

<sup>255</sup> *ibid*; Opinion of AG Colomer (n253) [37]; D Wyatt & A Dashwood, *European Union law* (4<sup>th</sup> edn Sweet & Maxwell, London 2000) 845-846.

<sup>256</sup> *Überseering* (n191) [65]-[66], [70]-[73].

<sup>257</sup> Opinion of AG Colomer (n253) [38].

supplements *Daily Mail*, in the sense that the choice of law for corporations remains within the sphere of national law which must ‘*comply with substantive Community law* (emphasis of the AG)’.<sup>258</sup>

#### **D. The ruling of the ECJ: the tenability of the real seat theory in a freedom of establishment context**

Having ruled on the interpretation of *Daily Mail*, the ECJ drew the line between the free movement of capital and the freedom of establishment. The former applies to cases where natural persons residing in a Member State acquire shares of a company incorporated in another Member State, so long as they do not acquire effective control of the company, whereas the latter applied in cases such a control has been achieved.<sup>259</sup> The ECJ went on to find that the denial of a *jus standi in judicio* to a company properly incorporated in another Member State and having its registered office there, as a consequence of applying the real seat theory, amounted to a restriction of the freedom of establishment.<sup>260</sup>

The final issue to be decided was whether such a restriction was unlawful or could be justified by overriding mandatory and proportionate requirements. Had the German rule applied distinctly to nationals and non-nationals, the ECJ would have examined the restriction under the higher threshold of article 46, namely the grounds of public policy, health and security. Although the ECJ acknowledged the reasons forwarded by the

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<sup>258</sup> *ibid* [38]-[39].

<sup>259</sup> *Überseering* (n191) [77].

<sup>260</sup> *ibid* [81]-[82].

German Government, namely the protection of creditors, minority shareholders and employees, as overriding mandatory requirements, it concluded that the measure in question was ‘tantamount to an outright negation of the freedom of establishment’.<sup>261</sup> This consequence of applying the real seat theory had been perceived by the ECJ as violating the very core of freedom of establishment.

This leads to the awkward conclusion that the measure had satisfied the three limbs of the proportionality test and failed under the post-proportionality requirement concerning the inviolability of the core of the right. Another possible reconciliation would be to read the aforementioned statement of the ECJ as a review of necessity (second limb of the proportionality test), namely that the measure had failed as not being the least onerous one. Be that as it may, the ECJ ruled that it is an unlawful restriction of the freedom of establishment for a Member State to deny the legal capacity accorded to the company by the Member State of incorporation.<sup>262</sup>

## **E. The reaction of commentators**

The judgment in *Überseering* stimulated academic debate over the status of the real seat theory. Some authors characterised the judgment as a blow to the real seat theory,<sup>263</sup> whereas others in fact argued that the ‘obsequies for

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<sup>261</sup> *ibid* [93].

<sup>262</sup> *ibid* [94]-[95].

<sup>263</sup> Chertok (n232) 513-515.

*Sitztheorie* are imminent<sup>264</sup> or that the company law cases involving choice of law issues will be resolved in favour of the Community and the Single Market.<sup>265</sup> The view that this judgment marked the end or inefficiency of the real seat theory has gained support both in Germany<sup>266</sup> and abroad.<sup>267</sup>

However, other eminent authors took a different view. Schanze and Jüttner argued that one should be reluctant to read more into the ruling in *Überseering* than was necessary to decide the case,<sup>268</sup> namely that the ECJ just ruled out the possibility of applying the real seat theory in order to decide whether the company has legal personality.<sup>269</sup>

At the same time some authors expressed the opinion that the Internal Market had not been ‘substantially enhanced’ by *Überseering* and that the compatibility of the real seat theory still remained to be seen.<sup>270</sup> Lagarde

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<sup>264</sup> Robertson (n234) 185.

<sup>265</sup> AJ Gildea, ‘*Überseering*: A European Company Passport’ (2004) 30 Brook J Int L 257, 290-292; Ryan (n237) 195.

<sup>266</sup> W Schön, ‘The Mobility of Companies in Europe and the Organizational Freedom of Company Founders’ [2006] ECFLR 122, 137; K Baelz & T Baldwin, ‘The End of the Real Seat Theory (*Sitztheorie*): the European Court of Justice Decision in *Überseering* of 5 November 2002 and its Impact on German and European Company Law’ (2002) 3 German LJ 5.

<sup>267</sup> Bachner (n249); J Lowry, ‘Eliminating Obstacles to Freedom of Establishment: The Competitive Edge of UK Company Law’ (2004) 63 CLJ 331, 342-345; R Drury, ‘A European Look at the American Experience of the Delaware Syndrome’ (2005) 5 JCLS 1-35.

<sup>268</sup> Dyrberg (n186).

<sup>269</sup> P Lagarde, ‘*Cour de justice des Communautés européennes. – 5 novembre 2002*’ (case note) (2003) 92 RCDIP 508, 524-536.

<sup>270</sup> S Ebert, ‘European Union: Company Law – Freedom of Establishment’ (2003) 14 ICCLR N51, N52.

accurately pointed that the ECJ had only decided on the legal personality of *Überseering*<sup>271</sup> as the ECJ did explicitly state in relation to the company that:

Indeed, its very existence is inseparable from its status as a company incorporated under Netherlands law since... a company exists only by virtue of the *national legislation which determines its incorporation and functioning* (see, to that effect, *Daily Mail and General Trust*, paragraph 19).<sup>272</sup> (emphasis added)

The ECJ in this passage did not choose the *lex incorporationis* over the *lex sedis*. It did not consider it its task to decide on the conformity of rules of conflict. In any event, it is hard to see how a rule of conflict can constitute a breach to freedom of establishment. It must be the *lex causae* that actually constitutes the breach. Not willing to state a preference over one or the other rule of conflict, all the ECJ did was to declare the intensity of the restriction imposed on *Überseering* by German company law contrary to freedom of establishment.

The BGH was alarmed by the possibility of a company being governed by various national laws.<sup>273</sup> Such segregation would be contrary to the *Einheitslehre* principle, according to which one national law should govern the corporation in a uniform manner.<sup>274</sup> The ECJ, however, adopted a different stance. Overriding public interest could justify the restriction of the freedom of establishment which results from the less than absolute nature of

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<sup>271</sup> Lagarde (n269).

<sup>272</sup> *Überseering* (n191) [81].

<sup>273</sup> *Überseering* (n191) [14].

<sup>274</sup> Baelz & Baldwin (n266) 6.

the rights of companies to exercise freedom of establishment.<sup>275</sup> This *dictum* has been interpreted to justify, under specific circumstances, the application of the rules (in this case of the *lex sedis*) that negate these rights so that it was only the extent of the *ratione materiae* of this exception that remained to be seen.<sup>276</sup>

This is an inaccurate reflection of the ECJ's ruling though. The phraseology of the German Government's submission that the 'application of the company seat principle is also justified by employee protection'<sup>277</sup> was not adopted by the ECJ, which broadly held that 'overriding requirements relating to the general interest... could justify restrictions on freedom of establishment'.<sup>278</sup> The ECJ did not use the term real seat or any of its equivalents in its own findings at all.

This could suggest that the ECJ actually accepted that the freedom of establishment could be justifiably restricted by mandatory rules of the *forum* and not of the State where the central management is located. Of course these two will usually coincide, but if the *forum* is not a court of the State of the real seat it cannot be seen why the national court seized of the matter

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<sup>275</sup> *Überseering* (n191) [83] *et seq.*

<sup>276</sup> Ebert (n270) N52.

<sup>277</sup> *Überseering* (n191) [89].

<sup>278</sup> *ibid* [92].

should restrict the freedom of establishment for the protection of interests of other Member States.<sup>279</sup>

It must be remembered that the judgment of the ECJ in *Überseering* is confined to the facts of the case where the state of incorporation adheres to the incorporation theory and the state where the central management is located adheres to the real seat theory. If one were to generalise the *Überseering* rule, one should bear in mind the fact that time is the crucial element. No matter what the rule of conflict may be, all jurisdictions require some act of incorporation in their territory which precedes time wise the establishment of a real seat and a principal place of business. The direct consequence of incorporation is the acquisition of legal personality which has to be recognised in all Member States. Thus the precedence of incorporation as a matter of time also limits the consecration of the real seat theory and the principal place of business in article 48 EC. Therefore, once legal personality is granted by the Member State of incorporation, in principle all other Member States have to recognise it and respect it.

The innovation of *Überseering* lies in the fact that it recognises that certain mandatory rules may lead to the application of the *lex fori*. There has been a suggestion that ‘mandatory requirements’ or ‘*exigences impératives*’ play exactly the same role that the ‘*lois de police*’ play in a national context.<sup>280</sup>

However, there is a difference between these two terms. The first one has

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<sup>279</sup> See *mutatis mutandis* Case C-200/02 *Zhu and Chen* [2004] ECR I-9925, paras 34-35 where it was held that the UK could not rely on an alleged abuse of Irish law; Sørensen (n224) 447-452.

<sup>280</sup> Ballarino (n189) 397.

been frequently used by the ECJ ever since *Cassis de Dijon*<sup>281</sup> in order to justify restrictive measures which apply indistinctly, whereas the second has been used only once and has been given an autonomous meaning by the ECJ as '*dispositions nationales dont l'observation a été jugée cruciale pour la sauvegarde de l'organisation politique, sociale ou économique de l'État membre*'.<sup>282</sup>

The ruling in *Überseering* has not clarified the requirements that need to be satisfied for a national provision to qualify as a mandatory rule. Provisions from which parties cannot derogate by contract and those set for the protection of weaker parties will probably amount to mandatory rules.<sup>283</sup> For some authors it appears that any rule justified by some kind of competing public interest will qualify as a mandatory requirement.<sup>284</sup> Be that as it may, it will be easier to have the ECJ recognise new grounds of public interest as mandatory requirements rather than uphold restrictions based on the protection of creditors and the participation rights of employees as proportionate.<sup>285</sup>

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<sup>281</sup> Case C-120/78 *Rewe v Bundesmonopolverwaltung für Branntwein* [1979] ECR 649.

<sup>282</sup> Case C-369 & 376/96 *J.-C. Arblade, Arblade & fils SARL, B. et S. Leloup et Sofrage SARL* [1999] ECR I-8453 [30]; M Fallon, 'Cour de justice des Communautés européennes. – 23 novembre 1999' (case note) (2000) 89 RCDIP 710, 729-730. The definition is almost identical with the one provided to the term '*lois d'application immédiate*' by Phaedon Francescakis in 'Quelques précisions sur les '*lois d'application immédiate*' et leurs rapports avec les règles de conflit de lois' (1966) 55 RCDIP 1, 13 *et seq.*

<sup>283</sup> Case C-381/98 *Ingmar GB Ltd v Eaton Leonard Technologies Inc* [2000] ECR I-9305 [16]-[25].

<sup>284</sup> F Wooldridge, 'Überseering: Freedom of Establishment of Companies Affirmed' (2003) 14 EBL Rev 227, 233-235; I Thoma, 'The *Überseering* ruling: a tale of serendipity' (2003) 11 ERPL 545, 552-553.

<sup>285</sup> TH Tröger, 'Choice of Jurisdiction in European Corporate Law – Perspectives of European Corporate Governance' (2005) 6 EBOR 3-64.

*Überseering* also left certain questions unanswered. One is linked with the possibility that a company may choose to place the central management outside the state of incorporation at the time of incorporation (*dissociation ab initio*).<sup>286</sup> This problem is probably artificial: the host Member State will have to accept the location of the real seat in its territory only if the incorporation has been concluded in the state of origin. Other than this, *Daily Mail* allows for the proposition that the State of incorporation may, in principle, require the real seat to be located within its territory without restricting unlawfully the freedom of establishment.<sup>287</sup>

Furthermore, if AG Colomer in *Überseering* was right to state that article 6(1) of the European Convention on Human Rights deemed the German rule depriving *Überseering* of its *jus standi in judicio* to be unlawful,<sup>288</sup> then perhaps this rule should also apply to companies incorporated outside the EU.<sup>289</sup> Rammello went further to suggest that it is absurd to apply the incorporation theory to US firms but not to other European companies.<sup>290</sup> It has also been argued that *Überseering* has created inconsistencies between the freedom of establishment<sup>291</sup> and the rest of the

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<sup>286</sup> Lagarde (n269) 534; Birkmose (n214) 93 n200.

<sup>287</sup> Lagarde (n286).

<sup>288</sup> Opinion of AG Colomer in *Überseering* (n191) [57]-[62].

<sup>289</sup> Lagarde (n269) 535. It is exactly for this reason that French Court of Cassation has recognised a *jus standi in judicio* to Liechtenstein *Anstalten* Cass, 05.12.1989, *Société Extraco Anstalt* (1991) 80 RCDIP 668; Cass, 12.11.1990, *Voarick et autres c Société Extraco Anstalt* (1991) 80 RCDIP 671.

<sup>290</sup> S Rammello, 'The Long and Winding Road Towards Freedom of Establishment for Legal Persons in Europe' (2003) 10 MJ 169, 190-195.

<sup>291</sup> Ringe (n252).

fundamental freedoms which have to be similarly construed.<sup>292</sup> Persons wishing to make use of the freedom of goods or services can rely on the Treaty provisions not only against their State of origin but also against the host State.<sup>293</sup>

*Überseering* is also expected to have an impact in the field of recognition and enforcement of judgments. Since article 22(2) of the Brussels Regulation allows for the seat to be interpreted as both the place of incorporation and the location of the central management, it will be possible for courts of different Member States to have jurisdiction.<sup>294</sup> This leads to a doubt about whether the public policy defence in article 34(1) of the Regulation could justify non-recognition and enforcement of judgments which have not respected the limited nature of liability of the managers or shareholders,<sup>295</sup> if that matter could ever rise in the context of article 22(2) given the latter's restricted scope.<sup>296</sup>

*Überseering* is a significant case in the field of private international law. It has been very persuasively argued that the subject of incompatibility is substantive company law and not private international law,<sup>297</sup> but Member States took divergent paths. National courts have taken a different view

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<sup>292</sup> *Gebhard* (n197)

<sup>293</sup> *Ringe* (n252).

<sup>294</sup> *Roth* (n206) 195-196.

<sup>295</sup> E Micheler, 'Recognition of Companies Incorporated in Other EU Member States' (2003) 52 ICLQ 521, 527.

<sup>296</sup> See 63 *et seq.*

<sup>297</sup> *Roth* (n165) 147-155.

ranging from a total negation of the real seat theory in intra-Community relations<sup>298</sup> to the so-called new real seat theory (*Neue Sitztheorie*).<sup>299</sup>

While *Überseering* was still pending before the ECJ another chamber of the BGH delivered a judgment in a case involving a company incorporated in Jersey but having its real seat either in Germany or in Portugal.<sup>300</sup> The BGH sensing the outcome of the ruling in *Überseering* and in an effort to preserve the real seat theory –under the erroneous belief that Jersey is part of the United Kingdom and thus part of the EU-<sup>301</sup> extended its recent jurisprudence<sup>302</sup> on the legal personality of civil law partnerships (hereinafter ‘GbR’) or general commercial partnerships (hereinafter ‘OHG’) and held that the Jersey company should be treated as a German GbR or OHG which enjoy *jus standi in judicio*, but whose partners are personally liable for the partnership’s debts. This decision was heavily criticised<sup>303</sup> and was subsequently abandoned by the BGH.<sup>304</sup> It is now impermissible under German law for a company incorporated abroad but having its real seat in

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<sup>298</sup> *Re Registration in Austria of a Branch of an English Company S v Companies Registrar, Graz* (Case number 6Ob 124/99z) [2001] 1 CMLR 38 (Austrian Court of Cassation); Judgment No 2/2003 (2003) 54 *Epitheorisi Emporikou Dikaïou* 60 (Greek Court of Cassation – Grand Chamber).

<sup>299</sup> Judgment of 01.07.2002 [2003] IPRax 62 (German Federal Court of Cassation).

<sup>300</sup> *ibid.*

<sup>301</sup> Jersey is excluded from the territorial field of application of the EC Treaty by virtue of article 299(3) and Annex II EC.

<sup>302</sup> Judgment of 29.01.2001 (2001) 146 BGHZ 341 (German Federal Court of Cassation); PC Leyens, ‘German Company Law: Recent Developments and Future Challenges’ (2005) 6 German LJ 1407, 1408.

<sup>303</sup> Lagarde (n269) 524-536; Baelz & Baldwin (n266) 7; T Koller, ‘The English Limited Company- Ready to Invade Germany’ (2004) 15 ICCLR 334, 340

<sup>304</sup> Judgment of 13.03.2003 (2003) 154 BGHZ 185 (German Federal Court of Cassation).

Germany to be treated as a German GbR or OHG with all the severe consequences that this conversion entails so long as the state of incorporation is a State of the European Economic Area.<sup>305</sup>

By contrast, Belgium sought to devise a way of preserving the real seat theory in its new *Code de Droit International Privé* (hereinafter ‘CDIP’) enacted by the Law of 16 July 2004.<sup>306</sup> Belgian courts will in principle still apply the *lex sedis* under article 110(1) CDIP. However, if the company has its real seat abroad and the law of that country applies the *lex incorporationis* a renvoi to that latter law will be made.<sup>307</sup>

The post-*Überseering* assumption is that Belgian courts will apply Belgian law to a company founded in the UK but having its real seat in Belgium. However, this rule will probably only apply to businessmen founding a corporation in the UK while they still remain in Belgium. Article 112 CDIP suggests that if a company is established abroad and transfers its seat to Belgium the law of the place of incorporation will apply as the *lex sedis* because the Belgian requirements for the transfer of seat in Belgium have not been abided by and thus the transfer is invalid.<sup>308</sup>

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<sup>305</sup> S Shandro, ‘The Risks of Using Pseudo-Foreign Corporations in Germany’ (2006) 25 Am Bankr Inst J 30, 30-31.

<sup>306</sup> *Loi du 16 juillet 2004 portant le Code de Droit International Privé* (2005) 41 RDIPP 231.

<sup>307</sup> Article 110(2) CDIP; M Fallon, ‘Le Droit International Privé Belge dans les Traces de la Loi Italienne Dix Ans Après’ (2005) 41 RDIPP 315, 334-335.

<sup>308</sup> Fallon (n307) 335.

#### ***IV. Inspire Art case***

##### **A. The Netherlands legislation on pseudo-foreign corporations and the facts of the case**

Just after *Überseering* it had been argued that the real seat theory should be abandoned as it is contrary to Community law and should be replaced by the Dutch doctrine of pseudo-foreign companies,<sup>309</sup> which was thought to be suitable and proportionate for safeguarding the interests which the real seat theory was supposed to promote.<sup>310</sup> However, the ECJ took exactly the opposite view when it reviewed the *Wet op de Formeel Buitenlandse Vennootschappen* (Law on Formally Foreign Companies) of 17 December 1997 (hereinafter ‘the WFBV’).<sup>311</sup>

The WFBV defined a formally foreign company as a capital company formed under laws other than those of the Netherlands, which carries on its activities entirely or almost entirely in the Netherlands and also does not have any real connection with the State of incorporation.<sup>312</sup> It provided for the company's registration in the commercial register, an indication of that status in all the documents produced by it, the minimum share capital and the drawing-up, production and publication of the annual documents. Penalty for non-compliance with these provisions was the joint and several liability of

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<sup>309</sup> According to the doctrine of pseudo-foreign corporations, a State is entitled to apply some of the corporate law rules of the *lex fori* to corporations that have only a virtual link with their State of incorporation.

<sup>310</sup> Rammeloo (n290) 194-197; M Menjucq, ‘Kamer van Koophandel en Fabrieken voor Amsterdam v Inspire Art Ltd’ (case note) (2004) 131 JDI 917, 924.

<sup>311</sup> Case C-167/01 *Kamer van Koophandel en Fabrieken voor Amsterdam v Inspire Art Ltd* [2003] ECR I-10155.

<sup>312</sup> *ibid* [22].

directors.<sup>313</sup> It must be clarified though that the WFBV applied not to any corporation formed in a Member State but to those that had not taken the form of a public limited company or *société anonyme*.<sup>314</sup>

Inspire Art Ltd was incorporated in England. However, its sole director was domiciled in The Hague and conducted his business in art dealing through the Amsterdam branch of the company.<sup>315</sup> The dispute arose due to the decision of the *Kamer van Koophandel* (hereinafter ‘the Chamber of Commerce’) to apply to the Dutch courts for a declaration that Inspire Art is a formally foreign company to the company’s registration. This would have as a consequence the application of the aforementioned rules.<sup>316</sup> The Dutch court was confronted with the compatibility of the WFBV provisions in question with Community law and submitted a reference for a preliminary ruling to the ECJ.

## **B. The submissions of the Governments and the Commission: the existence of a breach of freedom of establishment**

The ECJ took the view that all the aforementioned WFBV provisions were contrary to Community law and, in particular, to the Eleventh Directive.<sup>317 318</sup>

The issue of breach of freedom of establishment arose only in relation to the

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<sup>313</sup> *ibid* [23].

<sup>314</sup> *Menjucq* (n310).

<sup>315</sup> *Inspire Art* (n311) [34].

<sup>316</sup> *ibid* [36].

<sup>317</sup> Council Directive (EEC) 89/666 concerning disclosure requirements in respect of branches opened in a Member State by certain types of company governed by the law of another State [1989] OJ L395/36.

<sup>318</sup> *Inspire Art* (n311) [71]-[72].

penalty of joint and several liability of directors. Thus it was only articles 4(1) and 4(2) that were examined under the spectrum of articles 43 and 48 EC.

The Netherlands Government was joined by the Austrian Government and surprisingly by its former opponents in *Überseering*, the German and Italian Government. All four submitted that the WFBV did not constitute a restriction of freedom of establishment since it did not prohibit the establishment of a branch, as was the case in *Centros*, but that it imposed certain ‘additional obligations relating to the exercise of their business activities and the running of the company, with a view of ensuring that others are clearly informed that companies such as Inspire Art are formally foreign companies’.<sup>319</sup> They concluded this line of argumentation by referring to *Daily Mail* as authority for the proposition that it is within the authority of the Member States to decide the connecting factor and enact their own private international law rules, such as the WFBV.<sup>320</sup>

The Commission and the UK Government opposed this submission. They argued that the connecting factor of the WFBV, namely the place of actual activity, fell short of the factors recognised in article 48 EC.<sup>321</sup> In its oral argument the Commission went as far as suggesting that applying the ‘*de facto* company seat principle’ is contrary to freedom of establishment as

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<sup>319</sup> *ibid* [81].

<sup>320</sup> *ibid* [83].

<sup>321</sup> *ibid* [92].

propounded in *Centros* and that, in any event, the WFBV does not introduce such a principle but a *règle d'application immédiate*.<sup>322</sup>

Against the former argument, the German, Austrian and Italian Governments submitted that the branches of pseudo-foreign corporations should not be considered as principal establishments and should not be entitled to freedom of establishment.<sup>323</sup> The case at hand had been viewed by these three Governments as an opportunity to request the ECJ to revisit the question decided in *Centros*. The German and the Austrian Government complained that the ruling in *Centros* was unsatisfactory since it prevented the taking of any effective measure against brass plate companies.<sup>324</sup> For this purpose, they submitted that host Member States should be allowed to retain legislation which does not prevent the registration of branches but enacts 'a few limited preventive measures and penalties'.<sup>325</sup>

### **C. The ruling of the ECJ on the existence of a breach of freedom of establishment**

The ECJ was not sympathetic to this argumentation. It solemnly reaffirmed *Centros*.<sup>326</sup> It then ruled that the WFBV provisions in question constitute a restriction of freedom of establishment because the establishment of a

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<sup>322</sup> Opinion of AG Alber in *Inspire Art Ltd* (n311) [12]-[13] & [16].

<sup>323</sup> *Inspire Art* (n311) [85].

<sup>324</sup> Opinion of AG Alber (n322) [27].

<sup>325</sup> *Inspire Art* (n311) [88].

<sup>326</sup> *ibid* [95]-[96].

branch is subjected to rules provided by the host Member State with regard to the formation of limited liability companies.<sup>327</sup>

*Daily Mail* was the last line of defence the said Governments sought recourse to. They argued that as a consequence of *Daily Mail* each Member State was free to choose its rules of private international law, including rules such as the ones in question.<sup>328</sup> The ECJ reaffirmed that *Daily Mail* concerned only the relations between the Member State of origin and the company making use of freedom of establishment.<sup>329</sup> This could be distinguished from the case at hand as the latter concerned a company and the State where it carries out business.<sup>330</sup> The ECJ once again avoided addressing the relation between private international law and freedom of establishment. AG Alber though clarified that *Überseering* did not concern the real seat theory, but one of its consequences, merely the need that ‘a company which moves its *de facto* seat has to reincorporate in order to maintain its legal personality’.<sup>331</sup>

#### **D. The ruling of the ECJ on the justification of the breach of freedom of establishment**

Having established that the WFBV provisions constituted a restriction of freedom of establishment,<sup>332</sup> the ECJ went on to examine whether such a

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<sup>327</sup> *ibid* [100]-[101].

<sup>328</sup> *ibid* [102].

<sup>329</sup> *ibid* [103].

<sup>330</sup> *ibid*.

<sup>331</sup> Opinion of AG Alber (n322) [103].

<sup>332</sup> *Inspire Art* (n311) [104]-[105].

restriction could be justified.<sup>333</sup> The Netherlands, German and Austrian Government submitted that the WFBV provisions are justified both by article 46 EC and by overriding public interest, namely the prevention of fraud, the protection of creditors, the effectiveness of tax inspections and the fairness of business dealings.<sup>334</sup> The Governments conducted a comparative analysis of national corporate legislation and submitted that joint and several liability of directors is a penalty recognised by Community law<sup>335</sup> and that minimum capital requirements exist in all European legal orders, except for Ireland and the UK.<sup>336</sup> In the view of the Chamber of Commerce the national measure was necessary to attain the objectives pursued without denying the right of establishing a branch in the Netherlands.<sup>337</sup>

The ECJ held that the measures could not be justified under article 46 EC.<sup>338</sup> Reference to article 46 EC was necessary as it was not clear whether the nature of the measure was discriminatory or not.<sup>339</sup> Indeed the measure applied only to companies incorporated outside the Netherlands and was discriminatory in this sense but it merely extended to them the rules applying to Dutch companies and was not discriminatory from this angle. The ECJ

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<sup>333</sup> *ibid* [106] *et seq.*

<sup>334</sup> *ibid* [108]-[109].

<sup>335</sup> Council Regulation (EC) 2157/2001 of 8 October 2001 on the Statute for a European company (SE) [2001] OJ L294/1 art 51.

<sup>336</sup> *Inspire Art* (n311) [111] & [116].

<sup>337</sup> *ibid* [117].

<sup>338</sup> *ibid* [131].

<sup>339</sup> Opinion of AG Alber (n322) [111].

once again examined the legality of restriction through the *Gebhard* test.<sup>340</sup> Protection of creditors was held not to justify the restriction because when dealing with Inspire Art Ltd, creditors were aware, through its unusual suffix, of its foreign nationality and thus its subjection to different rules of minimum capital requirements and directors' liability.<sup>341</sup>

The ECJ recognised the combating of improper recourse to freedom of establishment as an imperative requirement.<sup>342</sup> Although the Chamber of Commerce and the Netherlands Government failed on the facts, the ECJ addressed the doctrine of abuse twice: first, independently and then as an imperative requirement. This attitude cannot be explained from a doctrinal point of view as the abuse doctrine and public interest are two distinct grounds of justification.<sup>343</sup>

Failing to distinguish between them the ECJ ended up in discussing the same issues and providing the same reasoning: incorporation in one Member State in order to benefit from its corporate laws cannot *per se* amount to an abuse.<sup>344</sup> Neither does the fact that the corporation has no substantial connection with the country of incorporation but conducts its

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<sup>340</sup> *Inspire Art* (n311) [133].

<sup>341</sup> *ibid* [135].

<sup>342</sup> *ibid* [136]-[139].

<sup>343</sup> A Looijestijn- Clearie, 'Have the dikes collapsed? *Inspire Art* a further break-through in the freedom of establishment of companies' (2004) 5 EBOR 389, 412-413.

<sup>344</sup> *Inspire Art* (n311) [137]-[138].

activities only or mainly through the branch established in the host Member State.<sup>345</sup>

The ECJ also recognised the protection of fairness in business dealings and the efficiency of tax inspections as imperative requirements but the Chamber of Commerce and the Netherlands Government failed to bring evidence that would satisfy the *Gebhard* test.<sup>346</sup>

### **E. The reaction of commentators**

While *Überseering* was the trigger for German commentators to declare the untenability of the real seat theory, it took *Inspire Art* for some of the French to do so. The response of the academic world was far from uniform. On the one hand, *Inspire Art* in discarding easily the arguments based on the interests justifying the application of *lois de police* was viewed as ‘excessive’ and encouraging ‘law shopping’.<sup>347</sup> This criticism was reinforced by the narrowing of the abuse doctrine enunciated in *Centros*.<sup>348</sup> At the other extreme, Professor Muir Watt characterised the consequence of the judgment in *Inspire Art* in effectively ruling out the real seat theory from the recognition of foreign corporations as ‘excellente chose’.<sup>349</sup>

The common ground of these lines of argumentations was that the field of application of the real seat theory was perhaps narrowed but not

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<sup>345</sup> *ibid* [139].

<sup>346</sup> *ibid* [140].

<sup>347</sup> Menjucq (n310) 925-926

<sup>348</sup> *ibid* 926.

<sup>349</sup> H Muir Watt, ‘*Kamer van Koophandel en Fabrieken voor Amsterdam v Inspire Art Ltd*’ (case note) (2004) 93 RCDIP 151, 177.

abolished. It was correctly argued that article 48 EC guarantees the real seat theory.<sup>350</sup> A distinction based on *Daily Mail* was drawn between the State appearing as State of origin or host State. In the former case, it can use the real seat theory to impose its *lois de police* on companies incorporated in its territory, whereas as a host State its freedom to do so is severely limited,<sup>351</sup> if any at all.<sup>352</sup> In French private international law *Inspire Art* was not thought to require the abolition of the real seat theory, but its reinterpretation. This would imply that article 1837 CC can no longer apply in favour of French law, unless this would be justified under the abuse doctrine.<sup>353</sup>

The failure of the Netherlands and German Governments to persuade the ECJ on the justification of restrictions of freedom of establishment has led commentators to argue that Member States need to reconsider their traditional approach to creditor protection.<sup>354</sup> In fact it is hard to imagine *a priori* any case where an abuse could be established or the requirements of the *Gebhard* test would be satisfied. The German Government actually asked the ECJ ‘how Member States could combat the formation of brass plate companies suspected or being an abuse of freedom of establishment’.<sup>355</sup> The ECJ did not even bother to answer it but AG Alber replied that ‘such a request

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<sup>350</sup> Menjucq (n310) 927.

<sup>351</sup> Menjucq (n310); Muir Watt (n349) 176.

<sup>352</sup> B Audit, *Droit International Privé* (4<sup>th</sup> edn Economica, Paris 2006) 880-881.

<sup>353</sup> Menjucq (n347) 928-929.

<sup>354</sup> WF Ebke, ‘The European Conflict-of-Corporate Laws Revolution: *Überseering*, *Inspire Art* and Beyond’ (2005) 16 EBL Rev 9, 38-39.

<sup>355</sup> Opinion of AG Alber (n322) [122].

to the Court is surprising: it ought rather to be addressed to the Member States' adding that it is none of the Court's business to indicate the lawful measures that Member States should take to prevent abuse.<sup>356</sup>

This probably demonstrates that neither the Member States nor the ECJ could envisage an example that would qualify as abuse or justified restriction of freedom of establishment.<sup>357</sup> It has been rightfully suggested that creditor protection in civilian systems has to be re-orientated from corporate rules on minimum capital requirements to rules of information and financial disclosure.<sup>358</sup> Cases like *Innoventif*<sup>359</sup> seem to support this proposition. In that case, the German requirements concerning the detailed disclosure of the objects of a company incorporated in England before authorising the establishment of a branch in Germany were held to be in conformity with freedom of establishment.

This is also the case in the UK where, under Part 34 of the Companies Act 2006, companies incorporated abroad are required to have a specified or identifiable place in the UK at which they carry on business and which has more than a fleeting character, and that there is some visible sign or physical indication that they have a connection with particular premises.<sup>360</sup> Such

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<sup>356</sup> *ibid* [123].

<sup>357</sup> For a contemplation of instances where a restriction could be justified see text to n153.

<sup>358</sup> Ebke (n354); Alexander Shall, 'The UK Limited Company Abroad' (2005) 16 EBL Rev 1534.

<sup>359</sup> Case C-453/04 *Innoventif Limited* [2006] ECR I-4929.

<sup>360</sup> Prentice (n213) 635-637.

provisions cannot even be considered to constitute a breach of freedom of establishment.

Consequently, *Inspire Art* has severely restricted, if not extinguished, the freedom of Member States to enact outreach statutes on pseudo-foreign corporations.<sup>361</sup> The only justification for an alleged restriction of freedom of establishment that might have some chances of success could possibly be the rights of employees<sup>362</sup> which are of constitutional value in many countries,<sup>363</sup> including Germany,<sup>364</sup> since the ECJ has indicated its willingness to afford protection to fundamental rights even when they contradict with the fundamental freedoms subject to the principle of proportionality.<sup>365</sup>

The balancing of the freedom of establishment with co-determination rights<sup>366</sup> that employees enjoy under the German two tier board management regulations<sup>367</sup> might justify a restriction on freedom of establishment. However, it will be extremely difficult to apply the co-determination rules in foreign companies with a simple tier board.<sup>368</sup> Other commentators have

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<sup>361</sup> Lowry (n267).

<sup>362</sup> C Kersting & CP Schindler, 'The ECJ's *Inspire Art* Decision of 30 September 2003 and its Effects on Practice (2003) 4 German LJ 1277, fn48.

<sup>363</sup> Article 22 of the 1975 Greek Constitution; paras 5 and 8 of the Preamble to the 1946 French Constitution; article 23 of the 1994 Belgian Constitution; ss 7 and 28 of the 1978 Spanish Constitution.

<sup>364</sup> Article 12 of the German *Grundgesetz*.

<sup>365</sup> Case C-112/00 *Schmidberger* [2003] I-5659.

<sup>366</sup> C Teichmann, 'Restructuring Companies in Europe: A German Perspective' (2004) 15 EBL Rev 1325, 1331-1336.

<sup>367</sup> JJ du Plessis, 'The German Two-Tier Board and the German Corporate Governance Code' (2004) 15 EBL Rev 1139-1164.

<sup>368</sup> Wooldridge (n284) 233-235.

taken the opposite view<sup>369</sup> arguing that the codetermination provisions in articles 42 and 45 of the SE Regulation and in SE Statute Directive 2001/86<sup>370</sup> do not *per se* lead to the qualification of German co-determination provisions as part of European public policy.<sup>371</sup>

At the same time, it has been argued that the consequence of *Centros*, *Überseering* and *Inspire Art* is that German companies would be able to avoid the rules in question by being established as subsidiaries of companies seated outside Germany.<sup>372</sup> One way out could be for Germany to re-enact its employee participation provisions by a change of the connecting factor. Such legislation could be applied collectively to all companies, both domestic and foreign, activating in Germany.<sup>373</sup> The ECJ might be more reluctant to discard national employment legislation which would cause unrest in the Member State and possibly damage the image of the ECJ itself.

In any event, the ECJ has not proven to be very receptive to arguments based on employee protection, in cases where there is no reference to constitutional values. *Payroll* concerned Italian legislation which allowed recourse to data processing centres by undertakings with less than 250 employees provided only that they are established and staffed exclusively by

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<sup>369</sup> Roth (n206) 200; Kersting & Schindler (n362) 1286; Leyens (n302) 1413-1414.

<sup>370</sup> Council Directive (EC) 2001/86 of 8 October 2001 supplementing the Statute for a European company with regard to the involvement of employees [2001] OJ L294/22.

<sup>371</sup> WF Ebke (n354) 43-46.

<sup>372</sup> Otto Sandrock, 'The Colossus of German Supervisory Codetermination: An Institution in Crisis' (2005) 16 EBL Rev 83, 95-96.

<sup>373</sup> Audit (n352) 882; the French *Conseil d'Etat* has upheld similar legislation in a freedom of establishment context in *CE Ass 29.06.1973 Syndicat général du personnel de la Compagnie des Wagons-lits* (1974) 63 RCDIP 344 though long before the major ECJ judgments in the field.

persons registered with the professional associations of employment consultants or persons with equivalent status.<sup>374</sup>

The ECJ held without any specific justification that the said legislation constitutes a restriction to freedom of establishment.<sup>375</sup> It then declined to justify the restriction on the basis of protection of employees because, regardless of whether the task of the data processing centres requires any special professional qualities, the tasks in question cannot be any less complex when the number of salaried staff concerned increases.<sup>376</sup> The disputed provision was thus deemed unnecessary. Things however might be different if the rights of employees of the pseudo-foreign company were at stake, which was not the case at *Payroll*.

### ***V. Sevic Systems AG: the survival of Daily Mail***

Despite the fact that *Daily Mail* has been reaffirmed recently in both *Überseering* and *Inspire Art*, there has been a growing opinion that *Daily Mail* is not desirable. *Sevic* concerned the refusal of a German court to register the merger of a German and a Luxembourgian company.

#### **A. The Opinion of AG Tizzano**

AG Tizzano seized the opportunity in *Sevic* to characterise all measures which prohibit, impede or render less attractive the exercise of the freedom of establishment as restrictions to the latter.<sup>377</sup> Without disregarding *Daily*

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<sup>374</sup> Case C-79/01 *Payroll Data Services (Italy) Srl* [2002] ECR I-8923.

<sup>375</sup> *ibid* [27].

<sup>376</sup> *ibid* [36]-[37].

<sup>377</sup> Opinion of AG Tizzano in Case C-411/03 *Sevic Systems AG* [2005] ECR I-10805 [44]-[45].

*Mail* explicitly, AG Tizzano took the view that restrictions ‘on entering’ or ‘on leaving’ national territory which are likely to discourage an operator from availing himself of the right of establishment are prohibited.<sup>378</sup>

If such statement were adopted by the Court, it would hardly leave any room for *Daily Mail* to apply. The national measure in question concerned article 1(1) of the German law on transforming companies (*Umwandlungsgesetz*) which allowed a merger only between corporations having their real seat in Germany. Although AG Tizzano did not refer to the rule in *Daily Mail*, he concluded that upholding the German legislation had an impermissible consequence, namely the loss of ‘a possibility of considerable and manifest importance in a common market such as the European market’.<sup>379</sup> The alternative provided under German law, that is to transform the foreign company into a German one before merging it with the already existing German corporation, had already been precluded by the ECJ in *Überseering*.<sup>380</sup>

## **B. The ruling of the ECJ**

However, the ECJ did not adopt the same terms as AG Tizzano. It took the view that precluding *in toto* the possibility of a merger between companies established in different Member States prevents them from using one single

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<sup>378</sup> *ibid.*

<sup>379</sup> *ibid* [48].

<sup>380</sup> *ibid* [50].

act to perform a complex financial activity and amounts to a restriction of freedom of establishment.<sup>381</sup>

The German and Dutch Governments allied to defend the measure as a justifiable restriction to freedom of establishment though unsuccessfully. The ECJ recognised the grounds forwarded by the said Governments, namely the interests of creditors, minority shareholders and employees, the effectiveness of fiscal supervision and fairness of commercial transactions as imperative reasons in the public interest.<sup>382</sup> Nonetheless, the ECJ held that the measure was both unsuitable and unnecessary to protect the aforementioned interests.<sup>383</sup>

It is significant that the ECJ did not even refer to *Daily Mail*, according to which Germany would have a right to determine the functioning of companies incorporated in its territory. It rather tacitly relied on its *dictum* in *Daily Mail* that freedom of establishment prohibits ‘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’.<sup>384</sup> The uncontested outcome of *Sevic* is that it guarantees the protection of article 43 EC to mergers.<sup>385</sup>

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<sup>381</sup> Case C-411/03 *Sevic Systems AG* [2005] ECR I-10805 [21]-[22].

<sup>382</sup> *ibid* [28].

<sup>383</sup> *ibid* [30].

<sup>384</sup> *Daily Mail* (n176) [16].

<sup>385</sup> Schön (n266) 141 .

The *Daily Mail* doctrine that Member States enjoy discretion in enacting measures that might prevent a company incorporated in its territory to migrate to another Member State and at the same time preserve the nationality of the Member State of origin has not been overruled. The ECJ in *Sevic* explicitly referred to the discrimination that the *Umwandlungsgesetz* had introduced against corporations established in other Member States before holding the measure to be a restriction.<sup>386</sup> While for AG Tizzano the focus was on the fact that German companies would not be able to merge with other European companies (exit type of case),<sup>387</sup> the ECJ emphasised the consequence of the *Umwandlungsgesetz* on other European companies that would not be able to merge with German corporations (entry type of case).<sup>388</sup>

Consequently, the dividing line between *Daily Mail* and *Sevic* lies in the existence or not of consequences affecting foreign corporations and stemming from national legislation which *prima facie* concerns only domestic corporations. The first case will lead to the implementation of *Sevic*,<sup>389</sup> whereas the second will lead to upholding the national measure under *Daily Mail*.

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<sup>386</sup> *Sevic Systems* (n381) [22].

<sup>387</sup> Opinion of AG Tizzano (n377) [44]-[45] & [48]-[49]; P Behrens, 'Case C-411/03 *Sevic Systems AG* [2005] ECR I-10805' (case note) (2006) 43 CML Rev 1669, 1678.

<sup>388</sup> *ibid* [21]-[22]; MM Siems, '*SEVIC*: Beyond Cross-Border Mergers' (2007) 8 EBOR 307, 309.

<sup>389</sup> Siems (n388) 315.

## ***VI. Grunkin & Paul: the relationship between primary EU law and national choice of law rules***

*Grunkin & Paul's* significance lies in the fact that it confronted the ECJ directly with a national rule of private international law. Both the judgment of the Grand Chamber of the Court and the Opinion of AG Sharpston settle the question concerning the relationship between primary EU law and national private international law rules.

It is this precise question that has become particularly significant in the line of cases that have been examined so far. *Überseering* left unclear the validity of the real seat theory vis-à-vis freedom of establishment. Many national courts thought that the ECJ had abolished the real seat theory and so did many commentators.<sup>390</sup> It will be demonstrated that these courts and commentators were too hasty and erroneous in their contentions.

### **A. The facts of the case**

The facts are very simple and can only cause embarrassment to German authorities. Leonard Matthias Grunkin-Paul (hereinafter 'Leonard') is a German national born in Denmark in 1998. His parents, Mr Grunkin and Dr Paul, are also German nationals who are no longer married. Leonard was given the surname Grunkin-Paul pursuant to Danish law. His parents sought to register him with the Registry Office (*Standesamt*) of Niebüll under the surname Grunkin-Paul. The application was refused on the basis that under article 10 EGBGB the name of a person is governed by the *lex patriae* and under §1617 of the German BGB a child can have only one surname from one

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<sup>390</sup> See p 101.

of its parents. The case was brought before the Amtsgericht Flensburg which submitted a reference for a preliminary ruling to the ECJ asking whether article 10 EGBGB is contrary to articles 12 and 18 EC.

### **B. The Opinion of AG Sharpston**

The Opinion of AG Sharpston is the only occasion where a Court official has actually addressed a matter that has caused much debate among commentators. It can be summarised in one question: what is the relationship between national private international law rules and primary EU law? In addressing this question, AG Sharpston makes a series of salient points, which demonstrate a great clarity of thought.

First, unlike the Court, she makes it explicit that the case does not concern article 10 EGBGB *per se*.<sup>391</sup> Rather it concerns the validity of the effect of the said provision in light of the facts of the case.<sup>392</sup> Second, in addressing the question asked by the referring court, the ECJ need not adjudicate between the two rules that Member States have adopted regarding personal status, i.e. *lex patriae* or *lex domicilii*.<sup>393</sup> It is for the Community legislature to decide which choice of law rule is better. The Court intervenes only to guarantee that the principle of equal treatment and free movement of persons are respected.<sup>394</sup>

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<sup>391</sup> Opinion of AG Sharpston in Case C-353/06 *Grunkin & Paul* [2008] ECR I-7639 [48].

<sup>392</sup> *ibid* [49].

<sup>393</sup> *ibid* [50].

<sup>394</sup> *ibid* [65]-[66].

In this context, AG Sharpston thought that the way article 10 EGBG had been applied by the Registry Office was incompatible with primary EU law. In particular, she thought that the Registry Office had violated the principle of equal treatment embodied in article 12 EC. She was convinced that to hold otherwise would actually require the Court to decide which of the two choice of law rules is better.<sup>395</sup> In her view, equal treatment requires equal weight to be placed on the Danish choice for the *lex domicilii* and the German choice for the *lex patriae*.<sup>396</sup>

With regard to free movement of persons, she thought the application of article 10 EGBG in this manner to constitute an unjustified breach.<sup>397</sup> AG Sharpston first examined whether there has been a restriction. Several Member States intervened in favour of Germany and argued that ‘there is nothing in the German choice of law rule in issue or its application in this case which is inherently liable to hamper or to render less attractive the exercise of the right to freedom of movement or residence’.<sup>398</sup> However, the likely discrepancies in official documents could be enough trouble to Leonard whenever he would be required to prove his identity. They were thought to suffice in order to hold that there has been a restriction.<sup>399</sup>

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<sup>395</sup> *ibid.*

<sup>396</sup> *ibid* [65].

<sup>397</sup> *ibid* [72] *et seq.*

<sup>398</sup> *ibid* [75].

<sup>399</sup> *ibid* [78].

The justifications that the German Government sought to produce were not satisfactory. They submitted that the restriction is justified by

the benefits of not allowing compound surnames combining those of both parents (in that, if the practice were allowed, future generations might find themselves with surnames of unmanageable length [...]) and of using only nationality as a connecting factor when determining the law applicable to an individual's name (in that it is a more stable and easily ascertainable criterion than habitual residence).<sup>400</sup>

It is no surprise that AG Sharpston found these reasons wholly unconvincing. She had already taken the view that the Court was not required to choose between the two possible choice of law rules.<sup>401</sup> Additionally, German law did not preclude compound surnames in an absolute manner. For instance, children with a foreign parent could have a compound surname if that foreign law would so command. Nor does German law preclude the use of the *lex domicilii* for persons born in Germany where neither parent has German nationality but at least one of them is habitually resident in Germany.<sup>402</sup>

Concluding her Opinion, AG Sharpston made a very important remark with regard to German law. She stated that

...my approach would not require any major change to Germany's substantive or choice of law rules in the field of names, but would simply require them to allow greater scope for recognising a prior choice of name validly made in accordance with the laws of another Member State. To that extent, it involves no more than an application of the principle

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<sup>400</sup> *ibid* [82].

<sup>401</sup> *ibid* [83].

<sup>402</sup> *ibid*.

of mutual recognition which underpins so much of Community law, not only in the economic sphere but also in civil matters.<sup>403</sup>

This point is reminiscent of the view taken by various authors that all that the Court ruled in *Überseering* was just to require Member States to recognise companies formed under the laws of another Member State without pronouncing on the desirability of the *lex sedis* or the *lex incorporationis*.<sup>404</sup>

### **C. The judgment of the ECJ**

The Grand Chamber of the Court did not take a very different stance to that of AG Sharpston. Unlike the latter it held that the German choice of law rule does not violate the principle of equal treatment of article 12 EC. The determination of surnames in Germany in accordance with German law cannot constitute discrimination on grounds of nationality when the parties have only German nationality.<sup>405</sup> It then moved on to find a restriction to free movement of persons. In paragraphs 21-28 the Court describes the difficulties that discrepancies in public documents may create to Leonard during the exercise of the right conferred to him by article 18 EC.

In examining whether the restriction to freedom of establishment is justified, the Court found that none of the justifications put forward by the German Government could be upheld. It noted that the German Government did not advocate that the restriction is justified by some reason of public

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<sup>403</sup> *ibid* [91].

<sup>404</sup> See e.g. Lagarde (n269).

<sup>405</sup> Case C-353/06 *Grunkin & Paul* [2008] ECR I-7639 [19]-[20].

policy.<sup>406</sup> Quite the contrary the German Government relied solely upon the rationale justifying the enactment of the rule in question rather than the restriction itself. The objectivity and legal certainty that flow from the implementation of the *lex patriae* do not warrant the refusal to recognise the giving of a surname according to the law of another Member State.<sup>407</sup> Arguments based on the practical benefits of prohibiting double-barrelled names did not have a better chance of success.<sup>408</sup>

In light of these considerations, the ECJ ruled that in circumstances such as those of the case in the main proceedings, Article 18 EC precludes the authorities of a Member State, in applying national law, from refusing to recognise a child's surname, as determined and registered in a second Member State in which the child – who, like his parents, has only the nationality of the first Member State – was born and has been resident since birth.<sup>409</sup>

#### **D. The implications of primary EU law on private international law: *Grunkin & Paul* and *Überseering***

##### ***i) The neutrality of private international law rules***

Despite the urge from AG Sharpston, the Court missed the chance to address in explicit terms the relationship between primary EU law and national rules of private international law. This would have helped clarify the fate of a national private international law rule once its application in a specific case

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<sup>406</sup> *ibid* [38].

<sup>407</sup> *ibid* [34].

<sup>408</sup> *ibid* [35]-[37].

<sup>409</sup> *ibid* [39].

has been found incompatible with the Treaty. However, its ruling in *Grunkin & Paul* is consistent with the view that national private international law rules are *per se* incapable of being incompatible with the Treaty.<sup>410</sup> Rather it is the content of the *lex causae*, whose application is triggered by the rule in question, in combination with the facts of the specific case that give rise to incompatibility.

*Grunkin & Paul* has to be read in conjunction with *Überseering*. In the latter case the ECJ was confronted with the German choice of law for companies. German courts had refused to recognise the legal personality of a company incorporated in The Netherlands, but having its real seat in Germany. To the eyes of German courts *Überseering* was a company that had failed to abide by the requirements of incorporation under German law and thus had never acquired legal personality. It can be seen that the violation of freedom of establishment did not actually come from the choice of law rule, but from the substantive provisions of company law.<sup>411</sup>

Both in *Grunkin & Paul* and *Überseering* the ECJ follows the same pattern of thought. There is no holding as to the choice of law rule itself. In fact, in *Grunkin & Paul* the ECJ held that: ‘Article 18 EC precludes the authorities of a Member State, *in applying national law*, from refusing to recognise a child’s surname, as determined and registered in a second

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<sup>410</sup> J Armour, ‘European Insolvency Proceedings and Party Choice: Comment’ in WG Ringe, L Gullifer & P Théry (eds), *Current Issues in European Financial and Insolvency Law: Perspectives from France and the UK* (Studies of the Oxford Institute of European and Comparative Law, Hart Publishing, Oxford 2009) 123, 127.

<sup>411</sup> Roth (n165) 147-155.

Member State' (emphasis added).<sup>412</sup> It is evident that the ECJ does not think the identification of German law as the applicable law itself a restriction to article 18 EC. It is rather the normative content of the *lex causae* that creates the problem and not the choice of law rule. AG Sharpston, therefore, has rightfully observed that it is not the validity of the choice of law rule that comes into question, but the validity of its effect.<sup>413</sup>

The rulings of the ECJ in *Grunkin & Paul* and *Überseering* allow the following conclusion to be drawn with regard to the relationship between primary EU law and national private international law rules. First, the private international law rule itself is not under scrutiny. Second, the Court is concerned with the compatibility of the *lex causae* with EC law. Third, the Court takes into consideration three factors: national choice of law, the normative content of the *lex causae* and the facts of the specific case. As pointed out by AG Sharpston, the Court must interpret Community law 'with regard to the specific situation which has arisen in the main proceedings. It should beware of encroaching to any unnecessary extent on Member States' competence in matters of private international law'.<sup>414</sup>

If and only if in light of these observations, a restriction is found the Court will review the restriction under the *Gebhard* test, which requires

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<sup>412</sup> *Grunkin & Paul* (n405) [39].

<sup>413</sup> Opinion of AG Sharpston (n391) [48]-[49].

<sup>414</sup> *ibid* [46].

restrictions to be applied in a non-discriminatory manner, be justified by imperative requirements of public interest and be proportionate.<sup>415</sup>

In case the outcome of the review is negative for the compatibility of national law with Community law, the Member State need not abrogate the private international law rule.<sup>416</sup> Choice of law rules are so neutral and abstract in themselves that it is not possible for them to have a content contrary to the Treaty. There is nothing contrary to the Treaty in applying German law to Leonard or to *Überseering*. In both cases, incompatibility did not arise from the application of the German choice of law rule. Nor did it arise from the mere identification of German law as the *lex causae*. It arose from the normative content of the *lex causae* in combination with the light of the facts of the specific case.

Therefore, as far as legal status or capacity is concerned there is nothing in the ruling of the Court to preclude the application of German law to German nationals, or even to foreign nationals provided that the outcome is not contrary to the rights that the Treaty confers to individuals. Similarly, in the context of company law, there is nothing in the ruling of the Court in *Überseering* to preclude the application of German corporate law to a company formed under the laws of another Member State. It is just required that the outcome of the application of German law does not discourage companies from exercising their rights under the Treaty in a way that violates freedom of establishment.

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<sup>415</sup> *Gebhard* (n197) [37].

<sup>416</sup> See Opinion of AG Sharpston (n391) [91].

*Grunkin & Paul* and *Überseering* constitute the two sides of the same coin. They both concern personality. The former requires Member States to shape their substantive law in a way to provide for the recognition of names and surnames as they have already been given in other Member States, even when the natural person concerned is their national. The latter requires Member States to recognise the legal personality that other Member States grant to companies incorporated under their laws.

**ii) Dual nationality: natural persons**

The issue of dual nationality has arisen so far only with regard to natural persons. The ECJ has already had the chance to rule on this matter when the natural person in question holds the nationality of two Member States. In *Garcia Avello* it ruled that administrative authorities of one Member State are precluded from refusing to grant an application for a change of surname made on behalf of minor children resident in that State and having dual nationality of that State and of another Member State, in the case where the purpose of that application is to enable those children to bear the surname to which they are entitled according to the law and tradition of the second Member State.<sup>417</sup>

This ruling of the Court put an end to the longstanding rule of private international law that, from the point of view of a State, whenever the *lex patriae* choice of law leads to the application of its law the State owes no regard to the laws of other States, even if the person in question holds their

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<sup>417</sup> Case C-148/02 *Garcia Avello* [2003] ECR I-11613.

nationality.<sup>418</sup> In applying their law as *lex patriae*, Member States are now required to take into account the consequences that this application might have on the individual with regard to his/ her other *lex patriae*. Member States need in so far it is possible to accommodate for solutions that are compatible with both systems of law.

**iii) Dual nationality: legal persons**

Perhaps *Überseering* can be viewed as a case of dual nationality. Both Germany and the Netherlands thought it to be their ‘national’, if this term can be employed in this context.

As a matter of public international law and for the purposes of exercise of diplomatic protection, a company has the nationality of the State in which it is incorporated, unless it is controlled by nationals of other States, it has no substantial business activities in the State of incorporation and the seat of management and financial control of the company are both located in another State. In this latter case, that other State has the right to exercise diplomatic protection.<sup>419</sup>

There is nothing to require private international law to adopt the same approach as public international law. Private international law is not concerned with the question of which State should have an interest in exercising protection over a company. It is rather concerned with identifying

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<sup>418</sup> E.g. article 31 of the Greek CC; article 3(2)(1) of the Belgian CDIP.

<sup>419</sup> ILC, ‘Report of the International Law Commission on the work of its 58<sup>th</sup> session’ (1 May- 9 June & 3 July- 11 August 2006) UN Doc A/61/10, Draft Articles on Diplomatic Protection, draft article 9.

the law that has the closest connection with a particular matter.<sup>420</sup> In principle, there is nothing that requires that only one national company law be applied to a corporation, in the same way that nothing would require the application of the same *lex contractus* to a contract through a common choice of law scheme if it were not for the 1980 Rome Convention on the law applicable to contractual obligations.<sup>421</sup>

There are two ways in which one can look at the interplay between private international law and freedom of establishment. The first requires a court to juxtapose the *lex sedis* to the *lex incorporationis*, as potential *leges causae*, vis-à-vis freedom of establishment (binary approach), whereas the second juxtaposes the *lex causae*, whichever that may be, with freedom of establishment (unitary approach).

Binary approach. An example that involves company law provisions that deal with conflicts of interest (or ‘agency problems’) between shareholders and managers will help illustrate best the point that is being made here. Let it be supposed that Y BV is incorporated in the Netherlands, but its real seat is in Hungary. Let it be also supposed that Dutch law requires a higher percentage of ownership of shares for a derivative action to be brought than Hungarian law. Would the application of Hungarian law as the *lex sedis* constitute a restriction to freedom of establishment?

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<sup>420</sup> Opinion of AG Sharpston (n391) [37]; D Bureau & H Muir Watt, *Droit international privé* (1<sup>st</sup> edn PUF, Paris 2007) vol I, pp 33-34.

<sup>421</sup> Soon to be replaced by Council Regulation (EC) 593/2008 of 17 June 2008 on the law applicable to contractual obligations (Rome I) [2008] OJ L177/6.

At that point one is faced with two potentially applicable laws: the *lex incorporationis* and the *lex sedis*. If the claim is brought in the Netherlands, it cannot be seen how the minority shareholders can argue that the application of the relevant Dutch company law provision to a company incorporated in The Netherlands constitutes a breach of freedom of establishment.

If, however, the claim is brought by the minority shareholders in Hungary it will be for the Hungarian court to decide whether the application of Hungarian company law is contrary to freedom of establishment. The managers' argument is actually targeting the application of Hungarian law. They request that Hungarian law be not applied, because this would constitute a breach of freedom of establishment. The breach, they would argue, is substantiated by imposing a liability on them and the company, which would not be imposed had Dutch law been applied. The application of Hungarian law in this particular instance would discourage Y BV from exercising its freedom of establishment. This approach is called binary, exactly because the managers are trying to substantiate the breach to freedom of establishment by fleshing out the discrepancy between the *lex sedis* with the *lex incorporationis*.

The Hungarian court may well reply that whether there is a breach or not depends on whether the application of Hungarian company law is detrimental to the company. The application of Hungarian law does not *per se* amount to a breach. This requires the Hungarian court to decide whether allowing the derivative action to proceed is detrimental to the company or not, without having identified the *lex causae* yet, i.e. without having

conclusively decided whether Dutch or Hungarian law should govern this particular issue.

Unitary approach. The problem that the binary approach creates is that this stage the court has not yet concluded on the *lex causae*. As a consequence, it is impossible to decide whether the measure is detrimental or not. In the eyes of managers, the application of Hungarian law is detrimental, whereas in the eyes of the minority shareholders the application of Dutch law is detrimental. There is no reason why a court should prefer the interests of one group over the other.

Undoubtedly, freedom of establishment is granted to the company and not to its managers and shareholders. While the binary approach juxtaposes the two potentially applicable laws, the unitary approach does not. It merely contrasts the *lex causae*, in this case Hungarian law, with freedom of establishment. This comparison should take place in a 'vacuum', i.e. the court should only consider the *lex causae*, the facts and the Treaty. Although the content of *lex incorporationis* is at the background of the case, it should not directly influence the decision of compatibility or not with the Treaty.<sup>422</sup>

Hungarian private international law leads to the application of Hungarian company law. Once the application of Hungarian law is contested, one should draw a crucial distinction between arguing that the application of

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<sup>422</sup> Nowhere in its leading cases of free movement of goods (Case C-8/74 *Procureur du Roi v Benoît and Gustave Dassonville* [1974] ECR 837; Case C-120/78 *Rewe v Bundesmonopolverwaltung für Branntwein* [1979] ECR 649; Cases C-267/91 & 268/91 *Keck & Mithouard* [1993] ECR I-6097) has the Court actually juxtaposed and compared national laws. In all cases, it examined the compatibility of the national provisions in question by sole reference to the Treaty.

Hungarian law, as opposed to Dutch law, is contrary to freedom of establishment and that the relevant Hungarian corporate provisions are contrary to freedom of establishment.

On the basis of *Grunkin & Paul* it can now be argued that the former is no longer plausible. The question is not whether Hungarian law is in conformity with Dutch law, but with the Treaty. As it has been alluded to above, to the eyes of Hungarian courts, Hungarian law has the closest connection with the dispute in question. There is no point in suggesting that Dutch law should apply instead. Freedom of establishment is not concerned with this. All the managers can argue is that the percentage of shares that minority shareholders are required to hold in order to bring a derivative action constitutes a restriction to freedom of establishment.

Notion of restriction. This brings forward the next question, i.e. what constitutes a restriction to freedom of establishment? It might be helpful to draw an analogy from the case-law on free movement of goods. The ECJ in *Dassonville* held that any measure which is ‘capable of hindering, directly or indirectly, actually or potentially, intra-Community trade’ was to be considered as a breach to free movement of goods.<sup>423</sup> However, some years later it reversed its jurisprudence so as to exempt measures that ‘apply to all relevant traders operating within the national territory and so long as they affect in the same manner, in law and in fact, the marketing of domestic products and of those from other Member States’.<sup>424</sup>

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<sup>423</sup> *Dassonville* (n422) [5].

<sup>424</sup> *Keck & Mithouard* (n422) [16].

Likewise, it can be argued in the context of freedom of establishment that in cases, similar to the one contemplated in the example above, the rule in question must be of a nature that causes a serious and real detriment to the company, i.e. seriously discouraging it from exercising its rights under the Treaty. It is submitted that the statement of the ECJ that '[a]ll measures which prohibit, impede or render less attractive the exercise of that freedom must be regarded as such restrictions'<sup>425</sup> should be viewed through the prism of the previous considerations.

In the aforementioned example, the relevant question would be whether the lower percentage of share ownership required by Hungarian law in order for a claim to be brought would have deterred the company in placing its real seat in Hungary. One possibility is to view this question as one of fact. This can develop into an *ex post facto* inquiry of the court as to whether the company, and not one of its composite groups of interests, would have still engaged in a cross-border activity even had it known that the provision in question would be applicable. The difficulty here would be that one group- usually the majority shareholders- will tend to make the decision.

The alternative option is to view it as a question of law, in which case the inquiry will inevitably develop into a cost benefit analysis. There will be some cases for sure, such as *Überseering*, where it will be relatively easy to say that the cost benefit analysis goes one or the other way. It may well turn out to be the case that in most instances, the company in question would have engaged in a cross-border activity. It is hard to imagine that a company would

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<sup>425</sup> Case C-442/02 *Caixa-Bank France* [2004] ECR I-8961 [11].

not have proceeded to make what seems to it to be a sound economic investment, for the mere fact that another law would have been applicable.

Issues of nationality. There is also an important conclusion to be drawn in relation to nationality, given that the ECJ has used the term in relation to companies.<sup>426</sup> This brings back to the stage a very old debate concerning the possibility of ascribing a nationality to company. Some argued that nationality is a political link with a State and can only ascribed to natural persons, since nationality presupposed personality and legal personality is just a fiction.<sup>427</sup> The view that prevailed in the end was that the nationality does not have precisely the same meaning when used for legal persons as it does for natural persons. It has been generally accepted that nationality in this context implies the existence of a link between a company and a State, without any reference to the nature of this link. In other words, it is a reference to the *lex causae*.<sup>428</sup>

It is perhaps time to look back into the minority view afresh. Although it is not now submitted as it once was that one should look at the nationality of shareholders,<sup>429</sup> there might have been some merit in refusing to think of choice of law for companies in term of nationality.

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<sup>426</sup> See Case C-210/06 *Cartesio* [2008] ECR (not yet published); [2009] 1 CMLR 50 [123].

<sup>427</sup> JP Niboyet, 'Existe-t-il vraiment une Nationalité des Sociétés?' (1927) 22 RCDIP 402; Léon Mazeaud, 'De la Nationalité des Sociétés' (1928) 55 JDI 30.

<sup>428</sup> P Mayer & V Heuzé, *Droit international privé* (9th edn Montchrestien, Paris 2007) 742.

<sup>429</sup> JP Niboyet, *Traité de droit international privé français* (2nd edn Sirey, Paris 1947) vol 1, pp 86-88, vol 2, pp 359 *et seq.*

Thus, in cases where the qualification for the benefits of freedom of establishment is not in doubt, i.e. in cases where the company is thought to exist under all potentially applicable laws, but the problem arises from a positive conflict of applicable laws, i.e. there are more than one laws that could apply to a particular issue, nationality is not a useful term. It means nothing and it adds nothing.

At that stage, any analogy with natural persons is not useful. Issues relating to which national law should govern the rights of minority shareholders, the extent of the directors' fiduciary duties and the liability for breach thereof etc cannot be resolved by mere reference to nationality. Unlike natural persons, companies are further divided into different groups with different interests. Managers and shareholders have different interests. Equally, majority and minority shareholders have different interests. Then, of course, there are institutional investors who, as shareholders, can exercise a great deal of influence on managers and keep them under some sort of control.

Therefore, as far as internal disputes are concerned, it appears more appropriate to preclude reliance on freedom of establishment. The reason is that the rights that are invoked by these parties are not rights of the company in reality. Of course, the company is affected by these disputes, but the truth of the matter is that the company is not the beneficiary of the rights that are accorded to managers or shareholders. If one takes this view, it becomes clear that the application of a law other than the *lex incorporationis* to an internal dispute is not a restriction to freedom of establishment. It does not deter the

company from moving. It might deter the managers, but they are not covered by freedom of establishment in their own right.

Conversely, the analogy with natural persons is drawn much more meaningfully in relation to the cross-border move of a company. It has been persuasively argued, even before *Cartesio*, that the compulsory liquidation of a company that wishes to emigrate is contrary to freedom of establishment, in the same way that natural persons cannot be killed by their Member State of origin when emigrating to another Member State.<sup>430</sup> Based on the same analogy, it has been argued that a company should not have a right against its Member State of origin to cease to be governed by its law while preserving its legal identity, in the same way that a Greek national cannot lose his nationality by the mere fact that, at some stage, he acquires French nationality.<sup>431</sup>

This begs the question of the merit of speaking of corporate freedom of establishment in terms of nationality. Unlike companies, for natural persons loss of nationality does not affect their existence. This shows how inappropriate a comparison with natural persons can be. Companies should not have nationality for the purposes of private international law, in the same way that contracts do not have nationality either. A company is something between a person and a contract. It is established through a contract, but in certain jurisdiction it can even have criminal responsibility.

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<sup>430</sup> FM Mucciarelli, 'Company "Emigration" and EC Freedom of Establishment: *Daily Mail Revisited*' (2008) 9 EBOR 267, 296-297.

<sup>431</sup> *ibid* 302.

Therefore, it might be helpful to say that an analogy to natural persons can be drawn perhaps only as far as the existence or nullity of companies is concerned. In relation to other issues that come under freedom of establishment, it is probably better to think of a company as a nexus of contracts among different classes of patrons (shareholders, creditors, employees et al),<sup>432</sup> despite the fact that article 48 EC puts legal and natural persons on the same footing. The fact that different laws could be applied to it by different courts should not engage freedom of establishment, in the same way that the application of a different law on a contract of sale of goods cannot engage the free movement of goods.

Therefore, both the aforementioned approaches to the interplay of private international law and freedom of establishment (binary and unitary approach) are unsuitable for claims that are concerned with the existence of the company and other claims of the sort that are contemplated in article 22(2) of the Brussels Regulation.<sup>433</sup> The reason is best illustrated by the case where a judgment obtained in the Member State of the real seat declaring the nullity of the corporation is brought for recognition and enforcement to the Member State of incorporation. Setting aside the fact that the Brussels Regulation mandates that the judgment be recognised provided that certain conditions are met, it would be otherwise futile for the courts of the Member

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<sup>432</sup> S Lombardo, 'Conflict of Law Rules in Company Law after *Überseering*: An Economic and Comparative Analysis of the Allocation of Policy Competence in the European Union' (2003) 4 EBOR 301, 314; the term 'nexus of contracts' has been developed in US literature on the basis of RH Coase, 'The Nature of the Firm' [1937] *Economica* 386.

<sup>433</sup> See pp 63 *et seq.*

State of the real seat to insist that the company in question is null and void, if the courts of the Member State of incorporation are willing to keep the company in the register.

Ideally it should be only for the courts of the Member State of incorporation to declare the nullity of a company. With regard to the applicable law, there is an argument to be made in favour of the *lex incorporationis*. If the a company is incorporated under the laws of a Member State and has its registered office there, it would be a breach of freedom of establishment to declare it null by applying another national law. The basis of this conclusion is analysed below.<sup>434</sup>

Free movement of capital. In certain situations contemplated above, where there is a dispute between the managers and the shareholders, the invocation of freedom of establishment may be unhelpful. This does not mean that no fundamental freedom is engaged. With regard to the latter,<sup>435</sup> what appears to be detrimental for shareholders is beneficial for managers and *vice versa*. However, one may argue free movement of capital confers benefits only to shareholders. It would thus appear plausible that an application of Dutch law in this case as the *lex incorporationis* would constitute a restriction to free movement of capital. To hold otherwise might discourage investors from Hungary to become shareholders in Dutch companies.

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<sup>434</sup> See pp 156 *et seq.*

<sup>435</sup> See to this effect *Überseering* (n191) [77].

Is it, therefore, desirable for a distinction to be drawn between cases that concern freedom of establishment and free movement of capital? If the response is affirmative, actions brought by the company against directors should be considered under freedom of establishment. By contrast, actions brought by minority shareholders against the company and/ or its directors should be reviewed under the latter freedom. It should be stated, however, that it is not the purpose of this thesis to explore this last possibility.

### **E. Reaction of Member States to a ruling of incompatibility**

The reaction to *Überseering* was that courts in civil law jurisdictions abandoned the real seat theory.<sup>436</sup> The reaction to *Grunkin & Paul* remains to be seen. It should be made explicit though that whenever the Court hands down a ruling in a case involving a private international law rule and finds a violation of the Treaty, it is not necessary for the Member State to change the choice of law rule. This course of action is of course open to the Member State, but it should not feel bound to act so.

AG Sharpston has rightfully pointed out that Germany is not required to alter its choice of law rule with regard to names and surnames.<sup>437</sup> After all, the incompatibility did not arise from the choice of law rule, but rather from substantive German family law. This means that Member States are required to shape their substantive national law in a way to recognise and accommodate for the solutions that other Member States have given or will

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<sup>436</sup> See pp 85 *et seq.*

<sup>437</sup> Opinion of AG Sharpston (n391) [91].

give to the same matter. This stance is inspired by the new general principle that the ECJ is evolving, i.e. the principle of mutual trust and confidence.<sup>438</sup>

It may be the case though that harmonisation of private international law in the domain of company law would be convenient. What would not be desirable though is a complete harmonisation of company law. The possibility of having different corporate law regimes adds to the diversity of legal systems of Europe. It allows businessmen and companies to choose the legal order that suits their purposes best. Differences in corporate law regimes are a necessary requirement for regulatory competition that can potentially improve the quality of European company law as it did in the United States.<sup>439</sup>

Concluding this section, it should be borne in mind that *Grunkin & Paul* clearly shows that in cases involving national private international law rules, where the ECJ has found a violation of the Treaty, the declaration of incompatibility does not concern the choice of law rule itself but its effect. This means that it has been erroneous to suggest that the ECJ in *Überseering* abolished the real seat theory or made it untenable.<sup>440</sup>

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<sup>438</sup> See e.g. Case C-292/05 *Lechouritou* [2007] ECR I-1519 [44]; Case C-159/02 *Turner v Grovit* [2004] I-3565 [28]; Case C-116/02 *Erich Gasser GmbH* [2003] I-14693 [72].

<sup>439</sup> J Armour, 'Who Should Make Corporate Law? EC Legislation versus Regulatory Competition' (2005) 58 CLP 369; R Romano, *The Genius of American Corporate Law* (1<sup>st</sup> edn AEI Press, Washington DC 1993).

<sup>440</sup> See e.g. H Eidenmüller, 'Free Choice in International Company Insolvency Law in Europe' (2005) 6 EBOR 423, 425; M Gelter, 'The structure of regulatory competition in European corporate law' (2005) 5 JCLS 247.

## ***VII. Cartesio: the real seat theory revisited***

*Cartesio* is the latest of a long series of cases decided by the ECJ in the field of freedom of establishment. It deals with two issues: first, the ability of an appellate court to submit a reference for a preliminary ruling when it hears cases coming from the courts below when they sit in their capacity as registers for companies; and second, the relationship between the real seat theory, *Daily Mail*, *Überseering* and freedom of establishment. In a nutshell, the Court in *Cartesio* reaffirmed *Daily Mail* and declared that the application of the real seat theory does not constitute *per se* a restriction to freedom of establishment.

### **A. The facts of the case**

*Cartesio* is a company established in Baja, Hungary, under Hungarian law in 2004. In 2005, it sought to transfer its *székhely*, i.e. its statutory and real seat,<sup>441</sup> to Italy while retaining Hungarian law as its *lex societatis*.<sup>442</sup> Its relevant application to the Regional Court of Bács-Kiskun was rejected on the basis that such transfers are not possible under Hungarian law without the prior dissolution and winding-up of the Hungarian company.<sup>443</sup> On appeal, the Szeged Court of Appeal submitted a reference for a preliminary ruling

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<sup>441</sup> V Korom & P Metzinger, 'Freedom of Establishment for Companies: the European Court of Justice confirms and refines its *Daily Mail* Decision in the *Cartesio* Case C-210/06' (2009) 6 ECFR 125, 135

<sup>442</sup> It should be noted that, according to Hungarian private international law, the law applicable to a legal person is the law of the State in which it is registered. It was a requirement of Hungarian company law, at that time, that the real seat of a Hungarian company should be located at the statutory seat. Law LXI of 2007 has redefined *székhely* as statutory seat and has allowed Hungarian companies to move their real seat out of Hungary. See *Cartesio* (n426) [17] & [20]; Korom & Metzinger (n441) 141-144, 158-159.

<sup>443</sup> *Cartesio* (n426) [102]-[103].

asking three questions concerning its capacity to submit such a reference under article 234 EC and one question on freedom of establishment. In particular, it asked whether articles 43 and 48 EC are to be interpreted as to preclude such transfers.

## **B. The ruling of the ECJ**

The ECJ held that as Community law now stands, articles 43 EC and 48 EC are to be interpreted as not precluding Hungarian legislation under which Cartesio was incorporated from prohibiting the transfer of its seat to Italy whilst retaining its status as a company governed by Hungarian law.<sup>444</sup> In reaching this conclusion, the Court reaffirmed its ruling in *Daily Mail* and, in particular, the famous dictum according to which corporations are creatures of national law and exist only by virtue of the national legislation which determines their incorporation and functioning.<sup>445</sup> *Überseering* was confined to its facts. It only requires Member States to recognise that legal personality is governed by the *lex incorporationis*, restrictions upon which will have to satisfy the *Gebhard* test.<sup>446</sup>

The Court held that in this type of case there is a preliminary question to be asked, namely whether the corporation in question may be entitled to rely on article 43 EC.<sup>447</sup> It then ruled that Member States are free to select the connecting factor according to which a company will be considered as

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<sup>444</sup> *ibid* [124].

<sup>445</sup> *ibid* [104].

<sup>446</sup> *ibid* [107].

<sup>447</sup> *ibid* [109].

incorporated in its jurisdiction and that such quality is retained.<sup>448</sup> The Court recognised the capacity of Member States ‘not to permit a company governed by its law to retain that status if it intends to reorganise itself in another Member State by moving its seat to the territory of the latter’.<sup>449</sup>

As one might have expected, the Court then articulated the limits of this open ended statement. The current case, in which a company seeks to retain its governing law despite the relocation of its real seat, is different from the case in which a company seeks to transfer its real seat and convert to a corporate form governed by the law of the host Member State.<sup>450</sup> In this latter case, any requirement of prior winding-up and liquidation imposed by the Member State of origin will be considered a restriction to freedom of establishment that will have to be justified under the *Gebhard* test.<sup>451</sup>

With regard to this particular point, the Commission pointed out that the absence of a convention between Member States on this matter has now been remedied by other Regulations that allow cross-border corporate formations bypassing any national requirement of prior winding-up and liquidation.<sup>452</sup> It is the same kind of argument that was relied upon by Commissioner McCreevy so as to halt legislative process on the 14<sup>th</sup> Directive

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<sup>448</sup> *ibid* [110].

<sup>449</sup> *ibid*.

<sup>450</sup> *ibid* [112].

<sup>451</sup> *ibid* [113]; see also to same the effect Mucciarelli (n430) 296-298.

<sup>452</sup> *ibid* [115].

concerning the cross-border transfers of registered offices.<sup>453</sup> The Court referred only to Regulation 2137/85 on the European Economic Interest Grouping, the SE Regulation and Regulation 1435/03 on the European Cooperative Society as examples of Community measures that provide the means for cross-border corporate formations.

No matter how convenient these measures may be to those who wish to create cross-border corporate formations and relocations, the truth remains, the Court pointed out, that it still remains impossible to transfer the real seat to another Member State and retain the original *lex societatis*.<sup>454</sup> All these Community measures, with the exception of the Cross-border Mergers Directive abide by the fundamental civilian idea that statutory and real seat should coincide at the same location.

Finally, the Court dealt with the proposition advanced by Cartesio, namely that Hungary should be precluded from objecting to the transfer of its real seat to Italy without prior winding-up and liquidation in the same way that in *Sevic* Germany was precluded from objecting to the merger between a German and a Luxembourgian company. In its usual opaque style, the ECJ distinguished *Sevic* from the case at hand stating that cross-border mergers are ‘fundamentally different’. It appears that the Court thought that *Sevic* was a case in which the Member State of origin/ incorporation was required to

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<sup>453</sup> See text to n1111.

<sup>454</sup> *Cartesio* (n426) [117].

recognise an ‘establishment operation’ performed by *Sevic* in another Member State.<sup>455</sup>

There is an important significant taxonomic aspect of *Cartesio* which deserves heightened attention. In *Überseering* and *Inspire Art* the Court delineated the boundaries of *Daily Mail* as a case that concerns outbound corporate mobility. In *Sevic* AG Tizzano casts doubt on the rationale and survival of *Daily Mail*. These considerations were echoed both in legal scholarship<sup>456</sup> as well as in judicial opinion.<sup>457</sup> The Grand Chamber of the Court was not convinced by the proposition that *Daily Mail* is inconsistent with freedom of establishment, insofar as it allows Member States to block cross-border mobility of companies that have been incorporated under their laws.

Instead, the Court in *Cartesio* clarified that two types of case need to be distinguished, namely the *Sevic* type of case and the *Cartesio* type of case. Under the first category, the relevant question is whether the corporation in question –which is governed by the law of a Member State– is faced with a restriction to its freedom of establishment.<sup>458</sup> Under the second category, the pertinent question is whether the company in question is a national of the

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<sup>455</sup> *ibid* [122]

<sup>456</sup> Ringe (n252).

<sup>457</sup> Opinion of AG Maduro in *Cartesio* (n426) [28].

<sup>458</sup> *ibid* [123].

Member State under whose legislation it has been incorporated, and is thus entitled to invoke the benefits of freedom of establishment.<sup>459</sup>

### **C. Commentary to the ruling**

*Cartesio* is going to be a landmark case. It concerns three fundamental aspects of freedom of establishment for corporations. First, the distinction between inbound and outbound cases is preserved. Second, the ability of Member States to apply to real seat theory is explicitly confirmed. Third, it cuts down *Daily Mail* in relation to outbound cases, which result in the assumption of legal personality in the Member State of destination. It is worth noting that, rather surprisingly, the Hungarian Government was joined by the Polish, Slovenian, UK and Irish Governments.<sup>460</sup>

One might have expected that the Irish and the UK Governments would be on the side of *Cartesio*. As far as the UK is concerned, it was the defence of *Daily Mail* that prompted this reaction. The UK Government argued that there are no good reasons to overrule *Daily Mail*, whereas there are good reasons not to do so.<sup>461</sup> The fact that the seat of a company must be situated within the jurisdiction is a requirement that needs to be fulfilled for a company to be established under Hungarian law and is in no way prohibiting *Cartesio* from carrying on business in Italy.<sup>462</sup> Both Ireland and the UK submitted that there are other effective means to transfer of a company's seat

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<sup>459</sup> *ibid* [109].

<sup>460</sup> Opinion of AG Maduro (n457) [24].

<sup>461</sup> Korom & Metzinger (n441) 133.

<sup>462</sup> *ibid* 133-134.

and the Court should let the matter to be decided by the Commission and the Member States.<sup>463</sup>

*Cartesio* was joined only by the Commission and the Dutch Government. It is important to note that the Commission first noted the increasing amount of complaints it has been receiving from companies over the past few years with regard to the length of proceedings that were necessary for the seat to be moved.<sup>464</sup> It then urged the Court to acknowledge that 20 years had passed since the delivery of its judgment in *Daily Mail* and that since then EC law had moved on.<sup>465</sup> The Commission argued that in the recent years the Court had examined issues of corporate mobility only from the host Member State's aspect and that it was time to extend the principles developed in the *Centros* line of cases to the 'exit' type of cases.<sup>466</sup>

***i) Inbound and outbound cases***

*Cartesio* begs the question as to where the Grand Chamber of the ECJ has left the status of the law in the field of freedom of establishment in December 2008. There is a fundamental dichotomy to be made between inbound and outbound cases. *Centros*, *Überseering*, *Inspire Art* and *Sevic* deal with the first, whereas *Daily Mail* and *Cartesio* concern the latter. Member States are at large to select the private international law they see fit to govern corporations in both types of cases.

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<sup>463</sup> *ibid.*

<sup>464</sup> *ibid* 131.

<sup>465</sup> *ibid* 132.

<sup>466</sup> *ibid.*

It is worth noting though that AG Maduro was unpersuaded of the merit of this distinction. He concluded that neither *Centros* nor *Überseering* or *Inspire Art* have been convincing as to their rationale.<sup>467</sup> In fact, he found that in these cases the Court had actually departed from *Daily Mail* itself, where the Court had held that ‘the Member State of origin is prohibited from hindering the establishment in another Member State of one of its nationals or a company incorporated under its legislation’. AG Maduro agreed with AG Tizzano in *Sevic* that article 43 EC prohibits any type of restriction regardless of whether the case is an inbound or outbound one.<sup>468</sup> The Court though has not been sympathetic to this view.

According to the Court’s rulings, in inbound cases, the effects that the *lex causae* will have on a corporation will be scrutinised under the *Gebhard* test, if its application is thought to constitute a restriction on freedom of establishment. In outbound cases, *Cartesio* has qualified *Daily Mail* so as to address the common perception that the latter recognised an unlimited authority of Member States over companies incorporated under their laws. If the company wishes to be subjected to the company law regime of the host Member State and convert to one of the latter’s corporate forms, it will be a restriction to freedom of establishment for the Member State of origin to require the winding-up and liquidation of the company in question before the transfer is performed.

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<sup>467</sup> Opinion of AG Maduro (n457) [28].

<sup>468</sup> *ibid*; Opinion of AG Tizzano (n377) [45].

*Cartesio* has thus expanded the normative content of *Überseering* with regard to the justification of restrictions into the field of outbound cases. However, this distinction that the Court has drawn between cases where the transfer leads to the assumption of new legal personality and cases where it does not has been characterised as unconvincing. For several authors, once a company has satisfied the requirements of article 48 EC, it should qualify for the benefits of freedom of establishment until its dissolution, regardless of where it positions its registered office, central management or principal place of business.<sup>469</sup>

In discarding both the Opinion of AG Maduro and the relevant scholarship on this point, the Court appears to abide by a bargain approach to incorporations. If a company has chosen to incorporate in a jurisdiction that applies the real seat theory and its company law forbids the transfer of the real seat abroad without the prior dissolution and liquidation of the company; so be it. The Court will only interfere to thwart the jurisdiction of the State of incorporation if it is using its power to prevent a transfer that will lead to the assumption of legal personality under the laws of the host Member State.

Simultaneously, *Cartesio* is distinguished from *Überseering* in the sense that it concerns the capacity of the State of incorporation to regulate the exit of companies incorporated under its law. By contrast, *Überseering* dealt with a case in which the company has been incorporated in another Member State, namely the Netherlands. It is thus evident that the real

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<sup>469</sup> M Szydło 'Case C-210/06 *Cartesio* [2008] ECR (not yet reported)' (case note) (2009) 46 CML Rev 703, 717-719.

distinction is not between inbound and outbound cases, but between cases in which the company in question has been incorporated in the Member State against which the breach of freedom of establishment is alleged and is thus a national of that Member State (*Cartesio* type of case), and cases in which it has been incorporated in a Member State other than the one in which it seeks to create an establishment (*Überseering* type of case).

This demonstrates that freedom of establishment cases are underpinned by a question of nationality.<sup>470</sup> *Cartesio* signifies an important conceptual innovation for the jurisprudence of the Court. Although in *Daily Mail* the Court had distinguished companies from natural persons and had referred to them as creatures of national company law<sup>471</sup> and it repeated that statement in *Cartesio*,<sup>472</sup> in the latter case the Court has also used the term nationality for the first time in relation to companies.<sup>473</sup>

One can only wonder what exactly the content of this term can be in this particular text. Reference to French private international law doctrine demonstrates that nationality in this context is a reference to the national law which governs a corporation. If this analogy with natural persons is taken to its logical end, one can contemplate the possibility of a company having two

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<sup>470</sup> See pp 143-147.

<sup>471</sup> See text to n178.

<sup>472</sup> *Cartesio* (n426) [104].

<sup>473</sup> *ibid* [123]; cf the analogy with natural persons at [109].

or more nationalities. The details of this analogy have been examined above.<sup>474</sup>

In this context, the Court made the following extremely crucial statement:

...in the absence of a uniform Community law definition of the companies which may enjoy the right of establishment on the basis of a single connecting factor determining the national law applicable to a company, the question whether Article 43 EC applies to a company which seeks to rely on the fundamental freedom enshrined in that article – like the question whether a natural person is a national of a Member State, hence entitled to enjoy that freedom – is a preliminary matter which, as Community law now stands, can only be resolved by the applicable national law. In consequence, the question whether the company is faced with a restriction on the freedom of establishment, within the meaning of Article 43 EC, can arise only if it has been established, in the light of the conditions laid down in Article 48 EC, that the company actually has a right to that freedom.<sup>475</sup>

Although it is clear that the Court is willing to make use of the private international law tool of an incidental question,<sup>476</sup> it does not make it clear, however, which State's private international law rules will be called for application. If one were to compare *Überseering* with paragraph 109 of the judgment in *Cartesio*, one can very easily wonder about the reasons that led the ECJ in that case to look at the issue of whether *Überseering* qualified for the benefits of freedom of establishment through the eyes of Dutch law. Why is it that the fact that under German law *Überseering* did not have legal personality, suffice to place it outside freedom of establishment?

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<sup>474</sup> See text between n433 and n434.

<sup>475</sup> *Cartesio* (n426) [109].

<sup>476</sup> M Menjucq, '*Cartesio Oktató és Szolgáltató bt*' (case note) [2009] JCP G 10026, 10027.

It appears though that in both *Überseering* and *Cartesio* the Court looked into the private international law rules of the Member State under whose law the company has been incorporated. There can be only one logical explanation to this puzzle. Article 48 EC states clearly that for a company to enjoy the benefits of freedom of establishment two requirements need to be satisfied. First, the registered office, the real seat or the principal place of business should be located in a Member State. Second, the company must be incorporated under the laws of a Member State.

Therefore, whenever nationality or legal personality becomes an issue, the Court will look into the private international law rules of the Member State that satisfies both requirements. In *Cartesio*, Italian nationality could not be established by reference to any connecting factor. The company was established under Hungarian law and had both its registered office and its real seat in Hungary. Despite the fact that in *Überseering* the company had its real seat in Germany, it had not been incorporated under German law. *Überseering* had been established under Dutch law and had its registered office in the Netherlands. This, however, did not preclude the application of German law. It only meant that the case for the finding of a restriction would be stronger. It is clear from *Daily Mail* and *Cartesio* that the Member State of incorporation has a greater degree of discretion in the way it treats its corporations. Thus, States enjoy different degrees of discretion in inbound and outbound cases.

Finally, *Cartesio* is also significant in another respect. If the UK exit charges appear clearly incompatible with freedom of establishment. In *Daily*

*Mail* and *Cartesio*, both outbound cases, the Court clarified that a Member State cannot hinder the establishment in another Member State of a company incorporated under its legislation. Exit charges are not a negation of establishment. A company is allowed to move its central management and control out of the UK. However, it is deemed to have sold its business and is taxed according to the market value of its UK assets. Since it is not a requirement of UK tax law that companies incorporated in the UK have their central management and control in the UK, exit charges lie clearly outside the scope of *Cartesio*. Exit charges are clearly a disproportionate restriction to freedom of establishment. There is no reason as to why the prohibition of exit charges on natural persons<sup>477</sup> should also be extended to corporations.

***ii) The survival of the real seat theory***

*Cartesio* is also significant for sanctioning the survival of the real seat theory.

In the wording of the Court,

...a Member 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.<sup>478</sup>

There is nothing to preclude a Member State from applying the real seat theory to both questions addressed in this extract. Hence insofar as the application of the real seat theory does not lead to the negation of the legal personality that another Member State has granted to a corporation by

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<sup>477</sup> *de Lasteyrie du Saillant* (n225); Case C-470/04 *N* [2006] ECR I-7409

<sup>478</sup> *Cartesio* (n426) [110].

virtue of the fact that it has incorporated under the laws of the latter, the *lex sedis* can be applied on an equal footing with the *lex incorporationis*. Indeed, one can easily imagine cases where the application of a law other than the *lex incorporationis* would not be objectionable, exactly because the *lex sedis* provisions are more enabling or less detrimental than those of the *lex incorporationis*.

There is, of course, an argument to be made that since *Cartesio* concerns an outbound type of case, the revival of the real seat theory is confined in these limits. However, the ECJ has made the relevant statement in a very general way that, taken together with the ruling in *Grunkin & Paul*, can be reasonably interpreted to cover both inbound and outbound cases. Alternatively, if one adheres to the view that the distinction between inbound and outbound cases is artificial, it is clear that the judicial pronouncement on the real seat theory covers both types of cases.

Therefore, *Cartesio* proves wrong all those who alleged that the real seat theory is contrary to freedom of establishment.<sup>479</sup> The question whether the ECJ took the right decision in *Cartesio* policy wise is a different one. It will be addressed in the chapter below, where AG Maduro's Opinion is presented.<sup>480</sup> In a very interesting Opinion, which merits individual attention, AG Maduro recommended a significant change in the law.

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<sup>479</sup> See pp 85 *et seq.*

<sup>480</sup> See pp 85 *et seq.*

## 9. Letter-box companies: hunting witches in European Company law

There is some indication that an anti-letter-box<sup>481</sup> company policy is taking roots in European Company law. In some instances several European institutions have made explicit their willingness to take action against letter-box companies. It appears that the pro-letter-box company considerations that led to the delivery of the judgment in *Centros* and *Inspire Art* have actually now been replaced by a letter-box company phobia.

It all started with the strong opposition of trade unions to the first draft of the Services Directive, which was thought to encourage the use of letter-box companies. The final text of the Directive seeks to restrict access of letter-box companies to the benefits of freedom of establishment. This anti-letter-box company policy has also been recently adopted by the ECJ. In three occasions so far, the ECJ has denounced letter-box or brass plate companies.<sup>482</sup> This is in stark contrast with the unsympathetic view the Court and AG Alber took in *Inspire Art*<sup>483</sup> with regard to the argument that the Dutch WFBV provisions were a lawful measure against the said kind of companies.

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<sup>481</sup> The term 'letter-box company' is ascribed to companies that do not retain any connection with their State of incorporation, other than a mere letter-box. This is the core meaning of the term. As it will be shown below, the limits of the term are not clear.

<sup>482</sup> Case C-341/04 *Eurofood IFSC* [2006] ECR I-3813 [35]; Case C-196/04 *Cadbury Schweppes* [2006] ECR I-7995 [68]; Case C-73/06 *Planzer Luxembourg* [2007] ECR I-5655 [62].

<sup>483</sup> Case C-167/01 *Inspire Art* [2003] ECR I-10155 [102]-[103]; Opinion of AG Alber in *Inspire Art* [122]-[123].

This chapter will present the new European anti- letter-box policy and explain the reasons for which this policy came into existence. It will then seek to predict the impact that this new policy will have in regulatory competition in the EU and question the merit behind the said policy.

## ***I. The new regime for corporate mobility under the Services Directive***

### **A. The political background of the Services Directive**

On 12<sup>th</sup> December 2006, the European Parliament and the Council of the European Union enacted a directive dealing with the provision of services in the internal market (hereinafter ‘Services Directive’).<sup>484</sup> This adoption marked a compromise between the European Commission and the European Parliament on what could possibly be characterised as the most controversial directive ever. Never before had a directive attracted so much public attention, as on 14<sup>th</sup> February 2005, 30,000 trade unionists from all over Europe rallied outside the European Parliament in Strasbourg in order to demonstrate their opposition to the political incentives of the Services Directive.<sup>485</sup>

All this might shed light as to why the Court has distanced itself from the clear pro-letter-box companies approach it had taken in *Centros* and *Inspire Art*. *Centros* was heavily criticised in the consultations prior to the

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<sup>484</sup> European Parliament and Council Directive 2006/123 on services in the internal market [2006] OJ L376/36.

<sup>485</sup> N Watt, ‘Unions protest as EU debates “plumbers” rule’ *Guardian* (London 15 February 2005) <<http://www.guardian.co.uk/eu/story/0,1710002,00.html>> accessed 13 December 2009.

adoption of the Services Directive.<sup>486</sup> The Court was probably mindful both of the severe criticism directed against its ruling in *Centros* and the massive demonstrations that took place outside the European institutions for the first time in such great numbers.

In order to understand fully the role that the Services Directive will play in this field, attention must be paid to the circumstances and policies that led to its drafting and adoption at a time when the European Commission was realising that some Member States markets were not as open and competitive as other markets.

## **B. The Lisbon Strategy**

The origins of the Services Directive can be traced back to the Lisbon European Council, which decided that ‘the Union has today set itself **a new strategic goal** for the next decade: *to become the most competitive and dynamic knowledge-based economy in the world capable of sustainable economic growth with more and better jobs and greater social cohesion*’.<sup>487</sup> The European Council went on to remark that: ‘Rapid work is required in order to complete the internal market in certain sectors and to improve under-performance in others in order to ensure the interests of business and consumers’.<sup>488</sup>

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<sup>486</sup> See text to n526.

<sup>487</sup> Presidency Conclusions at para 5 (Lisbon European Council, 23 & 24 March 2000) <[http://www.europarl.europa.eu/summits/lis1\\_en.htm](http://www.europarl.europa.eu/summits/lis1_en.htm)> accessed 13 December 2009.

<sup>488</sup> *ibid* at [16].

In compliance with this request the Commission conducted a survey in order to examine the legal and non-legal barriers imposed by Member States to the provision of services and assess their impact.<sup>489</sup> The report showed that companies could face a number of difficulties when providing a service in another Member State. These could include *inter alia* quotas or *numerus clausus* rules,<sup>490</sup> territorial restrictions, nationality and residence requirements, minimum capital requirements and authorisation and registration procedures.<sup>491</sup>

The Commission concluded that: '[c]ross-border establishment, which plays an important role for service providers, needs to be facilitated by removing unnecessary administrative burdens and reducing red tape.'<sup>492</sup> Almost two years later, the Commission proposed a directive that would resolve these issues and enhance the competitiveness of EU economy.

### **C. The content of the Services Directive**

The Services Directive presents several points of interest to corporate mobility in the internal market. First, with regard to its field of application, it covers services supplied by providers established in a Member State.<sup>493</sup> It does not apply to any of the activities listed in article 2(2), namely financial

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<sup>489</sup> Commission (EC), 'The State of the Internal Market for Services' (Report to the Council and the European Parliament) COM (2002) 441 final, 30 July 2002.

<sup>490</sup> For example, national regulations stipulating there may be only one provider of chimney sweeping services per district or per commune.

<sup>491</sup> State of the Internal Market Report (n489) 15-22.

<sup>492</sup> *ibid* 70.

<sup>493</sup> Services Directive 2006/123 art 2(1).

services, electronic communications services, transport, temporary work agencies, and healthcare, gambling, audiovisual, private security and social services.

This actually limits the field of application to services that are traditionally provided by small and medium sized enterprises (SME). These include management consultancy, certification and testing, facilities management including office maintenance, advertising, recruitment services, commercial agents, legal and fiscal advice, real estate services, construction, the services of architects, the distributive trades, the organisation of trade fairs, car rental, travel agents, tour guides, tourism and leisure services, sports centres and amusement parks, and, to the extent that they are not excluded as part of healthcare, household services such as support for the elderly.<sup>494</sup>

Second, it concerns service providers that are incorporated in a Member State and have their registered office, central administration or principal place of business within the Community.<sup>495</sup> It endorses the definition of establishment as provided by ECJ case law to include only ‘actual pursuit of an economic activity through a fixed establishment for an indefinite period of time’.<sup>496</sup> It also adds that ‘a mere letter box does not constitute an establishment’.<sup>497</sup>

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<sup>494</sup> Services Directive 2006/123 recital 33.

<sup>495</sup> *ibid* recital 36.

<sup>496</sup> *ibid* recital 37.

<sup>497</sup> *ibid*.

Third, the Directive also provides as a general rule that Member States should in principle abstain from subjecting the provision of services to prior authorisation.<sup>498</sup> In particular, article 14 explicitly prohibits Member States from imposing any nationality or residence requirements on service providers; requesting the existence of an establishment in one State only; requiring service providers to choose between a primary and secondary establishment; making the grant of authorisation to provide a service dependent on economic tests that would prove an economic need or a market demand. Authorisation can be required only if justified by ‘overriding reason related to public interest’.<sup>499</sup> The Directive further places a total prohibition on ‘discriminatory requirements based directly or indirectly... on the location of the registered office’.<sup>500</sup>

Finally, with regard to free movement of services, article 16 guarantees the right of service providers to access the market of a Member State other than the one in which they are established. It also allows for restrictions to this rule based only on ‘public policy public security, public health or the protection of the environment’.

It is evident from the handbook on the implementation of the Services Directive issued by the Commission that the Directive, to a large extent, is

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<sup>498</sup> *ibid* arts 9-13.

<sup>499</sup> *ibid* art 10(2)(b).

<sup>500</sup> *ibid* art 14(1).

nothing more than a codification of the existing ECJ case law.<sup>501</sup> *Centros* lies behind the total prohibition of restrictions on the freedom of service providers to choose between a primary and a secondary establishment and in particular have their principal establishment in the territory of the host Member State.<sup>502</sup> *Überseering*<sup>503</sup> is codified in article 14(1).<sup>504</sup> However, the content of the ECJ ruling with regard to minimum share capital as a means for providing security to creditors in *Inspire Art*<sup>505</sup> was not included in article 14 on prohibited requirements but in article 15(2)(c) on requirements that need to be evaluated by Member States and maintained only if they are justified by public interest.<sup>506</sup>

One of the most important changes introduced by the Directive is related to the limitations to the freedom of provision of services. Unlike article 15(3) on restrictions to freedom of establishment, article 16(1)(b) provides that all requirements of access to the market must be non discriminatory and justified for reasons of public policy, public security, public health and protection of the environment.

Thus the Directive seems to prevent Member States from taking measures that are discriminatory on grounds of nationality but justified by

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<sup>501</sup> Commission (EC), 'Handbook on Implementation of the Services Directive' pp 38-43 <[http://ec.europa.eu/internal\\_market/services/services-dir/proposal\\_en.htm#handbook](http://ec.europa.eu/internal_market/services/services-dir/proposal_en.htm#handbook)> accessed 13 December 2009.

<sup>502</sup> *ibid* 40 text to n78; Services Directive 2006/123 art 14(3).

<sup>503</sup> Case C-208/00 *Überseering* [2002] ECR I-9919.

<sup>504</sup> Commission Handbook (n501) 39 text to n75.

<sup>505</sup> Case C-167/01 *Inspire Art Ltd* [2003] ECR I-10155.

<sup>506</sup> Commission Handbook (n501) 46 text to n95.

public policy, public security and public health, which is a possibility conferred to Member States by the Treaty by virtue of articles 55 and 46(1) EC. It also seems to prevent Member States from placing requirements that are non-discriminatory but justified by mandatory requirements or overriding reasons relating to the public interest.<sup>507</sup>

The essence of this argument is to ask the question whether the Directive is trying to reduce the possibility for Member States to take measures against service providers who come within the ambit of its scope. This could well be the case as it is evident from juxtaposing articles 14-15 and 16 of the Directive. The first two explicitly recognise mandatory requirements as 'overriding reasons related to public interest' whereas the third does not. It only refers to public policy, public security, public health and protection of the environment.<sup>508</sup>

If this were indeed the case, this particular provision of the Directive would be illegal as it is not for Community institutions to reduce the grounds for derogations that the ECJ has interpreted the Treaty to provide. These provisions have to be read in tune with Treaty provisions. In fact, mandatory requirements were read in article 49 EC<sup>509</sup> and there is nothing to prevent the

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<sup>507</sup> G Davies, 'The Services Directive: extending the country of origin principle, and reforming public administration' (2007) 32 EL Rev 232, 235.

<sup>508</sup> *ibid* 236.

<sup>509</sup> Case C-279/80 *Webb* [1981] ECR 3305 [17]; Case C-180/89 *Commission v Italy* [1991] ECR I-709 [17]; Case C-198/89 *Commission v Greece* [1991] ECR I-727 [18]; Case C-76/90 *Säger* [1991] ECR I-4221 [15]; Case C-43/93 *Vander Elst* [1994] ECR I-3803 [16]; Case C-272/94 *Guiot* [1996] ECR I-1905; *Arblade* (n532) [33]-[34]; G Davies, 'Can Selling Arrangements be Harmonised?' (2005) 30 EL Rev 370, 376-377.

ECJ from doing the same with the Directive.<sup>510</sup> However, article 16(1)(b) should be contrary to the Treaty and thus illegal to the extent that a non-discriminatory measure justified by overriding reasons relating to the public interest, but not by public policy, or public security, public health or the protection of the environment, is allowed by the Treaty but prohibited by the Directive. To hold otherwise would be tantamount to usurpation of the competence of Member States to revise the Treaties.

In order to understand the changes that the Services Directive sought to bring, it is necessary to examine briefly the political and legal context in which it was drafted and put to a vote. In doing so, it will be necessary to present the Commission's proposal, the latter's ideology and understanding of the internal market for services and the grave reactions it caused.

#### **D. The Commission Proposal for a directive on services in the internal market**

According to the Commission's proposal, the Directive would 'establish a general legal framework... to all economic activities involving services'.<sup>511</sup> In doing so it would require Member States to remove obstacles that might hamper the cross border provision of services. Thus it was not meant to be a harmonisation measure but a framework directive.<sup>512</sup> The proposal was divided in two parts, one dealing with freedom of establishment and the other with the free movement of services. Articles 14 and 16 required Member

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<sup>510</sup> Davies (n507).

<sup>511</sup> Commission (EC), 'Proposal for a Directive of the European Parliament and of the Council on services in the internal market' COM (2004) 2 final/3, 5 March 2004, p 8.

<sup>512</sup> *ibid.*

States to abstain from taking measures that would discriminate against service providers established in other Member States.

In particular, article 16 provided that only the Member State of origin should supervise service providers. The host Member State should *inter alia* abstain from obliging a provider to have an establishment in its territory; obliging providers to make declarations concerning their registration in professional bodies in the Member State of origin; requiring providers to comply with requirements, relating to the exercise of a service activity; and obliging the provider to possess an identity requirement issued by the Member State of origin with regard to the exercise of a service activity.

The thrust of the Directive would be the adoption of the ‘country of origin’ principle. The latter would subject, with exceptions, service providers only to the law of the Member State in which they are established.<sup>513</sup> With regard to its legal effects, the proposal had some academic support. Basedow argued that the principle of mutual recognition embedded in articles 28 and 49 EC ‘has the characteristics of a conflict rule: it subjects a case to the substantive law of the country of origin of the goods or services’.<sup>514</sup> He added that the rules of the host Member State could apply only if they were more favourable to the intracommunity trade of goods and services.<sup>515</sup> In other words, articles 28 and 49 EC require the implementation of the law which is

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<sup>513</sup> *ibid* 9.

<sup>514</sup> J Basedow, ‘Der kollisionsrechtliche Gehalt der Produktfreiheiten im europäischen Binnenmarkt: favor offerentis’ (1995) 59 *RabelsZ* 1, 54.

<sup>515</sup> *ibid*.

more favourable to cross border mobility of goods and services (*favor offerentis*). Consequently, private international law rules of the host Member State should only be implemented if their application could be justified under the doctrine of mandatory requirements.<sup>516</sup>

A similar yet more modest argument, without a *favor offerentis* reservation, had been already put forward by Radicati di Brozolo. He had argued that the presumption of article 4(2) of the 1980 Rome Convention on the law applicable to contractual obligations <sup>517</sup> (hereinafter ‘Rome Convention’) is evidence of the assumption that the law of the country of origin should govern the contracts of provision of services.<sup>518</sup> It is thus possible that the application of another law could impose restrictions on the free movement of services.

However, the propositions advanced by Radicati di Brozolo and all the more so Basedow have confused the mechanism of choice of law with the consequences of the applicable law that will be designated by this mechanism. It is not necessarily the former that would be thought to contravene the Treaty, but the normative context of the *lex causae*. After all, article 48 EC does not contain a choice in favour of the incorporation theory,

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<sup>516</sup> *ibid.*

<sup>517</sup> [1998] OJ C27/34.

<sup>518</sup> LG Radicati di Brozolo, ‘L’influence sur les conflits de lois des principes de droit communautaire en matière de liberté de circulation’ (1993) 82 RCDIP 401, 410-415.

or any other connecting factor for that matter, and neither has the Court made such a choice.<sup>519</sup>

The strongest argument against Basedow's approach is that he takes a very narrow understanding of what the benefits to the intra-Community provision of services are. This approach tends to accord privileges to service providers at the expense of other market actors, e.g. consumers. This is not at all required by Treaty law or ECJ case law. Quite the contrary, measures in favour of consumers, such as the application of a law other than the law of the state of origin, do not necessarily restrict free movement of services. They are not restrictions of the Community policy on the provision of services but a valid part of it.<sup>520</sup>

One way or the other, it may be well argued that the Commission's proposal accommodated to some extent the views of Basedow and Radicati di Brozolo. Despite the subsequent amendments, the Directive still embodies the principle that once service providers satisfy requirements for the provision of a specific service in their country of origin, other Member States are, *prima facie*, required to admit the provision of services in their territory without imposing any further requirements.<sup>521</sup> It was this aspect of the proposal that provoked most of the reactions, as will be shown in the following section.

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<sup>519</sup> J Wouters, 'Private International Law and Companies' Freedom of Establishment' (2001) 2 EBOR 101, 116, 120.

<sup>520</sup> M Wilderspin & X Lewis, 'Les relations entre droit communautaire et les règles de conflit de lois des États membres' (2002) 91 RCDIP 1, 18-23.

<sup>521</sup> A Malatesta, 'Principio dello Stato di origine e norme di conflitto dopo la Direttiva 2006/123/CE sui servizi nel mercato interno: Una partita finita?' (2007) 43 RDIPP 293, 300.

## **E. The reaction to the Commission's proposal**

The proposal soon was met with great disapproval by a politically heterogeneous group of people. European left wingers and trade unions were openly against the adoption of this directive that was thought to promote social dumping in Europe.<sup>522</sup>

Not surprisingly, these political groups were joined by that part of the European right wing that wishes to reduce the extent of EU legislative initiatives. The far right wing Independence/ Democracy Group Member of the European Parliament, Philippe de Villiers, took the side of those opposing the Directive. He spoke of the 'Polish plumber' effect that the Directive would promote and characterised the Directive as a 'lie'.<sup>523</sup>

The Commission did not only have to face the reaction of several political groups within Parliament, but also had to confront the reaction of national Governments who could not afford the political cost of the Directive. France, Denmark, Sweden, Germany and Belgium reacted to the Directive requesting that changes be made.<sup>524</sup>

The European Council decided that the proposal did not meet the standards of the European social model. It further requested that a broad

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<sup>522</sup> C Bremner, 'Chirac has subdued Bolkestein's monster- but he's not safe yet' *The Times* (London 24 March 2005)  
<<http://www.timesonline.co.uk/tol/news/world/europe/article435675.ece>> accessed 13 December 2009.

<sup>523</sup> G Perrault, 'Villiers: La nouvelle directive Bolkestein est un mensonge' *Le Figaro* (Paris 16 February 2006)  
<[http://www.lefigaro.fr/france/20060216.FIGooooooooo11\\_villiers\\_la\\_nouvelle\\_directive\\_bolkestein\\_est\\_un\\_mensonge.html](http://www.lefigaro.fr/france/20060216.FIGooooooooo11_villiers_la_nouvelle_directive_bolkestein_est_un_mensonge.html)> accessed 13 December 2009.

<sup>524</sup> —, 'EU agrees to reform services plan' (BBC News 23 March 2005)  
<<http://news.bbc.co.uk/1/hi/world/europe/4374007.stm>> accessed 13 December 2009.

consensus be secured in order to promote both a social model and a fully operational internal market.<sup>525</sup> Part of the reaction against the Directive was concerned with letter-box companies, i.e. companies that are incorporated in one Member State but activate exclusively or almost exclusively outside that State.

One of the arguments put forward against the Directive was related to *Centros*. It was thought that the ruling of the ECJ in this latter case allowed for the spreading of letter-box companies in Europe. In turn, this subsequently lead to temporary employment agencies being established in one Member State, engaging workers from another Member State to work in a third Member State. In the late 1990s there was traffic of construction workers from the UK to Germany through letter-box companies incorporated in the Netherlands.<sup>526</sup>

The expansion of this phenomenon came to be seen as a threat by trade unions. They took the view that the Directive would create a 'race to the bottom' for letter-box companies in favour of jurisdictions where labour law is less employee friendly than other Member States and where collective

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<sup>525</sup> Presidency Conclusions [22] (Brussels European Council, 22 & 23 March 2005) <[http://europa.eu/european\\_council/conclusions/index\\_en.htm](http://europa.eu/european_council/conclusions/index_en.htm)> accessed 13 December 2009.

<sup>526</sup> Niklas Bruun in Rapporteur Evelyne Gebhardt, Consolidated Proceedings of the Public Hearing on the Proposal for a Directive on Services in the Internal Market (European Parliament, Brussels, 11 November 2004) pp 100-101 <[http://www.europarl.europa.eu/comparl/imco/services\\_directive/default\\_en.htm](http://www.europarl.europa.eu/comparl/imco/services_directive/default_en.htm)> accessed 13 December 2009.

agreements guarantee lower minimum remuneration with regard to other Member States.<sup>527</sup>

The secretary of the European Trade Union Confederation (hereinafter ‘ETUC’) illustrated the problems that the Directive would create in the example of a Polish letter-box company that would engage Polish or Ukrainian employees to work in Belgium on a long term basis.<sup>528</sup> Under the Rome Convention regime, the parties could choose Polish or Ukrainian law to govern the contract of employment. However, Belgian mandatory rules –e.g. Belgian collective agreements on minimum wages- would apply by virtue of articles 6(1) and 6(2)(a) of the Rome Convention. International mandatory rules of Belgium could also be given effect through article 7 of the said Convention.

The ETUC thought that the ‘country of origin’ principle, if enacted as it were, would preclude the application of Belgian law. Employment relationships would be thus governed by Polish law, or Ukrainian law, if this is what the parties chose. This is even clearer if the employee does not offer his services habitually in one place, but he is moved around Europe. Under

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<sup>527</sup> For indications of such a race see Case C-438/05 *The International Transport Workers’ Federation and the Finnish Seamen’s Union* [2007] ECR I-10779 and Case C-341/05 *Laval un Partneri* [2007] ECR I-11767. Both these cases were concerned with industrial action taken against companies established in a Member State other than the one in which they wished to exercise their activities. In both cases, the companies in question sought to avoid the application of the national minimum wage rules on the State in which the employees offered their services. In the former case, this was done by seeking to enlist a Finnish vessel in the Estonian register. In the latter, a Latvian company posted workers hired in Latvia to a construction site in Sweden.

<sup>528</sup> Catelene Passchier in Rapporteur Evelyne Gebhardt, Consolidated Proceedings of the Public Hearing on the Proposal for a Directive on Services in the Internal Market (European Parliament, Brussels, 11 November 2004) pp 110-111 <[http://www.europarl.europa.eu/comparl/imco/services\\_directive/default\\_en.htm](http://www.europarl.europa.eu/comparl/imco/services_directive/default_en.htm)> accessed 13 December 2009.

article 6(2)(b) of the Rome Convention Polish law would apply because the company, even though a letter-box one, would be deemed to be established in Poland.

This was the argument presented by the trade unionists despite the fact that article 17(5) of the proposal explicitly excluded matters covered by Directive 91/76/EC relating to posting of workers (hereinafter ‘Posting Directive’).<sup>529</sup> Trade unions thought that the country of origin principle denied the protection accorded to temporary posted workers when the workers are employees of service providers.<sup>530</sup> In their eyes, the Services Directive would disturb the balance between employees’ rights and employers’ interests struck by the *acquis communautaire*.

With regard to posting of workers the *acquis* consisted of three principles recognised by ECJ case law:<sup>531</sup> namely that (a) service providers may move from one Member State to another with their own personnel without having to satisfy any additional administrative requirements related to immigration or labour market regulations; (b) service providers may be required to comply with host Member State legislative requirements on minimum wages and other working conditions; and (c) service providers may not be required to comply with the entirety of host Member State social security legislation with regard to workers who actually enjoy a similar level

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<sup>529</sup> European Parliament and Council Directive 96/71/EC concerning the posting of workers in the framework of the provision of services [1997] OJ L18/1.

<sup>530</sup> Brunn (n526) 90.

<sup>531</sup> V Hatzopoulos & TU Do, ‘The case-law of the ECJ concerning the Free Provision of Services: 2000-2003’ (2006) 43 CML Rev 923, 972-973.

of protection in the Member State of establishment, unless such compliance significantly improves their protection.<sup>532</sup>

Thus the consequences the Services Directive might have on collective agreements became a serious concern. In the past few years though, the ECJ showed some willingness to place limits on the rule that a company should respect the rules of the host Member State on minimum wages. It admitted that there might be circumstances where the application of such rules ‘would be neither necessary nor proportionate’.<sup>533</sup> Despite this, it was still thought that some collective agreements might not qualify as ‘universally applicable’ in the sense of articles 3(1) and 8 of the Posting Directive and consequently be overridden by the country of origin principle.<sup>534</sup>

On 16 February 2006 the European Parliament conducted the first reading of the proposal introducing several amendments. Some of the most significant ones, for the purposes of this thesis, were *inter alia* the definition of place of establishment to the exclusion of letter-box installations in recital 41, the exclusion of private international law rules and labour law from the field of application of the Directive in articles 3(2) and 1(7) respectively and the new title of article 16, which changed from ‘country of origin principle’ to ‘effectiveness of supervision’.<sup>535</sup> The Commission accepted these amendments

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<sup>532</sup> Joined Cases C-62 & 63/81 *Seco v EVI* [1982] ECR 223; Case C-113/89 *Rush Portuguesa* [1990] ECR I-1417; *Vander Elst* (n509); Joined Cases C-369 & 376/96 *Arblade* [1999] ECR I-8453.

<sup>533</sup> Case C-165/98 *Mazzoleni* [2001] ECR I-2189 [30].

<sup>534</sup> Brunn (n526) 91.

<sup>535</sup> Position of the European Parliament adopted at first reading on 16 February 2006 <<http://www.europarl.europa.eu/omk/omnsapir.so/doclegcons3?FILE=WORD&VL=EN&YEA>

and also altered the title of article 16 from ‘effectiveness of supervision’ to ‘freedom to provide services’.<sup>536</sup>

#### **F. The consequences of the Services Directive on letter-box companies**

The following example may illustrate the changes that the Services Directive (setting aside the doctrine of abuse for a moment) will bring upon the expiry of its transposition period on 28<sup>th</sup> December 2009. A corporation like Centros Ltd, Überseering BV or Inspire Art Ltd will not qualify as ‘provider’ under the Services Directive.<sup>537</sup> However, this does not deprive them entirely their right to move throughout the Internal Market. While they still enjoy the rights conferred under freedom of establishment and free movement of services by Treaty, Member States can take proportionate measures against them. In doing so they may rely both on public policy, public safety, public health etc considerations, if the measures are discriminatory, and on mandatory requirements, in case such measures apply indistinctly.

One may validly ask whether this Directive is actually taking action against letter-box companies. The answer is probably negative. On the one hand, discriminatory measures are very hard to justify and are taken only in exceptional circumstances. On the other, the ECJ applies a very stringent proportionality test to all non-discriminatory measures that leaves little room

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[R=2004&NUM=0001&DOC=EP-PE\\_TC1-COD\(2004\)0001&LNG=EN](#)> accessed 13 December 2009.

<sup>536</sup> Commission (EC), ‘Amended Proposal for a Directive of the European Parliament and of the Council on services in the internal market’ COM (2006) 160 final, 4 April 2006.

<sup>537</sup> Services Directive 2006/123 articles 4(2) and 4(5) and recital 37.

for manoeuvre to Member States. All the Services Directive does is to exclude letter-box companies from the benefits of articles 9-14, in particular the prevention of prior authorisation schemes.

However, since the content of the Directive is a mere codification of existing ECJ case law, letter-box companies can still derive the same benefits through the way the ECJ interprets the relevant Treaty articles. In this sense, the exclusion of letter-box companies from the scope of the Directive is more of a political show than legal substance.

The reason though that nothing seems to be done against letter-box companies might lie elsewhere. The Directive is economically liberal.<sup>538</sup> It came to remove barriers and to improve the position of SME in the internal market.<sup>539</sup> The Commission explicitly stated that:

This Directive will establish a clear and balanced legal framework aiming to facilitate the conditions for establishment and cross-border service provision. It will be based on a mix of mutual recognition, administrative cooperation, harmonisation where strictly necessary and encouragement of European codes of conduct/professional rules.<sup>540</sup>

SME are the beneficiaries of freedom to provide services. While large corporations use freedom of establishment to incorporate subsidiaries in each jurisdiction they wish to activate, SME cannot usually afford this luxury.<sup>541</sup> The Commission's proposal came to remedy this situation contrary to the

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<sup>538</sup> Davies (n507) 245.

<sup>539</sup> Commission proposal (n511) p 12.

<sup>540</sup> Commission (EC), 'Internal Market Strategy - Priorities 2003-2006' COM (2003) 238, 7 May 2005.

<sup>541</sup> State of the Internal Market Report (n492).

predictions of certain scholars that Member States will react to *Centros* and its progeny by legislating at a Community level. These scholars neglected that the real seat theory was scrutinised by the ECJ in a period of regression of the European economy that the Commission sought to redress through the promotion of mobility of SME. This policy will be given effect through the removal of all barriers that would prevent SME from being established in one Member State and activating, even exclusively, in another. The extent to which this will not encourage a Delaware effect will depend largely on taxation policies of Member States and the harmonisation of company law in Europe. In any event, it will be interesting though to see the way in which Member States will transpose article 14(1) of the Directive in domestic law.<sup>542</sup>

## ***II. Letter-box companies: post- Centros development of the doctrine of abuse***

If it will be indeed the case that the Services Directive will not have a serious impact on letter-box companies, it still needs to be examined whether the use of such corporate vehicles will actually be impaired by the recent pronouncements of the ECJ directed against letter-box companies. In *Eurofood* the Court held that the presumption that the centre of main interests of a company for the purposes of the Insolvency Regulation will lie at the place where the registered office is located can be rebutted in favour of another place if the debtor is a letter-box company.<sup>543</sup>

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<sup>542</sup> The ECJ has ruled that Directives cannot be effectively transposed through national case-law: Joined Cases C-178/94, 179/94, 188/94, 189/94 & 190/94 *Dillenkofer and others v Bundesrepublik Deutschland* [1996] ECR I-4845 [66]-[68]; Case C-144/99 *Commission v Netherlands* [2001] ECR I-3541 [21].

<sup>543</sup> *Eurofood* (n482); see text to n778.

In *Planzer Luxembourg* the Court held that letter-box companies are fictitious establishments and as such cannot qualify for the benefits of the Thirteenth VAT Directive. The Court went on to say that article 1(1) of the Thirteenth Directive must be interpreted ‘as meaning that the place of a company’s business is the place where the essential decisions concerning its general management are taken and where the functions of its central administration are exercised’.<sup>544</sup> The most significant of these cases is *Cadbury Schweppes* where the Court appeared to be revisiting the doctrine of abuse.

### **A. Cadbury Schweppes**

On 12 September 2006 and exactly 3 months before the promulgation of the Services Directive on 12 December 2006, the Grand Chamber of the Court delivered its judgment in a case that elaborated the doctrine of abuse in the context of taxation law.<sup>545</sup> *Cadbury Schweppes* was a case concerning the taxation of Cadbury Schweppes Overseas by the UK in respect of the profits made in 1996 by Cadbury Schweppes Treasury International, a subsidiary of the Cadbury Schweppes group established in the International Financial Services Center in Dublin, Ireland. The Court was asked to decide whether freedom of establishment precludes national tax legislation which provides under certain conditions for the imposition of a charge upon the parent company on the profits made by a controlled foreign company.

The Grand Chamber did not actually decide the matter. It only provided the referring court with the tools to make the right decision. The

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<sup>544</sup> *Planzer Luxembourg* (n482).

<sup>545</sup> Case C-196/04 *Cadbury Schweppes & Cadbury Schweppes Overseas* [2006] ECR I-7995.

Court confirmed that the abuse test has two limbs, one objective and one subjective. The subjective element of wishing to evade provisions of national law that would normally apply to the individual is not enough *per se* to constitute an abuse.<sup>546</sup> Objective circumstances should confirm that despite formal observance of Community law the objective pursued by freedom of establishment has not been achieved.<sup>547</sup>

The Court made it clear that there can be no abuse if incorporation reflects economic reality.<sup>548</sup> On the other hand, relying on its previous case-law,<sup>549</sup> *inter alia Centros* itself, it declared that ‘incorporation **must** correspond with an actual establishment intended to carry on genuine economic activities in the host Member State’ (emphasis added).<sup>550</sup> It concluded that the finding that a corporation should qualify as a letter-box company should be ‘based on objective factors which are ascertainable by third parties with regard, in particular, to the extent to which the controlled foreign company physically exists in terms of premises, staff and equipment’.<sup>551</sup>

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<sup>546</sup> *ibid* [64].

<sup>547</sup> *ibid*.

<sup>548</sup> *ibid* [65].

<sup>549</sup> Case C-436/00 *X and Y* [2002] ECR I-10829; Case C-2/74 *Reyners* [1974] ECR 631; Case C-55/94 *Gebhard* [1995] ECR I-4165; Case C-221/89 *Factortame and Others* [1991] ECR I-3905; Case C-246/89 *Commission v United Kingdom* [1991] ECR I-4585.

<sup>550</sup> *Cadbury Schweppes* (n545) [66].

<sup>551</sup> *ibid* [67].

It is very strange that the Court, in making this statement, chose to rely on *Centros*, even indirectly.<sup>552</sup> In fact the Court in *Centros* did not make any reference to the pursuit of an actual economic activity. One would be inclined to say that if *Centros* had been followed in *Cadbury Schweppes* then there was nothing that could be wrong with the establishment in Ireland. *Centros Ltd* was the paradigm letter-box company. It had no contact whatsoever with the UK, except for its incorporation there. It is, therefore, plain that the Court in *Cadbury Schweppes* was actually inaccurate in relying on *Centros* in support of the proposition that letter-box companies are prone to be characterised as wholly artificial arrangements.

This may lead to three possible conclusions. First, *Centros* has to be narrowed to its facts, namely to the evasion of minimum capital requirements. Second, *Cadbury Schweppes* has altered the application of the doctrine of abuse in the sphere of company law by qualifying *Centros*. Third, *Cadbury Schweppes* has not affected or qualified *Centros*, because in *Centros* there was an establishment in Denmark. In *Cadbury Schweppes* though, the Irish subsidiary had no real establishment in Ireland or in any other Member State. The first proposition is not entirely implausible given that one may very reasonably wish to doubt that minimum capital requirements actually serve any realistic purpose.<sup>553</sup> The second view was taken by AG Maduro in *Cartesio*.<sup>554</sup>

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<sup>552</sup> *ibid* [66] & [52].

<sup>553</sup> See text to n577.

<sup>554</sup> See pp 188 *et seq.*

The third proposition deserves individual attention. It relies on the fact that in *Centros* the Court appears to be inconsistent in its treatment of the company. Sometimes it refers to the company itself and some other times to the Danish nationals who set it up. If England did not choose to take action against *Centros*, the argument goes, then no other Member State should be entitled to do so. The reason is that the establishment that is being created in Denmark is a real one. Thus Denmark should be precluded from objecting to it. By contrast, in *Cadbury Schweppes* it is likely that the Irish subsidiary did not have a real establishment anywhere in the Community. The UK sought to restrict freedom of establishment of the English mother company who established the Irish subsidiary. In doing so, it objected to an alleged abusive practice of its own nationals.

There is considerable force in this argument. It takes a very pragmatic approach. In *Centros* the primary establishment is in reality in Denmark and the secondary one in England. In *Cadbury Schweppes* it appears that there is no real establishment. However, it, first, seems to neglect that the terms 'primary' and 'secondary' establishment are not meant to reflect economic reality. Rather they connote priority in time. Incorporation is always the primary establishment. Any subsequent establishment is a secondary one. Second, it confuses the true meaning of the doctrine of abuse. The latter is a mechanism that exists for the benefit of any Member State other than the one in which the alleged abuse takes place. Its very purpose is to restrict the use of abusive mechanisms that are tolerated by other Member States.

Therefore, if *Centros* and *Cadbury Schweppes* are read together, a Member State can take proportionate measures against its nationals, both natural and legal persons, both when they seek to set up an artificial arrangement in another Member State (*Cadbury Schweppes*) and when this artificial arrangement subsequently seeks to set up an establishment in the Member State of its founders (*Centros*). It is clear from *TV10* that U-constructions are abusive.<sup>555</sup> In both scenarios the Court applied the doctrine of abuse. The definition that was given to the term ‘establishment’ in *Cadbury Schweppes* also extends to cover the *Centros* type of case.

### **B. *Cartesio*: the Opinion of AG Maduro**

*Cartesio* was a case concerning a company incorporated under the laws of Hungary that wished to move its registered office to Italy while still retaining its capacity as a Hungarian company governed by Hungarian law.<sup>556</sup> In his Opinion AG Maduro in *Cartesio* argued in favour of a significant change in the law.<sup>557</sup> It can be summarised as a proposition to narrow the scope of *Centros* by excluding letter-box companies from the scope of freedom of establishment. He thus suggested the enlargement of the scope of the doctrine of abuse and the incorporation of *Daily Mail* within it. In such a way he would discard the distinction between inbound and outbound cases, as enunciated in *Überseering*. Instead, a Member State, either the Member State of incorporation or the Member State in which the corporation seeks to

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<sup>555</sup> See pp 199 *et seq.*

<sup>556</sup> Case C-210/06 *Cartesio* [2008] ECR (not published yet); [2009] 1 CMLR 50.

<sup>557</sup> *ibid.*

activate, could restrict the said company's freedom of establishment, subject to a proportionality review. His analysis can be divided in two parts.

First, he surveyed the case-law concerning the distinction between inbound and outbound cases. Second, based on the assumption that *Daily Mail* was no longer good law –at least in the way it had been interpreted thus far- he sought to construe the law in an efficient and reasonable manner that would be consistent with the Treaty. In doing so, he revisited the doctrine of abuse as established in *Centros* and *Inspire Art*. He relied on *Cadbury Schweppes* to declare that companies that are 'wholly artificial arrangements, which do not reflect economic reality' and are aimed at circumventing national legislation<sup>558</sup> should be excluded from the scope of freedom of establishment.<sup>559</sup>

In his view, *Cadbury Schweppes* in particular had qualified the doctrine of abuse, as pronounced in *Centros*, although it would still be applied with restraint by the Court.<sup>560</sup> Thus the doctrine of abuse should be enlarged to cover companies like *Centros Ltd* and other letter-box companies. In this context, he sought to draw the line between the rights conferred to companies under freedom of establishment and the prerogatives of Member States. In doing so he pointed out two significant factors. First, Member States are free to adopt any choice of law rule for corporations, even the real

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<sup>558</sup> *Cadbury Schweppes* (n482) [51]-[55].

<sup>559</sup> Opinion of AG Maduro in *Cartesio* (n556) [29].

<sup>560</sup> *ibid.*

seat theory.<sup>561</sup> Second, there should be some degree of mutual recognition between States that adhere to the real seat theory and the incorporation theory respectively.<sup>562</sup> Consequently, neither of the two theories should be applied *in extremis*.<sup>563</sup> No Member State has been granted a ‘carte-blanche’ with respect to corporations, even the ones it considers its nationals.<sup>564</sup>

This proposition he thought to be beneficial for SME. The transfer of the headquarters to another Member State, like the one Cartesio tried to perform, can be a very cost-effective means of taking up genuine economic activities in another Member State, which should not be obstructed.<sup>565</sup> However, Member States, especially the Member State of origin, may be able on certain occasions to make the transfer subject to certain conditions being satisfied.<sup>566</sup> This subjection to prior proportionate conditions that need to be satisfied is analogous to the condition set by HM Treasury on Daily Mail in order to grant leave to move out of the jurisdiction. The paradigm example is that of the State that considers that it will no longer be able to exercise any effective control over the company. It could thus require that the company amends its constitution and ceases to be governed by the full measure of the

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<sup>561</sup> *ibid* [30].

<sup>562</sup> *ibid*.

<sup>563</sup> *ibid*.

<sup>564</sup> *ibid* [31].

<sup>565</sup> *ibid*.

<sup>566</sup> *ibid* [33].

company law under which it was constituted so that is fully governed by the law of the host Member State.<sup>567</sup>

### **C. Evaluation and criticism: what is wrong with letter-box companies?**

#### ***i) The historical links between the real seat theory and the term 'letter-box company'***

Action against letter-box companies is not a new trend. The real seat theory itself was adopted by the French courts towards the end of the 19<sup>th</sup> century for the very purpose of combating the use of English letter-box companies by French businessmen.<sup>568</sup> The real seat theory came as a reaction to the stiff regulatory arbitrage that was taking place between England and France. In the language of the French courts regulatory arbitrage was prompted by the wish to avoid some mandatory rules of French company law concerning '*la souscription du capital, le versement du quart, l'émission et la négociation des actions*'.<sup>569</sup> The *Loi de 24 juillet 1867* and the *Loi de 1 août 1893* introducing criminal sanctions for the breach of these rules would only apply to French companies.<sup>570</sup> Thus, the French courts devised the real seat theory in order to declare as French, companies that were French from every aspect, except for the place of their incorporation. This characterisation would trigger the application of these laws.

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<sup>567</sup> *ibid.*

<sup>568</sup> *Cass civ*, 21.11.1889, (1889) 16 JDI 850; *Cass civ*, 22.12.1896, (1897) 24 JDI 364.

<sup>569</sup> *Trib corr Seine* (10<sup>e</sup> ch), 02.07.1913, *The Moulin-Rouge Attraction Ltd* (1913) 40 JDI 1273.

<sup>570</sup> *Cour de Dijon* (2<sup>e</sup> ch), 24.11.1909, (1910) 37 JDI 892.

Despite the strong reaction of the French courts, there were instances where some scope for private autonomy was recognised. Thus, the court of Lille held that the needs of commerce and the *liberté des conventions* allowed businessmen to incorporate the company '*dans n'importe quel pays*', provided that the establishment of the company is '*sérieux et non fictif*'.<sup>571</sup> It was in this particular context that the concept of abuse and the term 'letter-box company' arose. The French courts soon cleared any doubt as to the extent that businessmen could rely on party autonomy. In relation to Universal Gaz Methane and Buisson Hella Ltd, the criminal court of Paris held that:

...son siège social consistait en un simple carton placé dans l'étude des sollicitors Sims et Syms qui avaient rempli les formalités de constitution de la Société... en fait, c'est à Paris que toutes les affaires ont été traitées et que le siège social à Londres n'a guère servi que de *boîte aux lettres* pour la transmission de toute la correspondance à Paris...<sup>572</sup> (emphasis added)

One can easily see the parallels between *West Canadian* and *Centros*. In both cases the court of Lille and the ECJ declared the liberty of parties to incorporate in any jurisdiction. Both judgments are characterised by a spirit of liberalism, characteristic of Europe both in the years before the outbreak of the First World War and the 2008 crash. In both instances the courts declared the existence of a doctrine of abuse, but found no abuse in the facts of each case.

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<sup>571</sup> *Trib civ Lille* (1<sup>ère</sup> ch), 21.05.1908, *Vanverts c West Canadian Collieries Ltd* (1909) 36 JDI 191, 194.

<sup>572</sup> *Trib corr Seine* (10<sup>e</sup> ch), 27.10.1910, *The Universal Gaz Methane and Buisson Ltd* (1911) 38 JDI 234.

These cases can be contrasted with the *Universal Gaz* and *Cadbury Schweppes*. In both instances, the court of Paris and the ECJ made the same proclamation against letter-box companies. In both instances the courts found that a company can only validly establish itself in another State provided that it maintains there a real establishment, i.e. incorporation in that jurisdiction is a real and natural choice- in the wording of the court of Paris- or it pursues a real economic activity in that State- in the wording of the ECJ.

***ii) The treatment of letter-box companies in the context of freedom of establishment***

The Opinion of AG Maduro encourages some sort of action to be taken against letter-box companies under the abuse doctrine. He takes the view that ‘the right of establishment does not preclude Member States from being wary of “letter box” or “front” companies.’<sup>573</sup> This implies that on certain occasions Member States are allowed to take action against letter-box companies. It is unclear in his Opinion which these circumstances are.

Before plunging into the details of this analysis, it is useful to summarise the core of the dilemma. The court of Lille has done that successfully: ‘l’écueil à éviter était, sous prétexte de protection efficace des intérêts des actionnaires qui savent qu’ils entrent dans une société étrangère, de paralyser toute initiative au point de vue de l’expansion commerciale’.<sup>574</sup> In other words, to the extent that shareholders are aware of the fact that they

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<sup>573</sup> See n559.

<sup>574</sup> *West Canadian* (n571).

are dealing with a foreign company,<sup>575</sup> one should be wary of employing the doctrine of abuse in a manner that upsets economic development.

Would Centros Ltd or another company that just seeks to avoid minimum capital requirements of the Member State in which it seeks to activate satisfy the test? One may well wish to doubt that minimum capital requirements actually provide some real protection to creditors,<sup>576</sup> ‘as a firm’s initial capital is likely to be long gone before it files for bankruptcy’.<sup>577</sup> Even if the initial capital cannot be legally repaid to shareholders, it is still not so significant that it could possibly suffice to satisfy all creditors.

In any event, the question that needs to be answered here is concerned with the definition of a letter-box company. The ECJ has never provided a definition for the term in question. Nor has any other EC institution or national court attempted to define it.<sup>578</sup> The reason probably is that the task of providing such a definition is rather difficult. There is a great deal of distance between a mere letter-box and the real seat. It is not clear where one

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<sup>575</sup> Astonishingly the exact same point is made by the ECJ in *Inspire Art*: see text to n341.

<sup>576</sup> H Halbhuber, ‘National doctrinal structures and European company law’ (2001) CML Rev 1385, 1417.

<sup>577</sup> RR Kraakman et al, *The Anatomy of Corporate Law: A Comparative and Functional Approach* (2<sup>nd</sup> edn OUP, Oxford 2009) 131; Luca Enriques & Martin Gelter, ‘How the Old World Encountered the New One: Regulatory Competition and Cooperation in European Corporate and Bankruptcy Law’ (2007) 81 Tul L Rev 577, 613.

<sup>578</sup> In *Cass comm*, 28.10.2008, *M X* at (Official website of the French Republic for the Diffusion of Law) <<http://www.legifrance.gouv.fr/>> accessed on 13 December 2009, the French *Cour de cassation* actually dealt implicitly with the concept of a letter-box domicile of a natural person. A German national, believing that France is a good place to be a debtor, sought to be declared insolvent in Colmar, a city located in Alsace, a few kilometres behind the Franco-German border. The *Cour de cassation* held that by becoming the sublessee of a 15 m<sup>2</sup> apartment and by remaining there irregularly he had failed to demonstrate that his COMI is located in France, given that he worked in Germany and all of his creditors were German banks.

should draw the line. *West Canadian* is of great assistance in this regard. There should be an abuse ‘quand on aura constitué à l’étranger une Société que *tout* indiquait comme devant être française, et qu’il sera clairement démontré que la Société n’avait *aucune* attache à l’étranger’ (emphasis added).<sup>579</sup> It is beyond doubt though that a company that merely preserves a registered office, which is nothing more than a postal address, should qualify as a letter-box company.<sup>580</sup>

This observation could lead to the reasonable conclusion that any company that does not possess a substantial connection with its jurisdiction of incorporation should be considered a letter-box company. In determining whether there is such a substantial connection between the corporation and the place of incorporation, courts may feel free to hold that any presence of a corporation that falls short of the definition of establishment, as provided by the ECJ and the Services Directive, will be deemed to constitute a letter-box company. Thus, any corporate presence in a jurisdiction that does not actually pursue a real economic activity should be classified as a letter-box company.

Given the consequences that such a classification will have for a corporation, it should be only with a great degree of caution that a court should characterise a corporation as a letter-box company. How compatible

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<sup>579</sup> *West Canadian* (n571).

<sup>580</sup> Empirical research has shown that ‘one of the most frequent addresses used by such companies is “Ground Floor Broadway House, 2-6 Fulham Broadway, Fulham, London SW6 1AA” and that ‘it is the registered office for 23,273 companies’: see M Becht, C Mayer & HF Wagner, ‘Where Do Firms Incorporate? Deregulations and the Cost of Entry’ (2008) 14 J Corp Fin 241, 253.

could this be with regard to the ruling of the ECJ in *Inspire Art*? In this latter case the Court had held that the Dutch WFBV was contrary to freedom of establishment, despite the fact that Inspire Art's only connection with England was its incorporation there. The Court did not respond to the argument made in favour of placing restrictions on the use of brass plate companies. It is evident that the policy against letter-box companies would be an effort to carve limits to the holdings of the ECJ in *Centros* and *Inspire Art*.

If it is a correct interpretation of the law that letter-box companies be excluded from the benefits of freedom of establishment, either via a restrictive definition of establishment or via an expansive interpretation of the doctrine of abuse, one can only wonder how much of the ruling in *Centros* has actually survived. As pointed out earlier,<sup>581</sup> *Centros* lies behind the total prohibition of restrictions on the freedom of service providers to choose between a primary and a secondary establishment and in particular have their principal establishment in the territory of the host Member State. But this is so only with regard to establishments that actually pursue a real economic activity. Therefore, it may well be the case that to the extent to which *Centros Ltd* was a letter-box company, companies of this sort will no longer be able to rely on *Centros*, all the more so if the Services Directive is interpreted in a way to ban letter-box companies completely from freedom of establishment.

It is submitted that it is not the principle of *Centros* that is attacked, but its application to the facts of that particular case. This will be the basis

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<sup>581</sup> See text to n502.

upon confusion will be created about the relation between the meaning of ‘establishment’ and its application of the doctrine of abuse in this particular area of law. The Court in *Cadbury Schweppes*, perhaps foreseeing the advent of the Services Directive held that ‘incorporation must correspond with an actual establishment intended to carry on genuine economic activities in the host Member State’.<sup>582</sup>

According to the Court,

...in order for a restriction on the freedom of establishment to be justified on the ground of prevention of abusive practices, the specific objective of such a restriction must be to prevent conduct involving the creation of wholly artificial arrangements which do not reflect economic reality, with a view to escaping the tax normally due on the profits generated by activities carried out on national territory.<sup>583</sup>

In deciding whether abuse has been committed or not, the Court defined freedom of establishment. The outcome is that on one reading of the judgment letter-box companies lie outside the scope of freedom of establishment. This grammatical reading cannot be correct. The Treaty guarantees freedom of establishment to all companies, regardless of whether they are letter-box companies or not. Thus, letter-box companies are not excluded from freedom of establishment. Neither can the Services Directive be read in such a way as to reach this conclusion.

The aspiration of both that directive and the Court is simply to restrict the *extent* to which letter-box companies can enjoy the benefits of freedom of establishment. Hence, it is impermissible for the courts of a Member State to

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<sup>582</sup> *Cadbury Schweppes* (n482) [66].

<sup>583</sup> *ibid* [55].

disregard entirely the legal personality of a company, even if it is a letter-box company. All it can do is restrict its enjoyment of freedom of establishment under the doctrine of abuse.

One way or the other, it has to be admitted that the reasoning of the Court is problematic. It has sought to refine the doctrine of abuse by reference to the very definition of establishment. It has thus created a circle. The question whether letter-box companies constitute an abuse has become a question of what constitutes an establishment. It is submitted that it would have been preferable for the Court to have applied the doctrine of abuse without reference to the meaning of establishment.

The doctrine of abuse needs to be clarified by the Court on these points. It is submitted that it should be shaped in a way that it is clear that not every evasion of any provision of national law should suffice to constitute an abuse. Particular regard should be paid to the nature of the national provisions in question. It should be ensured that only provisions that are aimed at safeguarding an interest pertaining directly to the State itself, as in the tax cases, can qualify for consideration under the abuse doctrine. Minimum capital requirements and other corporate rules that have a purely internal effect, not affecting the State or the general public, should by themselves not qualify for consideration under the doctrine of abuse.

This would mean that reliance on such internal corporate rules cannot suffice to establish an abuse when the company engages in ordinary commercial transactions such as the sale of commodities. Things should and could be different if the company in question is exercising an activity, which,

albeit private in its nature, affects the State and the general public as a whole. This should be the case for companies who exercise activities that require rigid State supervision.<sup>584</sup> The finding of an abuse is, therefore, a fact driven analysis. 'A general rule that applies irrespective of the concrete facts of each case' will, on all probabilities, constitute an unlawful restriction to freedom of establishment.<sup>585</sup>

#### **D. Revisiting the doctrine of abuse in relation to letter-box companies**

In order to examine how it is possible to refine the doctrine of abuse in relation to letter-box companies, it is necessary to examine the relation between two leading cases in the field of abuse. Identifying the underlying principles of abuse will assist in redefining abuse in a manner which independent of the meaning of establishment.

The reason for which the ECJ felt compelled to find an abuse in *TV10*<sup>586</sup> and not in *Centros* is not entirely clear. *TV10* was a case in which a public limited company had been incorporated in Luxembourg for the purposes of evading Dutch rules on broadcasting that were applicable to Dutch broadcasting companies. The Court found that the Netherlands Government

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<sup>584</sup> This will never become an issue in banking or insurance enterprises, because their registered office and the real seat should actually coincide in the same place. Cf. Opinion of AG Maduro in Case C-210/06 *Cartesio* [2008] ECR (not yet published); [2009] 1 CMLR 50 [33]: 'It might, for instance, be possible for the Member State to consider that it will no longer be able to exercise any effective control over the company and, therefore, to require that the company amends its constitution and ceases to be governed by the full measure of the company law under which it was constituted.'

<sup>585</sup> WG Ringe, 'Sparking regulatory competition in European Company Law: The impact of the *Centros* line of case-law and its concept of abuse of law' in R de la Feria & S Vogenauer (eds), *Prohibition of Abuse of Law- A New General Principle of EU Law* (Hart Publishing, Oxford 2009) (forthcoming).

<sup>586</sup> Case C-23/93 *TV10 v Commissariaat voor de Media* [1994] ECR I-4795.

could rely on the abuse doctrine to justify the characterisation of TV10 as a Dutch broadcasting company for the purposes of subjecting it to the statute governing the provision of radio and television programmes, the *Mediawet*. However, in *Centros* the fact that the company in question had been incorporated in England for the mere and explicit purpose of evading the Danish provisions on minimum capital requirements was not thought to constitute an abuse of Community law.

This contrast shows that the Court draws an implicit line between national rules which come within the core of the freedom in question and thus cannot be imposed upon a migrating company, and the national rules that do not come within this core. Therefore, national rules which actually regulate the exercise of commercial or other activities can be imposed upon a company under the doctrine of abuse, provided that they are suitable and necessary to achieve some legitimate aim.

More specifically, Denmark in *Centros* sought to impose its domestic rules on capital requirements on Centros Ltd. The ECJ understood those rules to come within the core of the freedom. This means that the very purpose of the freedom of establishment is to allow companies to choose that national company law, which is more appropriate for their purposes. In other words, national rules on minimum capital requirements are among the factors that businessmen are meant to be looking at in order to choose the jurisdiction of incorporation. Thus it held that an evasion of minimum capital requirements *per se* does not amount to an abuse of Community law. By contrast, in *TV10* the provisions of the *Mediawet* were meant to regulate the provision of radio

and television broadcasts. Thus they expressed the vested interest of a State in preserving diversity in local media.

A similar line of reasoning can be traced in *Van Binsbergen*.<sup>587</sup> The latter was a case concerning the Dutch provision that prevented a legal representative, with a right of appearing before courts where representation by an *advocaat* is not required, from residing outside the jurisdiction. In that case, the legal representative had moved to Belgium. Under the said provision he could no longer appear as a legal representative before Dutch courts. The ECJ held that the abuse doctrine can be employed against persons who seek to avoid national professional rules of conduct by moving to another State. However, in that particular case, the fact that there was no required qualification for a person to act as a legal representative demonstrated that the evasion of national professional rules would not actually have any consequence for the Netherlands. Thus the Dutch prohibition imposed on legal representatives to reside abroad was held to constitute a measure unsuitable to achieve the otherwise legitimate aim of safeguarding the administration of justice through professional rules of conduct.

What *Van Binsbergen* shows is that the rules in question actually concern the protection of a vested interest the State has in the administration of justice. National professional rules of conduct do not come within the core of the freedom in question, i.e. they are not what a person actually looks at when he or she decides to move to another Member State.

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<sup>587</sup> Case C-33/74 *Van Binsbergen v Bedrijfsvereniging voor de Metaalnijverheid* [1974] ECR 1299.

It is probably not accidental that in both *TV10* and *Van Binsbergen* the rules whose evasion in the former case sufficed to establish an abuse and in the latter came so close in doing so, were actually public law provisions. By contrast, in *Centros* the national rules in question were private law provisions. This does not mean that the evasion of private law rules will never amount to an abuse, but it will be harder to show an abuse in such instances. The reason is probably that private law actually strikes a balance of interests among private parties, whereas public law is meant to pursue interests of whose the State is the direct beneficiary.

This distinction is admittedly a very fine one, and perhaps slightly artificial. However, it remains a plausible explanation for the different conclusions reached by the ECJ in *Centros* and *TV10*. In both cases it is explicit that national rules which were in conformity with EC law, such as the Danish minimum capital requirements and the Dutch provisions of the *Mediawet*, were evaded and that incorporation abroad has taken place for the very purpose of evasion. Therefore, the real reason must be related to the nature of the national rules in question. If this distinction is rejected, it is hard to see what the compelling reason is for the Court to have found in favour of an abuse in *TV10* and against it in *Centros*.

The question to be asked here is: how does this analysis of the doctrine of abuse affect the realm of company and insolvency law, i.e. what are the implications of *Cadbury Schweppes* in relation to letter-box companies. This latter case is about tax evasion, i.e. evasion of public law rules aimed to safeguard interests that pertain to the State itself. It is evident from the

Court's ruling in that case that there is nothing impermissible in selecting the State of incorporation for its low tax rates.<sup>588</sup>

Indeed the Court has held that any advantage resulting from the low taxation to which a subsidiary established in a Member State other than the one in which the parent company was incorporated is subject cannot by itself authorise that Member State to offset that advantage by less favourable tax treatment of the parent company.<sup>589</sup> It has also held that the need to prevent the reduction of tax revenue is not even a matter of overriding general interest which would justify a restriction on a freedom introduced by the Treaty.<sup>590</sup>

What can really make a difference in the justification of a national measure that restricts freedom of establishment is the nature of company in question as a 'wholly artificial arrangement aimed at circumventing the application of the legislation of the Member State in question'.<sup>591</sup> Thus in deciding whether the abuse doctrine can be invoked it is crucial to establish that the aim of the freedom has not been met.

The Court has made it plain that the objective of this particular freedom is to allow a national of a Member State to set up a secondary establishment in another Member State. In doing so, he or she will assist economic and social interpenetration within the Community in the sphere of

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<sup>588</sup> *Cadbury Schweppes* (n545) [49]-[50].

<sup>589</sup> Case C-270/83 *Commission v France* [1986] ECR 273 [21].

<sup>590</sup> Case C-136/00 *Danner* [2002] ECR I-8147 [56]; Case C-422/01 *Skandia and Ramstedt* [2003] ECR I-6817 [53].

<sup>591</sup> *Cadbury Schweppes* (n588) [51].

activities as self-employed persons.<sup>592</sup> ‘To that end, freedom of establishment is intended to allow a Community national to participate, on a stable and continuing basis, in the economic life of a Member State other than his State of origin and to profit therefrom’.<sup>593</sup> In the case of companies, this requires ‘actual establishment of the company concerned in the host Member State and the pursuit of genuine economic activity there’.<sup>594</sup>

The Court then went on to make a statement that probably constitutes a serious blow at the very heart of *Centros*. It held that for the doctrine of abuse to be successfully invoked in order to justify a restriction to freedom of establishment, ‘the specific objective of such a restriction must be to prevent conduct involving the creation of wholly artificial arrangements which do not reflect economic reality’.<sup>595</sup> If minimum capital requirements are to make any sense, they should be viewed a way in which entrepreneurs demonstrate a serious commitment to their project.<sup>596</sup> They could be a suitable measure to prevent the creation of wholly artificial arrangements, albeit it is debatable whether they would be necessary or proportionate. Nonetheless the Court held that the mere evasion of minimum capital requirements is not an

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<sup>592</sup> *ibid* [53]; Case C-2/74 *Reyners* [1974] ECR 631 [21].

<sup>593</sup> *Cadbury Schweppes* (n588); Case C-55/94, *Reinhard Gebhard v Consiglio dell’Ordine degli Avvocati e Procuratori di Milano* [1995] ECR I-4165 [25].

<sup>594</sup> *Cadbury Schweppes* (n588) [54].

<sup>595</sup> *ibid* [55].

<sup>596</sup> See text to n603.

abusive practice. It did not go as far as addressing proportionality as in *Cadbury Schweppes*.<sup>597</sup>

Centros Ltd was a company with no connection with England other than its incorporation there. It was from every aspect a letter-box company. So far as we can tell from the judgment of the Court it pursued no economic activity in England. The relevant commercial activities were meant to be conducted in Denmark. If this is indeed the case it can hardly be seen how *Centros* would be still decided in exactly the same way. It is not the principle of *Centros* that is contested here, but its application to the facts. In light of the observations above,<sup>598</sup> it is submitted that according to *Cadbury Schweppes* Centros Ltd would qualify as a wholly artificial arrangement.<sup>599</sup>

There is a counter-argument that not even *Centros* qualifies as an artificial arrangement, because the ECJ did not hold so back in 1999.<sup>600</sup> It is submitted though that the general perception of artificial arrangements has been slightly modified by the Services Directive and the ruling of the Court in *Cadbury Schweppes*. For the reasons exposed above, it is more accurate to say that Centros would qualify as an artificial arrangement. There is of course another view, according to which the tests in *Centros* and *Cadbury Schweppes* are different.<sup>601</sup> It is submitted though that the test is one and the same. The

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<sup>597</sup> *ibid* [60] *et seq.*

<sup>598</sup> See pp 184-188.

<sup>599</sup> J Vella, 'Sparkling regulatory competition in European Company Law – a response' in de la Feria & Vogenauer (n585).

<sup>600</sup> Ringe (n585).

<sup>601</sup> Vella (n599).

difference in the outcome is caused by the different objectives pursued by the individuals in each of these cases and the nature of the evaded national provision.

The characterisation of a company as an artificial arrangement does not end the inquiry. If Centros Ltd would be classified as a letter-box company, and it is submitted that it should, the critical issue would then be whether the Danish minimum capital requirements would be considered to constitute a proportionate restriction to the freedom of establishment of letter-box companies. Proportionality has a great role to play in this area,<sup>602</sup> especially if one considers that the ECJ in *Centros* could have simply glossed over in its analysis of the abuse doctrine what was in reality a proportionality test. The answer to this question can only be speculated. There are reasons that could warrant both possible conclusions to be reached.

A positive answer to the question posed above could be based on the argument that minimum capital requirements act as ‘a rough-and-steady screening mechanism for the “seriousness” of entrepreneurs, by forcing them to commit a non-trivial amount of money to their project’.<sup>603</sup> Taking into account the three steps of the proportionality test –suitability, necessity, proportionality *stricto sensu*- minimum capital requirements are clearly suitable.

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<sup>602</sup> *ibid.*

<sup>603</sup> RR Kraakman et al, *The Anatomy of Corporate Law: A Comparative and Functional Approach* (2<sup>nd</sup> edn OUP, Oxford 2009) 131; J Hudson, ‘The Limited Liability Company: Success, Failure and Future’ (1989) 161 *Royal Bank of Scotland Rev* 26; H Eidenmüller, B Grunewald & U Noack, ‘Minimum Capital and the System of Legal Capital’ in Marcus Lutter (ed), *Legal Capital in Europe* (Walter de Gruyter, Berlin 2006) 1, 25-27.

Are they necessary though? One could say that it is hard to imagine a less onerous measure than minimum capital, which, although it cannot be repaid to shareholders, it can be used by the company in a productive way. What else could be easier and simpler in avoiding the formation of wholly artificial arrangements than rules on minimum capital? One could anticipate that Member States that are now abolishing their minimum capital requirements will soon face the problem of being unable to rely on them in order to take anti-letter-box companies measures, in case they wish to do so. On the other hand, the States that preserve them may now have more chances in opposing them to letter-box companies.

However, there are two problems with this view. First, it assumes that the prevention of formation of letter-box companies is in itself a mandatory requirement in the public interest. Indeed, there is good reason to believe that the Court would be willing to hold so. The relevant authority would be *Cadbury Schweppes*. However, it is submitted that the Court should not uphold minimum capital requirements as a necessary measure. The major reason is that minimum capital requirements are actually counter-intuitive. They achieve none of the aims they are supposed to pursue.

First, they are generally not of a size appropriate to ensure creditor protection. In fact, they have a negative impact on entrepreneurship and generate few benefits for creditors.<sup>604</sup> It is hard to see how sums ranging from

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<sup>604</sup> J Armour & D Cumming, 'Bankruptcy Law and Entrepreneurship' (2008) 10 ALER 303, 315-316.

2,500<sup>605</sup> to 60,000 euros are enough to protect creditors, especially when a company can incur liabilities that amount to millions. Second, the benefit of demonstrating the seriousness of entrepreneurs in establishing a company in a particular jurisdiction is overridden by the relevant cost. If minimum capital requirements were thought to constitute a necessary measure this would actually mean that entrepreneurs from jurisdictions with minimum capital requirements could no longer incorporate their companies in jurisdictions with no minimum capital requirements. This would place dynamite at the foundations of freedom of establishment and the internal market. The Court has rightfully held in *Centros* that the evasion of minimum capital requirements cannot in and of itself constitute an abuse.

Therefore, believing that the evasion of minimum capital requirements constitutes an abuse actually implies that the formation of letter-box companies is contrary to freedom of establishment. This cannot be the case. The whole purpose of the proportionality test here is not to eradicate letter-box companies. A measure that seeks to eradicate the behaviour which is being restricted is probably by definition disproportionate. The whole point of the proportionality test in this context is to identify the measure that can restrict the use of letter-box companies rather than ban them altogether.

Concluding this point, the *Centros* and *Cadbury Schweppes* test requires two issues still to be addressed. First, it needs to be decided if the company in question is a serious establishment or a letter-box company.

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<sup>605</sup> Minimum capital requirement for privately held companies in Finland. For a survey of minimum capital requirements across Europe see Armour & Cumming (n604) 312-313.

Second, the degree of scrutiny will depend on the outcome of the previous inquiry. If the company is a letter-box company, it will be easier for the Member State to impose a restriction and justify it. If the company is a serious establishment then it will be more difficult for the Member State to impose such a restriction and justify it. Member States that wish to have a better chance of success should seriously consider challenging a letter-box company not on the evasion of company law, but tax law. This might lead to decrease of the *Centros* type of cases and the increase *Cadbury Schweppes* type of cases being brought for adjudication.

Be that as it may, the fundamental premise of the entire abuse doctrine has not been proven yet. Why is it the case that companies should pursue a real economic activity through their establishment? Why should they become part of the economic life of the Member State in which they incorporate? The ECJ appears to ascribe to the old view that a company forms part of the country in which its seat is located, because it is linked with its economy.<sup>606</sup>

However, in case of an investor who buys shares in a company having its registered office in England and its COMI in Germany, he only has himself to blame if English law turns out to be more protective of directors.<sup>607</sup> Likewise, in a case of a creditor who lends capital to such a company, he only

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<sup>606</sup> JP Niboyet, *Traité de droit international privé français* (2nd edn Sirey, Paris 1947) vol II, p 369.

<sup>607</sup> Cf *Salomon v A Salomon & Co* [1897] AC 22 (HL) 53 (Lord MacNaghten): ‘The unsecured creditors of A. Salomon and Company, Limited, may be entitled to sympathy, but they have only themselves to blame for their misfortunes.’

has himself to blame if German law places him at a lower level at the ranking of claims than English law.

To the extent that the company has its registered office in one Member State and its centre of main interests in another, and to the extent that the centre of main interests as a connecting factor for insolvency is there to prevent forum shopping, i.e. an evasion of the law of the country that has the most substantial connection with the insolvency, it is impossible to see what is abusive in establishing the registered office in a Member State in order to avoid the company law of another.

After all, it is the Court itself that held that the finding whether incorporation corresponds with an actual establishment must be based ‘on **objective factors** which are **ascertainable by third parties**’ (emphasis added). In such a manner it actually made the connection with insolvency and the definition of the centre of main interests in the Insolvency Regulation<sup>608</sup> and in *Eurofood*.<sup>609</sup> In that latter case, the ECJ had held that the case for rebutting the presumption of the COMI for companies being located at the registered office is even stronger when the use of criteria which are objective and ascertainable by third parties lead to the conclusion that the debtor is actually a letter-box company. The outcome thus is that in appropriate circumstances, a letter-box company may not be able to rely on

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<sup>608</sup> Council Regulation (EC) 1346/2000 of 29 May 2000 on insolvency proceedings [2000] OJ L160/1.

<sup>609</sup> *Eurofood* (n482) [33]; see text to n775.

the *lex incorporationis* as the *lex societatis* and/ or the *lex fori concursus*, thwarting thus entirely the choice to incorporate in a particular jurisdiction.

Setting aside the argument that third parties are protected under the applicable *lex fori concursus*, *Cartesio* has made it plain that even the protections of the *lex sedis* could be applied to a letter-box company in order to safeguard the interests of these third parties. Frankly, neither the Court nor other EC institutions have furnished a rational basis for justifying restrictions on letter-box companies. One could only wonder whether there is any rational basis for restricting freedom of establishment for letter-box companies. It appears that the law is shaped based more on a phobia of letter-box companies rather than a rational understanding of their function.

## **10. Regulatory competition for corporate charters: Lessons to be drawn from the USA**

Regulatory competition is a term that has been used in US legal scholarship to describe the competition amongst States to attract incorporations of companies in their jurisdiction. This competition for corporate charters is not a recent trend in US corporate law. In the beginning of the 20<sup>th</sup> century, New Jersey was dominating the market of incorporations, until Woodrow Wilson, its Governor at that point, introduced legislation to restrict stock ownership and redefine the business trust.<sup>610</sup> It was then that Delaware emerged and has ever since dominated the market for incorporations for both public and private corporations.<sup>611</sup> Over 40% of companies listed in the New York Stock Exchange and 50% of Fortune 500 firms are incorporated in Delaware.<sup>612</sup>

This chapter will discuss regulatory competition in corporate law (otherwise known as the ‘Delaware effect’) in the USA and will explain the structure of the American market for corporate charters. It will then examine whether there is room for a Delaware effect for corporate charters in the EU.

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<sup>610</sup> R Romano, *The Genius of American Corporate Law* (1<sup>st</sup> edn AEI Press, Washington DC 1993) 42-43; WL Cary, ‘Federalism and Corporate Law: Reflections upon Delaware’ (1974) 83 Yale LJ 663, 664.

<sup>611</sup> R Daines, ‘The Incorporation Choices of IPO Firms’ (2002) 77 NYU L Rev 1559; J Dammann & M Schündeln, ‘Where Are Limited Liability Companies Formed? An Empirical Analysis’ 3rd Annual Conference on Empirical Legal Studies Papers <[http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1126257](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1126257)> accessed 13 December 2009.

<sup>612</sup> C Alva, ‘Delaware and the Market for Corporate Charters: History and Agency’ (1990) 15 Del J Corp L 885, 887.

## ***I. The structure of regulatory competition for corporate charters in the USA***

An enormous amount of literature has been written on the US regulatory competition for corporate charters. It is not the purpose of the present thesis to offer a novel account of the Delaware effect, which has been done thoroughly elsewhere.<sup>613</sup> For the purposes of the present analysis, this thesis will only provide a brief account of the US regulatory competition and the factors that have lead to the predominance of Delaware. It will then be examined whether such factors are present in Europe and whether it would be possible for regulatory competition to emerge in Europe. The reason for looking at the US is that regulatory competition for corporate law has been taking place for the past few decades in a very self-conscious manner. It is the paradigm that scholars have been referring to in order to support the argument in favour of such competition in post-*Centros* Europe.

### **A. The three approaches to the Delaware effect**

There have been three main approaches to the Delaware effect taken by the literature. The first two view the competition as a race, either to the top or to the bottom, but nonetheless a race amongst States. The third approach views the race as a certain equilibrium of regulation between States and the federal government. According to this latter view, regulatory competition has been a great success because the federal government has not thwarted the ability of States to compete.

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<sup>613</sup> See e.g. Romano (n610).

Therefore, while the first two views present a market-based approach to regulatory competition, the third view adopts a politics-based approach. This means that, according to the first two views, the States compete in order to attract incorporations by providing the law that entrepreneurs will like most, be that a good or a bad law. The third approach describes a tension between States and the federal government, which compete for regulating corporate affairs in the most efficient manner. To use a European term, it is a tale of subsidiarity.

### **B. The race to the bottom**

In 1974 the Yale Law Journal published a seminal article, in which a former Chairman of the Securities and Exchange Commission (hereinafter SEC) argued that States adopt legislation that favours managers to the detriment of shareholders in order to attract incorporations.<sup>614</sup> Cary called this a race to the bottom, in which Delaware ‘a pygmy among the 50 states prescribes, interprets, and indeed denigrates national corporate policy as an incentive to encourage incorporation within its borders, thereby increasing its revenue’.<sup>615</sup>

In Cary’s view, Delaware’s primacy is explained by the fact that its corporate law as interpreted by the local judiciary favours managers at the expense of shareholders.<sup>616</sup> Its incentive is the perks, i.e. the franchise fees<sup>617</sup> that it derives annually from the businesses that incorporate in its territory,

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<sup>614</sup> Cary (n610).

<sup>615</sup> *ibid* 701.

<sup>616</sup> *ibid* 668-672.

<sup>617</sup> Franchise fee is tax charged by some US States to corporations formed in those states based on the number of shares they issue or, in some cases, the amount of their assets.

which in 1971 amounted to USD 52 million out of a total of 222 million.<sup>618</sup> The desire to retain business at home and derive the highest possible income from taxation has led the rest of the States to engage in a competition with Delaware. However, Cary argued, in doing so States relax their shareholder protection laws in order to make themselves more appealing to managers. This competition for lax laws Cary has called a race to the bottom. Indeed this low esteem of Delaware's corporate law is reflected in the case-law of other US courts. Delaware law was considered lax and discarded in various cases.<sup>619</sup>

One remedy might be federal incorporation, i.e. the adoption a single corporate law code on a federal level. This would eliminate competition among States. Cary rejected this solution as 'politically unrealistic' with 'no public appeal'. Businessmen 'would unanimously reject such a convenient vehicle for government control of the major industries'.<sup>620</sup> Instead, he argued, it would more efficient to introduce a Federal Corporate Uniformity Act that would contain the minimum requirements that each State corporate statute would have to satisfy.<sup>621</sup>

The race to the bottom is no longer put as robustly as by Cary. Its modern version is still though based on Cary's main criticism, namely that the race increases managerial costs to the detriment of shareholders.<sup>622</sup> A number

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<sup>618</sup> Cary (n610) 668.

<sup>619</sup> See p 74.

<sup>620</sup> Cary (n610) 700.

<sup>621</sup> *ibid* 701-702.

<sup>622</sup> This term implies the costs that arise out of an agency problem. The latter arises whenever the welfare of one party, termed the 'principal' (in this case the shareholders), depends upon

of suggestions have been made for more power to be shifted from managers to shareholders. In particular, it has been proposed that shareholders satisfying some minimum ownership requirements would be able to place on the corporate ballot proposals for changing the charter or state of incorporation.<sup>623</sup> For the time being, this trend assumes that the race has created a body of corporate law which ‘inefficiently benefits managers’<sup>624</sup> over shareholders.<sup>625</sup>

### C. The race to the top

Cary’s thesis provoked a reaction among those who thought that State competition had a positive effect on corporate law. The main thrust of the argument is rather simple. If competition led to the adoption of lax corporate statutes that fail to maximise firm value, lower stock prices would either reduce the ability of the company to raise capital or would make it an easy takeover target.<sup>626</sup> In both case managers would lose their jobs. This undesirable result, the argument goes, would suffice to deter incorporations

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actions taken by another party, termed the ‘agent’ (in this case the managers). In economists’ terms these broad terms capture a greater range of relationships than those that would be characterised as agency by lawyers. For further information on agency problems and legal strategies to resolve them in corporate law, see RR Kraakman et al, *The Anatomy of Corporate Law: A Comparative and Functional Approach* (2<sup>nd</sup> edn OUP, Oxford 2009) pp 35-53; MM Blair & LA Stout, ‘A Team Production Theory of Corporate Law’ (1999) 85 Va L Rev 247, 258-259; *Item Software (UK) Ltd v Fassihi* [2004] EWCA Civ 1244, [2004] BCC 994 (LJ Arden) [66].

<sup>623</sup> LA Bebchuk, ‘The Case for Increasing Shareholder Power’ (2005) 118 Harv LR 833; LA Bebchuk, ‘Letting Shareholders Set the Rules’ (2006) 119 Harv LR 1784.

<sup>624</sup> Dammann & Schündeln (n611) 3.

<sup>625</sup> LA Bebchuk & A Ferrell, ‘Federalism and Corporate Law: The Race to Protect Managers from Takeovers’ (1999) 99 Colum LR 1168; LA Bebchuk, A Cohen & A Ferrell, ‘Does the Evidence Favor State Competition in Corporate Law?’ (2002) 90 CLR 1775.

<sup>626</sup> RK Winter, ‘State Law, Shareholder Protection, and the Theory of the Corporation’ (1977) 6 JLS 251, 275-276.

in jurisdictions that upset the balance of interests between managers and shareholders to the latter's expense. Therefore, States would legislate in a way to avoid this undesirable result. In his criticism of Cary, Winter went even as far as suggesting that the 'problem is not that states compete for charters but that too often they do not'.<sup>627</sup>

Winter's criticism is understood to be based on the assumption that it is shareholders' preferences that determine firms' demand for corporate law. The agency costs between managers and shareholders are minimised by the constraining influence that the differences among markets in which companies operate has on managers.<sup>628</sup> Winter and his followers counter Cary's argument that a harmonising federal corporate law would be beneficial. In their view, there is nothing to suggest that a federal measure would be more efficient than States' legislation.<sup>629</sup>

In its modern version, the supporters of the race to the top sustain that the race is beneficial for the shareholders. Winter's main proposition has survived. It is still maintained that the fear of discouraging investment prevents managers from selecting a legal regime under which they are exculpated from fraud.<sup>630</sup>

According to one of the most significant proponents of the race to the top, the reason that has made American corporate law so efficient and

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<sup>627</sup> RK Winter, 'Foreword' in Romano (n610) xi.

<sup>628</sup> Romano (n613) 15.

<sup>629</sup> *ibid.*

<sup>630</sup> R Romano, 'Empowering Investors: A Market Approach to Securities Regulation' (1998) Yale LJ 2359, 2366.

commercially successful is federalism. The federal government has abstained from regulation in the sphere of corporate law save in exceptional circumstances that required action on a national level. This left the field open for States to enact their own corporate statutes and compete for the attraction of incorporations. The quintessence of the success of American corporate law has been federalism, namely the diversity of legislatures and legal regimes that makes competition possible.<sup>631</sup>

The federal nature of law and politics in the US is intertwined with two crucial characteristics, without which the success of regulatory competition would not have occurred. First, in a state of complete federal regulation of corporate law there would be no incentive for the provision of efficient company statutes. Income from franchise fees is considerable for States, but for the federal government with its multi-billion dollar budget franchise fees are not a high incentive.<sup>632</sup> Second, it is also suggested that in a world of harmonised corporate law there would be no courts whose bench would possess a high level of expertise in company law and that the connections between the bar and the legislature, which are essential for the production of efficient corporate statutes, would be lost. These points will all become way clearer immediately below, where the parameters that have made Delaware so successful will be analysed.

As one might imagine, this view has not been uncontested. Recent empirical studies have shown that other states are not competing to attract

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<sup>631</sup> Romano (n613) 48.

<sup>632</sup> *ibid.*

franchise tax revenue.<sup>633</sup> Nor are they interested in developing good corporate law courts or produce the law that managers and shareholders want, leaving actually Delaware to compete alone.<sup>634</sup>

#### **D. The federal government: the Procrustes of American Corporate Law**

Roe is the major propounder of the view that State competition operates under the good graces of the federal government. The apparent dichotomy between the first two positions articulated above is the US is thus misconceived.<sup>635</sup> Rather, it is argued, the driving force that has placed Delaware at the lead of the race for incorporations is actually the equilibrium that the federal government maintains with States.<sup>636</sup> It is the federal government that draws the outer limits in which States can produce corporate statutes. If the matter is too serious to be left to States or State legislation has upset the market, the federal government will intervene.<sup>637</sup>

Therefore, Roe's view is really one of competition, but of subsidiarity. The issue is to identify the level, State or federal, in which the aim pursued can be better achieved. The federal government will interfere when the issue can be dealt with at a federal level, i.e. it is of such importance that requires federal action. This fear of intervention keeps Delaware within certain limits

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<sup>633</sup> M Kahan & E Kamar, 'The Myth of State Competition in Corporate Law' (2002) *Stan L Rev* 679, 724-735.

<sup>634</sup> Roe (n636) 5.

<sup>635</sup> MJ Roe, 'Delaware's Competition' (2003) 117 *Harv L Rev* 588, 590

<sup>636</sup> MJ Roe, 'Delaware and Washington As Corporate Lawmakers' (2009) 34 *Del J Corp L* 1, 6

<sup>637</sup> E.g. Securities Act 1933; Securities Exchange Act 1934 adopted as a consequence of the 1929 Crash of Wall Street; Sarbanes-Oxley Act 2002 adopted after the Enron scandal.

and prevents the enactment of legislation that upsets the balance of interests between managers and shareholders against the latter.<sup>638</sup> It is this very fine balance that Delaware keeps that keeps State competition going.<sup>639</sup>

Therefore, safeguarding the interests of managers and directors has not been Delaware's sole concern. It must be noted though that Congress has been reluctant to intervene save only in extreme circumstances. The 1929 crash led to the enactment of federal legislation on disclosure with regard to securities and their trading.<sup>640</sup> The 2002 Enron scandal led to the adoption of federal rules on corporate accounting and reporting practices.<sup>641</sup> In 2008, Delaware courts abstained from intervening in order to upset JPMorgan's takeover of Bear Stearns which had been brokered by the US Treasury and the Federal Reserve, despite the fact that the takeover was conducted in a way contrary to Delaware law.<sup>642</sup>

Delaware has been very cautious in creating this precious balance that would deter federal intervention and augment its income from franchise fees. Roe's conclusion is that American corporate law is made on the basis of a triangular model.<sup>643</sup> Part of it is directly Washington made and part of it is State made, as a result of a horizontal competition. However, he adds, there

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<sup>638</sup> Roe (n635).

<sup>639</sup> MJ Roe 'Delaware Politics' (2005) 118 Harv L Rev 2491.

<sup>640</sup> Securities Act 1933; Securities Exchange Act 1934.

<sup>641</sup> Sarbanes-Oxley Act 2002.

<sup>642</sup> Roe (n636) 13-14.

<sup>643</sup> *ibid* 9-10.

are two more categories: corporate governance law which is Delaware-made, 'with the eye on DC' and Delaware-made, discretionary. This latter category is comprised of corporate rules that are 'neither Washington influenced nor honed in state competition.'<sup>644</sup>

In addition to the cautious approach of Delaware, shareholders, who lobby in Washington DC, use their voting power to enhance deterrence.<sup>645</sup> The only serious federal reaction has been the Securities Exchange Act 1934 whose broad provisions on shareholding capture many corporations, which may have no major business in the US,<sup>646</sup> as well as the Sarbanes-Oxley Act 2002.

Therefore, the federal government is the Procrustes of US corporate law. In Greek mythology, Procrustes had a bed at Eleusis until he was killed by Theseus. Procrustes invited all passers-by to lie in the bed. He would either amputate or stretch his victims depending on whether they were too tall or too short for his bed. Similarly, the federal government has a procrustean bed. If State regulation of corporate affairs goes too far or falls short of the necessary requirements, the federal government can either restrain it or stretch it respectively. It should be noted though that no matter how intuitive one may find Roe's approach, it has been criticised as incomplete to the extent that it fails to explain the reasons for which Delaware has not seized

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<sup>644</sup> *ibid* 10.

<sup>645</sup> Roe (n639) 2494

<sup>646</sup> Ph J Kozyris, 'Conflict of Laws for Corporate Shareholdings: Predicaments and Prospects' in JAR Nafziger and SC Symeonides (eds), *Law and Justice in a Multistate World – Essays in Honor of Arthur T von Mehren* (Transnational Publishers, 2002) 309.

the opportunity to legislate in a way to lead off or head off federalisation threats.<sup>647</sup>

Although Roe's theory is not universally endorsed, there have been instances where one can see the merit of his argument. One such instance is actually related to insolvency law, but is very telling of the kind of relations between States and the federal government. The work of Professor LoPucki who attested the existence of forum shopping and a race to the bottom in relation to insolvency prompted the reaction of Senator John Cornyn of Texas to propose a reform in the Bankruptcy Code that will require companies to file for insolvency in their home State and not in Delaware.<sup>648</sup>

Vice President Joseph Biden, then Senator of Delaware, responded fiercely in defence of the status quo and refusing the existence of a race to the bottom. Relying upon the work of Professors Kenneth Ayotte and David Skeel Jr, he declared that 'bankruptcy courts do not abuse the venue rules, and companies choose a bankruptcy venue based on the expertise of the court in handling complex reorganizations, not in some sinister effort to game the system on their executives' behalf.'<sup>649</sup> He concluded that Congress should not make the mistake of intervening. This debate in and outside the US Senate shows how much fear federal intervention causes for States. However, it is quite another thing to deny the existence of a race to the bottom on the sole

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<sup>647</sup> LA Hamermesh, 'The Policy Foundations of Delaware Corporate Law' (2006) 106 Colum L Rev 1749, 1768.

<sup>648</sup> J Cornyn, 'They Owe Us: Companies Seeking Bankruptcy Relief Should Face Creditors in Their Home Court' *Legal Times* (6 June 2005) 67.

<sup>649</sup> J Biden, 'Give Credit to Good Courts' *Legal Times* (20 June 2005) 67.

basis of this fear.

## ***II. The Dynamism of Delaware: factors that have led to its prevalence in the market for corporate charters***

Although all three approaches are to a lesser or greater extent plausible, the second is the most persuasive. It appears to have the strongest rational argument in its favour and it is also backed by considerable empirical research. With federalism as the genius of American corporate law in mind, there are several reasons that have lead Delaware to take the lead of the incorporation competition in the US. There are two factors that play a key role in the success of States in regulatory competition: statutory flexibility and judicial quality.<sup>650</sup>

Delaware's law and judicial system have four characteristics that played a major role in placing it at the lead of the regulatory competition for incorporations. First, its corporate law provisions are not in principle mandatory in nature, which allows for private ordering. Second, its legislature has deferred to case-by-case development of the law by the judiciary, and legislation that is prescriptive or proscriptive is avoided. Third, the enactment of new corporate laws is done in a way to avoid the impairment of pre-existing contractual relationships and expectations. Fourth, Delaware avoids legislative change in the absence of clear and specific practical benefits.<sup>651</sup> These four components of Delaware's success will be now presented and briefly analysed.

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<sup>650</sup> M Kahan, 'The Demand for Corporate Law: Statutory Flexibility, Judicial Quality, or Takeover Protection?' (2006) 22 J L Econ & Org 340, 343-346.

<sup>651</sup> Hamermesh (n647) 1787.

### **A. Enabling provisions of corporate law**

States in regulating the agency problems between managers and shareholders may have recourse to various legal strategies. One of them is related to the nature of corporate rules as *ius dispositivum*. Corporate law thus offers a standard form of contract from which parties can deviate only by putting down the points in which they wish to achieve a different bargain. This characteristic facilitates negotiations among parties.<sup>652</sup> Not only does it allow parties to negotiate the deal that is best suited for their purposes, but it also provides a regulatory framework that will apply to all matters that the parties did not deal with in their agreement or that parties can choose at the outset.

Delaware though is far from adopting a corporate law which is totally composed by enabling default rules. Whilst some central matters like economic rights and voting rights of stocks can be altered by agreement of the parties almost without restraints,<sup>653</sup> others, such as the fiduciary duties of managers, are mandatory rules of Delaware corporate law from which parties cannot deviate by contract.<sup>654</sup> The trend in Delaware corporate law has been to minimise mandatory rules to the absolutely necessary ones.<sup>655</sup> In considering the possibility of an abuse of enabling provisions, the Delaware legislature considered that it would be unlikely for corporations to go public

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<sup>652</sup> Kraakman et al (n622) 20-25.

<sup>653</sup> Hamermesh (n647) 1782-1783.

<sup>654</sup> *ibid* 1782 n150.

<sup>655</sup> *ibid* 1783.

with ‘open-ended provisions’ and in any event Delaware courts were well equipped to tackle any problems that could arise.<sup>656</sup>

### **B. The positive contribution of the legislature and the judiciary**

A great part of Delaware’s success is owed to its legislature and judiciary. To begin with, it is now part of Delaware’s constitution that amendments to the Delaware General Corporations Law need a two thirds majority in the Senate and House of Representatives.<sup>657</sup> Corporate law production is formally vested with the legislature. However, the latter has been wise enough to allow the Corporate Law Section of the Delaware State Bar Association to draft the relevant bills. Contrary to popular perception, corporate bills are not the product of some lobbyists engaged by corporations whose interests are at stake.<sup>658</sup> In fact the Bar Association proceedings are conducted *in camera*, which implies that the lawyers participating do not reveal the content of the proceedings or discuss it with anyone, including their clients.<sup>659</sup>

Members of the judiciary do not participate in the proceedings either.<sup>660</sup> The judiciary though plays its own important role in the success of Delaware corporate law. The Delaware Court of Chancery and Supreme Court have accumulated years of experience in corporate litigation. Its members are not elected, as they are in other States, but are drawn from the business law

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<sup>656</sup> *ibid* 1784.

<sup>657</sup> Delaware’s Constitution, art IX(1).

<sup>658</sup> Hamermesh (n647) 1754-1755.

<sup>659</sup> *ibid* 1756.

<sup>660</sup> *ibid* 1757.

bar and are appointed.<sup>661</sup> Administration of justice is expedient. Trials take place without juries and punitive damages are prohibited.<sup>662</sup> Thus the law is developed on a case by case basis. The judiciary takes advantage of the lack of codification of the law to evolve it incrementally. This may lead to what is perceived by some as indeterminacy, but ‘it also allows space for the judiciary to pull back in future cases if a prior decision turns out, in the wake of experience, to have been unwise’.<sup>663</sup>

### **C. Delaware’s Conservatism**

Hamermesh writes of the existence of a principle of conservatism in Delaware’s legislative and judicial policy.<sup>664</sup> According to this principle, Delaware’s legislature and judiciary will not intervene to revise the law unless it is necessary to do so. There is an entrenched belief that the system has worked well so far. Delaware depends on franchise fees and permits corporations to reincorporate in and out of the jurisdiction. These fees actually constitute ‘a public choice bond’ in the sense that they indicate the group of managers and shareholders that will influence the shaping of Delaware corporate law.<sup>665</sup>

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<sup>661</sup> R Daines, ‘Does Delaware Law Improve Firm Value?’ (2001) 62 J Fin Econ 525.

<sup>662</sup> Hamermesh (n647) 1760.

<sup>663</sup> LE Strine Jr, ‘The Delaware Way: How We Do Corporate Law and Some of the New Changes We (and Europe) Face (2005) 30 Del J Corp L 673, 683.

<sup>664</sup> Hamermesh (n647) 1772 *et seq.*

<sup>665</sup> Roe (n636) 16-17.

The fees also play the role of a ‘qualitative bond’.<sup>666</sup> Delaware thereby commits not to upset the status quo of administration of corporate affairs. This is achieved by generally not upsetting the deals that are brokered by the parties when negotiating and concluding a corporate charter. The legislature also ensures not to alter the law in a manner which unpredictable or capable of causing entrepreneurs to worry. This provides businessmen with the valuable assurances that Delaware is committed to the non revocation of its beneficial provisions.<sup>667</sup>

For instance, the extent to which private autonomy can limit the authority of the board of directors is not clear. Section 141(a) of the Delaware General Corporations Law needs to be revised. However, it is not clear what direction the amendment should follow. Several contradictory proposals have been put forward. The matter has been left to the courts. According to Romano, ‘[o]ne should not expect to see a legislative response on this issue until Delaware courts decide at least one case squarely presenting it, and even then, the preference may well be to let the courts continue to redefine the subject’.<sup>668</sup>

This principle of conservatism and reluctance to upset established balances is also reflected in Delaware’s abstinence from amending the law in a way to upset or disrupt already existing commercial relationships.<sup>669</sup> For

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<sup>666</sup> *ibid.*

<sup>667</sup> Romano (n613) 37.

<sup>668</sup> Hamermesh (n647) 1773.

<sup>669</sup> *ibid* 1774 *et seq.*

instance, section 141(c) of the General Corporations Law was amended in 1996 to allow for the board to delegate to a committee the power to set the terms of and issue capital stock. However, this provision would apply only to newly incorporated companies. The rationale behind this limitation was that, especially with regard to closely held firms, parties may have relied on the prior to 1996 version of section 141(c) which prohibited such delegation.<sup>670</sup>

Hamermesh also points out that this unwillingness to upset existing bargains is evident in the legislative synopses that accompany amendments. These synopses usually describe such amendments as clarifications so that it is clear to the judiciary that the amendment was not meant to alter the meaning of the old statute.<sup>671</sup>

#### **D. Increase of firm value**

It had once been suggested that the increase in the value of the firm's stock by immigrating to Delaware increases the value of the firm's stock, as measured by its share prices, could just be correlated to the announcement of a new corporate strategy.<sup>672</sup> It has been counterargued though that such an announcement would not be enough *per se* to have a positive effect on the firm's stock, if reincorporation in Delaware would have a negative effect on

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<sup>670</sup> *ibid* 1775.

<sup>671</sup> *ibid* 1776.

<sup>672</sup> LA Bebchuk, 'Federalism and the Corporation: The Desirable Limits on State Competition in Corporate Law' (1992) 105 Harv L Rev 1435; MA Eisenberg, 'The Structure of Corporation Law' (1989) 89 Colum L Rev 1461, 1508; R Romano, 'Law as a Product: Some Pieces of the Incorporation Puzzle (1985) 1 J L Econ & Org 225.

the value of stock.<sup>673</sup> However, this was not enough to establish the relation between reincorporation in Delaware and increase in firm value.

Recent empirical research has now shown that incorporation or reincorporation in Delaware when the firm decides to go public tends to improve the value of the firm.<sup>674</sup> The hypothesis tested by Daines is simple. 'Delaware law affects firm value. If investors regularly pay more for assets governed by Delaware law, Delaware firms will be worth more.'<sup>675</sup> This is consistent with the finding that 'Delaware firms are more likely to receive a takeover bid and to be taken over, controlling for other factors associated with takeover likelihood.'<sup>676</sup>

This improvement in value (about 2% on average)<sup>677</sup> is thus achieved for two main reasons. First, Delaware may improve firm value through its specialised corporate courts. Second, Delaware law is less likely to entrench incumbent management due to its takeover legislation, political economy and specialised corporate courts.<sup>678</sup> This is made explicit by the significantly more takeover bids that Delaware firms receive in comparison to firms incorporated elsewhere. Simultaneously, Delaware firms are more likely to

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<sup>673</sup> Romano (n613) 18.

<sup>674</sup> Daines (n661); however, other studies suggest that this 'Delaware premium' has declined considerably over time: see G Subramanian, 'The Disappearing Delaware Effect' (2004) 20 J L Econ & Org 32.

<sup>675</sup> Daines (n661) 529.

<sup>676</sup> *ibid* 547.

<sup>677</sup> R Daines, 'The Incorporation Choices of IPO Firms' (2002) 77 NYU L Rev 1559, 1560.

<sup>678</sup> Daines (661) 555-556.

receive one bid and be acquired.<sup>679</sup> This finding is consistent with the finding that strong anti-takeover provisions in initial public offering charters do not increase firm value.<sup>680</sup>

The reason appears to be that strong anti-takeover provisions in a corporate charter might allow managers to defend themselves successfully against a takeover that would be beneficial for the shareholders, but not for them. In other words, anti-takeover provisions increase agency costs in a firm.

### **E. Is there regulatory competition for privately held firms?**

One might have observed that the discussion thus far seems to concern primarily publicly held companies. This is true. However, this does not imply that there is not a regulatory competition for limited liability companies (hereinafter LLC).<sup>681</sup> It has been recently found that in sample of 64,000 such companies with at least 20 employees, 93% were incorporated at their principal place of business and only 7% elsewhere. Of this latter percentage, 53% were incorporated in Delaware. However, when one looked at LLCs with more than 1,000 employees the picture was radically different. About half of the companies would incorporate elsewhere, 80% of which were incorporated in Delaware.<sup>682</sup>

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<sup>679</sup> *ibid* 555.

<sup>680</sup> R Daines & M Klausner, 'Do IPO Charters Maximize Firm Value? Antitakeover Protection in IPOs' (2001) 17 J L Econ & Org 83, 86.

<sup>681</sup> A contrary view is taken in I Ayres, 'Judging Close Corporations in the Age of Statutes' (1992) 70 Wash U L Q 365, who argued that States would be unlikely to compete for closely held companies, because the revenues to be gained from such firms are not significant.

<sup>682</sup> J Dammann & M Schündeln, 'Where are Limited Liability Companies Formed? An Empirical Analysis' (2008) University of Texas School of Law, Law & Economics Research

There are three particular issues that require attention with regard to LLCs: piercing of the corporate veil, fiduciary duties and exculpation clauses. With regard to the first, there are two factors that make regulatory competition difficult.<sup>683</sup> One is the abstract nature of the relevant rules. The other is that it is not always certain that the *lex incorporationis* will be applied, especially in tort cases. However, Delaware has allowed only a few cases to be heard and none of them was successful. These statistics send a clear message to LLCs that the threshold for piercing the veil is particularly high in Delaware law. Such information can come in handy when making incorporation choices.<sup>684</sup>

While in publicly held companies the major agency problem exists between managers and shareholders, in LLCs it exists between majority and minority shareholders.<sup>685</sup> Thus several States provide enhanced fiduciary duties<sup>686</sup> and/ or adopt oppression statutes which allow for the dissolution of privately held companies if minority shareholders' rights are violated.<sup>687</sup> Just like rules on veil piercing, this information is very useful in making incorporation choices.

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Paper No. 126/2008 <[http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1126257](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1126257)> accessed 18 June 2009.

<sup>683</sup> *ibid.*

<sup>684</sup> *ibid.*

<sup>685</sup> Romano (613) 24.

<sup>686</sup> DK Moll, 'Reasonable Expectations v. Implied-in-Facts Contracts: Is the Shareholder Oppression Doctrine Needed?' (2001) 42 BCL Rev 989.

<sup>687</sup> Dammann & Schündeln (n682).

As far as exculpation clauses are concerned, it is not entirely clear whether their permissibility actually matters in the case of LLCs.<sup>688</sup> There are two reasons for this. First, exculpation statutes may be counter balanced by the negotiation of veto rights for the minority shareholder. Second, exculpation clauses in relation to LLCs are not as efficient as they are in relation to publicly traded firms. In public held corporations exculpation clauses exist to prevent an imbalance between the risks faced by directors and the rewards they may receive. This imbalance is less evident in LLCs, where the controlling shareholder is frequently the director as well.

### ***III. What are the incentives for a State to engage in regulatory competition?***

States would not compete for corporate charters if they derived no benefit from such competition. There are, however, multiple financial benefits from a successful engagement in regulatory competition. Thus the primary incentive for States to compete in the US market for corporate charters has been the increase in revenue from franchise taxes, i.e. the taxes that a company will pay to the State in return for the incorporation package and the quality of services the State will provide to the company.

In 1990 about half of the largest industrial firms as well as the majority of firms listed in Wall Street were incorporated in Delaware.<sup>689</sup> In 1960 Delaware derived USD 9,864,000 from franchise taxes, which amounted to 13.7% of its total revenue. Thirty years later in 1990, Delaware received USD

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<sup>688</sup> *ibid.*

<sup>689</sup> Romano (n613) 6.

200,201,000 in franchise taxes, which made up 17.7<sup>0</sup>% of its total revenue that year.<sup>690</sup> Despite the fact that other States sought to compete with Delaware, in 1990 the States with the second highest revenue from franchise taxes were Pennsylvania and Tennessee deriving 4.6% of their entire annual income from franchise taxes.<sup>691</sup> Delaware was clearly at the lead of the race.

Income from franchise taxes is clearly the strongest incentive. Yet it is not the only one. Delaware's economic prosperity is also enhanced indirectly. Increased income from franchise taxes can be used to lower taxation on in-state constituents.<sup>692</sup> Additionally, the concentration of incorporations increases the income of corporate lawyers and law firms, which is of course subject to taxation.<sup>693</sup> It has been even suggested that the increase of income for lawyers is so big that Delaware increases the likelihood of litigation thus creating an agency problem between lawyers and shareholders.<sup>694</sup>

One though may be keen to dispute the bold statement that lawyers earn more in Delaware. It may be true that successful lawyers in Delaware earn higher fees in comparison to successful lawyers appearing before other State courts, but not in comparison with such lawyers appearing before federal courts.<sup>695</sup> In a sample of 139 shareholder suits (with only 24 suits filed

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<sup>690</sup> *ibid* 7-8.

<sup>691</sup> *ibid* 10-11.

<sup>692</sup> *ibid* 28.

<sup>693</sup> *ibid*.

<sup>694</sup> JR Macey & GP Miller, 'Toward an Interest-Group Theory of Delaware Corporate Law' (1987) *Tex L Rev* 469.

<sup>695</sup> Romano (n613) 29.

before the Delaware Chancery Court), the average fee awarded in settled cases in Delaware was USD 337,000 (11 cases), in comparison with USD 126,000 in other State courts (11 cases) and USD 1,487,000 in federal courts (34 cases).<sup>696</sup> This counter-argument though does not rebut the core of the proposition that success in regulatory competition equals increased income for corporate lawyers.

#### ***IV. The possibility for regulatory competition for corporate charters in the European Union***

As the process of European unification is evolving and Europe is acquiring a quasi-federal structure, it can be plausibly argued that there will be increasing room for regulatory competition. This will depend on the extent to which the European institutions will decide to harmonise the law. This thesis is concerned with the future of the law in corporate and insolvency matters. With regard to this issue two approaches have been identified, the so-called reflexive harmonisation and competitive federalism.<sup>697</sup>

The first one is ‘a basis for evolutionary selection of rules through mutual learning between national legal systems’ used to describe the European approach.<sup>698</sup> On the contrary, the second term describes the US approach, at least in the way the race to the top scholarship presents it, and

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<sup>696</sup> *ibid*; see also R Romano, ‘The Shareholder Suit: Litigation without Foundation’ (1991) *J L Econ & Org* 55; JC Alexander, ‘Do the Merits Matter? A Study of Settlements in Securities Class Actions’ (1991) *Stan L Rev* 497.

<sup>697</sup> S Deakin, ‘Two Types of Regulatory Competition: Competitive Federalism Versus Reflexive Harmonisation. A Law and Economics Perspective on *Centros*’ (1999) 2 *CYELS* 231-260.

<sup>698</sup> *ibid*; J Armour, ‘Who Should Make Corporate Law? EC Legislation versus Regulatory Competition’ (2005) 58 *CLP* 369, 370.

signifies the removal of all inter state mobility barriers ‘in an environment of minimal harmonisation of regulatory standards’.<sup>699</sup>

The harmonisation approach is akin to Roe’s theory. If the thrust of Roe’s argument is that Delaware always keeps an eye open to the potential reaction of Washington, it should apply *a fortiori* to Europe. It seems that the Community institutions can get engaged with the same material much more easily than the federal authorities in the US. The Commission can always initiate a procedure against a Member State before the ECJ. Cases can reach the ECJ more easily and in greater numbers than they reach the US Supreme Court through the preliminary reference mechanism.

Member States always examine the compatibility of new legislation with EC law. Whether they will finally adopt a measure which they know to be in contravention of EC law is a separate question. Nonetheless, corporate law comes within the core of freedom of establishment and the Common Market. Consequently, Community institutions are probably less conservative in their interventions than their US counterparts. Perhaps Roe’s theory is more descriptive of Europe than it is of the USA.

#### **A. The prospect of regulatory competition with regard to company law**

The prospect of a Delaware effect in European company law is not a new topic. It goes at least as far back as the early 1980s. As it will be shown immediately below, the debate in Europe is slightly different. The issue is not the nature of regulatory competition, but rather its likelihood of occurrence

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<sup>699</sup> Deakin (n697).

and its desirability. The nature of the instances of regulatory competition that have been observed are probably best described by Roe's theory. Member States are aware of the prospect of 'federal' intervention by the Commission or the ECJ, more than their US counterparts are. Unlike the US, where Washington plays a more conservative role, in Europe the Community institutions have played a crucial role in bringing about some of the conditions that are necessary for regulatory competition to occur.

## **B. Optimistic approach: plenty of, or some room for, regulatory competition**

### ***i) Reasons for the possibility of a Delaware effect in Europe***

Contrary to popular perception, regulatory competition for corporate charters is not a phenomenon that is unknown in Europe. Long before the delivery of *Centros* in 1999, there was a great deal of corporate mobility in pre-1914 Europe. Modern scholarship usually focused on the comparison of contemporary European company law with its US equivalent so as to assess the possibility of regulatory competition occurring in Europe. Before engaging in this exercise, the present thesis will devote some space to the unorthodox task of comparing European company law and regulatory arbitrage in the years prior to the Great War of 1914 with the recent developments in the post-*Centros* state of affairs.

It was written back in the day:

C'est une opinion répandue dans le monde du commerce et de la finance que pour établir une Société commerciale, les organisateurs sont libres de se placer sous l'empire de telle législation qui leur paraît plus convenable à leurs projets et surtout pour les formalités constitutives. A cet effet, ils jettent les yeux sur les législations des pays limitrophes, leurs

préférences vont tantôt à la législation belge ou suisse, fréquemment à la législation anglaise. On invoque en ce sens le jugement du trib. civ. de Lille du 21 mai 1908 (Clunet 1909, p. 191). Les praticiens qui encouragent leurs clients dans cette vue leur préparent, croyons-nous, quelques déceptions. Le précédent invoqué ne pousse point aussi loin la théorie de l'autonomie de la volonté. Cette théorie n'est pas applicable quand il s'agit d'échapper à des prescriptions que la loi française considère comme d'ordre public, puisqu'elle ne punit l'inobservation de peines pécuniaires ou corporelles, ainsi que le fait la loi de 1867 sur les Sociétés anonymes. De plus, il s'agit, dans l'espèce invoquée, d'un groupe anglais qui s'adjoint un group français pour fonder une Société ayant pour objet l'exploitation de mines de charbon en territoire anglais, au Canada. La soumission à la loi anglaise paraît naturelle en telle hypothèse, et le tribunal de Lille relève la circonstance. S'il s'était agi d'un commerce à exploiter rue Taitbout ou rue de la Paix, à Paris, la solution eût peut-être été différente... la nullité est proche pour les Sociétés, fréquentes aujourd'hui qui, bien qu'établies en France, n'ont d'autre raison de préférer la loi étrangère, que les commodités qu'elle leur présente. Les avertissements de la jurisprudence ne manquent pas...<sup>700</sup>

Save for the different dates one can hardly see any difference between the pre-1914 and the current debate. Both the 1990s and the years prior to the Great War were characterised by a generalised spirit of economic liberalism.

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<sup>700</sup> —, *Trib corr de la Seine* (10<sup>e</sup> ch), 27.07.1910, *The Universal Gaz Methane and Buisson Hella Ltd* (case note) (1911) 38 JDI 234, 241-242: (It is an opinion well spread in the world of commerce and finance that in order to establish a company the founders are free to position themselves in a jurisdiction whose legislation appears to be the most convenient for their projects and especially in relation to constitutive formalities. To this effect, they look at the legislation of neighbouring countries. Belgian and Swiss law figure on top of their preferences and so does frequently English law. In this sense we refer to the judgment of the civil court of Lille of 21 May 1908 (Clunet 1909, p. 191). The practioners that encourage their clients to follow this path prepare for them, we believe, some disappointments. The aforementioned precedent does not take the theory of autonomy of will very far. Such theory is not applicable when the case is concerned with the evasion of provision that French law considers to be part of *ordre public*, since it does not punish the non-observance of corporal and pecuniary penalties, as does the law of 1867 concerning public companies. Additionally, the present case is concerned with an English group that joins a French group in order to establish a company for the purpose of exploiting carbon mines in English territory in Canada. The choice of English law appeared to be natural in this case and the court of Lille points this out. If the case was about the exploitation of rue Taitbout or rue de la Paix, in Paris, things could have been different... nullity is imminent for the companies, which are frequent today, that have no reason to prefer foreign law other than the convenience it offers them, despite the fact that they are established in France. The warnings in case-law are ample...).

Several questions arise out of this narrative. First, which factors facilitated regulatory arbitrage in the pre-1914 period? Foremost, it must have been the *Zeitgeist* of the Belle Époque. The period between the Franco-Prussian War of 1871 and the outbreak of the First World War in 1914 is characterised by peace between the Great Powers, extended trade between all European nations, technological innovation that improves the life of the middle and upper class that is still unclouded by income tax, the flourishing of arts and minimum State intervention in the economy. In fact, it is surprising that the Great Powers went to war with each other despite the impressive volume of trade that was going on amongst them.

Post 1990s Europe has some of these characteristics as well. The establishment of the European Communities and the European Union has guaranteed the longest lasting peace in Europe. The substantive provisions of the EC Treaty have encouraged intra-Community trade. Several national governments have sought to minimise the role that the State plays in the economy. Technological innovations have improved the lives of the lower classes in an unprecedented manner.

Second, what has actually happened to that spirit of liberalism and what happened to regulatory arbitrage? The answer is simple. The Great War of 1914 changed Europe radically. Recent empirical studies have actually shown that by most measures, European countries 'were more financially developed in 1913 than in 1980 and only recently have they surpassed their 1913 levels.'<sup>701</sup>

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<sup>701</sup> RG Rajan & Luigi Zingales, 'The great reversals: the politics of financial development in the twentieth century' (2003) 69 J Fin Econ 5, 6-7.

In a seminal article Rajan & Zingales record that in 1913, France's stock market capitalisation (as a fraction of GDP) was almost twice that of the United States, whereas by 1980, France's capitalisation was almost one-fourth the capitalisation in the United States.<sup>702</sup>

The economic liberalism of the Belle Époque was succeeded by great State interventionism and protectionism, especially during the Great Depression. Maynard Keynes, architect of the Bretton Woods agreement, is recorded to have said that: '[n]ot merely as a feature of the transition but as a permanent arrangement, the plan accords every member government the explicit right to control all capital movements. What used to be heresy is now endorsed as orthodoxy.'<sup>703</sup>

Rajan & Zingales contrast this statement with

...the general desire of countries after World War I to return to the Gold Standard and thus reduce barriers to capital flow. If openness to trade is, by itself, insufficient to force financial development, then the restrictions on capital movements after WWII can explain why financial markets did not take off even though trade expanded. After all, they recovered rapidly after WWI. Even though the toll taken by the wars was admittedly very different, an important part of the explanation must be that there was no Bretton Woods after World War I endorsing capital controls.<sup>704</sup>

Aside from the restrictions on the free flow of capital which is necessary for cross-border corporate mobility, in the field of private international law, the First World War generated the theory of control, which

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<sup>702</sup> *ibid* 7.

<sup>703</sup> E Helleiner, 'From Bretton Woods to global finance: a world turned upside down' in Richard Stubbs & GRD Underhill (eds), *Political Economy and the Changing Global Order* (1<sup>st</sup> edn Macmillan, London 1994) 163, 164

<sup>704</sup> Rajan & Zingales (n701) 39.

was employed by French (and English) courts in order to seize the assets of companies controlled by enemy aliens.<sup>705</sup> The real seat theory no longer applied in wartime. Instead courts would look at the nationality of shareholders. After the conclusion of the Peace Treaties there was a great deal of controversy among French courts about which choice of law rule was preferable.<sup>706</sup> These factors put together eliminated the wish of businessmen to incorporate in other jurisdictions and extinguished regulatory arbitrage.

Why did it take more than 60 years to see change? The Great Depression, the two world wars and State intervention in the economy all played a role in delaying the coming of age in which corporate mobility would flourish again. Corporate mobility and regulatory arbitrage require some degree of free capital flow. However, after two world wars European governments were required to 'provide the various kinds of insurance that was increasingly being expected of them by their citizens, especially given the terrible state of post-war government finances.'<sup>707</sup>

It was probably only after the establishment of the Common Market that entrepreneurs felt secure to set up cross border corporate formations. The guarantee of freedom of establishment in the Treaty and the pro-integration role of the ECJ assisted the restoration of trust on behalf of entrepreneurs. It is thus astonishing to realise that it took about 100 years for

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<sup>705</sup> E Rabel, *The conflict of laws: a comparative study* (University of Michigan Press, Ann Arbor 1947) vol II, pp 56 *et seq.*

<sup>706</sup> JP Niboyet, *Traité de droit international privé français* (2nd edn Sirey, Paris 1947) vol 2, p 374-383.

<sup>707</sup> Rajan & Zingales (1991) 38.

Europe to reach exactly the same position as it was in 1909: the recognition of the freedom of incorporation with an exception for letter-box companies. The only difference is freedom of establishment, which guarantees far greater protection to entrepreneurs.

In these very similar conditions, one may inquire the reasons that encouraged regulatory arbitrage in the years prior to 1914 and consider whether the same factors exist in contemporary Europe. As evidenced in several French judgments, many French businessmen sought to establish corporations in England for the sole reason of benefiting from English company law and avoiding the relevant French provisions on subscription of capital, payment of a quarter of the capital and the issue and trading of shares.<sup>708</sup>

Nowadays, the conditions are probably analogous to those existing prior to 1914. The EC Treaty guarantees the free flow of capital and freedom of establishment. Regulatory arbitrage has been prompted so far primarily by minimum capital requirements. One conclusion that can be drawn is that regulatory competition in Europe is rule specific. As soon as differences amongst European company laws are obliterated in relation to the specific rule in question, then that particular wave of cross-border mobility probably dies out.

Therefore, in examining the details of regulatory competition for minimum capital requirements, it has been argued that there is room for a

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<sup>708</sup> See p 191.

regulatory competition in Europe,<sup>709</sup> although this is unlikely to be of the same scale and extent as that in the USA.<sup>710</sup> To support their view they have referred to the enactment of French legislation on *SARL*<sup>711</sup> with the effect of abolishing the minimum capital requirement of 7,500 euros and leaving the settling of the company's capital at the discretion of the founders (*SARL à un euro*)<sup>712</sup> and to the proposal to reduce the minimum capital requirement of the German GmbH,<sup>713</sup> which has now been enacted. The new GmbH, called *Unternehmergeellschaft* (hereinafter UG) is not though allowed to distribute its profits until it has concentrated the amount of 25,000 euros, which the minimum capital requirement of the traditional GmbH.<sup>714</sup> Similar developments have taken place in other European countries, such as The Netherlands and Spain.<sup>715</sup>

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<sup>709</sup> H Muir Watt, '*Kamer van Koophandel en Fabrieken voor Amsterdam v Inspire Art Ltd*' (case note) (2004) 93 RCDIP 151, 177; M Menjucq, '*Kamer van Koophandel en Fabrieken voor Amsterdam v Inspire Art Ltd*' (case note) (2004) 131 JDI 917, 926.

<sup>710</sup> F Munari, '*Riforma del diritto societario italiano, diritto internazionale privato e diritto communotario: prime riflessioni*' (2003) 39 RDIPP 29, 39-40.

<sup>711</sup> Article 1 of the *Loi n° 2003-721 du 1 août 2003* modifying article L223-2 *CComm*.

<sup>712</sup> Menjucq (n709) 926; C Frost, '*Transfer of Company's Seat- An Unfolding Story in Europe*' (2005) 36 VULR 359, 376; R Drury, '*The "Delaware Syndrome": European Fears and Reactions*' [2005] JBL 709, 728-729; C Kersting & CP Schindler, '*The ECJ's Inspire Art Decision of 30 September 2003 and its Effects on Practice*' (2003) 4 German LJ 1277, 1291; WG Ringe, '*Sparking regulatory competition in European Company Law: The impact of the Centros line of case-law and its concept of abuse of law*' in Rita de la Feria & Stefan Vogenauer (eds), *Prohibition of Abuse of Law- A New General Principle of EU Law* (Hart Publishing, Oxford 2009) (forthcoming) <[http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1326964](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1326964)> accessed 28 April 2009.

<sup>713</sup> S Shandro, '*The Risks of Using Pseudo-Foreign Corporations in Germany*' (2006) 25(7) Am Bankr Inst J p 30, 30n2.

<sup>714</sup> Ringe (n712).

<sup>715</sup> *ibid*.

Other countries, like Greece, chose a different path. Article 10(2) of Law 2339/1995 amending article 20(3) of Law 2190/1920 on public limited companies allowed for the first time the board to convene outside the seat, even abroad, if all of its members are present or represented and none has objected to this practice. More recently, article 27 of Law 3604/2007 amending article 20(1)-(2) and (3a) has allowed for a secondary seat, either within or without the jurisdiction, to be included in the articles of association; for board meetings to take place abroad without leave from the Minister of Trade; and for board meetings to take place by means of a teleconference, provided that the articles of association allow it or all of its members have agreed to it.

Thus, while not abolishing minimum capital requirements, the real seat theory is only partly relaxed. Article 34 of Law 3604/2007 amending article 25 of Law 2190/1920 requires that the general assembly of the shareholders meet at the seat of the company in Greece, if the company's shares are listed in the Athens Stock Exchange. By contrast, the general assembly may take place abroad if the articles of association so provide or the entirety of the capital with voting rights is represented in the meeting and nobody objects to this practice.

In this general mood of corporate reform, it appears that dissenting Member States would be unable to react to such the possibility of a Delaware effect.<sup>716</sup> Unlike the US Supreme Court, the ECJ has virtually prohibited the

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<sup>716</sup> Drury (n712); Chertok (n736) 513-515.

enactment of rules on pseudo-foreign corporations.<sup>717</sup> Those who agree that regulatory competition will occur, do not however agree on its nature.

Some have argued that there might be a case for forum shopping since directors may choose to incorporate in the country that has the most lenient directors' liability provisions (race to the bottom).<sup>718</sup> It has been persuasively forwarded that regulatory competition should not be viewed as a negative effect but as 'a significant and beneficial mechanism for the development of European company law' (race to the top).<sup>719</sup> In any event there is no jurisdiction in the EU with lax company law and if ever a Member State went down that road harmonisation could prevent this<sup>720</sup> or the ECJ would reverse its proportionality balancing in the *Gebhard* test.

Last but not least, it has been argued that Community intervention on the matter will be merely procedural.<sup>721</sup> In principle, as Roe's theory would suggest in the European context, harmonisation will 'seek to influence the process by which national law' develops and not the substance of the rules.

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<sup>717</sup> Case C-167/01 *Kamer van Koophandel en Fabrieken voor Amsterdam v Inspire Art Ltd* [2003] ECR I-10155.

<sup>718</sup> D Cohen, 'La responsabilité civile des dirigeants sociaux en Droit International Privé' (2003) 92 RCDIP 583-624.

<sup>719</sup> Armour (n234).

<sup>720</sup> A Looijestijn-Clearie, 'Have the dikes collapsed? *Inspire Art* a further break-through in the freedom of establishment of companies' (2004) 5 EBOR 389, 416; PS Ryan, 'Case C-167/01 *Kamer Van Koophandel en Fabrieken voor Amsterdam v Inspire Art Ltd* (ECJ September 23, 2003)' (2005) 11 Colum J Eur L 187, 201.

<sup>721</sup> Armour (n234) 373-375.

This will still allow national legislatures to design 'local level approaches to regulatory problems' within a framework common to all Member States.<sup>722</sup>

***ii) The possibility of the a Member State leading the competition for corporate charters in Europe***

Having these observations in mind, it might be possible for a Member State to seek to claim for itself the position of a pan-European Delaware. Relying upon the preceding arguments, English authors have argued that in the post-*Inspire Art* world the UK in particular may find incentives to engage in regulatory competition. The latter can be driven in favour of the UK not by tax privileges, as Delaware does, but by 'professional services firms facing an increasingly competitive global environment'.<sup>723</sup> It should be stated though that for regulatory competition to exist there is no need for a State to wish to lead the race. Regulatory competition can begin to exist just by the mere fact that for historic or other reasons businessmen prefer the law of a particular State. The explicit desire of a State to lead and win the competition would without doubt enhance the chances of a more rigid and clear competition.

John Armour argues forcefully that the UK may find it possible to prevail over the continental jurisdictions, despite the various relaxations of their national laws to which they may proceed by means of defence to the regulatory competition. He argues that the market oriented English company law in combination with valuable soft law developed by entrepreneurs

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<sup>722</sup> S Deakin, 'Legal Diversity and Regulatory Competition: Which Model for Europe?' (2006) 12 ELJ 440, 452.

<sup>723</sup> Armour (n719).

themselves, like the UK Listing Rules and the City Code on Takeovers and Mergers, may constitute the UK's spear point.<sup>724</sup>

However, one should not neglect that the whole issue of attracting incorporations has so far excluded the big multi-nationals corporations<sup>725</sup> which to choose to incorporate subsidiaries in every single jurisdiction they wish to operate. It may well be the case that such practice will be continued. However, it may also be the case after *Cartesio* and the Cross-border Mergers Directive (hereinafter CBM Directive)<sup>726</sup> even large 'mother' corporations may seek to relocate in more favourable jurisdictions.

This attitude towards reincorporations should be distinguished from the possibility of regulatory competition at the start-up level. Incorporating in one favourable jurisdiction in order to activate in another less favourable will probably be an issue for small and medium sized corporations who will try to make the most of out a limited capital and incorporate at the most convenient jurisdiction from the beginning trying thus to avoid the cost of reincorporating at a later stage. Crossing the border and incorporating in The Netherlands or in England and then returning in Germany or The Netherlands respectively may be cheap and easy to do for reasons of geographical proximity.

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<sup>724</sup> *ibid* 387-388.

<sup>725</sup> Neither Überseering nor Inspire Art was a multi-national company.

<sup>726</sup> European Parliament and Council Directive (EC) 2005/56 of 26 October 2005 on cross-border mergers of limited liability companies [2005] OJ L310/1.

Although the UK may find itself attracting incorporations from other jurisdictions, the possibility of a multi-polar regulatory competition is not out of the question. For instance, several countries may be able to attract incorporations on a regional basis. This could happen because of stronger economic and cultural ties that exist between certain countries in the EU. Thus, while one can imagine the UK attracting incorporations from the Netherlands and Germany, it may be the case, for instance, that Finland may be able to attract incorporations from Estonia, or Germany from Austria.

In this sense, it may be the case that Europe will see the rise of certain jurisdictions that will dominate the market for incorporations on a regional basis by virtue of the strong financial and cultural influence they exercise in their particular region. To this list one should also add the significant role that similar industrial structure and share ownership may play.

***iii) Possible responses to the prevalence of a particular Member State in regulatory competition for corporate charters***

One should be cautious not to underestimate the various practical problems that the use of a foreign corporate vehicle may involve. Even after *Überseering* and *Inspire Art*, German courts continue to apply German law with regard to directors' liability of companies incorporated in other Member States,<sup>727</sup> even though the compability of such practice with the EC Treaty is doubtful. In any event, this practice increases the risks of using pseudo-foreign corporations in real seat countries.<sup>728</sup>

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<sup>727</sup> Judgment of 20.04.2006 (Kiel Court of First Instance) cited in Shandro (n713) 30.

<sup>728</sup> Shandro (n713) 30.

It is true that the number of German businessmen selecting England as place of incorporation of their private company has increased considerably after the delivery of the judgments in *Überseering* and *Inspire Art*. One account German incorporations of limited liability companies increased from about 3,000 in 2003 to about 16,000 in 2006.<sup>729</sup> In the meantime though, the German Ministry of Justice has enacted legislation on transparency and disclosure of information concerning corporate governance with the entry into force of the 2002 Corporate Governance Code.<sup>730</sup> The more Germany reforms its corporate legislation the less likely it becomes that German businessmen will wish to use foreign vehicles. In any event, it will be interesting to see what will happen to all these German incorporations in the UK in the post-*Cartesio* and Services Directive world.

However, one might think that all the changes that have been made so far in the company laws of various Member States are actually meant to facilitate the start-up of a small and medium sized enterprises; not so as to attract incorporations from other Member States. By employing these defensive mechanisms, Member States can compete to prevent companies from leaving, rather than attracting them from elsewhere. This does not preclude the adoption of aggressive, as opposed to defensive, measures. For

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<sup>729</sup> Becht et al (n195) 248.

<sup>730</sup> PC Leyens, 'German Company Law: Recent Developments and Future Challenges' (2005) 6 German LJ 1407, 1411-1412.

instance, one of the explicit aims of the Companies Act 2006 was to make English company law more attractive to foreign entrepreneurs.<sup>731</sup>

### **C. Pessimistic approach: no or relatively little room for regulatory competition**

#### ***i) Lack of political intention and taxation incentives***

Some commentators have compared the US and the European approach<sup>732</sup> and found no political intention among EU Member States to imitate Delaware.<sup>733</sup> This is so because, contrary to Delaware practice, articles 2(1), 4 and 10(a) of the Council Directive 2008/7<sup>734</sup> allow franchise fees, whose imposition was the main incentive of Delaware, to be imposed only by the Member State of the real seat.<sup>735</sup> Countries, like the UK, which have arguably the most commercially appealing corporate legislation, have indicated no eagerness to become the Delaware of Europe.<sup>736</sup>

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<sup>731</sup> Ringe (n712).

<sup>732</sup> R Drury, 'A European Look at the American Experience of the Delaware Syndrome' (2005) 5 JCLS 1-35.

<sup>733</sup> TH Tröger, 'Choice of Jurisdiction in European Corporate Law- Perspectives of European Corporate Governance' (2005) 6 EBOR 3-64; E Vaccaro, 'Transfer of Seat and Freedom of Establishment in European Company Law' (2005) 16 EBL Rev 1348-1365; L Enriques, 'EC Company Law and the Fears of a European Delaware' (2004) 15 EBL Rev 1259, 1260-1273.

<sup>734</sup> Council Directive (EC) 2008/7 of 12 February 2008 concerning indirect taxes on the raising of capital [2008] OJ L46/11.

<sup>735</sup> Romano (n610) 133; Tröger (n733); HS Birkmose, 'A "Race to the Bottom" in the EU?' (2006) 13 MJ 35, 59-63; M Gelter, 'The structure of regulatory competition in European corporate law' (2005) 5 JCLS 247, 259-260.

<sup>736</sup> A Schall, 'The UK Limited Company Abroad' (2005) 16 EBL Rev 1534, 1554; PJ Omar, 'Centros, Überseering and Beyond: A European Recipe for Corporate Migration' (2005) 16 ICCLR 18, 23-24; R Drury, 'The "Delaware Syndrome": European Fears and Reactions' [2005] JBL 709, 730; S Chertok, 'Jurisdictional Competition in the European Community' (2006) 27 U Pa J Intl Econ L 465, 515.

**ii) The survival of the real seat theory**

The ruling of the ECJ in *Überseering* has not abolished the real seat theory.<sup>737</sup>

Despite the fact that the applicability of the real seat theory appears to be subject to the *Gebhard* test, it is still possible that the *lex sedis* may be applied to a corporation. *Cartesio* has confirmed this proposition. This is probably one of the biggest threats to the occurrence of a Delaware effect in European company law.<sup>738</sup>

Which are the reasons though that make the real seat theory the primary enemy of regulatory competition? The characterisation of the real seat theory as an inefficient conflict of laws rule is based on the fact that 'it precludes *ex ante* the possibility of using foreign regulations for efficient purposes and leads to an inefficient asset partitioning between creditors.'<sup>739</sup> Once ownership costs outweigh the increase in the costs of credit, the use of a foreign company will become more attractive.<sup>740</sup> All the real seat theory does it to discourage corporate mobility.

The prohibition of re-incorporations without prior dissolution by both common and civil law with few exceptions and the stop of progress of the 14<sup>th</sup> Directive on the cross-border transfer of the registered office have made in the recent past the possibility of a Delaware effect in Europe even thinner.<sup>741</sup>

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<sup>737</sup> See pp 162 *et seq.*

<sup>738</sup> Romano (n735) 132

<sup>739</sup> S Lombardo, 'Conflict of Law Rules in Company Law after *Überseering*: An Economic and Comparative Analysis of the Allocation of Policy Competence in the European Union' (2003) 4 EBOR 301, 331.

<sup>740</sup> *ibid.*

<sup>741</sup> Romano (n735) 133.

However, *Cartesio* has made it explicit that such a prohibition of re-incorporations is contrary to the Treaty.<sup>742</sup> The enactment CBM Directive and the SE Regulation and the possible adoption of the Regulation on the European Private Company might facilitate regulatory competition a lot.<sup>743</sup>

Although usually contemplated as a choice of law mechanism, the real seat theory is also one of the grounds that establishes jurisdiction within the realm of the Brussels Regulation. The question is whether grounds of jurisdictions, other than the place of incorporation, can have a positive, neutral or negative effect on the prospect of regulatory competition. Under the current state of the law, as well as under the regime that has been proposed above,<sup>744</sup> the possibility that internal corporate disputes might be litigated in courts of a Member State other than the jurisdiction of incorporation has two main effects.

First, it allows the court of the Member State in which a letter-box company has its real seat or head office to get seized of all corporate disputes. If the courts of this country are first seized then, all other things being equal, the Member State of incorporation will have to recognise and enforce the judgment in question. More importantly, the judgment might not even require recognition and enforcement at all, as the real seat of the company is within the territorial jurisdiction of the forum. Second, it offers more venues

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<sup>742</sup> See pp 162 *et seq.*

<sup>743</sup> Ringe (n712).

<sup>744</sup> See pp 63 *et seq.*

for litigation and thus encourages all interest groups within a firm to look for the forum whether they have more prospects of success.

As far as the first of these consequences is concerned, it is a desirable outcome only to the extent that an anti-letter-box company policy makes in itself sense. It has been demonstrated above that for the time being no fully convincing reason has been advanced to support such a policy.<sup>745</sup> With regard to the second effect, article 27 Brussels Regulation provides that when several courts would enjoy jurisdiction, all other courts should decline jurisdiction in favour of the court first seized, once the latter's jurisdiction has been established. Thus it is actually impossible to speak of impermissible forum shopping within the context of the Regulation. If a court has jurisdiction under the Regulation and it is seized first that will be normally the end of this inquiry.

This latter conclusion may appear inequitable to some. However, as the Roman maxim has it, *ius civile vigilantibus scriptum est*.<sup>746</sup> The famous jurist of the Late Republic, Quintus Mucius Scaevola (circa 159-88 BC), asks the question whether a creditor, who has recovered a debt from his debtor, before the latter's property was sold, should be liable to repay the amount he received. Scaevola responds that the man who has watched over his interests and has improved his condition should not be liable. The reason is that the civil law is written for those who are diligent in protecting their rights.

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<sup>745</sup> See pp 191 *et seq.*

<sup>746</sup> Scaev D.42.8.24.

Similarly, why should a minority shareholder be prevented from enforcing the judgment that he managed to obtain first in courts of the real seat. After all, why should he be required to sue to in the courts of the Member State of incorporation, only to find out that there is no asset against which he can enforce the judgment, and thus require him to incur the extra cost of recognition and enforcement abroad?

Nonetheless, it is still debatable whether corporate law would benefit from such a solution. Would the possibility of by-passing the courts of the Member State of incorporation discourage regulatory competition for corporate law? This is a hard question with no clear answer. Perhaps the right way to look at this is that the danger to regulatory competition does not come from the real seat theory as ground of jurisdiction, but as a choice of law mechanism.

If it is then desirable to facilitate regulatory competition for corporate law through harmonising national private international law, why should one prefer the place of incorporation as a connecting factor over the real seat? Legal certainty is probably one of the reasons. However, there are criteria that enable courts to identify the location of the real seat. Additionally, a universal acceptance of the real seat theory would have the benefit of a simple solution to the issue of letter-box companies and most probably the bundling of company, tax and insolvency law. This should definitely tidy up the existing mess.

The real problem that such a solution entails is that a company that wishes to change its *lex societatis* would have to move both its registered

office and the real seat to another country, which is considerably more costly than the transfer of the registered office. If the 14<sup>th</sup> Directive is to be adopted, the Commission should think carefully about the new dynamics it will release into the field of private international law. The public consultation process indicated that 'registration in the host Member State should result in the company losing its legal personality and being removed from the register in its home Member State'.<sup>747</sup> The consultation process showed that 99 interviewees out of 127 agreed or completely agreed with this proposition, whereas only 24 disagreed or completely disagreed.

Undoubtedly, if the 14<sup>th</sup> Directive is ever adopted it will constitute a step in the direction of the universal acceptance of the incorporation theory. It may turn out that a reasonable outcome resulting from the balancing of all the preceding considerations would be the universal acceptance of the incorporation theory and, perhaps, the exceptional application of the *lex fori* in relation to letter-box companies and other corporate schemes that are considered abusive.

For the time being, the courts applying the real seat theory should keep an eye to the European institutions and be mindful of the possibility of Community intervention that will harmonise private international law rules in this field. Expressing this point in Roe's term, the more inequitable or harsh the outcomes reached by national courts are the more likely it is that Community intervention will be triggered.

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<sup>747</sup> Public consultation concerning the cross-border transfer of the registered office (European Commission, Internal Market) <[http://ec.europa.eu/internal\\_market/company/seat-transfer/2004-consult\\_en.htm#onlineconsult](http://ec.europa.eu/internal_market/company/seat-transfer/2004-consult_en.htm#onlineconsult)> accessed 13 December 2009.

***iii) The consequences of compatibility of the Services Directive with the EC Treaty and the refinement of the doctrine of abuse***

In addition to the aforementioned objections and obstacles to the possibility of regulatory competition for corporate charters in Europe, it is necessary to examine the consequences of imposing restrictions on letter-box companies, via either a re-interpretation of the abuse doctrine or the implementation of the Services Directive after 28 December 2009. These concerns could not have been raised in earlier literature as the ruling in *Cadbury Schweppes* had not been delivered yet and the enactment of the Services Directive had not taken place yet.

It has to be seen whether these changes will affect regulatory competition for corporate charters in Europe. So far in post-*Centros* Europe letter-box companies have been the main vehicle for regulatory competition. For example, German businessmen who wished to avoid the rigid provisions of German corporate law would incorporate an English limited liability company and use it to do business in Germany.<sup>748</sup>

*Cartesio* has made it clear that the real seat theory may be applied to any company subject to the condition that the *lex causae* –in this case, German law- will not lead to a result that constitutes a breach of freedom of establishment. Additionally, both the doctrine of abuse has been revisited in *Cadbury Schweppes* and the notion of establishment has been defined by the Services Directive in a way to make the benefits of freedom of establishment less readily available to letter-box companies. This might have the

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<sup>748</sup> Becht et al (n580).

consequence that for such companies the real seat theory may be applied on certain occasions without even having regard to the consequences of its application.

Assuming for present purposes that this is going to be the way that the relevant law will be interpreted, there will be only one way out for the corporations in question. They will have to elevate their presence in the jurisdiction of incorporation from a mere letter-box to a place where a real economic activity is actually pursued. In doing so, it may be the case that some head office functions will have to be carried out at the registered office, or that the registered office performs the duties of a branch of the corporation in the jurisdiction of incorporation. This elevation of a mere letter-box to a place where an actual economic activity is pursued may also be determinative of the COMI, as the Court in *Eurofood* has indicated.<sup>749</sup>

It can be easily imagined that a lot of these small and medium sized enterprises (SMEs) will have to take relocation to the country of their real seat into serious consideration. This might not be the case as Germany has now abolished the minimum capital requirement for private companies and thus the reason that appears to have forced them to migrate will no longer exist. However, the argument made here is that in the future there might be another reason, which may not be foreseeable now, which would make immigration more attractive. In such a case, it may well be the case that the financial consequences of preserving an establishment instead of a mere letter-box in the country of incorporation would be too tough to bear for

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<sup>749</sup> See text to n778.

many of these SMEs. This does not mean that regulatory competition will be out of the picture. However, it will be severely obstructed as SMEs will find it more expensive to preserve a registered office in the jurisdiction of incorporation. This perhaps a reason for which regulatory competition is likely to be more associated with larger companies.<sup>750</sup>

Last but not least, it is not clear whether such an interpretation of the abuse doctrine, as proposed by AG Maduro, would actually make sense. After *Centros* it is clear that the abuse doctrine may be applied to corporations that are, in the Court's terms, 'wholly artificial arrangements'. However, what is the necessity of this restriction if the relevant stakeholders, especially the creditors, can be protected under the *lex concursus* prescribed by the Insolvency Regulation?

Several legal systems choose to protect creditors in different ways. Creditor protection can be effected both through insolvency and corporate law. Rules on minimum capital requirements, restrictions on payments out to shareholders, rules on actions that must be taken following serious depletion of capital are all part of corporate law.<sup>751</sup> At the other end, each legal system selects governance strategies<sup>752</sup> that apply to a corporation during the period

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<sup>750</sup> Vella (n599).

<sup>751</sup> See RR Kraakman et al, *The Anatomy of Corporate Law: A Comparative and Functional Approach* (2<sup>nd</sup> edn OUP, Oxford 2009) 130.

<sup>752</sup> *ibid* p 38 for a definition of the term: 'governance strategies seek to facilitate the principals' control over their agent's behavior'. These strategies include the selection and removal of managers, the initiation and ratification of management decisions, trusteeship that removes potential conflicts of interest for the managers-agents and reward strategies, which seek to reward agents for advancing successfully the interests of their principals.

of transition to insolvency and to the control of firms in insolvency.<sup>753</sup> These strategies usually form part of insolvency law.

Indeed, the Court itself in *Centros* and AG Maduro in *Cartesio* have made it clear that incorporation in another Member State for the mere purpose of evading minimum capital requirements does not constitute abuse. By positioning its registered office and COMI in different Member State, a company may be able to select a debtor friendly national corporate law and the least creditor friendly national insolvency law.<sup>754</sup> Thus far there is nothing in the judgments of the ECJ to indicate that this could be an impermissible construction.

There is one last point to be made here. In order to position the COMI at a location different to that of the place of incorporation, companies will frequently seek to set up a branch in the Member State in which they wish to have their headquarters and carry on business from there. Establishing a branch is in itself a costly procedure.<sup>755</sup> Empirical research has demonstrated that the use of UK Ltd in another Member State by setting up a branch may cost from 551 euros and 5 weeks in Ireland to 5,007 euros and 7.5 weeks in Italy.<sup>756</sup> Not surprisingly, bureaucracy and translation requirements increase the cost of the use of Centros-like Ltds in other Member States.<sup>757</sup> Thus, it has

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<sup>753</sup> *ibid.*

<sup>754</sup> H Halbhuber, 'National Doctrinal Structures and European Company Law' (2001) 38 CML Rev 1385, 1403.

<sup>755</sup> See M Becht, L Enriques & V Korom, 'Centros and the cost of branching' (2009) 9 JCLS 171.

<sup>756</sup> *ibid* 173, 177.

<sup>757</sup> *ibid* 173, 182.

been argued that major steps remain to be made, such as the revision of the Eleventh Directive,<sup>758</sup> so as to eliminate the obstacles imposed to freedom of establishment by bureaucracy.<sup>759</sup>

***iv) Taxation distorts regulatory competition for company law***

There is another factor that influences regulatory competition in Europe more than it does in the US and which plays a significant role in corporate mobility in Europe. In Europe corporate tax is due at the place of central management and control. The latter does not have to correspond to the registered office, but it may be the case that companies incorporated in a jurisdiction are also thought to be tax resident there. Indeed this is the case in the UK.<sup>760</sup>

Therefore, it may be possible that actually a heavy taxation regime can discourage companies from incorporating in a specific jurisdiction, despite the fact that its company law regime could be otherwise very appealing. Simultaneously, such a regime can also discourage companies already incorporated within the jurisdiction to move out, e.g. by means of a cross-border merger. For instance, the latter can be effected through the application of exit charges that a company should pay before moving its tax residence out of the jurisdiction. There is a very persuasive argument that

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<sup>758</sup> i.e. Council Directive (EEC) 89/666 of 21 December 1989 concerning disclosure requirements in respect of branches opened in a Member State by certain types of company governed by the law of another State (Eleventh Directive) [1989] OJ L395/36.

<sup>759</sup> Becht, Enriques & Korom (n755) 182.

<sup>760</sup> Finance Act 1988 s 66(1).

such charges are contrary to freedom of establishment.<sup>761</sup> However, so long as Member States preserve these rules it will be less likely for companies to be willing to test the validity of this argument.

Taxation poses such complexity at the level of regulatory competition that would require a separate thesis in order for it to be adequately explored. Suffice it to say, for present purposes, that there have been instances where tax has acted as a deterrent to incorporate in a particular jurisdiction. In the UK this has happened twice, in 1988-1993 and in 2008.<sup>762</sup> For present purposes only the first exodus is relevant. The second was motivated primarily by the wish to avoid UK taxation and company law considerations were not involved at all.<sup>763</sup>

At the eve of *Daily Mail* and subject to pressure from other European Governments, the UK introduced the Finance Act 1988. According to s 61(1), 'a company which is incorporated in the United Kingdom shall be regarded for the purposes of the Taxes Acts as resident there'. Until that point many companies had avoided paying corporate tax in the UK by the mere fact that their central management and control was located overseas despite the fact that they had been incorporated in the UK. This had led many European Governments to protest to the UK Government for this tax evasion. As a result, the Finance Act 1988 was introduced and several companies fled the

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<sup>761</sup> Gelter (n735) 267-268; Case C-9/02 *de Lasteyrie du Saillant* [2004] ECR I-2409 (declaring exit charges for natural persons incompatible with freedom of establishment).

<sup>762</sup> The details of both these exits were narrated to the author of this thesis by Philip Baker QC, a tax barrister at Gray's Inn, who advised several of the companies involved in the exodus (personal communication 5 March 2009).

<sup>763</sup> See J Cooklin, 'Corporate exodus: when Irish eyes are smiling' (2008) 6 BTR 613.

UK between the years 1988-1993 by means of reincorporation authorised by private acts of Parliament.

These companies had some common characteristics. They had been incorporated in England at the end of the 19<sup>th</sup> century and the beginning of the 20<sup>th</sup>.<sup>764</sup> They had done so for a variety of reasons. Among other things, they wished to be subject to English company law, which at that point, was thought to be more flexible and developed than the company laws of the place they wished to activate. Several of these companies were actually running railways in the Ottoman Empire or mines in the Americas, whose laws were not considered suitable for the purposes of the business.

Another significant reason was the wish to enlist their shares in the London Stock Exchange, which at that stage in history, was beyond doubt the most developed stock market in the world with the biggest volume of transactions. They also wished to be able to raise capital in debt from credit institutions established in London. All of these companies had just their registered office in London. Their central management and control, i.e. the place where the board of directors holds its meetings,<sup>765</sup> had always been overseas. Thus they had never been subject to UK tax.

By 1988, the considerations that had warranted incorporation in the UK almost century ago had more or less disappeared. The possibility of becoming liable to UK taxation was a huge deterrent to remain incorporated

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<sup>764</sup> See pp 191 *et seq.*

<sup>765</sup> See e.g. *De Beers Consolidated Mines, Ltd v Howe (Surveyor of Taxes)* [1906] AC 455 (HL); *Unit Construction Co Ltd v Bullock* [1960] AC 351 (HL). However, HMRC have never fully accepted this interpretation of the relevant case-law.

in the UK. Thus they sought and managed to obtain the necessary private acts of Parliament that allowed them to exit the UK without dissolution. The law as it stands nowadays allows for companies that have their registered office in the UK, but their central management and control is exercised abroad to pay corporate tax only to one of the two jurisdictions, provided that a double tax treaty with a tie-breaker has been concluded between the UK and that other country. In such a case, a company is liable to tax only in the country of effective management.<sup>766</sup>

This shows that countries like the UK, which, unlike most of its European counterparts, taxes worldwide profits, as opposed to profits realised within the jurisdiction, will have serious problems in attracting incorporations. Several entrepreneurs may be discouraged from incorporating in the UK because that could make them potentially liable to UK tax. This fear is alleviated to a certain extent by the existence of double tax avoidance treaties which provide for the aforementioned tie-breakers. Nonetheless, it is clear that tax can potentially nullify the company law incentives to incorporate in a specific jurisdiction.

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<sup>766</sup> HMRC do not longer take the view that the place of effective management is necessarily the place of central management and control and have, unsuccessfully so far, tried to introduce legislation to that effect: see HRMC, International Tax Handbook ITH-348.

## 11. Concluding remarks

Part II has sought to demonstrate the influence that freedom of establishment had on private international law for corporate affairs. It has demonstrated the reasons for which, contrary to what many have thought, the real seat theory is not contrary to freedom of establishment. It has also demonstrated the way in which the Services Directive and the refinement of the doctrine of abuse can restrict the use of letter-box companies. The possibility of a regulatory competition to attract incorporations is not eliminated. An analogy with the regulatory competition for corporate charters in the USA depicts all the reasons for which an analogous competition could and could not take place in the EU. In any event, it appears likely that those who have predicted a ‘sea of free reincorporations’<sup>767</sup> may have to reconsider the unconditional nature of this statement.

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<sup>767</sup> WG Ringe, ‘Sparking regulatory competition in European Company Law: The impact of the *Centros* line of case-law and its concept of abuse of law’ in R de la Feria & S Vogenauer (eds), *Prohibition of Abuse of Law- A New General Principle of EU Law* (Hart Publishing, Oxford 2009) <[http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1326964](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1326964)> accessed 28 April 2009.

**Part III**

**Insolvency in the context of Freedom of**

**Establishment**

## 12. Introduction

The real seat theory is not only present in the sphere of corporate affairs. It has also left its traces on European insolvency law. The Council Regulation (EC) 1346/2000 of 29 May 2000 on insolvency proceedings<sup>768</sup> (hereinafter the ‘Insolvency Regulation’) appears to contain a connecting factor that contains elements of the real seat theory. The centre of main interests (hereinafter COMI) is the factor that confers international jurisdiction for insolvency proceedings within the EU.<sup>769</sup>

This Part presents the scheme of the Insolvency Regulation. In Chapter 13 it seeks to examine the notion of the COMI in the case-law of both the ECJ and domestic courts. It will be argued that the compound notion of the COMI is mainly focused on the centre from which the debtor manages his affairs on a regular basis, a definition not very distant from the real seat theory. It will be shown that the concept of ‘ascertainability’, which makes the COMI differ from the real seat theory, has a limited role to play. This conclusion will be reinforced by a comparison of the notion of the COMI in the Insolvency Regulation to the COMI in the UNCITRAL Model Law on Cross-Border Insolvency, as interpreted by US courts.

Furthermore, Chapter 14 is dedicated to the definition of forum shopping and the ways in which companies can engage in it under the scheme of the Insolvency Regulation. It will be argued that forum shopping, a

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<sup>768</sup> [2000] OJ L160/1.

<sup>769</sup> *ibid* recital 33; Denmark has been exempt from the field of application of the Regulation. Henceforward references to the EU in the context of the Insolvency Regulation should be taken to exclude Denmark.

term with negative connotations, should be distinguished from the neutral term 'forum selection'. A law and economics analysis will be useful to explain this distinction. To the extent that the debtor and all the creditors negotiate an agreement to rescue the former that involves altering the COMI there is no reason for courts to thwart their decision.

Chapter 15 seeks to explore the consistency of the rebuttal of the presumption in article 3(1) of the Insolvency Regulation with the ECJ case-law on freedom of establishment. It may well appear desirable for a company to have both its corporate affairs and its insolvency governed by a single law. However, it will be demonstrated that there are reasons, in view of the different needs that choice of law rules for internal affairs and insolvency seek to accommodate, that might justify a differentiation in the applicable law.

Chapter 16 examines the possibility of a regulatory competition for insolvency laws in Europe. It seeks to draw an analogy with the conditions that have led to the emergence of a regulatory competition for corporate law in the USA. It also argues for the UK to engage in such a competition and suggests the reasons for which such an engagement would be successful.

Chapter 17 offers the reader a brief conclusion of Part III.

## 13. The scheme of insolvency proceedings in the European Union

### *I. General features and characteristics of the Insolvency Regulation*

The Insolvency Regulation was adopted in order to promote the ‘proper functioning of the internal market’.<sup>770</sup> According to article 1(1), the Insolvency Regulation governs all ‘collective insolvency proceedings which involve the partial or total divestment of a debtor and the appointment of a liquidator’.<sup>771</sup>

Unlike its material field of application, the personal field of application of the Regulation is not entirely clear. The text of the Regulation does not reveal whether it applies to any corporation that may be active within the EU or to corporations that satisfy the criteria of article 48 EC. Recital 14 of the Regulation explicitly mentions that the Regulation shall apply only to cases where the COMI of the debtor is found within the Community. Recital 13 defines the COMI as the place where the debtor conducts the administration of its interests on a regular basis and is thus ascertainable by third parties.

This definition of the COMI also captures corporations that have been established under the law of a State outside the EU, where the COMI is within the EU.<sup>772</sup> Therefore, not only is the COMI a connecting factor allocating

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<sup>770</sup> *ibid* recitals 2-3.

<sup>771</sup> Article 1(2) excludes from the Scope of the Regulation insurance undertakings, credit institutions, investment undertakings which provide services involving the holding of funds or securities of third parties and collective investment undertakings. Their insolvency is governed by a special regime.

<sup>772</sup> *Re BRAC Rent-A-Car International Inc* [2003] 2 All ER 201 (Ch); *Re Ci4net.com Inc* [2005] BCC 277 (Ch); *Re Sento Ltd* [2006] 1 BCLC 395 (Ch); IF Fletcher, *Insolvency in Private International Law* (2<sup>nd</sup> edn OUP, Oxford 2005) 365-366; Gabriel Moss, IF Fletcher & S Isaacs

international jurisdiction, but also the criterion defining the scope *ratione personae* of the Insolvency Regulation.

## ***II. The centre of main interests and its interpretation: the Eurofood case***

Article 3(1) of the Regulation sets out the rules of international jurisdiction on main insolvency proceedings. It specifies that such jurisdiction belongs to ‘the courts of the Member State within the territory of which the centre of a debtor’s main interests is situated’. It goes on to clarify that ‘in the case of a company or a legal person, the place of the registered office shall be presumed to be the centre of its main interests in the absence of proof to the contrary’.

Although recital 13 of the Regulation provides some guidance as to the interpretation of COMI, it is actually left to the ECJ and national courts to define the COMI. The ECJ has recently delivered a landmark judgment in *Eurofood* with regard to the interpretation of the COMI of corporations.<sup>773</sup> The presentation of *Eurofood* will be followed by a comparative analysis of domestic case-law on the interpretation of the COMI.

### **A. The facts of the case**

Eurofood IFSC Ltd was a company incorporated in Ireland in 1997. It was a subsidiary wholly owned by Parmalat SpA, a company incorporated in Italy. Eurofood’s objective was the provision of financing facilities for companies in the Parmalat Group. The daily administration of Eurofood was managed by

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(eds), *The EC Regulation on Insolvency Proceedings: A Commentary and Annotated Guide* (2<sup>nd</sup> edn OUP, Oxford 2009) 45.

<sup>773</sup> Case C-341/04 *Eurofood IFSC Ltd* [2006] ECR I-3813.

the Bank of America NA, a bank established in the United States. From 1998 to 2001, Eurofood issued notes by way of private placement in a total amount of USD 180 million in order to provide security for a loan to Venezuelan companies of the Group and fund a loan to Brazilian companies of the Group. Eurofood also entered a 'Swap' agreement with Bank of America. Later on Eurofood was unable to pay to its creditors the largest part of the debt incurred under the aforementioned transactions.

On 24<sup>th</sup> December 2003, Parmalat SpA was admitted to extraordinary administration proceedings after the discovery of a 14 billion euro hole in its accounts. In a nutshell, Parmalat had sold itself credit-linked notes, in effect placing a bet on its own credit worthiness in order to conjure up an asset out of thin air. On 27<sup>th</sup> January 2004, Bank of America petitioned the winding up of Eurofood before the High Court of Ireland. It demanded payment of approximately USD 3.5 million and requested the appointment of Mr Farrell as provisional liquidator. On the same date the appointment was made, 23<sup>rd</sup> March 2004, the High Court declared Eurofood insolvent with retrospective effect from 27<sup>th</sup> January 2004 and held that Eurofood's COMI was in Ireland.

In the meantime, the Italian Court of Parma had declared Eurofood insolvent on 20<sup>th</sup> February 2004 on the basis that its COMI was in Italy. Dr Bondi was appointed as extraordinary administrator. He appealed to the Supreme Court of Ireland against the judgment of the High Court. The former submitted a reference for a preliminary ruling to the ECJ asking *inter alia* whether the COMI of a subsidiary is located at its registered office or at the headquarters of its parent company.

## **B. The ruling of the ECJ**

The ECJ first observed that the COMI is a concept ‘peculiar to the Regulation’ and thus it requires an autonomous interpretation.<sup>774</sup> The ECJ brought attention to recital 13 of the Regulation and concluded that the COMI ‘must be identified by reference to criteria that are both objective and ascertainable by third parties’.<sup>775</sup> The Court noted that the presumption in article 3(1) can be rebutted only if under such criteria ‘an actual situation exists which is different from that which locating it at the registered office is deemed to reflect’.<sup>776</sup>

The Court adopted a very narrow interpretation of the rebuttal of the presumption introduced in article 3(1). It ruled that the presumption could be reversed in the case of letter-box companies whose only connection with the State of incorporation is the location therein of their registered office.<sup>777</sup> The Court concluded that:

...where a company carries on its business in the territory of the Member State where its registered office is situated, the mere fact that its economic choices are or can be controlled by a parent company in another Member State is not enough to rebut the presumption laid down by the Regulation.<sup>778</sup>

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<sup>774</sup> *ibid* [30].

<sup>775</sup> *ibid* [32]-[33].

<sup>776</sup> *ibid* [34].

<sup>777</sup> *ibid* [35].

<sup>778</sup> *ibid* [36].

### C. The Opinion of AG Jacobs

The Opinion of AG Jacobs is more revealing with regard to the arguments that were put forward to the Court. Dr Bondi and the Italian Government<sup>779</sup> relied on the Virgós- Schmit Report,<sup>780</sup> according to which the registered office ‘normally corresponds to the debtor’s head office’.<sup>781</sup> They argued that this is a functional test, which requires the Court to identify the location where the head office functions are performed and not where the head office is nominally located.<sup>782</sup> They demonstrated this interpretation as a necessity since in transnational business the location of the registered office is decided according to tax or regulatory considerations. They also stressed that this should be the interpretation of article 3(1) and recital 13 *a fortiori* in cases of insolvency of groups of companies.

AG Jacobs conceded that these submissions were sensible but admitted that he could not see the link between a parent company’s control over a subsidiary and the latter’s COMI as the place where day-to-day administration is carried out. AG Jacobs also rejected Dr Bondi’s effort to present the COMI as a pure real seat theory test.<sup>783</sup> In particular, Dr Bondi

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<sup>779</sup> It is worth noticing that Bank of America, the Director of Corporate Enforcement and the Irish Government were joined by the Note holders, the Austrian, Czech, Finnish, French, German, Hungarian Governments and the Commission.

<sup>780</sup> Report on the 1995 Convention on Insolvency Proceedings OJ L00000. The Convention never entered into force as the UK withheld its signature. See Fletcher (n772) 352-354. However, the text of the Convention was enacted as Regulation 1346/2000. The Report can thus be used as authoritative interpretation of the Regulation.

<sup>781</sup> *ibid* [75].

<sup>782</sup> Opinion of AG Jacobs in *Eurofood* (n773) [111].

<sup>783</sup> *ibid* [114].

submitted to the Court that recital 13 contains only one criterion, namely the location where ‘the debtor conducts the administration of his business on a regular basis’. He added that ascertainability is the consequence of the COMI being located in a specific Member State.<sup>784</sup> In his opinion, ascertainability did not involve a subjective inquiry as to where the creditors thought that the COMI was but an objective one as to where the COMI actually was.

AG Jacobs pointed out that the Regulation applies to ‘individual companies and not to groups of companies’.<sup>785</sup> Each company is treated as a separate entity. Consequently, the fact that the subsidiary is even absolutely controlled by its parent company has *per se* no bearing as to the location of the COMI. By contrast, ‘transparency and objective ascertainability’ are the attributes that should describe the COMI test.<sup>786</sup> AG Jacobs attributed particular importance to the fact that the COMI should be a place known to potential creditors of a company. Transparency and objective ascertainability are criteria to be used in their favour. It is on these premises that the reversal of the presumption should be based.<sup>787</sup> In his opinion, the presumption could be reversed only if it were shown that the parent company controlled the subsidiary’s policies and that this situation was transparent and ascertainable at the relevant time.<sup>788</sup>

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<sup>784</sup> *ibid* [113].

<sup>785</sup> Opinion of AG Jacobs (n782) [117].

<sup>786</sup> *ibid* [118].

<sup>787</sup> *ibid* [119-122].

<sup>788</sup> *ibid* [124].

#### **D. The role of ascertainability in defining the COMI**

The ECJ has based its interpretation of the COMI on recital 13 of the Insolvency Regulation. The COMI ‘should correspond to the place where the debtor conducts the administration of his interests on a regular basis and is therefore ascertainable by third parties’.<sup>789</sup> The ECJ has ruled that the criteria that national courts will use to identify the COMI be objective and ascertainable ‘in order to ensure legal certainty and foreseeability’.<sup>790</sup> Thus the ECJ does not appear to speak of ascertainability of the COMI, but of ascertainable criteria. After all, ascertainability is part of the necessary characteristics of the COMI. It is impossible to have a COMI which is not ascertainable.

In his Opinion, AG Jacobs had partly endorsed as a matter of principle the interpretation of recital 13 as put forward by Dr Bondi: ‘it is *because* the corporation’s head office functions are exercised in a particular Member State that the centre of main interests is ascertainable there’.<sup>791</sup> However, he thought it to be an unhelpful submission since the Irish courts had taken the view that the head office functions of Eurofood were conducted in Ireland. AG Jacobs also refused to comment on Dr Bondi’s final submission<sup>792</sup> with regard to ascertainability in the belief that it was not relevant as it had not been raised by the Irish Supreme Court.

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<sup>789</sup> *ibid* [32].

<sup>790</sup> *ibid* [33].

<sup>791</sup> Opinion of AG Jacobs (n782) [113].

<sup>792</sup> See above text to n784.

Dr Bondi had indeed made an interesting submission with regard to the meaning of the word ‘ascertainable’. He claimed that there is a significant difference between ‘ascertainable’ and ‘ascertained’. As AG Jacobs summarised the submission in his Opinion:

The question of ascertainability involves looking to see where the head office functions are actually carried out: that is an objective process and should not be confused with subjective evidence from particular creditors about where they thought the centre of main interests was.<sup>793</sup>

The question to be asked is whether the two approaches are at variance with each other. The ECJ has indicated what the main objective criterion is, namely the place where the debtor conducts the administration of his interests on a regular basis, but has not clarified the meaning of criteria that are ascertainable by third parties. AG Jacobs did not express his view with regard to the meaning of ‘ascertainable’ in recital 13.

## **E. The normative content of ascertainability**

### ***i) Ascertainable or ascertained COMI?***

Where is the COMI thought to be located if the debtor corporation conducts the administration of its interests on a regular basis in one Member State, but for some reason the creditors believe that its COMI lies elsewhere? The ECJ has missed an opportunity to address this question and clarify the law with regard to this matter. In such a case, Dr Bondi’s final submission will come to play again. The question is whether the COMI should be ascertainable or ascertained? The wording of the answer of the ECJ to the fourth question of

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<sup>793</sup> Opinion of AG Jacobs (n782) [115].

the Irish Supreme Court supports Dr Bondi's final submission.<sup>794</sup> So long as the third parties were in a position to ascertain the location where the debtor conducts the administration of his interests on a regular basis, under objective and ascertainable criteria, and failed to do so, they will not be able to prove that the COMI is located in the place they thought it to be located.

Indeed such constructions are not unusual. On various occasions the law imposes a certain degree of prudence on parties. For instance, in civil law the party that has concluded a contract by error or mistake will have to compensate the other party for the damage that the latter party has suffered as a result of his reliance on the declaration of the former, unless the party which was free of error or mistake knew or ought to have been aware of the error or mistake.<sup>795</sup>

A similar doctrine exists in English law. Rectification will be ordered if the non-mistaken party is aware of the mistake or wilfully shuts its eyes to an obvious mistake, or wilfully and recklessly fails to make such inquiries as an honest and reasonable man would make.<sup>796</sup> The same kind of rationale can also be seen in English company law, where 'a creditor who will not take the trouble to use the means which the statute provides for enabling him to protect himself must bear the consequences of his own negligence'.<sup>797</sup>

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<sup>794</sup> See above text to n784.

<sup>795</sup> Article 145(2) of the Greek CC; §122(2) of the BGB.

<sup>796</sup> E Peel (ed), *Treitel: The Law of Contract* (12<sup>th</sup> rev edn Sweet & Maxwell, London 2007) 354; *George Wimpey UK Ltd v VI Construction Ltd* [2005] EWCA Civ 77, 103 Con LR 67.

<sup>797</sup> *Salomon v A Salomon & Co Ltd* [1897] AC 22 (HL) 40 (Lord Watson).

If this is indeed the correct meaning of the ruling of the ECJ, it necessarily follows that in a case where the COMI is located in a place other than the place where third parties think it is located, the actual location of the COMI will prevail to the extent that it *could have been* ascertained by third parties!<sup>798</sup> Whether third parties actually succeeded or failed in locating the COMI will not carry much weight. Therefore, once the place where the debtor conducts the administration of his interests on a regular basis is established, the remaining inquiry is whether the COMI is reasonably *ascertainable* by third parties at that location. Thus, the test for reasonable ascertainability is an objective test.<sup>799</sup>

It remains to be seen what would be the standard that will apply to this inquiry. It seems likely that the inquiry would be whether a reasonable, cautious and prudent creditor should have ascertained the COMI at its actual and objectively identified location. Such a standard is not foreign to EC law. The ECJ has adopted a similar approach with regard to consumer protection as a mandatory requirement. Labelling is perceived to be a proportionate means to guarantee consumer protection.<sup>800</sup> The assumption is that the

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<sup>798</sup> *Shierson v Vlieland-Boddy* [2005] EWCA Civ 974, [2005] 1 WLR 3966 [55]: 'It is important, therefore, to have regard not only to what the debtor is doing but also to what he would be perceived to be doing by an objective observer.'; Moss, Fletcher & Isaacs (n772) 46.

<sup>799</sup> The use of the term 'objective' should not be confused with the use of the term 'objectivity' as opposed to 'ascertainability'. In this context it only connotes the fact that the court will inquire whether the COMI was reasonably ascertainable by an average man at the place where the debtor conducts regularly the administration of his affairs.

<sup>800</sup> Case C-178/84 *Commission v Germany* [1987] ECR 1227 [35] (German beer case); Case C-14/00 *Commission v Italy* [2003] ECR I-513 [78]-[82].

cautious and prudent consumer will read the label before purchasing a product.

This reading of *Eurofood* receives some support from the judgment of Drain J in the US Bankruptcy Court for the South District of New York. In commenting on *Eurofood*, he accepted that ‘the ECJ strongly indicated that if *third parties would objectively locate the administration* of such a debtor’s interests elsewhere, the presumption would be rebutted’.<sup>801</sup>

The ascertainable nature of the COMI flows from its identification at a specific location through the use of objective criteria. Such criteria include the place where decisions are made and administration or ultimate control is made, the location of the debtor’s assets such as bank accounts, the place wherefrom the debtor directs his trading activities, the place where human resources are managed etc.<sup>802</sup> This rebuttal will be much harder ‘in cases where *some* business is carried on in the place of the registered office’.<sup>803</sup>

According to this list of objective criteria, the test for the rebuttal of the COMI is one of locating the place where head office functions are performed. This list contains criteria, e.g. the location where the board of directors meets, which are impossible to ascertain for an outsider, such as a

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<sup>801</sup> *In re SPhinX* 351 BR 103 (Bkrtcy SDNY 2008) 119, aff’d 371 BR 10 (SDNY 2007) (emphasis added).

<sup>802</sup> See text to n863. Compare with *In re Bear Stearns High-Grade Structured Credit Strategies Master Fund Ltd* 374 BR 122 (Bkrtcy SDNY 2008) 128.

<sup>803</sup> J Armour, ‘European cross-border insolvencies: the race goes to the swiftest?’ (2006) 65 CLJ 505, 506.

creditor, even if the latter is a bank or another credit institution.<sup>804</sup> Thus one might feel inclined to remove all criteria that cannot be readily ascertained by the creditors.<sup>805</sup>

This matter has been recently pleaded before the English courts.<sup>806</sup> Summarising the arguments of the parties with regard to the appropriate, Lewison J stated that:

Mr Isaacs submitted that information would count as being ascertainable even if it was not in the public domain if it would have been disclosed as an honest answer to a question asked by a third party. Provided that a third party asked the right questions, and was given honest answers, the result of the inquiry would be ascertainable. Mr Zacaroli submitted that this formulation was far too wide and blurred the distinction between what was ascertainable and what was not. On the basis of Mr Isaacs' submission the requirement of ascertainability was diminished almost to vanishing point. Rather, what was ascertainable by a third party was what was in the public domain, and what a typical third party would learn as a result of dealing with the company. I agree with Mr Zacaroli... one of the important features is the perception of the objective observer. One important purpose of COMI is that it provides certainty and foreseeability for creditors of the company at the time they enter into a transaction. It would impose a quite unrealistic burden on them if every transaction had to be preceded by a set of inquiries before contract to establish where the underlying reality differed from the apparent facts.<sup>807</sup>

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<sup>804</sup> MV Benedettelli, “‘Centro degli interessi principali” del debitore e forum shopping nella disciplina comunitaria delle procedure di insolvenza transfrontaliera’ (2004) 40 RCIPP 499, 513-514.

<sup>805</sup> Judgment of 27 April 2004, *EMBIC I* [2004] ZIP 1064 (AG Mönchengladbach); J Armour, ‘European Insolvency Proceedings and Party Choice: Comment’ in WG Ringe, L Gullifer & P Théry (eds), *Current Issues in European Financial and Insolvency Law: Perspectives from France and the UK* (Studies of the Oxford Institute of European and Comparative Law, Hart Publishing, Oxford 2009) 123, 124.

<sup>806</sup> *Re Stanford International Bank Ltd* [2009] EWHC 1441 (Ch).

<sup>807</sup> *ibid* [62].

However, one should be cautious to break any link between the COMI and the head office. What would be the point of alienating the COMI from the head office as described above, if the location where the creditors think the COMI to be found is a mere letter-box, for instance? The opening of secondary proceedings at the location of the head office could defeat the nature of the proceedings opened by the creditors as main proceedings. The COMI should be the place which does retain a substantial connection with the debtor and whose courts are able to supervise the insolvency of the debtor with the minimum possible assistance from the judicial authorities of other Member States.<sup>808</sup>

Therefore, the debtor should disclose all the necessary information requested by the creditor. If he fails to do so or misrepresents reality, the outcome is that the creditors might reasonably ascertain the COMI to be at a place different to that where the debtor actually administers his affairs on a regular basis. The place where the debtor actually administers his affairs cannot be the COMI. Ascertainability is part of the definition of the COMI. If the location where the debtor actually administers his affairs on a regular basis is not ascertainable, then it is not the COMI.

The law should also place the duty on a creditor to make reasonable inquiries as to the location of the COMI and on the debtor to disclose this information. The imposition of the latter obligation on the debtor is not excessive. It reflects the fact that the debtor is always in the position to provide this crucial information at the lowest possible cost. By contrast, it

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<sup>808</sup> This point is developed further below: see pp 355 *et seq.*

would require greater cost and greater use of resources on behalf of the creditors in order to reach the same conclusion, which will not always be an accurate one.

By contrast to the holding of Lewison J, these duties do not constitute an excessive burden. To the extent that parties are mindful of them and of the consequences they bear, they can enter negotiations in order to identify the COMI at a specific location. For instance, a debtor might be willing to acknowledge the existence of his COMI at a place other than the one where it is actually located in return for lower interest rate etc.

However, even if they were not to bargain about the COMI, asking a question and receiving answer is not always a great burden to the speed of transactions. Indeed such a query could constitute a burden in case of an on-line transaction concerning the purchase of a book. Nonetheless, it might be a very prudent, in fact necessary, step, in case of a loan of 3 millions pounds. Different degrees of diligence should be applied to different kind of creditors. Thus, the fact the an on-line search on debtor's website indicated the place where the debtor administers his affairs on a regular basis to be located in a place other than the one put forward by the debtor himself might suffice to support a rebuttal of the presumption for the purchaser of a book, but not the bank that has lent 3 millions of pounds to him.

***ii) Ascertainability: an analogy with the law of contract***

An analogy with the law of contract will assist greatly in the elaboration of the notion of ascertainability. A common feature of all early legal systems has been the existence in contracts for the sale of goods of the *caveat emptor*

rule.<sup>809</sup> According to it, the buyer of a good cannot complain of a defect that he could have discovered when examining the object of sale.

In Roman law, by classical times, the *caveat emptor* rule had been elaborated and its scope was narrowed especially in the context of the sale of slaves by the *aediles curules*, the officials empowered to regulate market transactions.<sup>810</sup> The *aediles curules* obliged the slave traders to notify the purchasers if the traded slaves had any diseases (*morbis*) or defects (*vitium*), if they had some serious defect of character.<sup>811</sup>

*Morbis* and *vitium* were thus characteristics of the slave that the purchaser could not, in most cases, identify by a mere examination of the slave at the time when the contract of sale was concluded. The same applied to defects of character, which were impossible to be ascertained by the purchaser. Thus, it was for the seller to disclose to the buyer whether the slave had certain crucial defects of character: i.e. whether the slave had the habit of running away;<sup>812</sup> whether he had the habit of roving about;<sup>813</sup> whether he had perpetrated a capital crime;<sup>814</sup> whether he was prone to committing suicide;<sup>815</sup> or whether he had fought wild animals in the arena.<sup>816</sup> In order to

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<sup>809</sup> R Zimmermann, *The Law of Obligations: Roman Foundations of the Civilian Tradition* (OUP, Oxford 1996) 307.

<sup>810</sup> G Impallomeni, *L'editto degli edili curuli* (CEDAM, Padua 1955) 109 *et seq.*

<sup>811</sup> Ulpian D.21.1.1.1.

<sup>812</sup> Ulpian D.21.1.17.

<sup>813</sup> Ulpian D.21.1.17.14.

<sup>814</sup> Ulpian D.21.1.1.1; Ulpian D.21.1.23.2.

<sup>815</sup> Ulpian D.21.1.1.1; Ulpian D.21.1.23.3.

avoid liability, the seller also had the duty to disclose whether the slave was still burdened with noxal liability,<sup>817</sup> although this was neither a physical defect nor one of character.<sup>818</sup>

The common element of all these defects was that the purchaser could not be expected to ascertain by examining the slave at purchase. If this reasoning were to be applied by analogy to the COMI, it would require the debtor to bear a duty of disclosure of all the necessary information that the creditors could not themselves obtain. Undoubtedly, he is in a position to provide the relevant information without any inconvenience to him, or at least by incurring substantially less inconvenience or costs than the creditors. Thus in the case of the restructuring of Damovo, the latter moved its head office functions from Luxembourg to London, ‘telling all suppliers, creditors and counterparties of the new address in England’.<sup>819</sup>

On the other hand though, some creditors, especially the most sophisticated ones, like banks or other institutional investors, are going to provide the debtor with their funds. This requires also some sort of care to be demonstrated on their part. The identification of the COMI is a matter that concerns both the debtor and his creditors. It is an inquiry that eventually leads to the identification of the *lex concursus*. Thus both have an interest in investigating the matter. As Gaius has put it in the context of the contracts of

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<sup>816</sup> Ulpian D.21.1.1.1.

<sup>817</sup> Zimmermann (n809) 314.

<sup>818</sup> Ulpian D.21.1.1.1; Ulpian D.21.1.17.17-19.

<sup>819</sup> S Moore, ‘COMI migration: the future’ [2009] *Insolv Int* 25, 27.

*depositum* and *societas*, one has only himself to blame for selecting a careless depositor<sup>820</sup> or partner.<sup>821</sup>

Therefore, the creditors themselves should demonstrate a certain degree of diligence in trying to identify the COMI. If they do not, then they can only have themselves to blame. This line of arguments goes against the criticism that English courts have implemented criteria which creditors are not in a position to ascertain.<sup>822</sup> It is indeed submitted that creditors should not be exempt of any burden in assessing the location of the COMI. As Seneca has eloquently put it: ‘when we are about to lend money we first make a careful enquiry into the means and habits of life of our debtor, and avoid sowing seed in a worn-out or unfruitful soil’.<sup>823</sup>

An analogy can be drawn with the law of constructive notice in English law. Such notice was ‘the test which determined whether a person purchasing a legal estate in good faith would take priority over the holder of an earlier equitable interest which encumbered the vendor’s title’.<sup>824</sup> Purchasers are thus required to inquire into the history of the vendor’s title. The reason is that they will be acquiring title over land and they had an interest in taking

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<sup>820</sup> Gaius D.44.7.1.5; J.3.14.3.

<sup>821</sup> J.3.25.9.

<sup>822</sup> See to this effect SM Franken, ‘Three Principles of Transnational Corporate Bankruptcy Law: A Review’ (2005) 11 ELJ 232, 248-254.

<sup>823</sup> Seneca De Beneficiis I.1.2; A Stewart (tr), *L. Annaeus Seneca On Benefits* (George Bell & Sons, London 1905).

<sup>824</sup> D Fox, ‘Constructive Notice and Knowing Receipt: An Economic Analysis’ (1998) 57 CLJ 391.

reasonable steps to ensure that they are acquiring from a person who has good title.

Likewise, institutional creditors have an interest in ascertaining the location of the COMI. The duty of inquiry that they have can be the same with that of other creditors, e.g. employees, who cannot have recourse to the same means in order to ascertain the location of the COMI. Although the placing of this burden could allegedly increase the costs incurred by the creditors, the fact that the debtor is burdened with a corresponding duty of disclosure minimises the said costs.

In other words, creditors, and in particular sophisticated creditors, should not be allowed to ignore what, in the circumstances, a reasonable man in their place could be aware of. This is analogous to the argument advanced in the context of misrepresentation in the law of contract. There it has been submitted that the rule in *Redgrave v Hurd*, i.e. a person may still be entitled to relief despite the fact that he had the opportunity to find out the truth about the quality of the object of sale,<sup>825</sup> should no longer apply to the extent that ‘it is reasonable to expect the representee to make use of the opportunity to discover the truth’.<sup>826</sup>

There is, however, one important limitation to this analogy. Contracts bind only the parties that have concluded them. In the context of the COMI, there is an additional difficulty. What could be reasonably ascertainable for one creditor, could not be for another. Additionally, the debtor could

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<sup>825</sup> *Redgrave v Hurd* (1881-82) LR 20 ChD 1 (CA).

<sup>826</sup> Treitel (n796) 371.

misrepresent his COMI to one creditor but not to another. These cases can only be resolved by reference to the majority of creditors by value.<sup>827</sup> Therefore, the analogy with the law of contract is relied upon only to the extent that creditors should be under some duty to inquire into the location of the COMI and debtors should be estopped from relying on or benefiting from a misrepresentation they have made.

***iii) Caveat creditor : qui n'ouvre pas les yeux doit ouvrir la bourse***

There is a French saying that if one does not open his eyes, he should open his wallet. Creditors that are not diligent in identifying the true location of the COMI will have to bear the consequences of their negligence. Debtors who have misled creditors or have not disclosed the relevant information to their creditors should suffer the consequences of their acts or omissions.

It has been submitted that the COMI test is an objective test. If indeed ascertainable criteria are part of this objective test, it makes no sense to speak of the former independently from the latter. This leads to the conclusion that one group of objective factors (objective and ascertainable) has to be contrasted with another (objective and less or non ascertainable). The former will prevail over the latter. A creditor that has not identified the COMI via these objective and ascertainable factors will have to 'open his wallet'. The rule is thus *caveat creditor*.

It now falls to be decided which are these objective factors that are more ascertainable than others. In interpreting the notion of the COMI, the courts of Member States have referred to a variety of factors, some of which

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<sup>827</sup> See pp 291 *et seq.*

are more ascertainable than others.<sup>828</sup> Factors like the place where the board of directors meets, decisions are made and administration is directed, the place where the majority of employees are hired and offer their work, the place where communications are sent to and received from, the place where the debtor has its bank accounts created and used are more ascertainable than factors like the place of residence of directors, the place where IT and accounting systems are set up and run and the location where the debtor's documentation is held.

The type of corporate entity used by both the debtor and the creditors will undoubtedly influence this inquiry. If the debtor is organised as a public limited company that is obliged by law to keep records and have them readily available for consultation and inspection, it will be hard for the creditor to argue that certain factors, like the place where the management meets, are not ascertainable. After all, the debtor will be seen to have discharged his duty of disclosing the relevant information. Likewise, it is hard for a big bank to claim that certain factors were not ascertainable, in case of a SME debtor, given the sophistication of information services that are at the disposal of credit institutions.

#### **F. Is the potential conception of ascertainability as an independent subjective criterion sound in principle?**

So far it has been explained why ascertainability should be an objective test.

It will now be shown why ascertainability should not be viewed as an independent subjective criterion. The distinction drawn here is very much

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<sup>828</sup> See pp 295-297.

like the one drawn between *culpa levis in abstracto* and *culpa levis in concreto* in Roman law of obligations. Under the former, the debtor of an obligation is required to demonstrate the standard of care that the *bonus paterfamilias*, i.e. the average reasonable man, would demonstrate in the circumstances in question. Under the latter, the debtor is required to show the standard of care that he usually shows in the administration of his own affairs (*diligentia quam in suis*).<sup>829</sup>

This analogy serves to demonstrate the kind of diligence that a creditor needs to show in ascertaining the COMI in each particular case. So far it has been demonstrated that one way to do this is to consider ascertainability as the capacity of the location where the debtor administers his affairs on a regular basis to be identified by the *bonus creditor*. It will now be shown why the contrary, i.e. what the creditors in question could themselves ascertain based on the standard of care they show in the administration of their own affairs, is in fact undesirable.

The issue can be demonstrated through the following question: what would happen if an objective inquiry with regard to the location of the COMI would point in one direction whereas ascertainable criteria would point to another? Such would be the case for instance if under objective criteria the COMI of a company incorporated in Italy would be thought to be located in France, but the creditors had been given the impression that the COMI is located in Luxembourg.

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<sup>829</sup> Zimmermann (n809) 192-193, 198-199, 210-212.

One approach is to say that one of the two criteria will supersede the other. If one were to take this view indeed one would be more likely to opt for ascertainability rather than objectivity. There will be at least two justifications for such an approach. First, one would attribute more weight to the protection of creditors as against other purposes of insolvency law. Second, if one were to take the contrary view, the notion of subjective ascertainability would be deprived of all its significance, which would contradict the assumption that it is an independent subjective criterion. In other words, for those who believe that ascertainability is an independent subjective criterion, its prevalence over objectivity is an inevitable conclusion.

As far as the first point is concerned, the Virgós-Schmit Report on 1995 Brussels Convention on Insolvency Proceedings lends some support for this view. It states:

It is therefore important that international jurisdiction (which, as we will see, entails the application of the insolvency laws of that Contracting State) be based on a place known to the debtor's potential creditors. This enables the legal risks which would have to be assumed in the case of insolvency to be calculated.<sup>830</sup>

If the sole purpose of the provision is to afford protection to potential creditors the answer to the question should be that subjective considerations of ascertainability will trump the identification of the COMI by objective criteria. However, protection of creditors cannot be the only purpose of article 3(1). It is also supposed to confer jurisdiction on the courts of the

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<sup>830</sup> See n780.

Member State which has a substantial connection with the insolvent corporation.<sup>831</sup>

It is erroneous to view ascertainability as an independent subjective criterion that supersedes objectivity. Indeed, the ECJ has never suggested that ascertainability supersedes objectivity. In the aforementioned example of a company incorporated in Italy, where objectivity points to France and ascertainability to Luxembourg, it will be more appropriate for a court to decide that the presumption of article 3(1) had not been successfully rebutted. Jurisdiction would lie with the Italian courts, which are always a natural forum as the company in question had been incorporated in Italy.

Thus it is not enough to prove that the COMI is not at the place of the registered office.<sup>832</sup> To rebut the presumption one should prove that the COMI is located at another Member State.<sup>833</sup> The case for ascertainability is of course less strong when the place where the debtor conducts the administration of his interests on a regular basis coincides with the location of the registered office.

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<sup>831</sup> UNCITRAL, 'Legislative Guide on Insolvency Law' (2005) New York p 41, recommended for due consideration to all States by UNGA Res 59/40 (2 December 2004) UN Doc A/RES/59/40.

<sup>832</sup> Things might be arguably different in case where the place of incorporation is outside the EU, but objectivity points to one Member State and ascertainability to another. The reason is that the Regulation confers jurisdiction to Member States courts over all companies having their COMI 'in the Community'. The problem will be to identify the court of the Member State that will enjoy jurisdiction under article 3 of the Regulation. To the extent that the debtor has not sought to misrepresent his COMI to third parties, it will be possible to establish jurisdiction at the location where the debtor performs his head office functions.

<sup>833</sup> This is very much like the comparison to be conducted under the Private International Law (Miscellaneous Provisions) Act 1995 s 12, where the comparison is to be drawn between the tort or delict and the law of the country in which the events constituting the tort or delict occur, on one hand, and the significance of any factors connecting the tort or delict with another country. The comparison is always drawn between two countries only at a time.

Ascertainable criteria do not involve questions as to the place where the creditors think the COMI is located. Instead, one may argue, they involve a set of objective questions with regard to where the debtor holds himself out as conducting his affairs on a regular basis. What renders them ascertainable, one could argue, is the fact that they are capable of being answered by reasonably diligent creditors. This is an objective test.

To confirm the merit of this approach one has to return to the text of the Regulation. Recital 13 states that ‘the “centre of main interests” should correspond to the place where the debtor conducts the administration of his interests on a regular basis *and is therefore ascertainable* by third parties’ (emphasis added). Ascertainability is thus the consequence of objectivity. It flows from the fact that the debtor conducts the administration of his business at a specific location. This observation reinforces the conclusion that the test for ascertainability should be an objective one. The wording of the recital does not leave room for subjective considerations that may trump an objective conclusion as to the location of the COMI.

To the sum up the preceding arguments, it is *prima facie* for the courts of the Member State where the corporation’s registered office is located to open insolvency proceedings. If the location of the COMI is disputed, it is for the court seized to address two questions. The first question to be asked with regard to the COMI is to identify the location where the debtor conducts the administration of his interests on a regular basis. The second question is to locate the place where the creditors should have objectively identified the location of the COMI. If the two locations coincide, this will be the end of the

inquiry.<sup>834</sup> The courts of that country would have exclusive jurisdiction. If the creditors should have reasonably identified the COMI at a location other than that of the place where the debtor administers his interests on a regular basis (e.g. in a case of misrepresentation by the debtor), it is the courts of that other Member State that will enjoy jurisdiction.

### **G. The majority of creditors by value as a test for ascertainability**

Where will the court think the COMI to be located where the debtor has made different representations to different creditors? The same problem would arise even in cases where the different representations were made without a fraudulent intention. It might be the case that the debtor changed his COMI subsequent to the conclusion of the agreement establishing the debt. Ascertainability can be abused not only by the debtor but also by the majority by value of creditors against the minority creditors. The second type of case concerns instances where the debtor is a subsidiary of the majority by value of creditors or a subsidiary of their subsidiary etc.

Whatever the solution to the first case might be, one thing is certain: that a company cannot have more than one COMI depending on the creditor. On the other hand, it would be unfair to allow the debtor to influence the identification of the COMI just by making misrepresentations as to its location to its creditors. The court will inquire whether the creditors ought to have identified the COMI at the place where it is located according to objective criteria. In the case of misrepresentations on behalf of the debtor

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<sup>834</sup> The Honorable SL Bufford, 'Center of Main Interests, International Insolvency Venue, and Equality of Arms: the *Eurofood* Decision of the European Court of Justice' (2007) 27 NW J Intl L & Bus 351, 358.

the answer would probably be negative. If different creditors have different views due to different representations one solution might be to hold that the presumption of article 3(1) has not been successfully rebutted. The other is to apply a majority of creditors by value rule.

In relation to the second option, McGonigal J thought that the location which ‘a large majority of creditors *by value*’ (emphasis added) would regard as the COMI of their debtor would be necessary but not sufficient for the satisfaction of the requirement of ascertainability.<sup>835</sup> The majority of creditors by value is a criterion that a court should be inclined to use only within the narrow confines of ascertainability. Thus it does not matter where the majority of creditors by value thinks the debtor to conduct the administration of his affairs on a regular basis. Majority by value could become a useful tool only in cases where different groups of creditors have reasonably and objectively ascertained the COMI in different locations. This could happen because the debtor has misrepresented his COMI to either all or some or even one of group of creditors.

There would though be one caveat to the rule of majority by value. The rule that creditors are much better judges of what is to their commercial advantage than courts<sup>836</sup> must be displaced in cases where their preferences are tainted by self-interest.<sup>837</sup> The normal position in English liquidation proceedings in regard to the commencement of liquidation, appointment of a

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<sup>835</sup> *Re Daisytek-ISA Ltd* [2003] BCC 562 (Ch) [16].

<sup>836</sup> *Re English, Scottish & Australian Chartered Bank* [1893] 3 Ch 385 (CA) 409 (Lindley LJ).

<sup>837</sup> *Re Parmalat Capital Finance Ltd* [2004-05] CILR 22 (Grand Court of the Cayman Islands).

liquidator, etc, is to accord with the wishes of the majority by value save for votes that are tainted with partial self-interest in some way.<sup>838</sup>

In conclusion, in rebutting the presumption of article 3(1) the COMI should be first identified objectively at the place where the debtor conducts the administration of his interests on a regular basis. This place needs to be confirmed by ascertainable criteria. Unless the creditors show why they ought not to have identified the COMI at that particular place, the courts of that country will have jurisdiction. If several groups of creditors have reasonably and objectively reached different conclusions as to the location of the COMI, it is preferable to hold that the presumption of article 3(1) has not been successfully rebutted. There is no clear reason as to why the views of the majority of creditors by value should be preferred over those of the minority.

### ***III. The constitutive elements of the COMI in domestic case-law***

#### **A. Objective elements of the COMI**

Although not binding on the ECJ, case-law from the courts of Member States has helped a lot in clarifying the meaning of the COMI. It should be stated at the outset that there is no standard approach to COMI among the various jurisdictions comprising the EU. What the COMI usually comes down to is an accumulation of connecting factors with one or another jurisdiction, especially in civilian jurisdictions where judgments are rather on the short side.

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<sup>838</sup> *Re ABC Coupler & Engineering Co (No 1)* [1961] 1 WLR 243 (Ch); *Re Leigh Estates (UK) Ltd* [1994] BCC 292 (Ch).

One of the first approaches to the notion of the COMI for corporations came from an English court as early as 15 July 2002, just fifteen days after the entry into force of the Regulation. The case concerned a bankruptcy petition made by a company incorporated in Cyprus,<sup>839</sup> but Registrar Jaques dealt with the case of companies as well. In an *obiter dictum* he stated that:

It is the need for third parties to ascertain the centre of a debtor's main interests that is paramount, because, if there are to be insolvency proceedings, the creditors need to know where to go to contact the debtor. That is why with a company there is a rebuttable presumption that the centre of main interests is where the registered office is located. That is, typically, in English cases, the office of the company's accountants or auditors or sometimes one of its directors. Quite often it is not the place where the business is being conducted. The purpose of making the head office the rebuttable centre of main interests of the company is because that is where a creditor wishing to contact the company can be expected to go and that is where, for example, when winding a company up, you have to serve the petition; that is where you have to serve the evidence; that is where you have to serve the demand; and that is the address you have to give if you are taking proceedings to recover a debt and so on.<sup>840</sup>

This is the first time the COMI is linked with the head office, rather than the place where business is conducted. This is why in rebutting the presumption that the COMI is located in the place of incorporation, English courts have held that one needs to show that the head office functions are performed elsewhere.<sup>841</sup> It is only recently that doubt has been cast on this direct link between the COMI and the head office. Lewison J has held that '[p]re-

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<sup>839</sup> *Gerevan Trading Co Ltd v Skjevesland* [2003] BCC 209 (Ch), aff'd [2003] BCC 391 (Ch).

<sup>840</sup> *ibid* 223.

<sup>841</sup> Dicey, Morris & Collins, *The Conflict of Laws* (14<sup>th</sup> edn Sweet and Maxwell, London 2006) para 30-171; *Re Collins & Aikman Corporation Group* [2006] BCC 606 (Ch) [16]; G Moss QC, 'Group Insolvency – Choice of Forum and Law: the European Experience Under the Influence of English Pragmatism' (2007) 32 *Brook J Intl L* 1005.

Eurofood decisions by English courts should no longer be followed in this respect.<sup>842</sup>

Courts in civilian jurisdictions seem to have shaped the notion of the COMI towards a real seat approach. French courts have moved to identify the COMI as the effective centre where the debtor manages his business and which is verifiable by third parties.<sup>843</sup> Along the same lines, German courts seem to believe that the COMI is the place where administration lies, all business decisions are made and all business activities are lead from.<sup>844</sup>

Despite the fact that there are two nominally different approaches, courts in both common and civil law jurisdictions examine the same variety of factors that link a corporation with one or another jurisdiction. Such factors include the place where the management meets, decisions are made and administration or ultimate control is directed;<sup>845</sup> the place where the

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<sup>842</sup> *Re Stanford International Bank* (n806) [61].

<sup>843</sup> *Re Energtech SARL* [2007] BCC 123 (Tribunal de Grande Instance de Lure).

<sup>844</sup> Judgment of 01.10.2006, *Hans Brochier Holdings Ltd* (AG Nürnberg) at <<http://www.eir-database.com>> accessed 16 January 2008; see also the *PIN* case (AG Cologne) reported and analysed in A Gallagher & RK Janjua, 'European Insolvency Regulation: German Court Blesses Change of COMI to Bolster Cross-Border Group Restructuring' (2008) 27(7) *Am Bankr Inst J* 30, 48.

<sup>845</sup> *Trib Roma*, 14.08.2003 *Cirio Del Monte NV* [2004] *Dir fall* 1008; *Comm Bruxelles*, 02.10.2003, *Electra Airlines Compagnie* at <<http://www.eir-database.com>> accessed 16 January 2008; *Trib Parma*, 04.02.2004, *Parmalat Capital Netherlands BV* at <<http://www.eir-database.com>> accessed 17 January 2008; Judgment of 02.08.2004, *HUKLA* (AG Offenburg) at <<http://www.eir-database.com>> accessed 17 January 2008; Judgment of 14.06.2004, *Parmalat Hungária Rt & Mliekotej sro* (Court of Fejér, Hungary) at <<http://www.eir-database.com>> accessed 17 January 2008; *Re Aim Underwriting Agencies (Ireland) Ltd* [2005] *ILPr* 22 (Ch); *Re Daisytek* (n835); *Re Parkside Flexibles SA* [2006] BCC 589 (Ch) [34]; *Re Collins* (n841) [19]; *Re 3T Telecom Ltd* [2006] 2 BCLC 137 (Ch); *Hans Brochier* (n844); *Hans Brochier Holdings v Exner* [2007] BCC 127 (Ch) [26]; *Re Energtech* (n843).

majority of employees are hired and offer their work;<sup>846</sup> the *lex causae* of the contracts of employment;<sup>847</sup> the place where employees receive social security;<sup>848</sup> the place where human resources are managed;<sup>849</sup> the place where bank accounts of the companies are created and used<sup>850</sup> or where payments are made from;<sup>851</sup> the place where VAT numbers are maintained and income declarations are submitted to tax authorities;<sup>852</sup> the place where information technology<sup>853</sup> and accounting<sup>854</sup> systems are set up and run; the place where sales and other contracts are negotiated, directed and approved;<sup>855</sup> the *lex causae* of such contracts;<sup>856</sup> the place where cash management is directed from;<sup>857</sup> the place of residence of directors;<sup>858</sup> the place of meetings between

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<sup>846</sup> *Re Daisytek* (n835); *Re BRAC* (n772) [5]; *Electra Airlines* (n845); Judgment of 21.01.2005, *Bluegrid Ltd* (Stockholm District Court) at <<http://www.eir-database.com>> accessed 17 January 2008; *Re Parkside* (n845) [35]; *Re Sendo* (n772); *Hans Brochier v Exner* (n845) [26].

<sup>847</sup> *Re BRAC* (n846); *Hans Brochier v Exner* (n845) [25-26].

<sup>848</sup> *Trib Luxembourg*, 15.04.2005, *Silvarux SARL* at <<http://www.eir-database.com>> accessed 17 January 2008.

<sup>849</sup> *Re Collins* (n845) [22]; Judgment of 04.05.2004, *Hettlage-Österreich* (AG München) at <<http://www.eir-database.com>> accessed 17 January 2008; *Hans Brochier* (n844); *Re Energtech* (n843).

<sup>850</sup> *Electra Airlines* (n845); *Re Collins* (n849); *Re Sendo* (n846); *Re Parkside* (n846); *Hans Brochier v Exner* (n845) [25]; *Hans Brochier* (n844).

<sup>851</sup> *Bluegrid* (846).

<sup>852</sup> *Comm Bruxelles*, 12.12.2003, *SPRL Eurogyp* at <<http://www.eir-database.com>> accessed 16 January 2008; *Re Sendo* (n846).

<sup>853</sup> *Re Collins* (n849); *Re Daisytek* (n835); *Re Energtech* (n843).

<sup>854</sup> *Re Energtech* (n843); *Hettlage* (849).

<sup>855</sup> *Re Collins* (n849); *Re Sendo* (n846); *Re Daisytek* (n835); *Re Energtech* (n843); *HUKLA* (n845); *Hettlage* (n849).

<sup>856</sup> *Re BRAC* (n846); *Re Energtech* (n843); *Hans Brochier* (n844).

<sup>857</sup> *Re Collins* (n849).

the debtor and the creditors or the location of creditors;<sup>859</sup> the place where cash flow management takes place;<sup>860</sup> the place of manufacturing activities;<sup>861</sup> the location where company documentation is held;<sup>862</sup> the currency of the company's debt.<sup>863</sup>

The list of factors that has been created by national courts is endless and difficult to use. For the sake of uniformity of the interpretation of the COMI, a non-exhaustive list of objective and reasonably ascertainable factors should be established, similar to the one created by US courts.<sup>864</sup> This list can be composed by the factors that have been more frequently referred to by the courts of more than one Member State.

Such a list could include questions as to the location of the place where the management meets, decisions are made and administration or ultimate control is directed;<sup>865</sup> the place where the majority of employees are hired and offer their work;<sup>866</sup> the place where human resources are

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<sup>858</sup> *Re Ci4net.com* [2005] BCC 277; Judgment of 09.05.2006 (AG Hamburg) at <<http://www.eir-database.com>> accessed 17 January 2008.

<sup>859</sup> *ibid*; Judgment of 30.05.2003, *Radaflex OY* (Svea Court of Appeal) at <<http://www.eir-database.com>> accessed 17 January 2008; *Re Energtech* (n843); *Hans Brochier* (n844); *Bluegrid* (n846).

<sup>860</sup> *Re Collins* (n849); *Re Aim* (n845).

<sup>861</sup> *Re Parkside* (n846); *Bluegrid* (n846).

<sup>862</sup> *Cour d'appel de Douai*, 02.05.2006, *Soc Trading Logistics Mediations International Ltd* at <<http://www.eir-database.com>> accessed 17 January 2008; *Hans Brochier* (n844); *HUKLA* (n845).

<sup>863</sup> *Bluegrid* (n846).

<sup>864</sup> See text to n924.

<sup>865</sup> See n845.

<sup>866</sup> See n846.

managed;<sup>867</sup> the place where bank accounts of the companies are created and used;<sup>868</sup> the place of meetings between the debtor and the creditors or the location of creditors.<sup>869</sup>

If the majority of these factors point to a different location from that of the registered office then there is a strong case that the presumption be rebutted. National courts could also look at the location of those who manage the debtor (e.g. the headquarters of the holding company), like their US counterparts, but should be at the same time mindful of the ECJ's ruling in *Eurofood*, namely that the said factor is not enough *per se* to rebut the presumption of article 3(1).

## **B. Requirements of transparency of the COMI**

Although some of these factors, such as the location of the creditors or the place where the creditors have held meetings with the debtor, are linked with the element of ascertainability, on certain occasions courts have felt the need to address ascertainability more directly. For instance, in *Re Ci4net.com* Judge Langan QC thought that a report stating that the principal executive offices of the debtor were in London and which was sent by the debtor company, Ci4net.com Inc, to its creditor, HSBC, added to the ascertainability of London as the COMI of the debtor.<sup>870</sup> The rationale appeared to be that the provision of these documents to HSBC amounted to a representation made to the latter

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<sup>867</sup> See n849.

<sup>868</sup> See n850.

<sup>869</sup> See n859.

<sup>870</sup> *Re Ci4net.com* (n858) [24].

from which the debtor could not reside. The same could be said for the London telephone number that DBP Holdings Ltd, a wholly owned subsidiary of Ci4net.com Inc, provided to HSBC.<sup>871</sup>

Likewise, the placing of bond issues of a company incorporated in The Netherlands was undertaken exclusively by a private placing amongst institutional investors in Italy and was managed by Italian banks.<sup>872</sup> The *Tribunale di Parma* held that the COMI was in Italy.

In *re Daisytek* the court referred to ‘the perception of third parties, i.e. creditors, as to the location of a company’s COMI’ and ruled that ‘most of the subsidiaries’ important creditors were aware that many important functions were carried out at the registered office of the parent company’.<sup>873</sup> So the place which third parties would initiate contact in order to communicate with the company was also recognised a factor of ascertainability.

*Re Aim* was a case where the English parent company was the sole creditor of the Irish debtor company and thus it ‘was aware of how the company was run’.<sup>874</sup> Ascertainability was easily proven to flow from the very fact that the sole creditor was also the parent of the debtor. In such a case it will be hard to see how the creditor can rely on ascertainability for his

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<sup>871</sup> *ibid* [33].

<sup>872</sup> *Parmalat Capital Netherlands* (n845).

<sup>873</sup> *Re Daisytek* (n835); UNCITRAL, ‘Developments in insolvency law: adoption of the UNCITRAL Model Law on Cross-Border Insolvency; use of cross-border protocols and court-to-court communication guidelines; and case-law on interpretation of “centre of main interests” and “establishment” in the European Union’ (Vienna, 4-15 July) UN Doc A/CN.9/580 at p 13.

<sup>874</sup> *Re Aim* (n845); UNCITRAL (n873) 14.

benefit. Similarly, the District Court of Amsterdam held that ascertainability can be of no use to the creditors when they are all companies belonging to same group as the debtor.<sup>875</sup>

### **C. Letter-box companies and political considerations**

*Centros* is supposed to have encouraged the spreading of letter-box companies. In turn, this subsequently lead to temporary employment agencies being established in one Member State, engaging workers from another Member State or a non Member State to work in a third Member State. In the late 1990s there was traffic of construction workers from the UK to Germany through letter-box companies incorporated in the Netherlands.<sup>876</sup>

Reacting to this corporate behaviour, courts in various Member States, and especially those where the activity of the company takes place as opposed to incorporation, have created a ‘fictitious seat’ theory. The Court of Appeal of Brussels has recently enunciated two principles of jurisdiction on international insolvency cases.<sup>877</sup> The first is that Belgian courts do not have jurisdiction to open insolvency proceedings over a company whose registered office is abroad. The second is that Belgian courts will, however, open

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<sup>875</sup> B Wessels, ‘BenQ Mobile Holding BV battlefield leaves important questions unresolved’ [2007] *Insolv Int* 103, 104.

<sup>876</sup> N Brunn in Rapporteur Evelyne Gebhardt, Consolidated Proceedings of the Public Hearing on the Proposal for a Directive on Services in the Internal Market (European Parliament, Brussels, 11 November 2004) p 100-101 at <[http://www.europarl.europa.eu/comparl/imco/services\\_directive/default\\_en.htm](http://www.europarl.europa.eu/comparl/imco/services_directive/default_en.htm)> accessed 13 December 2009.

<sup>877</sup> *Cour d’appel de Bruxelles (9e ch civ)*, 08.04.2004 at (Official website of the Judiciary of Belgium) <<http://www.cass.be/juris/jurf.htm>> accessed 13 December 2009.

insolvency proceedings over a foreign company if the registered office is fictitious and the real centre of activities of the company is in Belgium.

A ‘fictitious seat’ theory has also been established in French case-law. French fiscal authorities discovered so many documents belonging to a company incorporated in England in the premises of a French company that it would be impossible for them to be carried in a suitcase from England to France. This was perceived to signify that the registered office in England was fictitious and the COMI was in France.<sup>878</sup>

Along the same lines, Rimer J has held that the only connection between a company and Northern Ireland was that incorporation took place there so as to take advantage of enterprise funding opportunities.<sup>879</sup> The COMI was thus deemed to be in England. In another case, counsel has tried to present the premises of his client, a Delaware corporation, in London as ‘no more than a “post box”’ in order to avoid English jurisdiction.<sup>880</sup> In another instance, counsel has observed that the reason for the incorporation of the applicant company in Ireland ‘was a perception that the regulatory regime in Ireland was less stringent than the UK regime’.<sup>881</sup> In the same way, Parmalat Capital Netherlands BV’s COMI was identified with Italy, while it was thought to have incorporated in The Netherlands for ‘tax optimisation’ purposes.<sup>882</sup>

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<sup>878</sup> *Soc Trading Logistics* (n862).

<sup>879</sup> *Re 3T Telecom* (n845) [7].

<sup>880</sup> *Re Ci4net.com Inc* (n858) [22].

<sup>881</sup> *Re Aim* (n845).

<sup>882</sup> *Parmalat Capital Netherlands* (n845).

Courts have also appeared to take into consideration additional factors for the determination of the COMI. It seems that even political or social considerations may be taken into account in order to verify the location of the COMI. The High Court of Birmingham initiated insolvency proceedings over SAS ROVER France as the COMI was located in Longbridge, England. French courts had to recognise the judgment. Given the political pressure exercised by the employees who were working for ROVER France,<sup>883</sup> the French courts confirmed that the COMI was indeed in England, although the Insolvency Regulation prohibits the denial of recognition of foreign judgments opening insolvency proceedings on the basis that the court that delivered the judgment did not enjoy jurisdiction under the Regulation.<sup>884</sup>

The French court having confirmed that the English liquidators had already taken steps to satisfy the claims of the ROVER employees for owed wages and had reassured the employees' trade union that they would cooperate with them, with regard to the matter, it then declared the English judgment not to be contrary to public policy under article 26 of the

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<sup>883</sup> Pending the decision of the Court of Cassation on the *Daisytek* case (Court of Appeal of Versailles, 4 September 2003), the French Ministry of Justice informed a French Member of Parliament that the location of the debtor's main interests as the criterion defined by the EC Regulation no. 1346/2000 of 29 May 2000 relating to insolvency procedures should always be checked by the courts before the opening of any insolvency procedure. It should not automatically be linked to the headquarters of the parent company. Ministerial Answer, QE No 40288 JO, 3 August 2004, p 6104.

<sup>884</sup> Insolvency Regulation, art 25(1); Fletcher (n772) 427-429; OLG Wien, 09.11.2004, Case number 28R 225/04w at <<http://www.eir-database.com>> accessed 13 December 2009; *Cour d'appel de Versailles*, 04.09.2003, *SAS ISA Daisytek*, aff'd *Cass comm*, 27.06.2006, *SAS Isa Daisytek* at (Official Website of the French Republic for the Diffusion of the Law) <<http://www.legifrance.gouv.fr>> accessed 13 December 2009.

Insolvency Regulation.<sup>885</sup> Swedish courts also have appeared to have attributed some weight to the fact that the debtor foreign company owed unpaid wages to Swedish former employees.<sup>886</sup>

## **D. The COMI of groups of companies**

### ***i) The definition of an international enterprise group***

The first issue to be dealt with is the definition of a group of companies. The lack of a universally accepted definition had caused some debate about the correct definition in Working Group V of UNCITRAL. One proposal was that an international corporate group could be defined as ‘an ensemble of companies subject to the legislation of different countries, bound by capital or control and organised in a coordinated manner’.<sup>887</sup> According to another opinion, the definition of an international group of companies requires references to:

the types of connection that might be found between members of a corporate group, such as shared assets, shared management, and the control or ability to control the interests of one or more members of the group by making binding decisions with respect to their financial and economic activities.<sup>888</sup>

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<sup>885</sup> *Comm Nanterre (9e ch)*, 19.05.2005, *SAS ROVER France* at (Official Website of the French Republic for the Diffusion of the Law) <<http://www.legifrance.gouv.fr>> accessed 13 December 2009, aff'd *Public Prosecutor v Segard (As Administrator for Rover France SAS* [2006] ILPr 32 (CA of Versailles).

<sup>886</sup> *Radaflex* (n859).

<sup>887</sup> UNCITRAL, ‘Report of Working Group V (Insolvency Law) on the work of its thirty-first session’ (Vienna) UN Doc A/CN.9/618 at p 13.

<sup>888</sup> *ibid.*

The definition that has been finally adopted speaks of enterprise groups.<sup>889</sup> An enterprise group is composed of ‘two or more enterprises, which may include enterprises that are not incorporated, that are bound together by means of capital or control. Capital is defined as ‘contributions to an enterprise, including assets and equity interests’. Control is ‘the power normally associated with the holding of a strategic position within the group that enables the possessor to dominate directly or indirectly those organs entrusted with decision-making authority’.<sup>890</sup>

***ii) The COMI of an international enterprise group: the work of UNCITRAL***

The location of the COMI of an enterprise group is another controversial topic in international insolvencies. One view was to deem the COMI of the group to be that of the parent company. Thus, the court of the country where the parent company has its registered office or potentially the place where it conducts its business activities will enjoy jurisdiction over the entire group.

Of course, there are difficulties with this approach. First, the parent enterprise may be solvent while group members incorporated elsewhere may be insolvent.<sup>891</sup> Second, other courts may refuse to recognise such a broad

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<sup>889</sup> *ibid*: the reason was to avoid excluding unincorporated entities and possibly individuals.

<sup>890</sup> UNCITRAL, ‘Treatment of enterprise groups in insolvency’ (New York, 3-7 March 2008) UN Doc A/CN.9/WG.V/WP.80 at p 2.

<sup>891</sup> UNCITRAL, ‘Treatment of corporate groups in insolvency’ (New York, 14-18 May 2007) UN Doc A/CN.9/WG.V/WP.76/Add.2 at pp 4-5.

jurisdictional rule.<sup>892</sup> A third issue is that creditors, including employees, located in other jurisdictions would be potentially disadvantaged with respect to the filing of claims, participating in creditor committees and attending hearings.<sup>893</sup>

Although no solid conclusion has been reached so far with regard to that matter within UNCITRAL, in its last meeting Working Group V dealt with the concept of the coordination centre. The recommendation that the place that administers the insolvency of the controlling member of a group acting as *primus inter pares* should be the coordination centre of the insolvency of the entire group was rejected.<sup>894</sup> Nevertheless, the Working Group recognized the value of one entity having the leading role in the cooperation and agreed to address the issue in the future.<sup>895</sup> The use of cross-border agreements between the courts administering the insolvency of a group was generally endorsed, but the discussion on the details is ongoing.<sup>896</sup>

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<sup>892</sup> This would not be an issue under the Insolvency Regulation as it does not allow for the court of recognition to review the jurisdiction of the court that opened main insolvency proceedings.

<sup>893</sup> UNCITRAL (n891).

<sup>894</sup> UNCITRAL, 'Report of the Working Group V (Insolvency Law) on the work of its thirty-sixth session' (New York, 18-22 May 2009) UN Doc A/CN.9/671.

<sup>895</sup> *ibid.*

<sup>896</sup> *ibid.*

***iii) International enterprise groups within the framework of the Insolvency Regulation***

In cases where the sole creditor was the parent company of the debtor, national courts did not have great difficulty in reversing the presumption of article 3(1) of the Insolvency Regulation.<sup>897</sup> However, this is not the case with groups of companies. The ECJ has clarified that the concept of the COMI applies to each legal entity separately.<sup>898</sup> The Insolvency Regulation does not provide for the insolvency of groups of companies.<sup>899</sup> *Eurofood* has reduced the possibility of a court to open insolvency proceedings over a group of companies on the basis that the head office functions of the subsidiaries are performed in the headquarters of the parent company, which is the COMI of the group.<sup>900</sup>

Prior to *Eurofood* English courts had thought it possible to open insolvency proceedings over companies incorporated abroad, if it could be found that the head office functions of the group were performed in England. With regard to a group of 24 companies out of which one was incorporated in Luxembourg, six in England, one in Spain, one in Austria, four in Germany, two in Sweden, three in Italy, one in Belgium, four in The Netherlands and

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<sup>897</sup> Judgment of 01.07.2004, *Zenith Maschinenfabrik Austria GmbH* (AG Siegen) at <<http://www.eir-database.com>> accessed 20 January 2008; *Re Aim* (n845); *Re 3T Telecom* (n845); *Parmalat Hungária* (n845) It is possible that it was this kind of cases that lead Dr Bondi and the Italian Government in *Eurofood* to believe that the COMI of a wholly owned subsidiary is located at the headquarters of its parent company.

<sup>898</sup> *Eurofood* (n773) [30].

<sup>899</sup> Opinion of AG Jacobs (n785).

<sup>900</sup> IF Fletcher, *Insolvency in Private International Law: Supplement to Second Edition* (1<sup>st</sup> edn OUP, Oxford 2007) 121-122.

one in the Czech Republic, Collins J held the COMI to be in England.<sup>901</sup> The headquarters of Collins & Aikman Corporation Group were in Michigan and bankruptcy proceedings had been initiated there. English courts established jurisdiction over the European part of the group on the basis that day-to-day management had shifted to the UK.<sup>902</sup> Such administrative functions were comprised of a variety of factors such as the management of cash flow from England, the pooling bank accounts for the group were held by JP Morgan Chase in London, the management of human resources, information systems, engineering design and sales took place in England.<sup>903</sup>

The same kind of considerations and factors led English courts to decide that England was the COMI of another network of related companies, called Daisytek.<sup>904</sup> Daisytek International Corp had filed for reorganisation under the US Bankruptcy Code. The English courts exercised jurisdiction over Daisytek-ISA Ltd, an English company, and over French and German companies of the group, whose shareholder was the English company. However, the initial response of the French and German courts to the recognition of the English judgment was negative. Both the French *Tribunal de commerce* of Pontoise and the German *Amtsgericht Düsseldorf* refused recognition on the basis that the English court lacked jurisdiction under the

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<sup>901</sup> *Re Collins* (n845).

<sup>902</sup> *ibid* [19]-[20].

<sup>903</sup> *ibid* [22], [30], [32], [35]-[36].

<sup>904</sup> *Re Daisytek* (n845).

Insolvency Regulation, since the COMI of the subsidiaries were in France and Germany respectively.<sup>905</sup>

This hostile approach of the first instance courts was soon reversed. The text of the Regulation is clear. Review of the jurisdiction of the court which delivered the judgment whose recognition is sought is prohibited by the Regulation.<sup>906</sup> The same conclusion was reached on appeal in Germany, with the exception of one company where the German courts held that, there, adequate notice had not been provided to the German side of the dispute and, thus, recognition was refused on public policy grounds.<sup>907</sup>

Courts will look at this variety of factors and then conduct a balancing exercise in favour of one or another jurisdiction. There are no clear guidelines for the conduct of this balancing. The argument according to which the English courts have developed a ‘command and control’ or ‘head office functions’ test for the COMI also admits this dependency on the factual circumstances of each case.<sup>908</sup> This approach has also been adopted by some European courts.<sup>909</sup> The District Court of Nürnberg has held that the presumption introduced by article 3(1) of the Insolvency Regulation is

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<sup>905</sup> Fletcher (n772) 390-392.

<sup>906</sup> *SAS ISA Daisytek* (n884) aff'd by *SAS Isa Daisytek* (n884).

<sup>907</sup> Fletcher (n772-780) 392.

<sup>908</sup> *ibid* 393-396.

<sup>909</sup> *Hettlage* (n849); *Parmalat Hungária* (n845); *MPOTEC GmbH* [2006] BCC 681 (Tribunal de Grande Instance de Nanterre); see Moss (n841) 1012-1014.

reversed only if all business decisions are made in another Member State and administration is effectuated there.<sup>910</sup>

It remains to be seen whether the ECJ will alter its view on the interpretation of article 3(1) with regard to international enterprise groups. It will probably feel constrained by the wording of the Regulation and will request legislative action to revise the Regulation. However, the conclusion of the work of UNCITRAL on this matter might alter the stance of the ECJ on this matter or, at least, make the case of revision of the Regulation stronger.

#### ***IV. Comparison of the COMI in the Insolvency Regulation with the COMI in UNCITRAL Model Law on Cross-Border Insolvency***

The United Nations Commission on International Trade Law (hereinafter UNCITRAL) was established for the purpose of furthering the progressive harmonization and unification of the law of international trade. Among other topics, UNCITRAL has focused its work on international insolvency.

Adopted by UNCITRAL on 30 May 1997, the Model Law on Cross-Border Insolvency (hereinafter Model Law) is designed to assist States to equip their insolvency laws with a modern, harmonized and fair framework to address more effectively instances of cross-border insolvency. Those instances include cases where the insolvent debtor has assets in more than one State or where some of the creditors of the debtor are not from the State where the insolvency proceeding is taking place. The Model Law does not attempt a

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<sup>910</sup> Hans Brochier (n844).

substantive unification of insolvency law. It offers solutions that help in several significant ways, including recognition of foreign proceedings.

The United Nations General Assembly (hereinafter UNGA) has recommended that ‘all States review their legislation on cross-border aspects of insolvency to determine whether the legislation meets the objectives of a modern and efficient insolvency system and, in that review, give favourable consideration to the Model Law, bearing in mind the need for an internationally harmonized legislation governing instances of cross-border insolvency’.<sup>911</sup> Thus far, legislation based on the Model Law has been adopted in Australia, the British Virgin Islands, Colombia, Eritrea, the UK, Japan, Mauritius, Mexico, Montenegro, New Zealand, Poland, Republic of Korea, Romania, Serbia, Slovenia, South Africa and the USA.

### **A. The scope of the Model Law: a comparison with the Insolvency Regulation**

Under article 1 of the Model Law, its scope extends to cases where recognition is sought of foreign insolvency proceedings; direct rights of access to the courts for foreign representatives and creditors; the rights of courts to apply for assistance and relief in another State; cooperation between courts and office holders from different States; and coordination of proceedings taking place simultaneously in different jurisdictions. Unlike the Insolvency Regulation regime, national rules on international jurisdiction for insolvency proceedings is untouched by the Model Law.<sup>912</sup>

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<sup>911</sup> UNGA Res 52/158 (15 December 1997) UN Doc A/RES/52/158.

<sup>912</sup> Fletcher (n772) 454.

Its most important feature which is relevant here is that the Model Law requires courts to recognise proceedings commenced abroad by a foreign court as foreign main proceedings, only if the COMI of the debtor lies within the territory of that foreign State.<sup>913</sup> The question to be asked is which of the two instruments will take precedence in case recognition of foreign proceedings is sought. Articles 16 and 17 of the Insolvency Regulation do not allow for the court of recognition to examine whether the court that opened proceedings actually enjoyed such jurisdiction. However, the Model Law does allow so in article 17(2)(a).

The answer is given by article 3 of the Model Law. It provides that '[t]o the extent that this Law conflicts with an obligation of this State arising out of any treaty or other form of agreement to which it is a party with one or more other States, the requirements of the treaty or agreement prevail'. After all, the Model Law, especially with regard to the notion of the COMI, has taken into account the 1995 Brussels Convention on Insolvency Proceedings.<sup>914</sup> The Model Law can cover the cases that fall outside the scope of the Insolvency Regulation, i.e. cases where the COMI is not located within the EU.<sup>915</sup>

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<sup>913</sup> *ibid* 457 *et seq*; Articles 2(b) and 17(2)(a) of the Model Law.

<sup>914</sup> UNCITRAL, 'Guide to the Enactment of the UNCITRAL Model Law on Cross-Border Insolvency' (1998) New York at para 18, as recommended to all States by UNGA Res 52/158 (1991).

<sup>915</sup> *ibid* para 19.

## **B. The notion of the COMI in case-law deliberating on the Model Law**

The USA is one of the few countries that have adopted the Model Law. Congress enacted chapter 15 of the Bankruptcy Code as part of the Bankruptcy Abuse Prevention and Consumer Protection Act 2005.<sup>916</sup> US courts have since had quite a few opportunities to address the notion of the COMI and contribute to the debate about its correct interpretation.

For the purpose of analysis here, a brief presentation of the pertinent parts of the Bankruptcy Code follows. Foreign main proceeding means a foreign proceeding pending in the country where the debtor has the centre of its main interests.<sup>917</sup> By contrast, foreign nonmain proceedings refer to proceedings in a country where the debtor has an establishment.<sup>918</sup> In absence of evidence to the contrary, the debtor's registered office is presumed to be its COMI.<sup>919</sup> A proceeding will be recognised in the US as a foreign main proceeding only if it is pending in a country where the debtor has its COMI.<sup>920</sup>

### ***i) In re SPhinX: the starting point***

By 2006 it had been admitted in the US that there was not sufficiently established case-law on the interpretation of the COMI, with regard to

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<sup>916</sup> Pub L No 109-8, 119 Stat 23.

<sup>917</sup> 11 USCA §1502(4).

<sup>918</sup> *ibid* §1502(5).

<sup>919</sup> *ibid* §1516(c).

<sup>920</sup> *ibid* §1517(b)(1).

insolvent companies.<sup>921</sup> Reference had to be made to the judgment of the ECJ in *Eurofood*. In recent years, things have been changing. Federal courts in the US have been engaging more frequently with the concept of the COMI.

The US Bankruptcy Court of the South District of New York cut new ground in 2006. In a petition filed by the joint official liquidators of hedge funds incorporated in the Cayman Islands, Drain J dealt with the recognition of Cayman voluntary winding-up proceedings in the US as a ‘foreign main proceeding’.<sup>922</sup> Only a few of the creditors objected. The dispute concerned whether the COMI of the SPhinX hedge funds was really in the Cayman Islands, rather than the US, where ‘substantially all’ of the debtors’ assets were located.

Drain J had to grapple with the COMI. He held that although the presumption is in favour of the Cayman Islands, where the hedge funds had been incorporated, the presumption may rebutted. The burden of proof will lie on the foreign representative, although the court is entitled to shift it to the other side.<sup>923</sup> In establishing the COMI, the court could assess a variety of factors. These include

...the location of the debtor’s headquarters, the location of those who actually manage the debtor (which, conceivably could be the headquarters of a holding company); the location of the debtor’s primary assets; the location of the majority of the debtor’s creditors or of a majority of the creditors who

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<sup>921</sup> *In re SPhinX Ltd* 351 BR 103 (Bkrcty SDNY 2006) 118 (Drain J), aff’d 371 BR 10 (SDNY 2007).

<sup>922</sup> *ibid.*

<sup>923</sup> *ibid* 117; neither the legislative history nor case-law indicate the occasions in which such as shift would be appropriate.

would be affected by the case; and/or the jurisdiction whose law would apply to most disputes.<sup>924</sup>

Due to the lack of US case-law on the notion of the COMI, the judge cited and discussed the judgment of the ECJ in *Eurofood*. Drain J thought that the presumption had not been rebutted on the facts of the case. He accepted that the ECJ had left unanswered the question whether the presumption may be rebutted in cases where the debtor conducts some business in his place of incorporation and may not, thus, be characterised as a ‘letter-box company’.

He noted that administration of the hedge funds was conducted outside the Cayman Islands, the only business conducted in the Cayman Islands was to maintain the funds’ registration there, there were no managers and employees in the Cayman Islands and the board never met there.<sup>925</sup> In addition to these factors, other ‘pragmatic considerations’ pointed away from the Cayman Islands, such as the fact that the funds had no assets in the Cayman Islands, all of the creditors and investors were located outside the Islands and the Cayman courts would have to rely on orders of other courts to bind them.<sup>926</sup>

Nonetheless, the joint official liquidators relied on the tacit consent of all other creditors to demonstrate that main insolvency proceedings should have indeed been rightfully brought before Cayman courts. This led Drain J

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<sup>924</sup> *ibid.*

<sup>925</sup> *ibid* 119.

<sup>926</sup> *ibid.*

to state that ‘in balancing all the foregoing factors the Court might be inclined to find the Debtor’s COMI in the Cayman Islands’.<sup>927</sup> This conclusion would be in tune with his previous holding that

Because their money is ultimately at stake, one generally should defer, therefore, to the creditors’ acquiescence in or support of a proposed COMI. It is reasonable to assume that the debtor and its creditors (and shareholders, if they have an economic stake in the proceedings) can, absent an improper purpose, best determine how to maximize the efficiency of a liquidation or reorganization and, ultimately, the value of the debtor, assuming also, of course, that chapter 15 requires the court to protect the legitimate interests of dissenters... particularly where other objective factors point to a different COMI.<sup>928</sup>

This extract demonstrates that Drain J was prepared to take a subjective approach to ascertainability, which is very similar to what has been contemplated above.<sup>929</sup>

Drain J, finally, decided that the COMI of the hedge funds was outside the Cayman Islands, based on anti-forum shopping considerations, which will be dealt with below.<sup>930</sup> Suffice it for now to note that the bringing of proceedings in the courts with territorial jurisdiction over the registered office was thought to be tainted with ‘improper purpose’ as their goal was to frustrate the settlement that had been reached with the creditor objecting to the petition US, Refco Capital Markets.

Were the Cayman proceedings recognised as foreign main proceedings the appeal on an action regarding the settlement with Refco would be stayed.

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<sup>927</sup> *ibid* 121.

<sup>928</sup> *ibid* 117.

<sup>929</sup> See above text to n838.

<sup>930</sup> See pp 330 *et seq*, in particular pp 362-363.

This would have the same consequence with overturning the ‘settlement without addressing or prevailing on the merits’.<sup>931</sup> In holding so, he displaced the Cayman Islands as the COMI, despite the fact that objectivity and ascertainability pointed to that direction. He took forum shopping into consideration after in fact establishing the location of the COMI, thus making use of the older doctrine of ‘improper purposes’ contained in §304(c) of the Bankruptcy Code, now superseded by Chapter 15.<sup>932</sup>

Concluding, all Drain J did in his judgment is to provide a list of objective criteria that can be taken into account in determining the COMI. Apart from this, he relied on *Eurofood* but at the same time accepted the location of the headquarters of the holding company as a valid consideration. He accepted that *Eurofood* set a test of reasonable and objective ascertainability, but held that in principle the court should defer to the place where creditors agree or acquiesce the COMI to be, ‘because their money is ultimately at stake’.<sup>933</sup> Finally, as will be shown below,<sup>934</sup> he failed to discern between the two limbs of COMI test, on one hand, and forum shopping, on the other, but instead mixed them all in one test.

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<sup>931</sup> *In re SPhinX* (n927).

<sup>932</sup> See text to n1091.

<sup>933</sup> *In re SPhinX* (n928).

<sup>934</sup> See pp 318-320.

**ii) The development of the law after *In re SPhinX***

At the delivery of judgment in *In re SPhinX*, it was not entirely clear exactly where the law stood. On appeal, Drain J's judgment was affirmed.<sup>935</sup> Gonzalez J's opinion demonstrated a slightly higher level of theorisation. He held that the presumption may be rebutted if objective and ascertainable factors demonstrate that the registered office is nothing but a letter-box company. However, he also agreed that the presumption can be rebutted by anti-forum shopping considerations.

*In re Sphinx* is one of the leading cases on the COMI. The law with regard to the recognition of foreign main proceedings in the US nowadays stands for the following propositions. First, there is an array of factors that the courts may have examine in establishing the COMI, such as the location of the debtor's headquarters, the location of those who actually manage the debtor etc.<sup>936</sup> Second, the burden of proof as to the location of the COMI is never on the party opposing the main status of the proceedings, but on the foreign –i.e. non US- representatives. The opposing party has only a burden of proof of going forward to adduce some evidence inconsistent with the location of the COMI at the registered office.<sup>937</sup> The presumption is not a particularly strong one.<sup>938</sup> The fact that the foreign company is registered

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<sup>935</sup> *In re SPhinX* 371 BR 10 (SDNY 2007).

<sup>936</sup> See text to n924; *In re SPhinX* (n924); *In re Bear Stearns* (n802); *In re Basis Yield Alpha Fund (Master)* 381 BR 37 (Bkrtcy SDNY 2008) 47; *In re Petition of Ernst & Young Inc* 383 BR 773 (D Colorado 2008) 779.

<sup>937</sup> *In re SPhinX* (n923); *In re Tri-Continental Exchange Ltd* 349 BR 627 (Bkrtcy EDCal 2006) 635; *In re Tradex Swiss AG* 384 BR 34 (Bkrtcy D Mass 2008).

<sup>938</sup> *In re Basis* (n936) 50-51; *Re Ci4net.com* (n772) [20].

abroad as an ‘exempted limited liability company’ will weigh against the recognition of the relevant foreign proceedings as main ones.<sup>939</sup>

Third, if the parties in interest do not object to the foreign proceedings being recognised as main, recognition cannot be automatically granted under the sole grounds that no party objected and no other proceeding had been initiated elsewhere.<sup>940</sup> Nor can a summary judgment be entered in such a case, as the court is not bound by parties’ failure to object and the COMI presumption need not be ‘blindly followed’.<sup>941</sup> Fourth, the consequences of recognition of the proceedings in question as foreign main proceedings are substantial. An automatic stay with respect to the debtor and property of the debtor located in the US is ordered. §§ 363, 549 and 552 of the Bankruptcy Code apply. The foreign representative is entitled to operate the debtor’s business and may exercise the rights and powers if a trustee.<sup>942</sup>

### ***iii) The views of commentators***

There has been strong criticism of *In re SPhinX*. Professor Westbrook and Daniel Glosband, both draftsmen of the Model Law and Chapter 15 of the US Bankruptcy Code, have overtly criticised Drain J’s judgment.<sup>943</sup> *In re SPhinX* was criticised for severing between recognition and determination of the

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<sup>939</sup> *In re Bear Stearns* (n936) 131.

<sup>940</sup> *ibid* 130 (Lifland J), parting partially from the dicta of Drain J in *In re SPhinX* (n921).

<sup>941</sup> *In re Basis* (n936) 50-51.

<sup>942</sup> *In re Artimm Srl* 335 BR 149 (Bkrtcy CD Cal 2005) 159.

<sup>943</sup> JL Westbrook, ‘Locating the Eye of the Financial Storm’ (2007) 32 Brook J Intl L 1019; DM Glosband, ‘*SPhinX* Chapter 15 Opinion Misses the Mark’ (2006) 25 Am Bankr Inst J 83.

nature of the foreign proceeding as main or nonmain.<sup>944</sup> Drain J had indeed decided that it was one step to decide whether to recognise or not and another to characterise the foreign proceeding, provided that recognition has been granted.<sup>945</sup>

*In re SPhinX* was also criticised for allowing for ‘subjective musings’ to intrude to the determination of the COMI and thus breaking away from the COMI test as established by the ECJ in *Eurofood*.<sup>946</sup> However, this concern was not shared by others. It was argued that there are important differences between the context in which the Model Law and the Insolvency Regulation operate. There are no jurisdictions with lax insolvency law that would justify an approach similar to that of an enhanced flexibility in recognition, which the court in *In re SPhinX* adopted.<sup>947</sup>

However, some voices have been raised in defence of some parts of the judgment in *In re SPhinX*. It has been argued that it is not for courts to search for evidence, but for parties to contest the location of the COMI and to seek to rebut the presumption.<sup>948</sup> Where there is no controversy as to the location of the COMI, requiring parties *ex officio* to induce evidence as to the location

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<sup>944</sup> *In re SPhinX* (n921) 115.

<sup>945</sup> Glosband (n943) 84; Westbrook (n943) 1026.

<sup>946</sup> Glosband (n945) 84-85.

<sup>947</sup> Westbrook (n943) 1034.

<sup>948</sup> Bufford (n834) 415.

of the COMI defeats the purpose of introducing the presumption in order to speed up proceedings in non contentious cases.<sup>949</sup>

### **C. An assessment of the comparison between US and European case-law on the COMI**

Despite the fact that US courts have consistently referred to and relied on the judgment of the ECJ in *Eurofood*, there are startling differences between US and European case-law on the matter.

As far as the definition of the COMI is concerned, US courts, unlike European courts, have wisely decided to have a brief, yet non-exhaustive, list of factors when examining where the COMI is located. However, it is a list that goes beyond a mere inquiry into the location where the debtor administers his affairs on a regular basis. It includes other objective factors which do not *prima facie* appear to be included in the definition of the COMI. Such factors include the location of the debtor's assets, the location of the majority of creditors and the jurisdiction whose law would apply to most disputes that would involve the debtor. None of these criteria appear to be *ab initio* ascertainable to third parties.

European courts have been more faithful to the definition of the COMI in Recital 13 of the Insolvency Regulation. They have looked at an endless variety of factors that deal primarily with the identification of the location where the debtor regularly administers his interests. There are few factors that consistently appear throughout all European jurisdictions, the most

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<sup>949</sup> TT Brock, 'The Assault on Offshore Havens in *Bear Stearns* Undermines New Chapter 15: Part II' (2008) 27 Am Bankr Inst J 71, 73.

prominent of which is the location of the place where the management meets, decisions are made and administration or ultimate control is directed.<sup>950</sup>

Therefore, this is the main reason one would be tempted to say that the European courts have taken more of a real seat approach to the COMI,<sup>951</sup> whereas the US courts have identified it with the principal place of business.<sup>952</sup>

The role that ascertainability is to play in the determination of the COMI is not clear in US case-law. *In re SPhinX* did not deal with it in depth. Drain J just quoted the extract from *Eurofood* that refers to objective and ascertainable criteria.<sup>953</sup> Although he admitted that the test in *Eurofood* is an objective one,<sup>954</sup> the wishes of the majority of creditors were thought to be of great weight that the court should normally hesitate from frustrating them.<sup>955</sup> Ascertainability is not dealt with by any case.<sup>956</sup>

However, there are such considerations that show up from time to time in judgments. For instance, a good example is a case where the debtor was an exempted limited liability company incorporated in the Cayman Islands and its administrator and investment manager were both other

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<sup>950</sup> See above text to n845.

<sup>951</sup> G Khairallah, 'The "Centre of the Debtor's Main Interests": Comments of the *Eurofood* Judgment of the ECJ' in Ringe, Gullifer & Théry (n805) 111.

<sup>952</sup> *In re Tri-Continental* (n937) 634; *In re Bear Stearns* (n936) 129.

<sup>953</sup> *In re SPhinX* (n921) 118.

<sup>954</sup> *ibid* 119; See text to n801.

<sup>955</sup> See text to n933.

<sup>956</sup> *Re Stanford International Bank* (n806) [67].

Cayman companies, and the foreign representatives revealed neither their task nor the location where their employees perform their duties. These factors added to the general distrust of Gerber J towards the Cayman debtor.<sup>957</sup>

Another significant difference between the two approaches is related to rebuttal of the presumption and the burden of proof. The ECJ in *Eurofood* has taken a very broad approach to the presumption and a very narrow one as to its rebuttal.<sup>958</sup> US courts have repeatedly cited *Eurofood* as a leading authority as to the rebuttal of the presumption in the case of letter-box companies, but at the same time adopted<sup>959</sup> the views of Westbrook, according to whom ‘whatever may be the proper interpretation of the EU Regulation, the Model Law and Chapter 15 give limited weight to the presumption of jurisdiction of incorporation as the COMI’.<sup>960</sup> The degree to which they pretend to find no contradiction between *Eurofood* and their line of reasoning is rather astonishing.<sup>961</sup> Thus, US courts appear ready to rebut the presumption more easily than European courts.<sup>962</sup>

The attitude of US courts with reference to the burden of proof appears rather awkward when compared to the European one. Although not

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<sup>957</sup> *In re Basis* (n936) 41, text in notes 7 & 8.

<sup>958</sup> See text to n777.

<sup>959</sup> *In re Bear Stearns* (n936) 128; *In re Basis* (n936) 50-51.

<sup>960</sup> Westbrook (n943) 15-16.

<sup>961</sup> See *In re Bear Stearns* (n802) 337.

<sup>962</sup> See *Re Stanford International Bank* (n806) [65].

explicitly mentioned in *Eurofood* or any other case before a Member State court, the presumption works in a rather simple way. The courts of the place where the registered office is located have international jurisdiction, unless one of the parties can prove to the satisfaction of the court that the COMI of the debtor is located elsewhere. The burden of proof is always on the party that wishes to rebut the presumption.

By contrast, in US case-law the burden of proof is always on the foreign representative.<sup>963</sup> Federal courts have always referred to the wording of the presumption, as introduced by the Bankruptcy Abuse Prevention and Consumer Protection Act 2005: ‘In the absence of **evidence** to the contrary, the debtor’s registered office... is presumed to be the centre of the debtor’s main interests’ (emphasis added).<sup>964</sup> The wording of the Insolvency Regulation is slightly different: ‘In the case of a company or a legal person, the place of the registered office shall be presumed to be the centre of main interests in the absence of **proof** to the contrary’ (emphasis added).<sup>965</sup> This can help to explain why the presumption is more readily rebutted in the US. It is easier to adduce evidence regarding a point than to prove it.

US courts have looked into legislative history to interpret the use of the term ‘evidence’, instead of proof. Indeed, the Report of the Committee on the Judiciary states that:

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<sup>963</sup> See text to n937.

<sup>964</sup> 11 USCA §1516(c).

<sup>965</sup> Article 3(1).

The word proof in subsection (3) has been changed to “evidence” to make it clearer using United States terminology that the ultimate burden is on the foreign representative... The presumption that the place of the registered office is also the centre of main interests is included for speed and convenience of proof where there is no serious controversy.<sup>966</sup>

Adherence to this extract from legislative history has been consistent,<sup>967</sup> with the exception of the departure of Lifland J in *In re Bear Stearns* from the dictum of Drain J in *In re SPhinX* concerning the power of the court to investigate the location of the COMI, even in cases where the majority or even all of the creditors support or acquiesce in the location of the COMI at the registered office.<sup>968</sup>

What might explain this significant difference between the interpretation of the presumption in 11 USCA §1516(c) and in article 3(1) of the Insolvency Regulation is the context in which the cases are heard. US courts are dealing with the recognition of foreign proceedings, whereas European courts are dealing with their own international jurisdiction to open insolvency proceedings. Courts in EU Member States are not allowed to review the jurisdiction of the court that opened insolvency proceedings on the conviction that the COMI of the debtor lied within its territorial jurisdiction.

However, this is still not enough to justify such a distortion of the presumption included in 11 USCA §1516(c). Creditors from all over the world

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<sup>966</sup> HR Rep 109-31, pt 1, 109<sup>th</sup> Cong 1<sup>st</sup> Sess pp 112-113 (2005).

<sup>967</sup> *In re SPhinX* (n923); *In re Tri-Continental* (n937); *In re Bear Stearns* (n936) 127-128; *In re Basis* (n936) 53.

<sup>968</sup> See text to n940.

are apt to seek a debtor's assets in the US and thus debtors are apt to seek the help of US courts against them, especially in New York. §1516(c) was intended to get the benefits of speed and cost savings from the incorporation presumption while guarding against US courts being forced to recognize proceedings brought in haven jurisdictions with no real economic connection with the debtor.

If *In re Bear Stearns* is indeed affirmed on appeal, the position of the law will be that while the court has a power *ex officio* to contest the location of the COMI at the registered office, it is nonetheless for the foreign representative at all times to prove the existence of the COMI there.<sup>969</sup> If absent objection the US judges ignored the statutory provisions in favour of a "see no evil" approach, they would be supporting the use of the public courts for purely private manoeuvres by parties with a variety of interests and agendas.

For example, Merrill Lynch fussed and whispered in *Bear Stearns* but failed to object formally,<sup>970</sup> perhaps because it had hedge funds in the Caymans itself or because it was afraid of offending the Cayman courts if they were not recognized as the primary courts, or perhaps because they had achieved other deals with other competing considerations. If one regards the courts simply as a tool for the private interests involved, there may be no reason to raise a question if the parties do not formally object. If one believes there are public purposes to be served, and risks of abuse of a system of

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<sup>969</sup> *In re Bear Stearns* (n936) 129.

<sup>970</sup> *ibid* 125-126.

private control publically enforced, one would take a different view.<sup>971</sup> US courts appear to take the latter view. Thus companies like *Bear Stearns* should be liquidated in New York in the full glare of US media scrutiny, because of the importance of its history and fate to the investing public, taxpayers' dollars, and the US economic system.

By contrast, the European approach differs from the US one with regard to the methodology of the rebuttal of the presumption. In particular, it appears that before US courts the presumption may be rebutted in a negative manner, i.e. by arguing that the COMI is not located at the registered office, without necessarily pointing at the location where the COMI is. European courts, on the other side, will not rebut the presumption, unless an alternative country is indicated as the debtor's COMI.

The explanation of this difference lies with the different nature of proceedings before US and European courts. The first are seized of petition for recognition. If it is not proven that the COMI is at the registered office, the proceedings will be recognised as foreign nonmain proceedings, provided that the debtor has some sort of establishment in his country of incorporation.<sup>972</sup>

By contrast, the courts of the place of the registered office in EU Member States need to hear cogent evidence as to the location of the COMI elsewhere before they desist themselves of the petition to open insolvency proceedings. If the court seized is not the court of the place where the

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<sup>971</sup> Statement by Professor J Westbrook (Personal email correspondence 16 July 2008).

<sup>972</sup> 11 USCA §1517(b)(2).

registered office of the debtor is located, it will also need to hear cogent evidence as to why it should deprive the court of the registered office of its inherent jurisdiction. In both cases, the COMI test requires a comparison of the registered office with usually one, but potentially more than one, alternative locations. In this sense, it can be said that the approach of European courts to the COMI is a positive one.

There is one last question that needs to be addressed here. One should wonder why the US courts appear to have taken a narrow approach on the presumption. The reason could be possibly related to the provenance of the judgments of which recognition is sought. All leading cases with regard to the interpretation of the COMI concerned entities incorporated in the Cayman Islands.<sup>973</sup> In *In re Bear Stearns* and *In re Basis*, the debtor had suffered losses following the volatility in the market related to US sub-prime lending. *In re SPhinX* was a case where the debtor tried to deprive some of its US creditors from the benefits of a settlement they had previously agreed to. *In re Tradex* and *In re Petition of Ernst & Young* were cases of fraud.<sup>974</sup> In all these cases, the COMI was thought to be in the US.

The sole exception is *In re Tri-Continental*.<sup>975</sup> Proceedings were brought before the Eastern Caribbean Supreme Court by the International Financial Services Authority of St Vincent and the Grenadines against two insurance companies that had defrauded their clients. One of the creditors, a

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<sup>973</sup> *In re SPhinX* (n921); *In re Bear Stearns* (n936); *In re Basis* (n936).

<sup>974</sup> See n936, 937.

<sup>975</sup> See n937.

company incorporated in the US, contended that the COMI of Tri-Continental is in the US, 'because most of the creditors are insureds located in the United States'.<sup>976</sup> Recognition of the St Vincent and the Grenadines proceedings was sought before the US Bankruptcy Court in California. Klein J held that on the facts of the case the federal court should not impede the progress of the main proceedings in St Vincent and the Grenadines, 'which is the vehicle through which it is anticipated that the primary recovery for all creditors, including creditors in the United States, will be accomplished'.<sup>977</sup>

With the exception of two cases,<sup>978</sup> US courts appear to have rebutted the COMI presumption in all cases, with the result of depriving the foreign representatives of all the advantages that the recognition of the foreign proceedings as foreign main proceedings would bring.<sup>979</sup> These cases show that there might be a tendency for US courts to favour US creditors over foreign debtors and creditors.<sup>980</sup>

Concluding, it can be fairly said that US case-law stands far from European case-law on the interpretation of the COMI, despite the fact that US courts have consistently referred to *Eurofood* as a leading authority in this area. Be that as it may, there is not much in common between the two approaches. There is probably little for the ECJ and Member States courts to

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<sup>976</sup> *ibid* 631.

<sup>977</sup> *ibid* 640.

<sup>978</sup> *ibid*; *In re Artimm* (n942) 159, where the COMI was not disputed.

<sup>979</sup> See text to n942.

<sup>980</sup> LA Bebchuk & AT Guzman, 'An Economic Analysis of Transnational Bankruptcies' (1999) 42 JLE 775, 782-783.

learn from the US approach, except perhaps for the creation of a brief non-exhaustive list of objective factors that can be used in the determination of the COMI.<sup>981</sup>

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<sup>981</sup> See text to n924.

## **14. The COMI and forum shopping**

One of the objectives of the Insolvency Regulation is to avoid incentives for debtors to transfer assets or judicial proceedings from one Member State to another in order to obtain a more favourable judgment. In these terms, recital 4 clearly speaks of forum shopping as a threat to the internal market. The question to be examined here is whether the transfer of the registered office from one Member State to another in order to benefit from the latter's insolvency laws is permissible under the Regulation.

### ***I. The notion of forum shopping***

#### **A. Forum shopping as a term of art in private international law**

It is not the purpose of this thesis to go at great length in order to discuss the intricacies of forum shopping, which has been done successfully elsewhere.<sup>982</sup>

This part of the thesis will focus only on explaining briefly the meaning that forum shopping and the negative connotations it carries in private international law theory in some of the key jurisdictions whose law is surveyed in this thesis. This will be performed only to the extent necessary to ensure a better understanding of forum shopping within the Insolvency Regulation.

#### ***i) The notion of forum shopping at common law***

Despite its extensive use in modern litigation, there is no standard and universally agreed definition of forum shopping. English courts used the term

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<sup>982</sup> A Bell, *Forum Shopping and Venue in Transnational Litigation* (1<sup>st</sup> edn OUP, Oxford 2003).

for the first time in 1969.<sup>983</sup> Three out of five Law Lords, Lord Hodson, Lord Donovan and Lord Pearson, made explicit references to forum shopping, out of which Lord Pearson's was the most substantial. Referring to double actionability as the English choice of law for torts committed abroad, Lord Pearson stated:

...it might lead to what has been described in American cases as 'forum-shopping', i.e., a plaintiff by-passing his natural forum and bringing his action in some alien forum which would give him relief or benefits which would not be available to him in his natural forum.<sup>984</sup>

Lord Pearson's definition envisages only forum shopping by the plaintiff and is defined as the latter's effort to have his case heard by the courts of a country other than the natural forum.

As such, forum shopping was not a concept unknown to English courts and was not necessarily borrowed by American case-law. Focusing on the plaintiff's behaviour, Lord Cooper spoke against the encouragement of forum shopping stating that 'pursuers should not be encouraged to improve their position vis-à-vis of their opponents by invoking some secondary forum in order to exact compensation for a type of loss which the primary forum would not regard as meriting reparation'.<sup>985</sup>

Despite the condemnation of forum shopping by the House of Lords, there were instances where English judges sought to justify certain behaviours that on Lord Pearson's definition would constitute forum shopping. Lord

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<sup>983</sup> *Boys v Chaplin* [1971] AC 356 (HL).

<sup>984</sup> *ibid* 401.

<sup>985</sup> *M'Elroy v M'Allister* 1949 SC 110, 135.

Denning MR held that if the plaintiff believes that English law provides him with an advantage, he is entitled to bring the action here, provided that he can serve the defendant within the jurisdiction of English courts and that his action is not vexatious or oppressive.<sup>986</sup> He went on to state explicitly that '[y]ou may call this "forum shopping" if you please, but if the forum is England, it is a good place to shop in, both for the quality of the goods and the speed of service'.<sup>987</sup> Again this approach was not unprecedented. Bowen LJ, although implicitly, had referred to forum shopping and held that:

It seems to me we have no sort of right, moral or legal, to take away from a plaintiff any real chance he may have of an advantage. If there is a fair possibility that he may have an advantage by prosecuting a suit in two countries, why should this court interfere and deprive him of it?<sup>988</sup>

Lord Reid's reaction in the House of Lords was fierce. He condemned Lord Denning's statement for '[recalling] the good old days, the passing of which many may regret, when inhabitants of this island felt an innate superiority over those unfortunate enough to belong to other races'.<sup>989</sup> Lord Reid's approach was very similar to that of Lord Pearson. He drew a distinction between cases where England is the natural forum for the plaintiff and cases where the plaintiff merely sues in England to serve his own ends. With regard to the latter, he held that 'the plaintiff... should be expected to offer some reasonable justification for his choice of forum if the defendant

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<sup>986</sup> *The Atlantic Star* [1973] QB 364 (CA) 382.

<sup>987</sup> *ibid.*

<sup>988</sup> *Peruvian Guano Co v Bockwoldt* (1883) 23 ChD 225 (CA) 234.

<sup>989</sup> *The Atlantic Star* [1974] AC 436 (HL) 453.

seeks a stay... There have been many criticisms of “forum shopping” and I regard it as undesirable’.<sup>990</sup>

While allowing the appeal, Lord Wilberforce did not seem to believe that the plaintiff had engaged in forum shopping by bringing the English action, which he thought had better prospects of success by comparison to the Belgian action. He held that ‘there is nothing wrong with this. As Lord Esher MR said in *The Reinbeck* (1889) 6 AspMLC 366, 368 you may expect men of business to act as such, in a good stand-up fight. But one must weigh the considerations on the other side’.<sup>991</sup>

However, there were voices in the House of Lords that defended Lord Denning’s approach to forum shopping. Lord Simon of Glaisdale held that:

It may, indeed, be merely a particular application of the promise made at Runnymede that ‘to no one will We deny justice.’ (It would be an inadequate performance of such a promise to say, “You can get perfectly satisfactory justice elsewhere.”) “Forum shopping” is a dirty word; but it is only a pejorative way of saying that, if you offer a plaintiff a choice of jurisdictions, he will naturally choose the one in which he thinks his case can be most favourably presented: this should be a matter neither for surprise nor for indignation.<sup>992</sup>

Lord Simon made a cynical, but pragmatic argument. The plaintiff will always try to sue in a court which is available to him and where he has the best prospects of success. This is only natural. Simultaneously, defendants will try to be brought before a court in which they are more likely to win than not.

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<sup>990</sup> *ibid* 454.

<sup>991</sup> *ibid* 471.

<sup>992</sup> *idid*.

The possibility of a defendant seeking to forum shop has been also condemned by English courts. In a case involving a Turkish and a Romanian company, *Morison J* held that:

There was no good reason for Astra to seek to have the dispute determined in Romania. Its avowed aim was to prevent proceedings in this jurisdiction, or in Turkey. It asserted no positive case for starting the action in Romania at that time and I described this conduct as forum shopping...In my view, the proceedings were started as a 'defensive' step to prevent other courts from taking jurisdiction, rather than because Astra thought Romania was the natural and appropriate forum.<sup>993</sup>

It can be noted, by means of conclusion, that English courts have identified forum shopping with the effort of either litigant to have the case heard in a court other than the natural forum, in which he would have better chances of success. Despite the fact that some judges thought that forum shopping is a right that litigants have, it is clear that on the whole English courts have taken the view that forum shopping is undesirable and should be avoided.

The US approach to the definition of forum shopping is also very similar. Forum shopping is 'a litigant's attempt "to have his action tried in a particular court or jurisdiction where he feels he will receive the most favourable judgment or verdict"'.<sup>994</sup> The term was used for the first time by the US Court of Appeals in 1951.<sup>995</sup> However, its origin as a concept can be traced back to 1938, when the US Supreme Court eliminated much of the

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<sup>993</sup> *Cadre Sa v Astra Asigurari Sa* [2006] 1 Lloyd's Rep 560 (QBD Comm) [18].

<sup>994</sup> —, 'Forum Shopping Reconsidered' (1990) 103 Harv L Rev 1677.

<sup>995</sup> *Covey Gas & Oil Co v Checketts* 187 F2d 561, 563 (US CA 9<sup>th</sup> Cir 1951).

incentive for State-federal forum shopping by requiring federal courts in diversity cases to apply the substantive law of the state in which they are located.<sup>996</sup> Federal courts were subsequently required to apply the forum State's private international law rules.<sup>997</sup>

Just like English judges, their American counterparts did not consistently conceive forum shopping as an evil practice. There were judges who thought forum shopping was a corollary of the existence of different legal systems that accord different rights to the same litigants. Widener J stated that:

There is nothing inherently evil about forum-shopping. The statutes giving effect to the diversity jurisdiction under the Constitution, 28 USC § 1332 (jurisdiction) and § 1391 (venue) are certainly implicit, if not explicit, approval of alternate forums for plaintiffs.<sup>998</sup>

Other courts have taken a different view. They have recognised that some kinds of forum shopping are legitimate. In differentiating between legitimate and illegitimate forum shopping, Ellis J provided the following guidelines:

In legitimate forum shopping, personal jurisdiction either antedates the cause of action or arises in conjunction with the action, as a consequence of it. Here, by contrast, the personal jurisdiction post-dated the accrual of the cause of action and was manufactured by plaintiff solely for the purpose of providing plaintiff with a preferred forum for litigation.<sup>999</sup>

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<sup>996</sup> *Erie Railroad v Tompkins* 304 US 64 (1938); in *Hanna v Plumer* 380 US 460, 468 (1965) the US Supreme Court held that the two policies underlying the *Erie* doctrine were the 'discouragement of forum-shopping and avoidance of inequitable administration of the laws'.

<sup>997</sup> *Klaxon Co v Stentor Electric Manufacturing Co* 313 US 487 (1941).

<sup>998</sup> *Goad v Celotex Corp* 831 F2d 508, 512 n12 (US CA 4<sup>th</sup> Circ 1987).

<sup>999</sup> *De Santis v Hafner Creations Inc* 949 FSupp 419, 424 n14 (ED Va 1996).

## **ii) The notion of forum shopping in civil law**

French case-law has a theory of forum shopping and the term is used widely in French scholarship. Forum shopping goes hand in hand with *fraude à la loi*, it is thought to be a means of obtaining in another court ‘what could not be obtained under the applicable law’.<sup>1000</sup>

Forum shopping is, in French eyes, a kind of fraud and its story goes back to the 19<sup>th</sup> century. As early as 1878, French courts demonstrated their willingness not to allow parties voluntarily to alter their legal relationship for the sole purpose of avoiding the law that would be otherwise applicable to them.<sup>1001</sup> Thus *fraude à la loi* was thought to be comprised of three elements: first, the physical element –i.e. the act of the parties that will lead to the change of the applicable law; second, the legal element –i.e. the change of the applicable law; and third, the *animus fraudis* –i.e. the intention of the parties to perform an act for the sole purpose of altering the applicable law.<sup>1002</sup>

On this background French courts developed another kind of definition of fraud. To the extent that French courts do not enjoy exclusive jurisdiction under French private international law for a particular matter, they will refuse recognition of a foreign judgment if the foreign court did not have a substantial connection with the litigation and the choice of forum was fraudulent.<sup>1003</sup> It is not clear what a fraudulent choice of forum means but it

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<sup>1000</sup> B Audit, *Droit international privé* (4<sup>th</sup> edn Economica, Paris 2006) 219.

<sup>1001</sup> Cass civ, 18.03.1878, *Princesse de Bauffremont c Prince de Bauffremont* (1878) 5 JDI 505; B Ancel, Cass civ, 17.05.1983, *Soc Lafarge* (case note) (1983) 72 RCDIP 346.

<sup>1002</sup> B Ancel & Y Lequette, *Les grands arrêts de la jurisprudence française de droit international privé* (5<sup>th</sup> edn Dalloz, Paris 2006) 49-55.

<sup>1003</sup> Cass civ, 06.02.1985, *Mme Fairhurst c Simitch* (1985) 74 RCDIP 243.

has been held to cover the intention to have a case heard by a court other than the natural forum.<sup>1004</sup> However, there is a long line of authority to show that in cases where French courts thought *fraude à la loi* to exist, one of the parties had tried to obtain judgment from a court that would not apply the law that to the eyes of French conflict of laws would be applicable and thus deprive the other party of the possibility to win the case.<sup>1005</sup>

Thus, forum shopping is perceived to be the strategic search on behalf of either the plaintiff or the defendant concerning access to the most favourable court, either with regard to its procedural or substantive law.<sup>1006</sup>

### ***iii) The virtues and vices of forum shopping***

Forum shopping is a term which, undoubtedly, has negative connotations in all jurisdictions. There are two major reasons that have led to the vilification of forum shopping: first, it undermines the authority of substantive law and thus creates a public mistrust of the equity of the legal system; and second, it overburdens certain courts and creates unnecessary expense as litigants pursue their claims not in the natural but in the most favourable forum.<sup>1007</sup>

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<sup>1004</sup> GAL Droz, *Cass civ*, 24.11.1987, *Garrett* (case note) (1988) 77 RCDIP 364; P de Vareilles-Sommières, 'Le forum shopping devant les juridictions françaises' [1998-1999, 1999-2000] *Trav Com fr d i p* 49, 54; for a different view on the significance of *Garrett* in relation to forum shopping see comments of Hélène Gaudement-Tallon in the debate that followed the presentation of Vareilles-Sommières' presentation at p 79.

<sup>1005</sup> Ph Francescakis, *Cass civ*, 22.01.1951, *Époux Weiller* (case note) (1951) 40 RCDIP 167; P Lagarde, *Cass civ*, 15.05.1963, *Patiño c Dame Patiño* (case note) (1964) 53 RCDIP 532; H Battifol, *Cass civ*, 07.01.1964, *Munzer c Dame Munzer* (case note) (1964) 53 RCDIP 344; *Simitch* (n1003); *Garrett* (1004); P Courbe, *Cass civ*, 06.06.1990, *Akla* (case note) (1991) 80 RCDIP 593; Ancel & Lequette (n1002) 366; de Vareilles-Sommières (n1004) 52-58.

<sup>1006</sup> D Bureau & H Muir Watt, *Droit international privé* (1<sup>st</sup> edn PUF, Paris 2007) vol II, p 214; cf —, 'Forum Shopping Reconsidered' (n994) 1678.

<sup>1007</sup> —, 'Forum Shopping Reconsidered' (n994) 1684.

With regard to the first reason, one's opinion on forum shopping depends, largely but not solely, on the view that one takes with regard to the relation between the administration of justice as a reality and as an ideal. The fact that courts exorcize it demonstrates that judges are orientated towards the ideal of the rule of law, according to which, for each dispute there is a natural forum. The fact that forum shopping occurs, and is occasionally tolerated too, proves that judgments are not the product of a pure logical process utilised by a judge, but the function of social and other factors.<sup>1008</sup>

*In re SPhinX* is an example of a case where the court could be seen to be implicitly driven by some kind of protectionism of US creditors.<sup>1009</sup> The collection and publication of data on federal judges, like the Almanac of the Federal Judiciary or the Judicial Staff Directory, which *inter alia* contain information on temperament, political views and other personal characteristics of judges, is also another example of the dissonance between legal ideals and legal practice.

Although some may wish to deny the influence of such factors on judicial reasoning, it is nonetheless true that in certain countries forum shopping is entrenched not only in the behaviour of litigants, but also in politics. Political theorists in the US recognise 'the American habit of shopping for favourable laws, first in local legislatures, then in Congress, and

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<sup>1008</sup> FS Cohen, 'Transcendental Nonsense and Functional Approach' (1935) 35 Colum LR 809, 843.

<sup>1009</sup> See text to n1090.

finally in courts'.<sup>1010</sup> However, it can be debated whether this statement is true of Europe to the extent that it is in the USA. It would appear that shopping in Europe occurs first in courts, although one should not neglect the amount of lobbying that takes place in Brussels.

Referring to the second reason relating to the economic cost of forum shopping, there are rules that mitigate this concern. Undeniably, forum shopping is costly to the extent that it removes litigation from the forum with the closest connection to and the most knowledge of the dispute. Rules though, like the *forum non conveniens* doctrine and rules on subject matter and personal jurisdiction exist to facilitate this mitigation. In practice, when forum shopping allows for 'substantively efficient rules to be enforced... the outcome is efficient; where it allows such laws to be avoided, [it] is inefficient'.<sup>1011</sup> This statement summarises that characterisation of forum shopping as 'impermissible'<sup>1012</sup> or 'undesirable'<sup>1013</sup> depends by and large on the fairness and efficiency of the forum and the *lex causae*.

Forum shopping though is not always a vice. It has been argued in connection to the Insolvency Regulation that:

forum shopping, is not a completely unlawful practice. The Community legislation counters the *opportunistic* and *fraudulent* use of the right to choose a forum, which is very different to the

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<sup>1010</sup> JN Shklar, *Legalism: Law, Morals, and Political Trials* (HUP, Cambridge 1986) p x.

<sup>1011</sup> —, 'Forum Shopping Reconsidered' (1994) 1692.

<sup>1012</sup> *Pennzoil Co v Texaco Inc* 481 US 1, 24 (1987) (Marshall J).

<sup>1013</sup> *The Atlantic Star* (1989) (Lord Reid).

demonisation for the sake of it of a practice which on occasions it is appropriate to encourage.<sup>1014</sup>

The definition that one gives to forum shopping really matters. It is not necessary to describe forum shopping as a kind of *fraude à la juridiction* or *fraude à la loi*. Choice of courts agreements included in contracts is a kind of forum shopping which is *per se* not objectionable. On the contrary, it is rather common and guaranteed by party autonomy. Article 23 of the Brussels Regulation on prorogation agreements confirms the truth this statement. For these reasons, one needs to distinguish between good and bad forum shopping (*forum shopping bonus et malus*).<sup>1015</sup>

It is probably hard to give a definition of good forum shopping. It will be seen that any forum shopping that is not bad forum shopping is good forum shopping. Bad forum shopping is a choice of jurisdiction of an available forum, which is not a natural forum, with the sole purpose and knowledge that the opponent is most likely to lose there.<sup>1016</sup> Of course, the plaintiff will always look for the forum in which he has the best chances of success and his opponent the most chances of losing, but this should not be done in a way to deprive the opponent of his right to have the case heard in a natural forum.

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<sup>1014</sup> Opinion of AG Colomer in Case C-339/07 *Deko Marty Belgium* [2009] ECR (not yet reported) n49.

<sup>1015</sup> de Vareilles-Sommières (n1004) 51 *et seq.*

<sup>1016</sup> See Opinion of AG Colomer in Case C-1/04 *Staubitz-Schreiber* [2006] ECR I-701 [73]: ‘where forum shopping leads to unjustified inequality between the parties to a dispute with regard to the defence of their respective interests, the practice must be considered and its eradication is a legitimate legislative objective.’

In this sense, the English and French definition of bad forum shopping is very similar.<sup>1017</sup> Bad forum shopping thus appears to be an affront to the court itself<sup>1018</sup> rather than the other party to the dispute. Although this appears to be the understanding of forum shopping in civilian jurisdictions, there is even some authority to support this conclusion in English law. It has been held that a court can use its discretion to grant anti-suit injunctions to protect its jurisdiction.<sup>1019</sup> The latter was conceived as a separate ground from actually enforcing the consent of parties to litigate in England, either by agreement or submission.

However, bad forum shopping is more accurately described as an injury to the interests of the other party, to the extent that one views jurisdiction as rights based. There is indeed public interest in safeguarding the finality of litigation. The natural forum, however, has other means of protecting its jurisdiction, such as the granting of anti-suit injunctions or the refusal to recognise the judgment handed down by the foreign court. Thus, bad forum shopping is primarily an injury to the rights of the other party

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<sup>1017</sup> Cf *Boys v Chaplin* (1984) (Lord Pearson) with *Garrett* (1904).

<sup>1018</sup> See *Princesse de Bauffremont* (1901) where the *Cour de cassation* held that '[Attendu que] se plaçant uniquement au point de vue de la loi française, qui en effet, domine le débat et s'impose aux parties, [l'arrêt] a décidé que, **même eût-elle été autorisée par son mari**, la demandresse ne pouvait être admise à invoquer la loi de l'État où elle aurait obtenu une nationalité nouvelle, à la faveur de laquelle, transformant sa condition de femme séparée en celle de femme divorcée, elle se soustrairait à la loi française, qui, seule, règle les effets du mariage de ces nationaux, et en déclare le lien indestructible;' (emphasis added).

<sup>1019</sup> *Masri v Consolidated Contractors International Co SAL* [2008] EWCA Civ 625, [2009] 2 WLR 669 [83] *et seq* (Collins LJ); see also *Re Norton's Settlement* [1908] 1 Ch 471 (CA) 484 (Farwell LJ) allowing a stay of proceedings because the process of the court was being used 'for a sinister or bye purpose'; *St Pierre v South American Stores (Gath & Chaves) Ltd* [1936] 1 KB 382 (CA) 398 (Scott LJ) allowing a stay in cases of abuse of process.

which has, in a sense, a legitimate expectation that the dispute in question should be litigated in a particular forum.<sup>1020</sup>

Bad forum shopping is thus comprised of two components. The physical element is the behaviour that is destined to remove the case away from the judge who 'is normally competent'. The intention to follow a 'reprehensible procedural' or substantive aim constitutes the relevant mental element.<sup>1021</sup> Bad forum shopping or *forum shopping malus* are rather unfortunate terms. One could speak instead of forum shopping (which corresponds to bad forum shopping), as a *species* of forum selection, in other words as a term without positive or negative connotations. Of course, there is an important question to be answered: in which cases should forum shopping be impermissible?

***iv) Drawing the line between good and bad forum shopping on the basis of consent***

An example will show how consent amongst stakeholders or the lack thereof can explain the difference between forum shopping and forum selection. Suppose A AG is incorporated in Germany and realises it is about to become insolvent. German law requires the directors declare the company insolvent, whereas under English law there is a possibility of a Company Voluntary Arrangement (hereinafter 'CVA'), which may allow for the company to renegotiate its debt with its creditors. The directors of the company together

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<sup>1020</sup> See *Lubbe v Cape* [2000] 1 WLR 1545 (HL) 1566, where Lord Hope of Craighead held that if a defendant is sued in England as of right, the English courts should exercise their jurisdiction as 'the doctrine of forum non conveniens rest leave no room for considerations of public interest or public policy which cannot be related to the private interests of any of the parties or the ends of justice in the case which is before the court.'

<sup>1021</sup> de Vareilles-Sommières (n1004) 54.

with the shareholders and all the creditors have a meeting. They agree to set up an English company that will succeed to the assets and liabilities of A AG through the German doctrine of *successio universalis*.<sup>1022</sup> The reason is that the debtor, its shareholders and the creditors wish to benefit from the possibility of a CVA. The question becomes, in case of insolvency, whether this transfer of the company abroad is forum shopping or a forum selection.

The stakeholders are meant to be able to tell whether a corporate debtor can be salvaged or not better than anyone else. Thus, if all interested parties are present and they agree to a transfer of the company to the UK in order to perform a CVA and the latter is successful,<sup>1023</sup> there is not much a court can say. In fact, creditors often would prefer a restructuring to formal insolvency proceedings.

Insolvency calls the debtor's existence in question, 'with the consequence that its suppliers and customers downgrade their expectations about its commitment to performance –which, in turn reduces the value that can be obtained by selling the firm's assets.'<sup>1024</sup> Few jurisdictions permit firms to contract with their creditors to use a particular procedure and no jurisdiction allows firms to design its own.<sup>1025</sup> This leaves the transfer of the COMI to another Member State as a viable solution that creditors and

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<sup>1022</sup> For the details of this transfer: see pp 385 *et seq.*

<sup>1023</sup> The debtor and his creditors are the best parties to tell the prospects of success of a CVA.

<sup>1024</sup> RR Kraakman et al, *The Anatomy of Corporate Law: A Comparative and Functional Approach* (2<sup>nd</sup> edn OUP, Oxford 2009) 122.

<sup>1025</sup> *ibid* 123.

debtors can use to select a national insolvency law that is more appropriate to their ends.

Under the London approach to voluntary arrangements supported by the Bank of England, commercial banks are traditionally urged to take a supportive attitude toward their debtors that are in financial difficulties. Decisions about the debtor's longer-term future should be made only on the basis of comprehensive information, which is shared between all the banks and other parties that would be involved in any agreement as to the future of the debtor. Interim financing is facilitated by a standstill and subordination agreement and banks work together with other creditors to reach a collective view on whether and on what terms a debtor entity should be given a financial lifeline.<sup>1026</sup>

Parties have a high incentive to reach an agreement. The directors and the shareholders do not wish the company to become insolvent. Neither do the creditors, as that will decrease their chances of recovering their investment in the debtor. The courts should hesitate to interfere in this bargaining. It should just ensure that it conducted in a fair manner, i.e. that all interested parties are involved and that no information on the condition of the debtor is withheld. This efficiency is that makes the transfer of the company, not forum shopping, but forum selection.<sup>1027</sup>

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<sup>1026</sup> UNCITRAL, 'Legislative Guide on Insolvency Law' (2005) New York pp 25-26, recommended for due consideration to all States by UNGA Res 59/40 (2 December 2004) UN Doc A/RES/59/40.

<sup>1027</sup> G Moss, IF Fletcher & S Isaacs (eds), *The EC Regulation on Insolvency Proceedings: A Commentary and Annotated Guide* (2<sup>nd</sup> edn OUP, Oxford 2009) 262.

On the contrary, if the transfer is conducted by the debtor only, without any prior consultations with stakeholders, like the creditors, there is good reason to believe that it is a strategic move to benefit the debtor only and not the creditors. This is the reason that a transfer without prior consultation with stakeholders (e.g. the exit of B&C Finanziaria from Italy to Luxembourg)<sup>1028</sup> will be seen as forum shopping and not as a benign forum selection.

What would happen though in a case where the cross-border transfer will increase the value of the firm by improving the position of the creditors,<sup>1029</sup> but will partially reduce the value of the firm to shareholders? It has been argued that in the event that lending is concentrated, ‘sophisticated adjusting’<sup>1030</sup> creditors, such as the firm’s main bank, will be able to stimulate the other groups’ to enter negotiations.<sup>1031</sup> However, on the creditors’ side the benefits will be limited to adjusting creditors and, on the debtor’s side, such benefits will be available only to large shareholders and directors to the exclusion of the minority shareholders.<sup>1032</sup>

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<sup>1028</sup> See pp 373 *et seq.*

<sup>1029</sup> Re-incorporation in Delaware is proven to increase the value of the firm: R Daines, ‘Does Delaware Law Improve Firm Value?’ (2001) 62 J Fin Econ 525.

<sup>1030</sup> Adjusting in this context is a term describing creditors who can adapt the terms of their relationship with the debtor to differences in the creditor protection mechanism in case the latter chooses to reincorporate in another jurisdiction, which potentially provides lesser protection to creditors. Banks are adjusting creditors, whereas tort creditors are not adjusting.

<sup>1031</sup> L Enriques & M Gelter, ‘How the Old World Encountered the New One: Regulatory Competition and Cooperation in European Corporate And Bankruptcy Law’ (2007) 81 Tul L Rev 577, 619 n191.

<sup>1032</sup> *ibid.*

Consequently, whenever there is consent among the stakeholders about the relocation of the COMI in order for the parties to achieve what they think to be an efficient result, regardless of whether it actually is or not, there can be no forum shopping.<sup>1033</sup> Courts should refrain from upset this bargain because they are less likely to strike a bargain that leads to greater firm value maximisation than the parties themselves. From a doctrinal point of view, if all parties have agreed to the transfer of the COMI, they cannot complain against it later, even if they miscalculated the possible outcomes of the transfer by their own fault. This is so because *volenti non fit iniuria*, provided that one shares the view that jurisdiction is rights based. Undeniably, parties can pursue their interests in an efficient manner without State interference.

## **B. How different, if at all, is the meaning of forum shopping in the Insolvency Regulation?**

### ***i) Forum shopping in the Insolvency Regulation***

According to recital 4 of the Insolvency Regulation, forum shopping is comprised of two alternative acts, which constitute its physical element: transfer of assets or judicial proceedings. The mental element required is the intent to obtain a more favourable legal position.

The concept of forum shopping is not unique to the Insolvency Regulation. It also exists in relation to the Brussels Regulation, where, on one view,<sup>1034</sup> the ECJ is thought to have involuntarily encouraged forum shopping

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<sup>1033</sup> WG Ringe, 'Forum Shopping under the EU Insolvency Regulation' (2008) 9 EBOR 580, 606-607.

<sup>1034</sup> Bureau & Muir Watt (n1006) 215.

through its jurisprudence.<sup>1035</sup> Although the ECJ has only stated that the Brussels Regulation seeks to discourage forum shopping,<sup>1036</sup> it has never defined the term. According to two AGs, forum shopping is the choice of a forum ‘according to the advantages which may arise from the substantive (and even procedural) law applied there’.<sup>1037</sup>

The ECJ has not ruled yet on the notion of forum shopping in the context of the Insolvency Regulation. However, some domestic courts have provided some guidance so as to its interpretation. The English Court of Appeal has directed some of its criticism against the phrasing of recital 4 of the Regulation.<sup>1038</sup> It did not consider the definition of forum shopping in recital 4 to be particularly helpful.<sup>1039</sup> Chadwick LJ held that:

The need ‘to avoid incentives for the parties to transfer assets... from one jurisdiction to another’ is met by the Community regime (introduced by the Regulation) which gives to the main proceedings ‘universal scope’ and the aim of ‘encompassing all the debtor’s assets’. So no advantage is obtained by moving assets from one territory to another. The need to ‘avoid incentives for the parties to transfer... judicial proceedings from one member state to another’- by which, I think, is meant (at least, primarily) the need to avoid forum shopping by the creditor- is met by restricting the courts in which insolvency proceedings may be opened.<sup>1040</sup>

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<sup>1035</sup> Case C-159/02 *Turner v Grovit* [2004] ECR I-3565; Case C-116/02 *Erich Gasser GmbH* [2004] ECR I-14693.

<sup>1036</sup> Case C-539/03 *Roche Nederland* [2006] ECR I-6535 [38].

<sup>1037</sup> Opinion of AG Colomer in Case C-440/97 *GIE Groupe Concorde* [1999] ECR I-6307 [19] n11, repeated in Opinion of AG Mengozzi in Case C-98/06 *Freeport v Arnoldsson* [2007] ECR I-8319 [52] n27.

<sup>1038</sup> *Shierson v Vlieland-Boddy* [2005] EWCA Civ 974, [2005] 1 WLR 3966.

<sup>1039</sup> *idid* [46] (Chadwick LJ).

<sup>1040</sup> *ibid.*

The Court of Appeal then went on to clarify the significance of recital 4 in the following manner:

Recital (4) cannot be read as imposing some restriction on the ability of the debtor to choose where he carries on the activities which fall within the concept ‘administration of his interests’; nor to require the court to give some special meaning to the phrase ‘where the debtor conducts the administration of his interests on a regular basis’. The most that can be said, as it seems to me, is that the court should look critically at the facts which are said to give rise to a change in the centre of a debtor’s main interests in circumstances where there are grounds for suspicion that the debtor has sought, *deliberately*, to change his centre of main interests at a time when he is insolvent in order to alter the insolvency rules which will apply to him in respect of existing debts.<sup>1041</sup> (emphasis added)

This interpretation is in tune with the holding of Langan QC that there is a difference between a restructuring of the debtor’s business ‘which is carried out for sound commercial reasons long before the question of insolvency proceedings becomes live’ and ‘a more or less cynical removal of the seat of a company’s operations’ outside the EU ‘a few weeks before the business goes to the wall’.<sup>1042</sup>

Therefore, as far as the English courts’ interpretation is concerned, forum shopping can materialise through change of the COMI only prior to the insolvency of the debtor. The mental element<sup>1043</sup> of forum shopping is intent with regard to the change of the COMI and a view to alter the *lex concursus*. In the extracts from *Shierson* discussed above,<sup>1044</sup> Chadwick LJ

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<sup>1041</sup> *ibid*; Longmore LJ and Sir Martin Nourse concurring at [70] & [75] respectively.

<sup>1042</sup> *Re C4net.com Inc* [2005] BCC 277 (ChD) [18].

<sup>1043</sup> —, ‘Forum Shopping Reconsidered’ (1994).

<sup>1044</sup> See text to n1041.

stressed the ‘deliberate’ manner in which the change of the COMI needs to be performed in order for forum shopping to be established. This matches perfectly with the aforementioned principle of *volenti non fit iniuria*.<sup>1045</sup>

The holding of Chadwick LJ is not contrary to ECJ case-law. The latter has held that an effort to move the COMI posterior to the filing of an insolvency petition with the view of altering the applicable law would amount to forum shopping.<sup>1046</sup> In *Shierson* the debtor moved the COMI before filing for insolvency.

It is exactly for these reasons that several authors have argued that the COMI is ‘fuzzy and manipulable, allowing forum shopping at the vicinity of bankruptcy.’<sup>1047</sup> As a consequence, it is argued, creditors cannot plan adequately ascertain the applicable insolvency regime and ‘this leads to risk-inadequate credit terms.’<sup>1048</sup> Furthermore, the manipulability of the COMI affects especially the category of creditors who are not in a position to readjust their legal position in case of a shift in the COMI and the *lex causae*.<sup>1049</sup> The use of the COMI as a connecting factor ‘will often lead to discrepancies between the applicable insolvency and company law rules.’<sup>1050</sup>

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<sup>1045</sup> See pp 342-346.

<sup>1046</sup> Case C-1/04 *Staubitz-Schreiber* [2006] ECR I-701 [25].

<sup>1047</sup> H Eidenmüller, ‘Free Choice in International Company Insolvency Law in Europe’ (2005) 6 EBOR 423, 430.

<sup>1048</sup> *ibid.*

<sup>1049</sup> *ibid* 431.

<sup>1050</sup> *ibid.*

In the place of the COMI, it has been suggested that article 3(1) of the Regulation should be revised. The presumption in favour of the registered office should become an un rebuttable one. The law should also be revised to allow for free choice of the *forum concursus* and the *lex societatis*.<sup>1051</sup> The bundling of company and insolvency law in this particular way would have certain advantages. It provides for a stable and ascertainable forum, it is less fact-sensitive and less costly to administer. Additionally, it disavows any divergence between the *lex societatis* and the *lex fori concursus* and it prohibits the shifting of risk to less sophisticated or non-adjusting creditors.<sup>1052</sup>

It is also admitted that the greatest disadvantage of this approach is that it discourages value-maximizing strategies, thus group insolvencies may only be administered through *ad hoc* protocols,<sup>1053</sup> potentially in the way that UNCITRAL is also considering.<sup>1054</sup> However, there is more than this. The bundling of corporate and insolvency law has two significant disadvantages, one functional and one practical. First, it discourages forum shopping, but it also discourages regulatory competition, to the extent that whenever a company wishes to alter the *lex societatis* will have to alter the *lex concursus* as well and vice versa.<sup>1055</sup>

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<sup>1051</sup> *ibid* 438-440.

<sup>1052</sup> *ibid* 439.

<sup>1053</sup> *ibid* 440.

<sup>1054</sup> See text to n896.

<sup>1055</sup> Cf MA Kane & EB Rock, 'Corporate Taxation and International Charter Competition' (2008) 106 Mich L Rev 1229, arguing against the bundling of the connecting factors of the

Second, in case of letter-box companies, the court of the COMI will be in charge of proceedings, which are main only nominally. Other stakeholders will be able to deprive the main proceedings of actual enforceability by opening secondary proceedings in other Member States. Not to mention, of course, that the judgment may not qualify for recognition and enforceability outside the EU, to the extent that the State where recognition and enforcement is sought has to follow the Model Law. Under the latter proceedings are recognised as main only if the COMI is located within the territorial jurisdiction of the foreign court. The approach taken by the non-EU court will not necessarily be one of identification between the COMI and the registered office. It is mainly for these two reasons that it is submitted that the possibility to rebut the presumption of article 3(1) should not be removed.

***ii) The relationship between forum shopping, regulatory competition and abuse of law***

The Insolvency Regulation has enacted the COMI as a mechanism to combat forum shopping. The question thus is whether the placing of the COMI at a particular location can be resisted on grounds of the doctrine of abuse. It is submitted that the doctrine of abuse applies throughout EC law. The prevention of forum shopping constitutes the said doctrine's specific application in the context of the Insolvency Regulation.

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applicable corporate and tax law and in favour of encouraging regulatory competition by allowing entrepreneurs to choose the best corporate law and the best tax law.

The application of the doctrine of abuse in the field of the Insolvency Regulation has been very recently examined.<sup>1056</sup> The main thrust of the argument is that COMI shifts that evidently do not contribute to maximising the debtor's net assets are abusive. Eidenmüller draws a distinction between abuse and fraud. The first 'is about applying the law to a specific set of facts, whereas fraud is about correctly determining the facts to which the law then is applied'.<sup>1057</sup> This actually means that abuse is committed when the facts which call for the application of the law are fraudulently constructed, whereas fraud is when a court erroneously considers the COMI to be considered in its territory. *Brochier*, a case considered above, is given as an example of the latter.<sup>1058</sup>

In Eidenmüller's submission, abuse can be constituted if the law is employed contrary to each purpose, without paying regard to the existence of a specific abusive intent.<sup>1059</sup> This second proposition though is contrary to the case-law of the Court, which requires the finding of a subjective element of abuse.<sup>1060</sup> Although on certain occasions it is evident that Eidenmüller conflates the real seat and the COMI to a certain extent,<sup>1061</sup> his article really brings to the scene a very interesting question. The crucial issue is under

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<sup>1056</sup> H Eidenmüller, 'Abuse of Law in the Context of European Insolvency Law' (2009) 6 ECFLR 1.

<sup>1057</sup> *ibid* 9.

<sup>1058</sup> See n845.

<sup>1059</sup> Eidenmüller (n1056) 10.

<sup>1060</sup> Case C-110/99 *Emsland-Stärke* [2000] ECR I-11569 [53].

<sup>1061</sup> e.g. Eidenmüller (n1056) 11.

which circumstances the shift of the COMI, even when it is the consensual decisions of all the stakeholders, can constitute an abuse. Eidenmüller follows an economic analysis. In his view, the purpose of insolvency law is to maximise the net assets available in order to satisfy the creditors' claims.<sup>1062</sup> While this is undoubtedly one of the aims of insolvency law, the Court has nonetheless interpreted the purpose of the freedom of establishment to the participation of a corporation in the economic life of another Member State.<sup>1063</sup>

It is not clear to what extent the coordinated shift of the COMI by the debtor and his creditors would qualify as participation in the economic life of another Member State. On one reading of the definition of freedom of establishment an artificial shift of the COMI would not qualify for the protections of freedom of establishment, even though both the debtor and the creditor agree to it.

This could be so, because the debtor and his creditors actually create the conditions for finding the COMI in another Member State artificially, i.e. by taking advantage of the presumption of article 3(1) in favour of the registered office. The registered office of the debtor, as will be shown below, is somehow moved to another Member State, whereas in fact the real COMI could have remained in the Member State of origin, but neither the debtor nor the creditors would contest that. In applying article 3(1), a civilian court,

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<sup>1062</sup> *ibid* 14; see also to the same extent J Armour, 'Abuse of European Insolvency Law? A Discussion' in R de la Feria & S Vogenauer (eds), *Prohibition of Abuse of Law- A New General Principle of EU Law* (Hart Publishing, Oxford 2009) (forthcoming).

<sup>1063</sup> See pp 184 *et seq.*

which is not bound by the submissions of the parties as to jurisdiction, could disregard the construction created by the debtor and the creditors.

This point brings the discussion back to a fundamental question. What is the philosophical basis of jurisdiction in article 3(1)? Is it rights or *imperium* based?<sup>1064</sup> Is it based on considerations of economic efficiency or public interest, in the sense that the public has the right to know the details of insolvencies that are in a position to affect national or global economy (e.g. Bear Stearns)?<sup>1065</sup> Eidenmüller appears to consider jurisdiction in the Insolvency Regulation as based on economic efficiency. The COMI must be interpreted in a way to safeguard the economic interests of creditors, and not as a link of substantial connection of insolvency proceedings with a particular State.<sup>1066</sup> All that matters is maximising the value of the debtors' assets. In his view, the need to prevent forum shopping is secondary.<sup>1067</sup>

On the other hand, one may view the COMI as embodying a jurisdictional rule that safeguards State or public interest. Let it be supposed that X SA is incorporated in France and both the company and its creditors, with the exception of employees, agree that the COMI be transferred to the UK. If French courts were to take this view of jurisdiction then they could intervene in order to safeguard the interests of employees by appending the

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<sup>1064</sup> *Imperium* signifies the prerogative power of the State to regulate the rules on jurisdiction in a way that its own interests are safeguarded; see text to n1019.

<sup>1065</sup> See text to n971.

<sup>1066</sup> See also Armour (n1062).

<sup>1067</sup> Eidenmüller (n1056) 15.

tag of forum shopping on the COMI shift.<sup>1068</sup> Taking this view to its extreme, national courts could consider the COMI itself as the result of anti-forum shopping considerations and thus refuse to uphold any change or shift of the COMI so as to defend their jurisdiction.

The COMI is a connecting factor serves multiple purposes. First, it is a connecting factor of substantial connection. Second, it is meant to provide a certain degree of creditor protection. In other words, the COMI indicates the natural forum for the insolvency proceedings of a debtor. In very unequivocal terms the Court has recently held:

Article 3(1) thereof must be interpreted as meaning that it also contributes international jurisdiction on the Member State within the territory of which insolvency proceedings were opened in order to hear and determine actions which derive directly from those proceedings and *which are closely connected to them*.<sup>1069</sup> (emphasis added)

The Court clarified that the courts of the COMI have exclusive jurisdiction to decide an action to set a transaction aside brought against a company whose registered office is in another Member State. The reason is

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<sup>1068</sup> Such cases are not unlikely. See *Comm Nanterre (9e ch)*, 19.05.2005, *SAS ROVER France* at (Official Website of the French Republic for the Diffusion of the Law) <<http://www.legifrance.gouv.fr>> accessed 13 December 2009, aff'd *Public Prosecutor v Segard (As Administrator for Rover France SAS* [2006] ILPr 32 (CA of Versailles). The French court confirmed that the English liquidators had already taken steps to satisfy the claims of the ROVER employees for owed wages and had reassured the employees' trade union that they would cooperate with them. It then declared the English judgment not to be contrary to public policy under article 26 of the Insolvency Regulation. Similarly, in *Re MG Rover España SA* [2006] BCC 599 (Ch) the English court upheld the decision of English administrator making a payment otherwise than in accordance with paragraph 65 of Schedule B1 or paragraph 13 to the Insolvency Act 1986 so as to satisfy the claims of employees of the Rover group in Europe, given that other national laws gave higher priority to their claims than English law. This was thought to prevent the possibility of the English judgment being refused recognition on the basis of public policy, if the rights of employees were to be equated with constitutional guarantees in these other Member States.

<sup>1069</sup> *Deko Marty* (n1014) [21].

that although this action could be brought by the liquidator in another forum, in that particular case Belgium, it is expedient to hear and determine the action together with the main insolvency proceedings. Why is it expedient though? The reasons are threefold. First, the action to set a transaction aside is **closely connected** with the main proceedings. Second, it discourages forum shopping.<sup>1070</sup> Third, the action in question 'is intended to increase the assets' of the insolvent debtor.<sup>1071</sup>

This conclusion is also reinforced by the possibility of rebutting of the presumption in article 3(1). What is truly argued in case of a rebuttal, is that if proceedings are carried on in the forum in which they are brought, the judgment will not enjoy a great deal of recognition.<sup>1072</sup> The reason is that there is another secondary establishment where the debtor's assets are located and where proceedings can be brought successfully. This would render the main proceedings main in name and not in fact.

In fact, even secondary proceedings require an establishment, which should be interpreted as article 2(h) of the Regulation requires.<sup>1073</sup> If the registered office is a letter-box then why should the courts of the Member State of incorporation enjoy the exclusive jurisdiction to open main proceedings, whereas for the same amount of presence jurisdiction to open secondary proceedings would not be established? The fact that the

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<sup>1070</sup> *ibid* [23]-[24].

<sup>1071</sup> *ibid* [17].

<sup>1072</sup> See *In re Betcorp* 400 BR 266 (Bkrtcy D Nevada 2009) 293.

<sup>1073</sup> 'Establishment' shall mean any place of operations where the debtor carries out a non-transitory economic activity with human means and goods.

presumption of article 3(1) is rebuttable safeguards the integrity of the main proceedings.

Therefore, it is erroneous to treat it as purely belonging to one of the three aforementioned categories. Close connection is not directly concerned with economic efficiency. Rather it is concerned with the administration of justice. Insolvency disputes should be 'dealt with at the place which is most suitable for reasons of substance and procedure.'<sup>1074</sup> In principle, insolvency proceedings should be administered by the court which has the closest connection with the dispute. Expedient administration of justice though does indirectly affect efficiency. The more readily enforceable a judgment is the lesser the costs.

On the other hand, no court has the right to upset the agreement of the parties to place the COMI at a particular location, even if that it is not an economically efficient decision. The reason is that in such a case the creditors have expressed their will to conduct their affairs in a particular manner. The courts should, in principle, trust their judgement as well as that of the debtor. However, under the current state of EU law courts could potentially upset such arrangements if it turned out that the shift of the COMI was not real but artificial and it did not lead to participation in the economic life of the host Member State.<sup>1075</sup>

Therefore, jurisdiction in the Insolvency Regulation is not solely a matter of economic efficiency. The doctrine of abuse cannot be applied in this

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<sup>1074</sup> Opinion of AG Colomer in *Staubitz-Schreiber* (n1016) [72].

<sup>1075</sup> See definition of establishment in *Cadbury Schweppes*, text to n557.

context on the basis of pure economic considerations. Forum shopping is the specification of abuse in the context of the Insolvency Regulation and it is not primarily related to economic efficiency, but rather to consent. As the ECJ has indicated in the context of the Brussels Regulation, abuse can only have a limited role to play.<sup>1076</sup> Indeed it is hard to see how the application of rule on jurisdiction can be abusive. Abuse requires that the purpose of the freedom has been evaded. Forum shopping requires that one party is seeking to unduly disadvantage the other. Therefore, the latter is more suited than abuse of law for the purposes of the Insolvency Regulation.

Indeed, as pointed out by Armour, the reasons that necessitate the existence of an independent abuse of the Insolvency Regulation are not entirely clear.<sup>1077</sup> First, there are corporate law mechanisms that often ensure that creditors are consulted before a shift is effected.<sup>1078</sup> Second, there can be other ways that protect creditors, such as the conclusion of contractual clauses according to which a change of the COMI without prior consultation with the creditor would trigger the debtor's default. On top of these considerations, the existence of a separate abuse doctrine of the Insolvency Regulation could increase uncertainty over a term as loose and uncertain as the COMI.<sup>1079</sup>

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<sup>1076</sup> *Freeport* (n1046) [51]-[54].

<sup>1077</sup> Armour (n1062).

<sup>1078</sup> See pp 85 *et seq.*

<sup>1079</sup> Armour (n1062).

Having said this, it is also crucial to differentiate between forum shopping and regulatory competition. If forum shopping is conceived as any effort made to unduly disadvantage one's opponent, regulatory arbitrage is the effort made by debtors and creditors to submit an insolvency to the most efficient national law, while regulatory competition is the effort made by Member States to attract such submissions. Regulatory competition and arbitrage can take two forms, i.e. either the form of a race to the top or the form of a race to the bottom. Whether any of these races in fact constitutes forum shopping depends on the meaning that one attaches to the terms 'top' and 'bottom'.

Both views, namely that the insolvency race in Europe will go to the top<sup>1080</sup> and to the bottom,<sup>1081</sup> have been suggested. Before examining their individual merit, a few preliminary observations should be made. As in the case of regulatory competition for corporate charters, it is hard to tell whether favouring a particular interest group in insolvency encourages a race to the top or to the bottom. For some, ranking employee claims above these of secured creditors is monstrous and for some others it is ideal. Economic efficiency can be opposed to social efficiency and so on. There appears to be no solid answer in Europe as to what is desirable and undesirable or right and wrong in insolvency law.

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<sup>1080</sup> DA Skeel Jr, 'European Implications of Bankruptcy Venue Shopping in the U.S.' (2006) 54 *Buff L Rev* 439.

<sup>1081</sup> LM LoPucki, *Courting Failure: How Competition for Big Cases Is Corrupting the Bankruptcy Courts* (University of Michigan Press, Ann Arbor 2005).

In any event, if by ‘race to the top’ one refers to regulatory competition that facilitates what the stakeholders believe to be firm value increasing then it can be safely concluded that a race to the top and forum shopping do not usually overlap. By contrast, a race to the bottom implies an effort that is being made to advantage a particular group of interest more than others, which subsequently leads to a decrease in the quality of insolvency law. As in the case of forum shopping, a race to the bottom does not presuppose stakeholders’s consent. Actually, it usually tries to avoid it.<sup>1082</sup>

Notwithstanding these conclusions, one should note that forum shopping and a race to the top/ bottom do not always match perfectly. It is at least theoretically possible that insolvency proceedings will be opened in the courts of Member State without prior negotiation of the stakeholders. Courts can create regulatory competition just by the mere interpretation they give to the notion of the COMI. The nature of the race that will emerge will depend on the quality of each national law. However, one can reasonably anticipate that no Member State will wish to initiate a race to the bottom and the European Commission will always do its best to ensure that such thing never happens.

Regardless of whether one views the (potential) race for insolvencies in Europe as one to the top or the bottom, one should also bear in mind the disparities between the race as it has been evolving in the US and in Europe. Delaware’s success stems from two main factors. First, it has enjoyed the pre-

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<sup>1082</sup> See S Moore, ‘COMI migration: the future’ [2009] *Insolv Int* 25, 26.

eminent position in relation to incorporations.<sup>1083</sup> Second, insolvency law in the US is debtor, and in particular manager, friendly, as managers enjoy the possibility of remaining at their post, even after the filing, which they usually make themselves.<sup>1084</sup>

One of the major factors that prevent a race to the bottom is the leading role that banks play in insolvency. As debtors are desperate for cash, banks ‘use the financing agreement to exert substantial control over the debtor, both before and in bankruptcy.’<sup>1085</sup> This goes to the extent that ‘the banks themselves often appear to be the ones who make the venue decision.’<sup>1086</sup>

By contrast, in Europe a Member State has yet to assume the role of Delaware and insolvency law is, in varying degrees, creditor friendly. Creditors very frequently file for insolvency instead of the managers.<sup>1087</sup> Most European insolvency regimes, including the English one, are manager displacing:

Directors are not rewarded with the carrot of prolonged control over the corporation, but threatened with the stick of liability in the case of a late filing. However, it appears that this stick does not work effectively, because the case placers are usually creditors.<sup>1088</sup>

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<sup>1083</sup> Skeel Jr (n1080) 457.

<sup>1084</sup> *ibid* 458-459.

<sup>1085</sup> *ibid*.

<sup>1086</sup> *ibid* 459.

<sup>1087</sup> *ibid*.

<sup>1088</sup> Enriques & Gelter (n1031) 635; See also J Armour, BR Cheffins & DA Skeel Jr, ‘Corporate Ownership Structure and the Evolution of Bankruptcy Law: Lessons from the United Kingdom’ (2002) 55 Vand L Rev 1699, 1723-1730.

**iii) Forum shopping in the UNCITRAL Model Law**

US courts have not dealt with forum shopping in bankruptcy in great depth.

*In re SPhinX* is the leading authority with regard to this matter.<sup>1089</sup> In that case, Drain J decided that the COMI of the hedge funds was outside the Cayman Islands, based on anti-forum shopping considerations. The bringing of proceedings in the courts with territorial jurisdiction over the registered office was thought to be tainted with ‘improper purpose’ as their goal was to frustrate the settlement that had been reached with the US creditor, Refco Capital Markets, objecting to the petition. If the Cayman proceedings were recognised as foreign main proceedings the appeal on an action regarding the settlement with Refco would be stayed. This would have the same consequence as overturning the ‘settlement *without addressing or prevailing on the merits*’.<sup>1090</sup>

The ruling appears absurd, at least on the face of it. How can it be that bringing a petition for insolvency at the courts of the registered office will constitute forum shopping? Drain J has committed a grave mistake. He derived the forum shopping incentives from the attempted frustration of the settlement reached with Refco. On a proper construction, he should have concluded that the COMI lay elsewhere in order to deny recognition of the Cayman proceedings. On the contrary, he had held that he would be prepared to accept that the COMI of SPhinX lay in the Cayman Islands.

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<sup>1089</sup> 351 BR 103 (Bkrtcy SDNY 2006).

<sup>1090</sup> *ibid* 121.

This stance which mixes forum shopping with the older doctrine of ‘improper purposes’ contained in §304(c) of the Bankruptcy Code replaced by Chapter 15 was heavily criticised. The basis of the criticism was that the purpose of the very Chapter 15 was to provide a new legal framework that would limit the flexibility that US courts enjoyed under the old regime.<sup>1091</sup>

However, this was the end of the critique related to forum shopping and improper purposes, namely that there is no legislative authorisation for such considerations of flexibility to overturn the established belief of the court that, otherwise, the COMI is located in the registered office, as no party disputes this finding. Glosband took the view that it is not necessary to recognise the proceedings brought in the place of registered office as main or nonmain. Recognition may be refused on the basis that the registered office is neither the COMI nor an establishment.<sup>1092</sup>

***iv) The transfer of the COMI is not by definition a detrimental act***

Returning to the transfer of the COMI as a kind of forum shopping, it should be stated that a change of the *lex concursus*, effected through a transfer of the COMI to a Member State with less restrictive company or insolvency law, is not necessarily detrimental to the creditors. According to the 2008 ‘Doing Business’ World Bank statistics, countries with rigid insolvency law regimes have expensive insolvency proceedings, low recovery rates and the proceedings instituted under their law are time consuming, whereas

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<sup>1091</sup> JL Westbrook, ‘Locating the Eye of the Financial Storm’ (2007) 32 Brook J Intl L 1019, 1026-1027; DM Glosband, ‘SPhinX Chapter 15 Opinion Misses the Mark’ (2006) 25 Am Bankr Inst J 83, 84-85.

<sup>1092</sup> Glosband (n1091) 85.

countries with less restrictive insolvency and company law regimes have cheaper insolvency proceedings, which guarantee a much higher recovery rate and are concluded promptly.<sup>1093</sup>

A study of defaults and bank recovery rates in France, Germany and the UK revealed that ‘the median recovery rate in bankruptcy is 82% in the UK, 61% in Germany and only 39% in France’.<sup>1094</sup> Expediency of procedures influences efficiency. ‘The median total length of reorganisation proceedings and case closure is 1.45 years in the UK, 3.05 years in France and 3.82 years in Germany’.<sup>1095</sup> By contrast, ‘renegotiation of debt’ processes (e.g. CVAs) have very high recovery rates for banks across all three jurisdictions: 78% in the UK, 83% in France and 76% in Germany.<sup>1096</sup> Of course, banks are not the only creditors and this study does not reveal the overall rate of recovery.

There are a number of reasons why recovery rates differ so much. Different insolvency regimes pursue different objectives. The UK is said to be a ‘creditor friendly’ jurisdiction. In the event of insolvency, control passes to the creditors. An administrator is appointed with the sole purpose of materialising funds to pay the debts to the creditors whose hierarchy of claims is prescribed by law.<sup>1097</sup>

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<sup>1093</sup> The World Bank, ‘Doing Business 2008’ at (Washington DC 2007) <<http://www.doingbusiness.org/Downloads/>> accessed 13 December 2009.

<sup>1094</sup> SA Davydenko & JR Franks, ‘Do bankruptcy codes matter? A study of defaults in France, Germany and the UK’ (2008) J Fin 565, 584.

<sup>1095</sup> *ibid* 581.

<sup>1096</sup> *ibid* 582.

<sup>1097</sup> *ibid* 569.

In Germany, a judicially appointed administrator supervises the insolvent company and designs a plan for reorganisation that has to be approved by the majority of secured creditors; otherwise the company must be liquidated.<sup>1098</sup>

In France, the objectives of a judicially appointed administrator are to maintain the company 'as a going concern, preserve employment,<sup>1099</sup> and satisfy creditors' claims, in that order'.<sup>1100</sup> Despite recent legislation introducing a rescue procedure, which resembles that of Chapter 11 of the US Bankruptcy Code,<sup>1101</sup> French insolvency law is indeed orientated towards attempting to achieve a social efficiency rather than an economic efficiency model.<sup>1102</sup> Indeed, the State and employees have priority and thus higher recovery rates than secured and unsecured creditors.<sup>1103</sup>

Concluding, the paradigm case of forum shopping is that of a debtor company, which, upon realising it is about to become insolvent, moves its COMI to another Member State. The exit from the jurisdiction may be performed in four different ways. One is to transfer the central management.

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<sup>1098</sup> *ibid* 569-571.

<sup>1099</sup> French insolvency courts favour buyers who promise to preserve employment to the higher bidder. *Ibid* 588.

<sup>1100</sup> *ibid*.

<sup>1101</sup> P Théry, 'The Evolution of Insolvency Law in France' in WG Ringe, L Gullifer & P Théry (eds), *Current Issues of European Financial and Insolvency Law* (Studies of the Oxford Institute of European and Comparative Law, Hart Publishing, Oxford 2009) 1; M Haravon, 'French Overhaul Bankruptcy Regime' (2005) 24 *Am Bankr Inst J* 32.

<sup>1102</sup> R Blazy et al, 'How Do the Courts Choose between Different Bankruptcy Outcomes? The Results of a French Survey' in Ringe, Gullifer & Théry (n1101) 181.

<sup>1103</sup> *ibid* Table 4; Articles L 622-17 and 641-13-III *CComm*.

Another is to transfer the registered office. A third way is to perform a cross border merger with a foreign company that either pre-existed the merger or was set up for this specific purpose. A fourth way is to set up a company in another Member State which will become a shareholder of the debtor and then it will gradually acquire the shares of the other shareholders until it succeeds to the debtor by *successio universalis*. Each case will be examined in turn.

## ***II. Transfer of central management***

The transfer of the place of central management, i.e. of the place where the debtor conducts the administration of his business on a regular basis, will be performed for the purpose of affecting the COMI test. Since the COMI has to be established under *inter alia* objective criteria, such a transfer will undermine the solidity of the presumption of article 3(1) in favour of the place where the registered office lies. Although it is no longer possible for the host Member State to deny the legal personality of a company that moves its head office into that jurisdiction,<sup>1104</sup> this method of forum shopping can be very troublesome for a number of reasons.

First, some Member States might prohibit companies to move their head office out of the jurisdiction and at the same time retain the legal personality of the State of incorporation.<sup>1105</sup> Second, even if it is permissible

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<sup>1104</sup> Case C-208/00 *Überseering v Nordic Construction Company Baumanagement GmbH (NCC)* [2002] ECR I-9919.

<sup>1105</sup> Case C-81/87 *R v HM Treasury and Commissioners of Inland Revenue, ex parte Daily Mail and General Trust plc* [1988] ECR 5483; Case C-210/06 *Cartesio* [2008] ECR (not yet published); [2009] 1 CMLR 50.

under the *lex societatis* to transfer the head office abroad and to the extent that the registered office is not moved, there is nothing to guarantee that in the event that a petition for insolvency is brought in the courts of the State of incorporation, the latter will hold that the COMI has indeed moved. Not to mention, of course, that transferring the head office is not a very cost effective decision.

On the other hand, there have been instances where such a move has been effective. The major competitor of Deutsche Post, PIN Group AG, was registered in Luxembourg. When it ran into difficulties, it decided to shift its COMI to Cologne and restructure itself there. All statutory books, all personnel files and other substantial documents were transferred to a rented office in Cologne; the top management was based in Cologne; the board of directors launched an executive committee (*Lenkungsausschuß*), which held its meetings only and regularly in Cologne; the areas of finance/controlling and human resources were all transferred to Cologne etc. At the end the only parts that remained in Luxembourg were a small legal department and a registry to forward mail.<sup>1106</sup>

Cases like PIN show that it is actually possible for a debtor to move out the COMI gradually and that some courts will be willing to accept the new location as the place where affairs are managed regularly. As far as ascertainability is concerned, in that case it sufficed that third parties (i.e.

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<sup>1106</sup> A Gallagher & RK Janjuah, 'European Insolvency Regulation: German Court Blesses Change of COMI to Bolster Cross-Border Group Restructuring' (2008) 27 Am Bankr Inst J 30.

creditors, employees, other companies of the group and other contracting parties) that the place where the policy of the group was planned had shifted.

One may reasonably think that this could be a clear-cut case of forum shopping. However, the German court reasoned that a COMI shift can be abusive only 'if its primary purpose is to evade protection for creditors.'<sup>1107</sup> The court found that the debtor performed the shift 'in the interests of the creditors, preservation of the group and with a view of restructuring the group.'<sup>1108</sup>

It is submitted that such an approach is regrettable. In principle, no court should be willing either to take the word of the debtor on the merit of the transfer at face value or to substitute its own judgement to that of the stakeholders about the efficiency of a transfer in or out of the jurisdiction. Unilateral transfers should be viewed as highly suspicious of being tainted with improper purposes. Courts should be expected to enforce some level of cooperation between debtors and creditors.

Consequently, if a transfer is effected in a manner too similar to that employed in *PIN* the COMI shift should not be recognised, especially if the filing for insolvency takes place straight after the shift is completed. By contrast, if the debtor took steps to inform the creditors and either the latter did not react or they consented to the COMI shift the case should be stronger for recognising the shift.

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<sup>1107</sup> *ibid* 48.

<sup>1108</sup> *ibid*.

### ***III. Transfer of the registered office***

Another way to alter the jurisdiction under article 3(1) of the Insolvency Regulation is to transfer the registered office to another Member State. This would suffice to confer jurisdiction under the presumption of article 3(1) of the Insolvency Regulation in favour of the courts of the place where the new registered office is located.

#### **A. The 14<sup>th</sup> Directive on the cross-border transfer of the registered office**

It must be stated at the outset that progress on the 14<sup>th</sup> Directive on the cross-border transfer of the registered office has been stopped. The Impact Assessment concluded that the best option to tackle the problems of cross-border transfer of the registered office concluded that “no action” option or a directive would be suitable to achieve the policy objectives. However, when the proportionality test is applied, it is not clear that adopting a directive would represent the least onerous way of achieving the objectives set’.<sup>1109</sup>

The rationale behind the ‘no action’ option is to await the impact of other developments in Community law, such as the ‘practical effects of the cross-border merger directive, the developments in Community case law or an action on a European Private Company’.<sup>1110</sup> In light of this conclusion, Commissioner McCreevy has decided there is no need for action at EU level on this issue. He may prove to be right, especially if Member States in

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<sup>1109</sup> Commission (EC), ‘Impact assessment on the Directive on the cross-border transfer of registered office’ Part I (Commission Staff Working Document) SEC(2007) 1707, 12 December 2007, p 6.

<sup>1110</sup> *ibid* p 29.

transposing the CBM Directive revise their domestic law in a way to allow for the transfer of the registered office in and out of the jurisdiction.<sup>1111</sup>

One might have expected that the Commission would not halt the drafting of the 14<sup>th</sup> Directive. The Commission in its Impact Assessment admits that:

...it appears from the above considerations that currently the only realistic possibility for existing companies to carry out the transfer of the registered office is to **wind up the company in the home Member State and create a new company in the host Member State**. Such operation involves substantial costs, including administrative burden, time, financial, social and tax costs. In particular, an average number of procedures involved in winding up and re-incorporating a company could vary **from 13 to more than 35**. An approximate cost of winding up and re-incorporating a company could, for example vary from €39,500 to €169,500 if a company moves from UK to EL. Winding up of a company would also involve liquidation taxation. On top of that, there will be the hidden costs of paying creditors earlier than in a normal trading environment, and of losing the use of the company's cash and assets during the liquidation period.<sup>1112</sup>

It further points out

Using the percentage of European limited liability companies incorporated in a different EU country (notably UK) in 2005 (approximately 0,6%, in some Member States even 3%) as a that proxy, a rough estimate could be made that between 0,6-3% of existing companies would use the possibility to transfer their registered office to another Member State if it was possible without winding up and subsequent reincorporation and without loosing the legal continuity of a company. It means that **approximately 60.000-300.000 companies would likely use the option to relocate their legal seat to another EU country**.<sup>1113</sup>

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<sup>1111</sup> The Spanish Government has submitted a bill in Parliament with that effect: see Miguel Torres, 'Spain: company law – relocation of registered office' (2009) 20 ICCLR N8.

<sup>1112</sup> Commission (EC) (11109) p 12.

<sup>1113</sup> *ibid* 13-14.

None of this, however, was enough to persuade the Commission to take action in order to facilitate the transfer of the registered office throughout the Community. On the other hand, it has been argued that the ECJ, perhaps cautious of these considerations, took the liberty in *Cartesio*, to foster corporate mobility.<sup>1114</sup>

### **B. The transfer of the registered office as a means of forum shopping**

The decision to transfer the registered office is thus both risky and extremely costly. The ECJ has condemned the requirement of reincorporation as ‘tantamount to outright negation of freedom of establishment’ only with regard to the transfer of the real seat.<sup>1115</sup> Regardless of whether they adhere to the incorporation or the real seat theory, several Member States do not usually allow companies incorporated in their territory to both transfer their registered office to another State and maintain their initial legal personality.<sup>1116</sup> The ECJ has also acknowledged that such a prohibition does not constitute an unlawful restriction of freedom of establishment.<sup>1117</sup> So the only way open to a debtor corporation is to dissolve in the Member State of incorporation and reincorporate in another Member State, unless both States

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<sup>1114</sup> R Kovar, ‘Cour de justice des Communautés européennes (gde ch.) 16 décembre 2008’ (case note) [2009] *Receuil Dalloz* 465, 468-470; M Menjucq, ‘*Cartesio Oktató és Szolgáltató bt*’ (case note) [2009] *JCP G* 10026; contrary view taken in: V Korom & P Metzinger, ‘Freedom of Establishment for Companies: the European Court of Justice confirms and refines its *Daily Mail* Decision in the *Cartesio* Case C-210/06’ (2009) 6 *ECFR* 125, 152.

<sup>1115</sup> *Überseering* (n1104) [81].

<sup>1116</sup> Commission (EC) (n1109) p 9; one exception is Italy: see article 25(3) Law No 218 of 31 May 1995 on the reform of the Italian system of private international law, according to which the registered office may be transferred to another State provided that the requirements imposed by the laws of both States are observed.

<sup>1117</sup> *Daily Mail* (n1105).

allow such a transfer and assumption of the new legal personality without dissolution of the corporation.<sup>1118</sup> If, however, a company wishes to perform this transfer to convert to a new legal person governed by the law of another Member State, the requirement of prior dissolution and liquidation amounts to a restriction to freedom of establishment that needs to be justified.<sup>1119</sup>

If the transfer of the registered office is performed successfully, it would *prima facie* seem that the debtor has succeeded in altering the *forum concursus*. Under article 3(1) of the Insolvency Regulation, the courts of the State where the new registered office will enjoy exclusive jurisdiction. The European Commission seems to believe that this transfer would constitute a valid exercise of freedom of establishment and cannot *per se* be seen as an abuse of Community law. Quite the contrary, it is viewed as a desirable consequence of the transfer of the registered office.<sup>1120</sup>

There have been indeed a few instances where companies have tried to use this mechanism. Some Italian companies transferred their registered offices abroad and a Luxembourgian company moved its registered office to Spain.<sup>1121</sup> On all occasions the transfer was allowed and was successfully performed. However, when a petition for insolvency was filed, the Italian courts reacted to this transfer which had the effect of companies evading the application of Italian insolvency law.

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<sup>1118</sup> E.g. Article L225-97 *CComm*.

<sup>1119</sup> *Cartesio* (n1105) [112]-[113].

<sup>1120</sup> Commission (EC) (n1109) 16.

<sup>1121</sup> *ibid* Part I 23.

A leading Italian case has demonstrated the willingness of the Italian courts to adopt a rigid stance against this kind of transfer. Upon realising that it would become insolvent, B&C Finanziaria lawfully moved its registered office to Luxembourg and acquired Luxembourgian legal personality under the name 'B&C Finanziaria Srl'. Its creditors filed a petition for insolvency before Italian courts. B&C Finanziaria sought to contest the jurisdiction of the Italian courts by relying on the valid transfer of its registered office and real seat to Luxembourg by virtue of article 25(3) of Law No 218/ 31 May 1995. The argument did not succeed.<sup>1122</sup> Although it is possible for an Italian company to move its registered office abroad and still be governed by Italian law, the transfer of the registered office to Luxembourg and the re-incorporation there was thought to result in the loss of Italian legal personality. Only the new company was thought to be exclusively subjected to Luxembourgian law. Thus the Italian courts would enjoy jurisdiction over the winding-up of the Italian company.

The Italian Court of Cassation also rejected an argument based on articles 43 and 48 EC that such an interpretation of article 25(3) of Law No 218/ 31 May 1995 is contrary to freedom of establishment. It held that freedom of establishment does not come at all into play in such a case. Relying on the ruling of the ECJ in *Daily Mail*, it reasoned that the dissolution of legal persons established under Italian law is a matter that falls squarely within the realm of Italian domestic law.

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<sup>1122</sup> Cass SU, 23.01.2004, n 1244 (2005) 41 RDIPP 1381 (Italian Court of Cassation).

Even more interestingly, the Italian Court of Cassation also declared the Insolvency Regulation irrelevant in this particular case to the extent the case did not concern the location of the COMI or the location of the statutory seat. It explicitly ruled that cross border transfers do not fall within the field of application of the Regulation, which clearly names the combat of forum shopping as one its objectives in recital 4.

The soundness of this ruling of the Italian Court of Cassation should be contested. First, aside from the criticisms that one can direct against the judgment from a domestic law point of view,<sup>1123</sup> the application of *Daily Mail* in this context could be arguably challenged. *Daily Mail* has recognised that companies do not have a Treaty right to move their central management and control and their central administration to another Member State while retaining their status as companies established under the legislation of the Member State of incorporation.<sup>1124</sup>

However, the ECJ in *Daily Mail* did not rule on the transfer of the registered office.<sup>1125</sup> The Italian Court of Cassation has assumed that *Daily Mail* can be expanded to include cases like *B&C Finanziaria* although the company in question at no times wished to transfer its registered office abroad and at the same time retain its Italian legal personality. More importantly, the ECJ in *Cartesio* has made it plain that a company, like B&C

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<sup>1123</sup> FM Mucciarelli, 'The Transfer of the Registered Office and Forum-Shopping in International Insolvency Cases: an Important Decision from Italy' (2005) 2 ECFR 512, 523-524.

<sup>1124</sup> *Daily Mail* (n1105) [24].

<sup>1125</sup> See Opinion of AG Maduro in *Cartesio* (n1105) [28]-[31], where he is dismissing the argument based on *Daily Mail* that a Member State can prevent a company incorporated under its laws to move its registered office abroad.

Finanziaria, cannot be prevented from moving its seat –without differentiating between real and statutory seat- to another Member State, if the company is going to acquire the legal personality of the Member State of destination.<sup>1126</sup>

Second, the soundness of the Italian judgment might also be contested with regard to the argument on the non applicability of the Insolvency Regulation to the cross-border transfer of the registered office of a company. It is explicit that the Regulation applies to the insolvency proceedings of any company that has its COMI in the Community.<sup>1127</sup> In this sense, it is the Regulation that confers jurisdiction on the Italian courts for the opening of insolvency proceedings over the Italian B&C Finanziaria. The Italian Court of Cassation has in effect held that so long as there is no continuity of the legal personality, article 3(1) of the Insolvency Regulation cannot be of much use. In a sense the COMI of the old company was in Italy and the COMI of the new company is in Luxembourg. The Italian courts have demonstrated their will to combat forum shopping by not recognising the continuity of legal personality and by dissolving the Italian company.

However, the validity of this approach is doubtful. The ECJ in *Cartesio* held that the transfer of the seat should not be blocked if the company is going to be converted to a corporate form governed by the law of the Member State of destination. The only resort that Italian and other national courts may have is to claim that such transfers constitute forum shopping, i.e.

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<sup>1126</sup> *Cartesio* (n1105) [111].

<sup>1127</sup> Insolvency Regulation 1346/2000 recital 14.

they are meant to deprive the natural forum (Italy) of its jurisdiction or, preferably, they are performed without the consent of the other stakeholders and for the purpose of depriving them of some procedural or substantive benefit available under Italian law.<sup>1128</sup>

Therefore, the understanding that one has of the basis of jurisdictional rules will become increasingly important. If the civilian trend prevails, i.e. that jurisdiction is based on *imperium* and forum shopping constitutes an act directed against the State, then national courts will have much more space in thwarting the decisions to shift the COMI. If, on the contrary, jurisdiction is understood to be rights based and that parties should be allowed to bargain as to where to litigate in the context of insolvency, then national courts will have substantially less space to interfere.<sup>1129</sup> *B&C Finanziaria* fell short of both tests.

Similarly to *B&C Finanziaria*, in *Italfinanziaria Iberica sa c Globo srl e Concordato fallimentare della Supermeg di Bosso Emilio & C sas* an Italian company upon realising that it would become bankrupt transferred its registered office to Spain, lost its Italian nationality and acquired a Spanish one.<sup>1130</sup> The Spanish company was declared insolvent with retroactive effect from the date that the company was in fact unable to pay its debts. This period included the transfer of its registered office to Spain. The Italian Court of Cassation held that due to the retroactive effect of insolvency and the loss

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<sup>1128</sup> Mucciarelli (n1123) 532-533.

<sup>1129</sup> See pp 351 *et seq.*

<sup>1130</sup> *Cass SU*, 28.07.2004, n 14348 (2005) 41 RDIPP 441 (Italian Court of Cassation).

of legal personality for any purpose other than insolvency, article 25(3) of Law No 218/ 31 May 1995 was not available to the insolvent company and that it had always remained an Italian company.

Thus, if the transfer of the registered office abroad is caught by relation back to the time of commencement of insolvency, the company will fail to benefit from its effort to exit the jurisdiction of incorporation. Italian courts will apply the *lex incorporationis* under article 25(1) of the Law No 218/ 31 May 1995 in order to establish the actual real seat of the company for the purpose of asserting jurisdiction in insolvency proceedings.<sup>1131</sup>

These anti-forum shopping considerations apply even if the registered office has been transferred to another Member State for the purpose of asserting jurisdiction under article 3(1) of the Insolvency Regulation.<sup>1132</sup> Similarly, a company that has validly transferred its registered office abroad, thus being vested with a new legal personality, may bring an action before Italian courts to challenge a judgment declaring the bankruptcy of the original Italian company. The transfer of registered office abroad does not affect the ‘legal continuity’ of the company.<sup>1133</sup> However, much like *B&C Finanziaria* analysed above, it is doubtful whether this trend in Italian law would survive a close scrutiny with regard to the Insolvency Regulation and freedom of establishment.

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<sup>1131</sup> *Cass SU*, 16.02.2006, n 3368 (2006) 42 RDIPP 1074 (Italian Court of Cassation).

<sup>1132</sup> *Cass SU*, 20.05.2005, n 10606 (2006) 42 RDIPP 432 (Italian Court of Cassation).

<sup>1133</sup> *Cass civ*, 28.09.2005, n 18944 (2006) 42 RDIPP 774 (Italian Court of Cassation).

#### ***IV. Shifting the COMI through cross-border corporate formations***

A third potential way to forum shop in insolvency proceedings is to merge with another foreign company that either pre-existed or has been set up for the purposes of the merger. Of course the possibility of merging with a pre-existing foreign company is not as likely as the other possibility given that the prospective of a merger with a company that is about to become insolvent would normally not be very attractive. It is this consideration that might prevent the creation of a *Societas Europaea* (hereinafter 'SE').<sup>1134</sup>

Nonetheless, it is still an option for the debtor to merge with other companies in order to exit the jurisdiction to which it is subjected.<sup>1135</sup> So far though it appears that SEs have been set up to achieve tax advantages or evasion of co-determination regimes,<sup>1136</sup> but there is nothing to preclude the formation of an SE in order to achieve a COMI shift. Actually, given that the statutory and the real seat of the SE have to coincide, the incorporation of a SE will decrease the likelihood of litigation over the location of the COMI.

Unlike the the case of the SE, there has been clear indication that the CBM Directive has been used for the purpose of effecting a change in the applicable company law.<sup>1137</sup> There are three requirements for the applicability

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<sup>1134</sup> Council Regulation (EC) 2157/2001 on the Statute for a European Company (SE) [2001] OJ L294/1, art 17.

<sup>1135</sup> See L Enriques, 'Silence Is Golden: The European Company as a Catalyst for Company Law Arbitrage' (2004) 4 JCLS 77.

<sup>1136</sup> H Eidenmüller, A Engert & L Hornuf, 'Incorporating Under European Law: The *Societas Europaea* as a Vehicle for Legal Arbitrage' pp 26 *et seq.* <[http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1316430](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1316430)> accessed 13 December 2009.

<sup>1137</sup> M Gelter, 'The structure of regularoty competition in European corporate law' (2005) 5 JCLS 247, 267.

of the CBM Directive.<sup>1138</sup> First, there has to be a merger of some kind (e.g. merger by acquisition, merger by creation of a new corporation or merger by transfer of share capital to a holding corporation).<sup>1139</sup> Second, the merger should involve at least two companies governed by the laws of different Member States.<sup>1140</sup> Third, the companies involved should fall under the scope of the Directive, namely they should be limited liability companies as referred to in article 1 of the First Directive<sup>1141</sup> that qualify under article 48 EC to enjoy the benefits of freedom of establishment, have legal personality and possess separate assets.<sup>1142</sup>

The CBM Directive has adopted a mixed approach to choice of law for mergers.<sup>1143</sup> First, the capacity of companies to merge will be judged on the basis of both national laws.<sup>1144</sup> Second, the merging companies should observe all the requirements imposed by their respective *lex societatis*.<sup>1145</sup> The

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<sup>1138</sup> M Siems, 'The European Directive on Cross-Border Mergers: An International Model?' (2005) 11 Colum J Eur L 167, 172-173, updated in 2007 at <[http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=853804](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=853804)> accessed 13 December 2009.

<sup>1139</sup> CBM Directive 2005/56 arts 1 & 2(2).

<sup>1140</sup> *ibid* art 1.

<sup>1141</sup> First Council Directive (EEC) 68/151 on coordination of safeguards which, for the protection of the interests of members and others, are required by Member States of companies within the meaning of the second paragraph of article 58 of the Treaty, with a view to making such safeguards equivalent throughout the Community [1968] OJ Spec Ed 41, as amended.

<sup>1142</sup> Cross-border Mergers Directive 2005/56 arts 1 & 2(1): the Directive covers the major types of companies incorporated with limited liability, such as the English plc and Ltd, the German AG and GmbH, the French SA and SARL, the Italian SpA and Srl etc.

<sup>1143</sup> Siems (n1138) 169.

<sup>1144</sup> Cross-border Mergers Directive 2005/56 art 4(1)(a).

<sup>1145</sup> *ibid* art 4(1)(b).

Directive does not make it clear which law will govern the transfer of the assets and liabilities of the company being absorbed or acquired. One argument is that ‘the transfer of all assets and liabilities and the cessation of the corporate acquisition refer only to the law of this first corporation’.<sup>1146</sup>

It is submitted that there is another, more plausible, argument. There is no need for a governing law because under articles 14 (1)(a) and (2)(a) of the Directive the assets and liabilities are transferred *ipso facto*, that is by virtue of the very act of the merger. On this view, the purpose of article 14 is to ensure that there will not be an effort to set free the acquiring or the new company of the debts of their predecessors.<sup>1147</sup> Regardless of the fact that the Directive in question ensures that the assets and liabilities will be transferred to the acquiring or the new company, it is still the case that a merger may be performed in order to benefit from the insolvency laws of another Member State.

The question then becomes whether the Insolvency Regulation can be read in a way to deprive companies of their rights under the CBM Directive. Once the merger is performed and its consequences have been brought about, is it open for the courts of the Member State where the COMI of the debtor used to be to declare the merger void and establish jurisdiction over the debtor?

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<sup>1146</sup> Siems (n1138) 175.

<sup>1147</sup> Compare with *National Bank of Greece and Athens SA v Metliss* [1958] AC 509 (HL) and *Adams v National Bank of Greece and Athens SA* [1961] AC 255 (HL).

Article 4(2) allows for a Member State whose law will apply to a merger to adopt appropriate provisions for the protection of minority members who have opposed the merger. The pre-merger certificate requirement introduced by article 10 can also be used by such a Member State to achieve a better protection of minority members. Nonetheless, this is the limit or the extent to which a Member State can react to a merger. Under article 17, a merger cannot be declared null and void. Nor will it be possible for a court to hold that the merger with a foreign company had the consequence of dissolution of the debtor. The ECJ has precluded this possibility in a recent ruling.<sup>1148</sup>

The last alternative solution is for the court to hold that the COMI of the new company is not at the Member State where the new registered office is located. By reversing the presumption of article 3(1) of the Insolvency Regulation it may reach the conclusion that the COMI has remained at the place where it was before the merger had been performed. In displacing the requirements of objectivity that point to the Member State where the new registered office is located, the court will have to rely on the requirements of ascertainability.

However, this will not be possible either, to the extent that the debtor company had complied with the publicity requirements of article 7 of the CBM Directive. Under the latter article, the management or the administrative organ of each merging company is required to produce a report explaining and justifying the legal and economic aspects of the merger, among others, to the creditors as well. If the company has observed this

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<sup>1148</sup> Case C-411/03 *Sevic Systems AG* [2005] ECR I-10805.

requirement, it will be hard for the creditors to argue that they ought not to have known the objective location of the COMI.

Therefore, it seems that there is not much room for an argument that such a merger constitutes forum shopping. The reason is that the debtor has made use of rights conferred to it by EC law itself and did so in a public process so that creditors and other stakeholders are aware of it. Nor does it *prima facie* appear that there is some scope for an abuse of Community law argument. Allowing businessmen to have recourse to a corporate structure provided by the less restrictive laws of another Member State is by no means in and of itself an abuse of Community law.<sup>1149</sup> With the view of establishing an abuse, one objective requirement and one subjective need to be satisfied.<sup>1150</sup> First, the purpose of the EU law provision in question must not have been achieved. Second, there must be an intention to obtain an advantage by creating artificially the requirements of application of the provision in question.

In the kind of case contemplated above, the purpose of the CBM Directive is the completion and good functioning of the Internal Market through the facilitation of cross-border mergers. Even if one were to satisfy the courts that such a requirement is met it would be hard to see how one would proceed about establishing that the debtor company has artificially

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<sup>1149</sup> Case C-212/97 *Centros Ltd v Erhvervs- og Selskabsstyrelsen* [1999] ECR I-1459 [27].

<sup>1150</sup> Case C-373/97 *Diamantis* [2000] ECR I-1705 [33-34]; Case C-110/99 *Emsland-Stärke* [2000] ECR I-11569 [52]-[53].

created the requirements of application of the CBM Directive, since the latter is available in any event.

The only way forward for the creditors would be to point to some fraudulent behaviour on behalf of the company. The ECJ has indicated that it is likely for an abuse to be found in cases of artificial arrangements and pro-forma transactions.<sup>1151</sup> However, the creditors will have to go uphill in showing this. The change of the *lex concursus* does not necessarily mean that they will be defrauded. At the same time, there is no legal system in Europe with lax insolvency laws. Thus, it will be hard for them to rely on an abuse of the CBM Directive.

This leaves only one plausible argument to the creditors. They will have to place reliance only on recital 4 of the Insolvency Regulation which purports to prevent forum shopping. The problem with this argument is that the Regulation was enacted as a means to eradicate forum shopping in insolvency proceedings by transferring assets or judicial proceedings from one Member State to another. Although it can be argued that a debtor trying to prove that the COMI lies outside its registered office constitutes forum shopping, it is hard to see how a merger would be tantamount to forum shopping, given that creditors are aware of it and have consented to it.

The same considerations can apply by analogy to the formation of a SE. However, the formation of a SE is more problematic. First, the European

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<sup>1151</sup> Case C-324/00 *Lankhorst-Hohorst* [2002] ECR I-11779; Case C-9/02 *de Lasteyrie du Saillant* [2004] ECR I-2409 [60].

Company Regulation concerns mainly public limited liability companies.<sup>1152</sup> There is a limited role for private limited liability companies.<sup>1153</sup> One important difference with the CBM Directive is that national authorities to which the debtor is subjected have the right to oppose to the latter's participation to the formation of a SE on grounds of public policy.<sup>1154</sup> It is arguable that this opposition may be validly made when the debtor is fraudulently trying to alter his COMI.

It has been argued, however, that a right to oppose in such a context should not be available to a Member State because the creditors have other effective means of protection under the SE Regulation.<sup>1155</sup> Such means are provided by the publicity requirements of article 21. Additionally, article 24(1)(a) provides that the law governing each merging company shall apply with regard to the protection of the interests of their creditors. Indeed, it is not hard to see how the State of incorporation of the debtor will have a right to prevent the fraud of creditors, which is independent from the protection and rights conferred to creditors. The ECJ has indicated that when the creditors have had the chance of assessing the risk themselves then it will not

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<sup>1152</sup> SE Regulation 2157/2000 art 2(1), (2) and (4).

<sup>1153</sup> *ibid* art 2(2).

<sup>1154</sup> *ibid* *ibid* art 19.

<sup>1155</sup> WG Ringe, 'The European Company Statute in the Context of Freedom of Establishment' (2007) 7 JCLS 185, 207, where he has made this argument with regard to the transfer of the registered office of the SE.

be open to the Member State to impose restrictions on freedom of establishment justified by the protection of creditors.<sup>1156</sup>

The conclusion, thus, is that the use of the CBM Directive cannot be seen *per se* as forum shopping in the sense of recital 4 of the Insolvency Regulation. Additionally, it is hard to contemplate any situation in which a merger under the Directive would amount to forum shopping.

### ***V. Transfer of the assets and liabilities to a foreign company by means of successio universalis***

The fourth way of engaging in forum selection is by transfer of the assets and liabilities of the debtor to a company incorporated under the laws of another or a non Member State by means of *successio universalis*. To the extent though that the successor is a limited liability company incorporated in a Member State, in the sense of article 2(1) of the CBM Directive, the latter nowadays applies and thus reliance on the doctrine of *successio universalis* as a separate construction has become unnecessary.<sup>1157</sup> Of course, *successio universalis* may still be relied upon in cases where national laws do not allow the merger of specific types of companies and thus the CBM Directive is not applicable.<sup>1158</sup>

This mechanism has been used several times so far. The first to use it was Deutsche Nickel Group, which had entered trading difficulties in 2004, principally as a result of high losses being incurred in the Euro coins business

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<sup>1156</sup> Case C-167/01 *Kamer van Koophandel en Fabrieken voor Amsterdam v Inspire Art Ltd* [2003] ECR I-10155 [135].

<sup>1157</sup> Ringe (n1033) 592-593.

<sup>1158</sup> CBM Directive recital 2.

as a result of the demand for such coins dropping considerably following the completion of the introduction of the Euro. Close Brothers were appointed financial adviser to the *ad hoc* committee of creditors and they came up with the following consensual restructuring plan.<sup>1159</sup> Deutsche Nickel AG was converted into a German limited partnership and all assets and liabilities were passed to it. DNICK Ltd became the general partner and EuroCoin Ltd the limited partner. Both companies had been incorporated in England for this purpose. EuroCoin Ltd subsequently withdrew and DNICK Ltd took on all assets and liabilities of the old German AG. The incentive for Deutsche Nickel and its stakeholders was to benefit from a CVA which is not available in German law.

The same mechanism was applied by Close Brothers to the consensual restructuring of another German company, Schefenacker AG.<sup>1160</sup> Schefenacker announced its poor trading performance. Unrealised operational restructuring savings would result in an inability to service its existing indebtedness. Close Brothers recommended a migration to England in order to benefit from a CVA.

A new company was set up in England with the name 'Schefenacker plc'. Schefenacker AG was transformed to a limited partnership in accordance with German law and named 'Schefenacker GmbH & Co KG'. Schefenacker

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<sup>1159</sup> —, (Case Study 2005: Deutsche Nickel GmbH at the official website of Close Brothers) <<http://www.cbcbf.com/Case%20Studies/2005/Deutsche%20Nickel%20GmbH.aspx>> accessed 13 December 2009.

<sup>1160</sup> —, (Case Study 2007: Schefenacker AG at the official website of Close Brothers) <http://www.cbcbf.com/Case%20Studies/2007/Schefenacker.aspx> accessed 13 December 2009.

plc became one of the general partners of Schefenacker KG. All the rest of the partners then withdrew from Schefenacker KG either by mere withdrawal or by transfer of their partnership share to Schefenacker plc. As a result of this latter stage, the KG, being left with only one partner, collapsed. Its assets and liabilities passed to its sole partner, Schefenacker plc, *ipso jure* and without any further transfer declarations being required (*successio universalis*).<sup>1161</sup>

The question whether these cases constitute examples of forum shopping is dependent upon the way that the COMI is transferred to another Member State.<sup>1162</sup> If the COMI together with the debtor is moved to another Member State by means of an agreement to which the creditors are a party, it is hard to see how the COMI could not be ascertainable at the new registered office. To the extent that the creditors have consented to the transfer of the debtor company and the COMI to another Member State, they should be estopped from relying on it against the debtor. The creditors should be required to prove some fraudulent behaviour on behalf of the debtor.

If, however, the company and the COMI have been moved to a non Member State, the courts of a Member State, having found under objective and ascertainable criteria, that the COMI is located outside the Community, they may still entertain a petition for insolvency based on their national rules of international jurisdiction in insolvency proceedings. In English law,

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<sup>1161</sup> Declaration of H Krause dated 13 June 2007 in *Re Schefenacker plc* (US Bankruptcy Court, SDNY, 14 June 2007) available at <[http://www.chapter15.com/bin/chapter15\\_company\\_dockets?cid=1185158833&search=all&orby=docket\\_num&ordertype=asc&tbl=docket](http://www.chapter15.com/bin/chapter15_company_dockets?cid=1185158833&search=all&orby=docket_num&ordertype=asc&tbl=docket)> accessed 13 December 2009.

<sup>1162</sup> See pp 342 *ets eq*.

companies incorporated abroad are classified as unregistered companies and may be wound up: (a) if the company is dissolved, or has ceased to carry on business, or is carrying on business only for the purpose of winding up its affairs; (b) if the company is unable to pay its debts; (c) if the court is of opinion that it is just and equitable that the company should be wound up.<sup>1163</sup> The enactment of the UNCITRAL Model Law on 4 April 2006 has not altered these rules.<sup>1164</sup>

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<sup>1163</sup> Insolvency Act 1986 s 221(5); IF Fletcher, *Insolvency in Private International Law* (2<sup>nd</sup> edn OUP, Oxford 2005) 154 *et seq.*

<sup>1164</sup> Cross-Border Insolvency Regulations 2006 SI 2006/1030.

## 15. The COMI in the context of freedom of establishment

### *I. Is the COMI a real seat theory choice of law for insolvency?*

It now needs to be examined whether the COMI is in essence a real seat theory approach to insolvency. Recital 13 defines the COMI as the place where the corporation conducts the administration of its interests on a regular basis and is thus ascertainable by third parties. Article 3(1) introduces a rebuttable presumption with regard to corporations. According to it, the registered office of a corporation will be thought to constitute its COMI, unless it can be established that the COMI lies elsewhere.

The similarities between the COMI and the real seat theory are evident. The place where the corporation conducts the administration of its affairs is nothing but a real seat theory test.<sup>1165</sup> However, it does not stand on its own. The other component of the COMI is ascertainability by third parties. In relation to the previous real seat theory influence, this has been described as a ‘victory of substance over form’.<sup>1166</sup> It must be noted though that it must be rare in practice that the real seat, namely the centre of administration of a corporation will not be ascertainable.

What would seem to amount to a prevalence of the real seat theory within the scope of the Insolvency Regulation is mitigated by the presumption introduced by article 3(1) with regard to corporations. The burden will fall upon the petitioners to prove to the satisfaction of the court

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<sup>1165</sup> IF Fletcher, *Insolvency in Private International Law* (2<sup>nd</sup> edn OUP, Oxford 2005) 367.

<sup>1166</sup> *ibid.*

that COMI and registered office do not coincide. This presumption does not amount to an adoption of the theory of incorporation by the Regulation. Instead, the possibility to rebut it in favour of another place appears to be a similar construction to the real seat theory. After all the Insolvency Regulation had been drafted before *Centros* and its progeny came into existence. The construction of this presumption is analogous to that of the French *Cour de cassation* with regard to the real seat of corporations. The real seat of a company is presumed to be located in its registered office, unless it can be proved otherwise.<sup>1167</sup>

In conclusion, it can be said that the COMI would be tantamount to a real seat theory approach, if it were not for ascertainability. The latter allows for the real seat to be displaced, if the debtor has misrepresented its true location to the creditors.<sup>1168</sup> However, no big difference can be seen between the real seat theory and the requirement of objectivity in the COMI test. If this is indeed the case, it needs to be examined whether part of the COMI test is contrary to freedom of establishment, given that, on one view, the ECJ has effectively made the real seat theory untenable under its rulings in *Centros* and its progeny.

It might appear awkward to compare a choice of law theory with a basis of international jurisdiction. However, in insolvency proceedings the

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<sup>1167</sup> Cass Ass, 21.12.1990 *Directeur général des impôts c Soc Roval* (1992) 81 RCDIP 70-72; see also G Khairallah, 'The "Centre of the Debtor's Main Interests": Comments of the *Eurofood* Judgment of the ECJ' in WG Ringe, L Gullifer & P Théry (eds), *Current Issues in European Financial and Insolvency Law: Perspectives from France and the UK* (Studies of the Oxford Institute of European and Comparative Law, Hart Publishing, Oxford 2009) 111.

<sup>1168</sup> See pp 85-85.

establishment of jurisdiction over a debtor leads inevitably to the application of the *lex fori* as choice of law. Indeed, article 4(1) of the Insolvency Regulation stipulates that, with few exceptions, the *lex concursus* will be the law of the Member State where insolvency proceedings have been opened. Thus, to a great extent, the COMI is both a basis for jurisdiction and a choice of law.

## ***II. The compatibility of the presumption contained in article 3(1) of the Insolvency Regulation with freedom of establishment***

The ECJ in *Überseering* held that all Member States have to recognise the legal personality conferred by other Member States on the companies incorporated in their territory and under their laws. The argument that *Überseering* is a German company by virtue of its real seat situated in Germany and thus German law should apply was not endorsed by the ECJ. On the contrary, the ECJ held that

...its very existence is inseparable from its status as a company incorporated under Netherlands law since, as the Court has observed, a company exists only by virtue of the national legislation which determines its incorporation and functioning (see, to that effect, *Daily Mail and General Trust*, paragraph 19).<sup>1169</sup>

Thus, *Überseering* was thought to be a Dutch company. Its legal personality had to be recognised. To the extent that the ECJ had decided that *Überseering* is a Dutch company and that, on the view of certain authors and national courts, the real seat theory has been effectively abolished by the ECJ,

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<sup>1169</sup> Case C-208/00 *Überseering v Nordic Construction Company Baumanagement GmbH (NCC)* [2002] ECR I-9919 [81].

the question is whether the possibility to reverse the presumption of article 3(1) of the Insolvency Regulation is consistent with freedom of establishment. In other words, how sound is it both with reference to articles 43 and 48 EC and as a matter of principle to treat *Überseering* as a company subject to Dutch law, regarding its legal personality and internal affairs, and potentially a company subject to German law, regarding its insolvency?

In order to answer this question, there are several other issues that need to be addressed. First, one should examine the boundaries between freedom of establishment and Title IV of the EC Treaty, under which the Insolvency Regulation has been adopted. In doing so, it will be necessary to analyse the aims and purposes of both freedom of establishment and the Insolvency Regulation. Second, the notion of impediment or restriction to freedom of establishment needs to be clarified. Last, the extent to which the rebuttal of the presumption of article 3(1) of the Insolvency Regulation will amount to such an impediment needs to be assessed.

#### **A. The boundaries between freedom of establishment and Title IV of the EC Treaty**

As it has been stated in the beginning of this Part, there are no watertight compartments in the Treaty to isolate *Überseering* and its consequences from the Insolvency Regulation.<sup>1170</sup> The Insolvency Regulation has been adopted under Title IV of the EC Treaty as a measure ‘in the field of judicial cooperation in civil matters’.<sup>1171</sup> The content of Title IV, titled ‘Visas, Asylum,

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<sup>1170</sup> WG Ringe, ‘Forum Shopping under the EU Insolvency Regulation’ (2008) 9 EBOR 579, 608-609.

<sup>1171</sup> Art 61(c) EC.

Immigration and Other Policies Related to Free Movement of Persons', initially formed part of the Third Pillar of the EU, which under the Treaty of Maastricht was called: Justice and Home Affairs. The Treaty of Amsterdam moved the content of Title IV to the First Pillar. The aim of this Title is to establish an area of freedom, justice and security (whatever this can be taken to mean).<sup>1172</sup>

It is clear from the outset that freedom of establishment and Title IV are not unrelated. Title IV has been introduced and moved from a Pillar of inter-governmental cooperation to a Pillar of supra-national cooperation in order to promote *inter alia* the free movement of persons. This includes corporations, in their capacity as legal persons. In doing so, Title IV requires the EU to take measures in order to promote the compatibility of national conflict of laws rules and rules on international jurisdiction as a means of promoting the free movement of persons.<sup>1173</sup>

Freedom of establishment is one of the constituent freedoms of the internal market. Its purpose is to remove barriers that prevent, restrict, discourage or even might discourage companies from setting up an establishment in another Member State. Title IV provides the legal basis for Community institutions to ensure the 'proper functioning of the internal market. Thus, Title IV is a corollary to freedom of establishment. It does not establish the internal market, but it enhances its functioning.

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<sup>1172</sup> P Craig & G de Búrca, *EU Law: Text, Cases and Materials* (4<sup>th</sup> edn OUP, Oxford 2008) 22.

<sup>1173</sup> Art 65 EC.

However, at the same time the Insolvency Regulation has other effects outside the establishment of an area of freedom, justice and security. By introducing a single rule for international jurisdiction and choice of law for cross-border insolvencies, the Insolvency Regulation pursues objectives of insolvency law. It is supposed to provide certainty in the market to promote economic stability and growth.<sup>1174</sup> By granting exclusive jurisdiction to the courts of the COMI, which leads to the application of the *lex fori concursus*, the Regulation strikes a balance between voluntary restructuring negotiations, reorganisation and liquidation.<sup>1175</sup> It also influences the timely, efficient and impartial resolution of insolvency through a transparent and predictable procedure.<sup>1176</sup>

Having said this, it is also important to notice another importance difference between freedom of establishment and the scheme of the Insolvency Regulation. Freedom of establishment grants rights and guarantees their protection to all companies incorporated under the laws of a Member State. In this context, the EC Treaty is striking a balance between the rights of companies, as private entities, and the rights of Member State to take action to protect a public policy purpose. By contrast, article 3(1) of the Insolvency Regulation in combination with recital 13 strikes a balance between the conflicting interests of private parties, i.e. the debtor on one side

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<sup>1174</sup> UNCITRAL, 'Legislative Guide on Insolvency Law' (2005) New York p 10, recommended for due consideration to all States by UNGA Res 59/40 (2 December 2004) UN Doc A/RES/59/40.

<sup>1175</sup> *ibid* 11.

<sup>1176</sup> *ibid* 13.

and his creditors on the other. This will become a crucial point in the discussion under the following heading.

**B. Is the reversal of the presumption in Article 3(1) of the Insolvency Regulation an unjustifiable impediment to freedom of establishment?**

***i) Thesis: the reversal of the presumption in Article 3(1) of the Insolvency Regulation is contrary to the EC Treaty***

It has been argued that the reversal of the presumption is indeed contrary to freedom of establishment.<sup>1177</sup> The thrust of Ringe's argument is that the reversal of the presumption in article 3(1) of the Insolvency Regulation leads to the application of a law other than the one the founders of the company chose. It is thus a disincentive for companies to move throughout the EC. In his view, this is contrary to what he calls the 'home state principle', namely that a company must be subjected to the *lex incorporationis*. In his view, the COMI so far as it differs from the registered office is analogous to the real seat theory that the ECJ has discarded in *Überseering* and *Inspire Art*.<sup>1178</sup> Let it be supposed for argument's sake that the ECJ has indeed discarded the real seat theory *in toto*, the question is whether the COMI in combination with article 4 of the Regulation is contrary to the Treaty.

***ii) Antithesis: The reversal of the presumption in Article 3(1) of the Insolvency Regulation is compatible with freedom of establishment***

It is hereby submitted that the COMI test is in conformity with the EC Treaty.

There are five reasons for which this conclusion is inevitable. The present

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<sup>1177</sup> Ringe (n1170) 609-610.

<sup>1178</sup> *ibid* 611.

analysis proceeds on the assumption that the preceding interpretation of the notion of restriction to freedom of establishment is corrects.<sup>1179</sup>

First and foremost, it has to be acknowledged that the Insolvency Regulation is a measure with several recipients. As Ringe himself admits, the debtor is not the only beneficiary of the Insolvency Regulation.<sup>1180</sup> The COMI has been designed in a way to balance the interests of debtors and creditors. It may well be the case that the *lex fori concursus* is more restrictive to the debtor than the *lex societatis*, but that it is more beneficial to all or some of the creditors. There is no profound reason justifying the prevalence of the debtor's interests over those of the creditors. If the presumption is reversed, it is because either the debtor or the creditors have proved to the satisfaction of the adjudicating court in an adversarial trial that the COMI does not lie at the place of incorporation. The Insolvency Regulation in this sense guarantees an equality of arms among the debtor and the creditors.

Second, there is nothing in freedom of establishment that requires the application of a single *lex causae* to a corporation. The ECJ has never held that a company should be subjected to its *lex incorporationis* at all times. Quite the contrary, it has held that Member States are free to adopt the real seat theory<sup>1181</sup> and that choice of law rules cannot be found to be *per se* contrary to freedom of establishment.<sup>1182</sup> The underlying principle of the ECJ's case-law

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<sup>1179</sup> See pp 85 *et seq.*

<sup>1180</sup> *ibid* 605-608.

<sup>1181</sup> Case C-210/06 *Cartesio* [2008] ECR (not yet published); [2009] 1 CMLR 50 [110].

<sup>1182</sup> Case C-353/06 *Grunkin & Paul* [2008] ECR (not yet published); in particular see the Opinion of AG Sharpston [49]; John Armour, 'European Insolvency Proceedings and Party

on freedom of establishment is that Member States should refrain from imposing requirements that are detrimental to companies incorporated in other Member States and, thus, discourage them from exercising the freedom of establishment. The application of another law is not in and of itself sufficient to constitute a breach of freedom of establishment.

Mindful of the fact that the plea of illegality<sup>1183</sup> is directed against a rule on jurisdiction and a subsequent choice of law attached to it, the ECJ will definitely refrain from ruling on the validity of the reversal of the presumption *in abstracto* in the same way it has never explicitly declared the real seat theory to be contrary to freedom of establishment. It has actually now proclaimed it to be in conformity with the Treaty.<sup>1184</sup> However, the content of the *lex causae* should be such so as not to amount to a restriction. After all, the kind of cases that had reached the ECJ in relation to the real seat theory and might reach the ECJ with regard to the reversal of the presumption in article 3(1) had been and will only be the problematic cases in which the application of another law other than the *lex incorporationis* will be detrimental to the company.

Indeed, in the case of the real seat theory, it is hard to see how it can be seen as contrary to freedom of establishment, if, for instance, under the *lex incorporationis* a derivative action can be brought by the minority

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Choice' WG Ringe, L Gullifer & P Théry (eds), *Current Issues in European Financial and Insolvency Law: Perspectives from France and the UK* (Studies of the Oxford Institute of European and Comparative Law, Hart Publishing, Oxford 2009) 123, 127.

<sup>1183</sup> Art 241 EC; Craig & de Búrca (11172) 533-535.

<sup>1184</sup> *Cartesio* (11181).

shareholders, if they hold 1/5 of the company's capital in shares, but under the *lex sedis* the relevant fraction is only 1/6. The application of the *lex sedis* is not necessarily detrimental in this case as it was in *Überseering*. Likewise, the reversal of the presumption may lead to the application of a law that may benefit the debtor and some, but not all, of the creditors. It is not entirely clear why in these circumstances the reversal should be held to be in contravention of the Treaty.

A third reason to advocate in favour of the validity of the COMI test is related to the timing of the kind of considerations that directors take into account before moving the company to another country.<sup>1185</sup> Whereas incorporation in a specific country and the transfer of the head office from one country to another is usually tax driven,<sup>1186</sup> such cross-border transfers may also be performed for the purpose of benefit from the host State's corporate law. Insolvency law is not usually a consideration at this stage.<sup>1187</sup> It is, therefore, hard to see how the potential reversal of the presumption will act as a disincentive to move the head office around Europe. When a transfer is performed for the sole purpose of shopping for insolvency laws in a manner which is detrimental to creditors, this will amount to an impermissible forum shopping.<sup>1188</sup>

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<sup>1185</sup> The contrary view is put forward in Ringe (n1170) 611-612.

<sup>1186</sup> Cf Case C-81/87 *R v HM Treasury and Commissioners of Inland Revenue, ex parte Daily Mail and General Trust plc* [1988] ECR 5483.

<sup>1187</sup> L Enriques & M Gelter, 'How the Old World Encountered the New One: Regulatory Competition and Cooperation in European Corporate and Bankruptcy Law' (2007) 81 *Tul L Rev* 577, 634.

<sup>1188</sup> See pp 342 *et seq.*

Assuming *arguendo* that the ECJ were to hold the reversal contrary to freedom of establishment either *in abstracto* or *ad hoc*, it would seek to justify the restriction under its mandatory requirements jurisprudence and the *Gebhard* test. Protection of creditors, which is the relevant ground of justification here, is a recognised imperative requirement in the general interest.<sup>1189</sup> The balancing of proportionality would depend on the specific facts of the case before the ECJ. It would thus be an exercise in futility to predict the ECJ's response without a specific pattern of facts. Suffice it to say that article 3(1) would have the best chances of survival from the Court's scrutiny in comparison with the rules in question in *Centros* and its progeny.

Fourth, Ringe's position on the COMI defeats the pro-creditor considerations that he addresses explicitly in his article.<sup>1190</sup> If the COMI is permanently fixed at the registered office it may well be the case that the court of a State that has no real connection with the debtor will have jurisdiction over the latter's insolvency. Suffice it to imagine that if that jurisdiction is pro-debtor then the creditors will actually have to negotiate additional terms under which the debtor would be willing to move to the creditor friendly jurisdiction that has a substantial connection with the latter. If, on the other hand, the argument is that such creditors must bear the consequences of their bad choice, the consequence would only be that creditors would actually impose severer terms on the debtor –such as higher

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<sup>1189</sup> Case C-212/97 *Centros Ltd v Erhvervs- og Selskabsstyrelsen* [1999] ECR I-1459 [32]-[33]; *Überseering* (n1169) [92]; Case C-167/01 *Kamer van Koophandel en Fabrieken voor Amsterdam v Inspire Art Ltd* [2003] ECR I-10155 [123].

<sup>1190</sup> Ringe (n1170) 603-607.

interest rates or collateral of greater value- at the time when the debt is contracted for fear that they may not fully recover. Higher costs for acquisition of debt can only act as an impediment to corporate and economic growth. Not to mention, of course, that if Ringe's approach were adopted, the creditors could always avail themselves of their right to establish even multiple secondary proceedings in the Member State,<sup>1191</sup> where the COMI and the assets are actually located. Thus his approach could, in certain occasions, actually deprive the term 'main' in 'main proceedings' of its meaning and in reality turn the latter into secondary proceedings.

Fifth, Ringe's position has the effect of removing the jurisdiction of Member States courts over companies that are incorporated outside the EU, but have their COMI in an EU Member State. Therefore, a company incorporated in Turks & Caicos and having its COMI in London could not be subject to the jurisdiction of English courts.

Last but not least, it would be worthwhile to contemplate Ringe's view on article 3(2) of the Insolvency Regulation. If he believes that the application of a *lex concursus* different to the *lex incorporationis* violates the so called 'home State principle' what would be Ringe's opinion about the possibility of secondary proceedings? The opening of secondary proceedings clearly subjects part of the debtor to a law other than the *lex incorporationis*. If he were to remain faithful to the so called 'home State principle', would he argue that article 3(2) is also contrary to freedom of establishment?

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<sup>1191</sup> See Insolvency Regulation art 17(2).

This, however, cannot be the case. Article 3(2) serves diverse legitimate interests and concerns. The need to protect local interests and the complexity of the estate of the debtor may mandate the opening of secondary proceedings. An effort to justify the validity of secondary proceedings by reliance on the secondary nature under the proportionality test would not render the desired result either, especially in the case of letter-box companies.

## 16. THE CASE FOR REGULATORY COMPETITION FOR INSOLVENCY LAWS IN EUROPE

It is typical of the law in the USA that if a matter becomes highly controversial among States the federal government will intervene and harmonise the law. This was the case with insolvency law in the United States which was finally federalised under the Nelson Act in 1898 after several continuous enactments and repeals of federal bankruptcy statutes throughout the 19<sup>th</sup> century.<sup>1192</sup> Thus, there has not been a chance to test whether Romano's view on the virtues of federalism can be applied to insolvency law. In fact, there appears to have been no recorded race for insolvency law. It is clear that the 19<sup>th</sup> century debate in the US about federalisation of insolvency law was not a reaction to a regulatory competition for insolvencies. It was rather a debate on whether the purposes of insolvency can be met at a higher degree on a federal or State level.<sup>1193</sup>

This does not preclude the fact that regulatory competition for insolvencies have arisen for different reasons. Indeed it has been recognised that Delaware has been successful in attracting insolvencies due to the alleged efficiency of its bankruptcy court. A detailed examination of the reasons for which regulatory competition for insolvencies arose in the USA,

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<sup>1192</sup> For details see C Warren, *Bankruptcy in United States History* (reprinted by Beard Books, Washington DC 1999).

<sup>1193</sup> *ibid*; see also DA Skeel Jr, *Debt's Dominion: A History of Bankruptcy Law in America* (1<sup>st</sup> edn PUP, Princeton & Oxford 2004).

which has been done successfully elsewhere,<sup>1194</sup> is not the purpose of this thesis. However, reference to the US regulatory competition in this field will be made where necessary.

### ***I. General remarks***

It should be first clarified that insolvency is an appropriate field for regulatory competition. First, it requires parties who are interested for some reason to look for laws. In the field of corporate law, directors look for alternative legal regimes because of the agency problem that exists between them and shareholders. Big shareholders may also look for alternative laws (especially in the context of limited liability companies<sup>1195</sup>) because of the agency problem that exists between them and the minority shareholders. These groups also look for the legal regimes that provide greater expertise not only in terms of substantive law, but also in terms of administration and expedience of justice.

Likewise, agency problems exist in insolvency between the debtor and his/ her creditors and among the majority and the minority creditors. Stakes are arguably higher in the sphere of insolvency in Europe than they are in corporate law. This is probably explained by the fact that takeovers do not take place in the same degree and manner as they do in the USA, but COMI battles are fierce. Creditors and debtors are also concerned about the quality

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<sup>1194</sup> LM LoPucki, *Courting Failure: How Competition for Big Cases Is Corrupting the Bankruptcy Courts* (1st edn University of Michigan Press, Ann Arbor 2005); DA Skeel Jr, 'European Implications of Bankruptcy Venue Shopping in the US' (2006) 54 Buff L Rev 439.

<sup>1195</sup> See n685.

of legal services and administration and expedience of justice in the legal regimes they choose and not only about substantive insolvency law itself.<sup>1196</sup>

Second, there is not a need for States or courts to be willing to create or participate in a competition. They could be implicated in it just by virtue of their law which parties find attractive.<sup>1197</sup> In any event, the willingness of States and courts to compete can only reinforce the competition and make it more profound. There is, of course, nothing to exclude the possibility that States and courts would be interested in it.

In the USA, there has not been a regulatory competition for insolvencies as for corporate charters.<sup>1198</sup> Nonetheless, this has not prevented the Southern District of New York, at first, and Delaware later on from becoming the favourite forum for insolvencies.<sup>1199</sup> The European Union may though prove to be the place where the case for regulatory competition in insolvency law may be tested. Unlike corporate law, European insolvency law is not harmonised at all. There has only been the European Insolvency Regulation that has unified rules on international jurisdiction and choice of

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<sup>1196</sup> L Enriques & M Gelter, 'How the Old World Encountered the New One: Regulatory Competition and Cooperation in European Corporate and Bankruptcy Law' (2007) 81 Tul L Rev 577, 632; M Cole, "Delaware Is Not a State": Are We Witnessing Jurisdictional Competition in Bankruptcy? (2002) 55 Vand L Rev 1845, 1859-1876; KM Ayotte & DA Skeel Jr, 'Why Do Distressed Companies Choose Delaware? An Empirical Analysis of Venue Choice in Bankruptcy' pp 15-17 (2004) University of Pennsylvania, Institute for Law & Economics Research Paper No 03-29 <[http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=463001](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=463001)> accessed 13 December 2009.

<sup>1197</sup> This is regulatory arbitrage rather than full-blown regulatory competition. This distinction appears to be more frequent in Europe rather in the United States, where both kinds are referred to as regulatory competition.

<sup>1198</sup> RK Rasmussen & RS Thomas, 'Timing Matters: Promoting Forum Shopping by Insolvent Corporations' (2000) 94 Nw U L Rev 1357.

<sup>1199</sup> *ibid* 1369-1376.

law across the EU, except for Denmark. As for the rest, Member States, like States in the US in relation to corporate law, have retained their competence to introduce the insolvency laws they see fit. It is thus possible to inquire whether the field of European insolvency law possesses the characteristics and attributes which are necessary to facilitate the emergence of a regulatory competition. Regulatory competition in this context means a competition to attract firms to locate their COMI within a particular jurisdiction.

## ***II. Incentives for Member States to compete***

It should be stated at the outset that it is not necessary for Member States to wish to compete for regulatory competition to occur.<sup>1200</sup> However, the willingness of States to attract insolvencies will facilitate the competition and make it more evident. It is not the purpose of this thesis to judge whether at this point there is a Member State that is so willing. In fact it appears that no State is currently contemplating such a possibility. The purpose of the thesis is to show that there are favourable conditions for regulatory competition to occur and for the UK to take the lead in it.

As it has been pointed out above with regard to the competition for corporate charters in the USA,<sup>1201</sup> the States involved derive franchise fees from incorporations. It is though only in few States that the income from such fees actually constitutes a significant part of their annual revenue. There is no such financial incentive in insolvency. However, the financial benefits for the State could be indirect. If the income of law firms increases then the

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<sup>1200</sup> See text after n723.

<sup>1201</sup> See pp 232 *et seq.*

State's income from taxation will increase as well. Law firms as well as accountancy firms will make money from both the rescue operation of the debtor and the litigation that may arise, if the latter is unsuccessful.<sup>1202</sup> The State's income will also increase through litigation by virtue of the trials fees that will be paid to the courts.

Furthermore, the transfer of the COMI to another State results also in an investment in human capital. New employees may be hired at the new COMI and some old ones may be moved to the new COMI.<sup>1203</sup> In both cases, the State derives benefits. The first reduces unemployment and both increase income from taxation.

On the other hand, there have been some concerns as to whether competition in this area can give rise to a race to the bottom through the creation of debtor havens, i.e. places to which debtors seek to shift their COMI in order to transfer value from creditors to themselves.<sup>1204</sup> Such shifts are employed by debtors in order to transfer value not from fully adjusting

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<sup>1202</sup> The fees for conducting insolvency cases are very high: see J Armour, A Hsu & A Walters, 'The Costs and Benefits of Secured Creditor Control in Bankruptcy: Evidence from the UK' (2006) University of Cambridge Centre for Business Research Working Paper No. 332/2006 <[http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=912302](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=912302)> accessed 13 December 2009; AL Paskay & FP Wolstenhome, 'Chapter 11: A Growing Cash Cow, Some Thoughts on How to Rein in the System' (1993) 1 Am Bankr Inst L Rev 331; LA Weiss, 'Bankruptcy Resolution: Direct Costs and Violation of Priority Claims' (1990) 27 J Fin Econ 285, 285-289.

<sup>1203</sup> The extent to which old employees may be replaced by new ones in a restructuring by Council Directive (EC) 2001/23 of 12 March 2001 on the approximation of the laws of the Member States relating to the safeguarding of employees' rights in the event of transfers of undertakings, businesses or parts of undertakings or businesses [2001] OJ L82/16 arts 5 & 6.

<sup>1204</sup> LM LoPucki, 'Cooperation in International Bankruptcy: A Post-Universalist Approach' (1999) 84 Cornell L Rev 696, 739; LoPucki (n1194).

but from weak non-adjusting creditors.<sup>1205</sup> While adjusting creditors can be in a position to face the dangers of a unilateral reincorporation (e.g. by covenants which identify or restrict the debtor's COMI to a particular location),<sup>1206</sup> non-adjusting creditors frequently cannot (e.g. tort victims).<sup>1207</sup>

It has been suggested that a universalist approach to insolvency, such as the one contained in the Insolvency Regulation, is recipe for a race to the bottom.<sup>1208</sup> LoPucki has presented some empirical evidence to support this conclusion. He has found that in the period 1991-1996 30 firms filed for insolvency in Delaware and the latter's reputation emerged on that basis. However, he also found that 9 out of these 30 firms had filed for a second time by 2000.<sup>1209</sup> His investigation led to the conclusion that filing for insolvency at Delaware was not as efficient as in other States, which led to a

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<sup>1205</sup> RK Rasmussen, 'Resolving Transnational Insolvencies Through Private Ordering' (2000) 98 Mich L Rev 2252, 2264-2266. The terminology is derived from LA Bechuk and JM Fried, 'The Uneasy Case for the Priority of Secured Claims in Bankruptcy' (1996) 105 Yale LJ 857. 'Fully adjusting creditors' is a term employed to connote creditors who price their transactions such that each transaction offers, *ex ante*, a market rate of return. In providing credit, such creditors take into account the possibility of an attempt to forum shop on behalf of the debtor. Therefore, this would lead debtors in selecting an insolvency regime that can reduce the cost of credit. 'Non-adjusting creditors' are those who cannot adjust the individual rate of interest. However, there are strong non-adjusting creditors who can adjust their overall interest rate so as to earn a competitive rate of return and there are weak non-adjusting creditors who cannot adjust their policy in response to a change in policy of their debtor.

<sup>1206</sup> H Eidenmüller, A Engert & L Hornuf, 'Incorporating Under European Law: The Societas Europaea as a Vehicle for Legal Arbitrage' <[http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1316430](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1316430)> accessed 13 December 2009.

<sup>1207</sup> L Enriques & M Gelter, 'How the Old World Encountered the New One: Regulatory Competition and Cooperation in European Corporate and Bankruptcy Law' (2007) 81 Tul L Rev 577, 621.

<sup>1208</sup> LoPucki (n1194).

<sup>1209</sup> *ibid* 100-101.

loss of filings of 9% in Delaware, as opposed to 3% loss in New York.<sup>1210</sup> On the basis of these findings, LoPucki argued that judges in Delaware had overegged the pudding in favouring directors and lawyers<sup>1211</sup> and that competition ‘was actually destroying companies’ along with ‘eroding the integrity of courts’.<sup>1212</sup>

As one might imagine, this proposition caused strong reaction. If LoPucki can be parallelised with Carry then Skeel Jr played the role of Winter in this domain. In a very persuasive article, Skeel Jr rebutted one by one most of LoPucki’s contentions. First, he doubts that Delaware judges can be blamed for the demise of some companies.<sup>1213</sup> After all, it is hard to advise the captain of the Titanic once the ship has hit the iceberg! Second, he contests that a second filing actually proves that the process has failed.<sup>1214</sup> To support this argument, he notes that it is hard to draw conclusions from the small number of cases that LoPucki has used.<sup>1215</sup> He also underlines the fact that courts, which are renown for the quick administration of insolvencies, as Delaware was because of its so-called first day orders, are more likely to attract firms will most probably fail again, as they ‘tend to emerge with more

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<sup>1210</sup> *ibid* 112-113.

<sup>1211</sup> *ibid* 140-145.

<sup>1212</sup> *ibid* 118.

<sup>1213</sup> Skeel (n1194) 444-445.

<sup>1214</sup> *ibid* 445-446.

<sup>1215</sup> *ibid* 445.

debt in their capital structure than companies that file elsewhere and undergo a costly [r]estructuring.<sup>1216</sup>

Skeel Jr also gives an account of Delaware's decline as **the** insolvency venue, which is very different to that of LoPucki. While the latter takes the view that other courts adopted Delaware's approach and were eventually 'corrupted' as well,<sup>1217</sup> Skeel Jr depicts a much more complex picture.<sup>1218</sup> From 1996 onwards, the National Bankruptcy Review Commission proposed the abolition of domicile as a basis of jurisdiction for the opening of insolvency proceedings. This was probably done with a view to decrease Delaware's share of insolvencies.

Simultaneously, the federal government did not appoint new insolvency judges in Delaware with the result that only two judges had to deal with an increasing number of filings. On top of this, most other States adopted some of Delaware's practices, 'such as prompt approval of first day orders.'<sup>1219</sup> All this made Delaware 'marginally less attractive as a venue', while other States 'were beginning to see cases that were similar to Delaware cases and might previously have been filed in Delaware.'<sup>1220</sup>

It is submitted that Skeel's line of argument appears to be more persuasive than that of LoPucki. It seems more rational that 'firms are more

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<sup>1216</sup> *ibid* 448-449; K Ayotte & DA Skeel Jr, 'An Efficiency-Based Explanation for Current Corporate Reorganisation Practice' (2006) 73 U Chi L Rev 425, 437.

<sup>1217</sup> LoPucki (n1194) 122.

<sup>1218</sup> Skeel Jr (n1194) 451-452.

<sup>1219</sup> *ibid* 452.

<sup>1220</sup> *ibid*.

likely to choose the regime that best handles financial distress than they are to choose one that best frustrates the claims of non-adjusting creditors'.<sup>1221</sup> It is for this reason, that a race to the bottom in insolvency law can be avoided.

### ***III. Common private international law rules for insolvency proceedings at a European level***

Apart from the financial reasons that may appeal to a Member State in order to engage in a regulatory competition, there are also certain objective factors that increase the likelihood of such a competition occurring. The most significant is the system of private international law applicable in this context.

Unlike the field of corporate law, there is a single rule of international jurisdiction and choice of law that has to be applied uniformly throughout Member States. However, the fluidity of COMI in combination with the automatic recognition of the judgment that will be delivered by the court which is first seized undermines this uniformity to a certain extent. The ECJ has provided and will provide the necessary guidance for the interpretation of these common rules. The Insolvency Regulation is supposed to have created the common sphere in which debtors and creditors can predict the competent forum and the applicable law with a certain degree of certainty. There is, of course, always the possibility for secondary proceedings. The key point though is that rescue proceedings are only permitted as primary

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<sup>1221</sup> Rasmussen (n1205) 2273.

proceedings,<sup>1222</sup> hence the competition will be to offer the best rescue proceedings.<sup>1223</sup>

Although this degree of certainty is limited, it is still the case that the presumption in favour of the place of incorporation has dispelled the fears of debtors that a court will disregard this choice of law without second thought. This is closer to the conditions prevailing in the US, where States will apply the incorporation theory with few exceptions, like the Californian doctrine of pseudo-foreign corporations.

This predictability discourages to a certain degree debtors and creditors from spending money and time litigating about where to litigate. Although it is far from unlikely that debtors and creditors will not wish to litigate about the location of the COMI –and indeed *Eurofood* is the best example so far- it will most certainly become apparent to them that it would be better to cooperate in order to move the COMI to a jurisdiction which is more favourable to both, either at the dawn of insolvency or perhaps even earlier. Only if reaching such an agreement is impossible or too costly for the parties would it then be preferable to them to litigate about where to litigate. Ideally though the presumption in article 3(1) could promote cooperation between the debtor and the stakeholders.

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<sup>1222</sup> Insolvency Regulation, art 3.

<sup>1223</sup> J Armour, ‘Who should make corporate law? EC legislation versus regulatory competition’ (2005) 58 CLP 369, 408-409.

#### ***IV. Diversity in European insolvency laws creates incentive to compete in order to attract insolvencies***

There are several reasons why a Member State might find itself at the lead of regulatory competition for insolvencies in Europe. There are some startling differences between insolvency laws in Europe that debtors and creditors can take advantage by transferring the COMI in another Member State in order to achieve more efficient results. It has been demonstrated above that the UK is said to be a ‘creditor friendly’ jurisdiction.<sup>1224</sup> However, there is more to the creditor friendly nature of English insolvency law when comes the moment of administration and liquidation. English law provides the possibility to debtors and creditors to enter into a CVA or scheme of arrangement under the Companies Act and reorganise the debtor. In an appropriate case, this will save the debtor from liquidation and offer the creditors increased chances of recovering their money.

An administrator is appointed with the purpose of materialising funds to pay the debts to the creditors who hierarchy of claims is prescribed by law. The administrator has the following duties in order of preference: first, to try to rescue the company as a going concern; or, second, to obtain a better result for the creditors as a whole than would be likely if the debtor was liquidated; or, third, to realise property in order to distribute the proceeds to one or more secured or preferential creditors.<sup>1225</sup> However, none of these options,

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<sup>1224</sup> See text to n1097.

<sup>1225</sup> Insolvency Act 1986 sch B1 para 3.

especially rescue of the debtor, can be employed at the expense of the creditors as a whole.<sup>1226</sup>

This brings English law at a sharp contrast with French law. Despite the fact that the *Loi de 26 juillet 2005* provides of the judicial appointment of an *ad hoc* mandatory to facilitate the negotiation of a CVA-like conciliation procedure between the debtor and the creditors,<sup>1227</sup> L.620-1 *CComm* provides the following aims of administration in this particular order: survival of the firm, maintenance of employment and payment of creditors.<sup>1228</sup> German law is more creditor-friendly. However, the German *Insolvenzordnung* provides for a single procedure available to and for the benefit of all creditors through the judicial appointment of an administrator.<sup>1229</sup> It also has a 3-week ‘cutoff’ for overindebted firms.<sup>1230</sup> German law is thus deprived of the CVA option that allows creditors to choose the most efficient and convenient course of action.

However, there is a lot more that Member States could take into account in competing for insolvencies. If the group of creditors happens to be homogeneous, they could negotiate with the debtor a transfer of the COMI to an appropriate jurisdiction for the purpose of facilitating restructuring and maximising firm value perhaps without great difficulty. By contrast, if the

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<sup>1226</sup> J Israël, *European Cross-Border Insolvency Regulation* (1<sup>st</sup> edn Intersentia, 2005) 23.

<sup>1227</sup> See P Théry, ‘L’évolution du droit des procédures collectives en France’ in WG Ringe, L Gullifer & P Théry (eds), *Current Issues of European Financial and Insolvency Law* (Studies of the Oxford Institute of European and Comparative Law, Hart Publishing, Oxford 2009) 1; M Haravon, ‘French Overhaul Bankruptcy Regime’ (2005) 24 *Am Bankr Inst J* 32.

<sup>1228</sup> Israël (n1226) 25-27.

<sup>1229</sup> *ibid* 19-21.

<sup>1230</sup> See §15, 15a & 19 *InsO*.

group of creditors is heterogeneous then it might be the case that some might wish to file for insolvency in a Member State where insolvency law favours secured creditors, others in a Member State where insolvency law favours unsecured creditors, and managers in a Member State whose insolvency law favours them in particular.<sup>1231</sup> Thus, there are different interest groups that, perhaps much more than there in regulatory competition for corporate law, it is impossible to satisfy all.

One could contemplate the diverse interests that the majority and minority shareholders, the directors, the employees, the secured and unsecured creditors, tort victims and State revenue services would pursue. On top of that each of these groups may wish to have the proceedings opened at several stages. For some of them, especially the directors, the decision is not purely dictated by economic considerations. They might occasionally wish to avoid or delay the opening of insolvency proceedings, because of the stigma an insolvency might have on their own subsequent career.<sup>1232</sup>

This leaves a great deal of leeway for States to compete, as each Member State may seek to advance the interests of certain groups more than the ones of others. Luckily, under normal circumstances, the potential locations of the COMI would be much less than the different groups of interest. This means that these groups will form alliances to support litigation in one or the other of the usually two potential fora. It is hard to say that there is a recipe for success.

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<sup>1231</sup> Enriques & Gelter (n1207) 635-636.

<sup>1232</sup> *ibid* 636.

It would be though fairly credible to suggest that regulatory competition could come in waves as it appears to have done in company law. The first wave could be one which is generated by the fact that CVAs are available in English law and not in other continental European jurisdictions. Once they become available in all European jurisdictions regulatory competition might reach a halt until another feature of a Member State's insolvency law stirs competition again. This would, more or less, analogous to the fact that Europe will be probably witnessing a decline in regulatory competition for corporate law, which is generated by the big differences in minimum capital requirements.<sup>1233</sup>

There is, of course, the contrary view, namely that it can be reasonably predicted that 'states will not actively compete to attract bankruptcies.'<sup>1234</sup> It relies on two main reasons. First, the possibility to open secondary proceedings may limit the extent to which Member States may be willing to compete to attract insolvencies.<sup>1235</sup> Second, the number of companies that are sufficiently international in order to be able to make a gain out of regulatory competition in this area is relatively small.<sup>1236</sup> Unlike the USA, where firms can file for insolvency in a variety of jurisdictions,<sup>1237</sup> corporations having their COMI in the EU can only have their main insolvency proceedings

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<sup>1233</sup> See pp 85-85.

<sup>1234</sup> Enriques & Gelter (n1207) 640.

<sup>1235</sup> *ibid* 639.

<sup>1236</sup> *ibid*.

<sup>1237</sup> LM LoPucki, *Courting Failure: How Competition for Big Cases Is Corrupting the Bankruptcy Courts* (1st edn University of Michigan Press, Ann Arbor 2005) 15.

brought before the courts of the country where the COMI is situated, which shall enjoy exclusive jurisdiction.

Enriques & Gelter do not deny the possibility for regulatory arbitrage, but for regulatory competition, i.e. the willingness of Member States to engage in it. Even if one were to accept their reasoning, this does not entirely eliminate the scope for regulatory competition. Cases like *MG Rover*, *PIN*,<sup>1238</sup> *Eurofood* or *ISA Daisytek* demonstrate the fact that there instances where national courts are very keen on an ‘expansionist’ approach to jurisdiction, especially when they fear that the foreign court would not reach the same result as they would. So there have been instances where, albeit possible, the possibility of recourse to secondary proceedings was not taken advantage of. As far as the second point is concerned, regulatory competition is not necessary a matter of quantity. The increase of cross-border incorporations will inevitably lead to the increase of cross-border insolvencies as well. Therefore, it appears that the prediction of Enriques & Gelter may not hold entirely true.

## ***V. Conclusion***

It will be good news for Europe if Member States would be willing to engage in a regulatory competition for insolvencies. As in the US for corporate charters, a potential regulatory competition in the EU for insolvencies can only improve the quality of the law. The positive contribution of regulatory competition to insolvency law will be guaranteed if forum shopping under the

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<sup>1238</sup> The German courts seized jurisdiction over all of the companies of the PIN Group: see A Gallagher & RK Janjuah, ‘European Insolvency Regulation: German Court Blesses Change of COMI to Bolster Cross-Border Group Restructuring’ (2008) 27 Am Bankr Inst J 30.

European Insolvency Regulation were to be interpreted to allow creditors and debtors to negotiate for the transfer of the COMI to another Member State. Simultaneously, the case whereby a debtor wishes to transfer his COMI to another Member State in order to disfavour some or all of his creditors should be the paradigm example of impermissible forum shopping that the Insolvency Regulation should not tolerate.

Member States cannot afford having a race to the bottom. For example, if regulatory competition over insolvency occurred in order for debtors to escape their creditors that would send Member States the wrong incentives with regard to the development of insolvency law. There are good reasons to believe that Member States will not be willing to engage in a race to the bottom. Stakes are just too high. In the market for corporate charters, a State can choose to have lax corporate law, especially if the company will operate in another jurisdiction, with any fear of consequences. Unlike the market for corporate charters, in insolvency a State is inviting in its territory and economy the COMI of a company in difficulties. Destroying the balance between the interests of the debtor and his/ her creditors can only have devastating consequences in the economy.

If a State favours debtors disproportionately so that creditors face serious difficulties in recovering their dues, the national market will face problems. Creditors will be willing to lend capital only on high interest rates and greater collateral. By contrast, in the sphere of corporate law States may avoid the negative domestic impacts of lax corporate law by providing this kind of corporate schemes only to companies that wish to activate abroad

(offshore companies).<sup>1239</sup> In insolvency, no State has ever been observed to wish to apply a different and more lax scheme of insolvency law to companies that have their COMI in the jurisdiction but are incorporated abroad. It is not imaginable that an EU Member State would be keen on being innovative in this particular way.

If corporate law is overly favourable to creditors through e.g. minimum capital requirements etc, one might reasonably expect to observe lower rates of entrepreneurship in the country.<sup>1240</sup> Likewise, if a State decides to favour creditors disproportionately to the debtors, it may end up having problems in attracting incorporations or encouraging entrepreneurship even on a pure domestic level. Such an imbalance might also be disfavoured by the credit institutions themselves who will become less attractive to potential debtors.

All that is required is for Member States to compete for striking the appropriate balance between the debtors and the creditors and among majority and minority creditors. In doing so, the quasi-federalism of the EU and the lack of Community intervention in the field of substantive insolvency law constitute the genius of European insolvency law.

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<sup>1239</sup> See e.g. the legislation on offshore companies of many Caribbean jurisdictions.

<sup>1240</sup> J Armour & D Cumming, 'Bankruptcy Law & Entrepreneurship' (2008) 10 ALER 303.

## 17. Concluding Remarks

Part III has sought to explore the relation between international jurisdiction and choice of law for corporate affairs as influenced by ECJ case-law on freedom of establishment, on hand, and international jurisdiction and choice of law for insolvency proceedings under the Insolvency Regulation. In particular, in Chapter 13 it presented and analysed the scheme of the Insolvency Regulation for the purpose of inquiring whether there is any scope for and merit in the argument that the rebuttal of the presumption in article 3(1) of the Insolvency Regulation is contrary to freedom of establishment. Chapter 14 has explored the possibility for forum shopping in relation to the Insolvency Regulation.

This question has not been asked before and it is hard to tell what the ECJ might think of the matter. As it has been demonstrated above in Chapter 15, there are compelling arguments on both sides. On the whole though it is improbable that the ECJ would declare the rebuttal of the presumption a restriction to freedom of establishment, even though it may lead to companies like Überseering being governed by the *lex incorporationis* -or perhaps the *lex sedis*- with regard to their corporate affairs and by another law with regard to insolvency.

Even if this difference in treatment is permissible, the question is how sound a proposition that may be. Although it does appear desirable that a company be constituted and dissolved under the same laws, it may be more appropriate to have the company dissolved under a law other than the *lex societatis*. Indeed the Insolvency Regulation caters for such an approach. In

principle a company's insolvency should be governed by the *lex incorporationis*, unless its COMI is located elsewhere, in which case the law of that other country will apply. Such an exceptional application of another law appears justified in cases where the company is, in *Eurofood* terms, a letter-box company.

Finally, Chapter 16 has examined the possibility of a regulatory competition for insolvency laws in Europe. An analogy has been drawn with the USA. As insolvency law is federalised in the latter, the analogy is drawn with US regulatory competition for corporate law. It has been argued that the conditions for regulatory competition are more analogous between European insolvency law and US corporate law than between European company law and US corporate law. The reasons for which the UK may wish to engage in such a competition have been analysed above.

## **18. Conclusion**

This thesis has sought to sustain one main argument. Freedom of establishment is not universal. Never before have companies enjoyed so many opportunities for crossing borders and creating establishments in other Member States at such a low cost. However, after a brief period of encouraging corporate mobility in Europe (1999-2005), the ECJ and other Community institutions have recently taken action to demarcate the boundaries of freedom of establishment.

The refinement of the doctrine of abuse in relation to letter-box companies and the enactment of the Services Directive mark the beginning of a new era in freedom of establishment for companies. The European Institutions have demonstrated their wish to limit the access of letter-box companies to the benefits of freedom of establishment and, simultaneously, guarantee a universal enjoyment of these benefits to all other companies.

This refinement and enactment have coincided with the greatest economic crisis the world has known since the Great Depression of 1929. Although some analysts, economists and bankers appear positive about the recovery of the economy in the immediate future, it is absolutely certain that attitude towards companies and corporate mobility is dependent on the economic prosperity of States.

During the current crisis, corporations, and especially letter-box and offshore companies, have been frequently accused having caused this crisis. Whether this is true or not, such a popular perception exists and that national governments might respond to this popular demand by taking measures to

prevent mobility that allows corporations to subject themselves to less stringent corporate and insolvency regimes. It is also certain that States will take measures to ensure that corporate activity does not take forms that facilitate tax evasion. Letter-box and offshore companies will be the first 'victims' of this urgent need for cash that States are now facing.

In this context, the next period of freedom of establishment is one that has recognised the validity of the real seat theory and has allowed Member States to restrict the exit of companies incorporated there, unless they are to take up legal personality in the Member State of destination. This shows how the ECJ is keen on preserving real ties between companies and their State of incorporation. This must be the reason why the ECJ did not allow for the real seat to be moved to another Member State without altering the *lex societatis*. If this were allowed, it would have made the creation of letter-box companies possible with the blessings of the ECJ.

Likewise, letter-box companies and other artificial formations will not enjoy the benefits of the regime provided by the Insolvency Regulation. However, the transfer of the COMI to another Member State appears possible when all the stakeholders are acting in concert. Allowing thus Member States to prevent companies from moving their real seat out of the jurisdiction is a mechanism which prevents the transfer of the COMI solely by the debtor without the consent of the creditors. When the transfer is conducted by general agreement, there are other mechanisms, such as the CBM Directive, to allow the shift to be performed.

Regulatory competition for corporate law is thus possible. However, its nature will be very different to that which takes place in the US. European regulatory competition is EU regulated. Unlike the USA, in Europe the ‘federal’ EU institutions promote regulatory competition, while States could observe a positive, neutral or negative stance. Reincorporations cannot happen. Companies that wish to migrate to another Member State and establish their registered office will have to employ the means provided to them either by the CBM Directive or the SE Regulation. This requires a level of publicity and consultation with other stakeholders that affects the way in which corporate wars are conducted.

In parallel to all the corporate law reasons that might push companies to migrate or to establish themselves in a cross-border manner, lies insolvency law. There are strong reasons for companies to migrate to other Member States so as to benefit from more efficient insolvency regimes. There are also equally strong reasons for creditors to consent to transfers that will increase firm value and subsequently recovery of the debt.

Insolvency law in Europe is far from harmonised. Additionally, there are acute differences between English, Germanic and French insolvency regimes. The variety of options that are available to debtors and creditors is very rich. This is indeed a good thing. Even if it turns out that Member States are not keen on engaging in a regulatory competition, debtors and creditors have a lot to gain from polymorphy of insolvency law in Europe. As Roberta Romano argued for American corporate law, federalism will appear to be the genius of European insolvency law.

It is, therefore, predicted that Europe has just entered a new phase of freedom of establishment. It is characterised by modesty and caution in regulating corporate mobility. Tax, insolvency and corporate policies of Member States and the EU, perhaps in this particular order, affect the shaping of freedom of establishment.

At one end of the spectrum, i.e. taxation, Member States wish to preserve complete authority over the ways in which companies come into and out of their jurisdiction. At the other end, i.e. corporate affairs, the European Institutions are trying to push for corporate mobility, which pursues some genuine economic activity. Member States are allowed to intervene and thwart the decisions of private individuals to a much more restricted extent. Insolvency lies in the middle.

All this shows that the canvas of State and company relations is dominated by the aging debate of delineating the boundaries between the public and the private sphere. State interest is opposed to private autonomy. Perhaps the third phase of freedom of establishment will be one in which private autonomy will gain more ground to the detriment of State interest. This will depend largely on the state of the economy in Europe and the prosperity of Member States. It is submitted that it would be a desirable goal for freedom of establishment to yield more to private autonomy, where the founders of a company can enter a choice of law and a choice of court clause in the articles of association, regardless of where the company is established. Restrictions should be based solely on supervisory needs, which apply to specific industries.

Be that as it may, it should be noted that although corporate mobility in Europe becomes more and more intrinsically linked with freedom of establishment and thus acquires a public law profile, the significance of private international law is not impaired. *Cartesio* has clearly shown that the choice of law rules do not matter from a freedom of establishment perspective. Instead, the *lex causae* is scrutinised. As the debate shifts from private international law to substantive law, the case for regulatory competition becomes stronger. In this context, it will be of crucial importance to deter the European institutions from harmonising the law and thus establishing ‘a stalinist monoculture’.<sup>1241</sup>

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<sup>1241</sup> A Briggs, ‘The death of Harrods: forum non conveniens and the European Court’ (2005) 121 LQR 535, 537.

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