WAKE FOREST UNIVERSITY
School of Law

COMPARATIVE LAW PROGRAM
Venice, Italy
Summer 2010

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COMPARATIVE COMPANY LAW
(WEEKS 3 & 4)

SYLLABUS AND COURSE MATERIALS

Prof. Alan R. Palmiter
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My ventures are not in one bottom trusted,
Nor to one place; nor is my whole estate
Upon the fortune of this present year:
Therefore my merchandise makes me not sad.

Antonio

*The Merchant of Venice*

Act I, Scene 1

William Shakespeare
DEFINITIONS

CAPITALIST
You have two cows.
Your neighbor has none.
So?

COMMUNIST
You have two cows.
The government seizes both and provides you with milk.
You wait in line for hours to get it.
It is expensive and sour.

CAPITALISM, AMERICAN STYLE
You have two cows.
You sell one, buy a bull, and build a herd of cows.

AMERICAN CORPORATION
You have two cows.
You sell one, lease it back to yourself and do an IPO on the 2nd one.
You force the two cows to produce the milk of four cows.
You are surprised when one cow drops dead.
You tell analysts you have downsized to cut costs.
Your stock goes up.

FRENCH CORPORATION
You have two cows.
You go on strike because you want three cows.
You go to lunch.
Life is good.

GERMAN CORPORATION
You have two cows.
You engineer them so they are all blond, drink lots of beer, give excellent quality milk, and run a hundred miles an hour.
You also discover they demand 13 weeks of vacation per year.

ITALIAN CORPORATION
You have two cows but you don't know where they are.
While ambling around, you see a beautiful woman.
You break for lunch.
Life is good.

RUSSIAN CORPORATION
You have two cows.
You have some vodka.
You count them and learn you have five cows.
The Mafia shows up and takes however many cows you really have.
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- **Law articles - Social Science Research Network (SSRN)**
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- **Delaware General Corporation Law**
  http://www.delcode.state.de.us/title8/c001/

- **Model Business Corporation Act (NC BCA)**
  http://wwws.wfu.edu/~palmitar/CorporationLawPolicy/Conexus/Conexus.htm

- **EU Company Law (EC Materials)**
  http://ec.europa.eu/internal_market/company/index_en.htm

- **Italian Civil Code (company law provisions, including 2003 reforms)**
  http://www.aspman.it/raggio/CodiceCivile/Nuovo%20Codice%20Civile.htm

- **Italian Civil Code**
  http://www.jus.unitn.it/cardozo/obiter_dictum/codciv/codciv.htm

My thanks to Alayna Ness (WF Law 2011) and Melinda Hanzel (WF Law 2009)
for their invaluable help in assembling and editing these materials
Class Participation and Grading

Daily preparation and answers. The readings are interesting and the cases/statutes worth learning. Ours will be a small group; your participation will add to the class experience.

To prepare for class, you will want to prepare your own summary of the readings. For each court case, law review article and legislative statute, you should prepare a “brief” – either on a separate sheet of paper or in the margin. The brief should contain the following:

- **F** Factual summary of the case (or facts anticipated by the article or statute)
- **I** Issue (or issues) addressed by the author and the author’s position
- **R** Statement of the rule (or rules) proffered by the author
- **A** Summary of the analysis presented by the author
- **C** Your view (importance of the case, article or statute)

US students. For US students, I will base your grade on class participation (25%) and a final exam to be administered when we return to the States (75%). The written portion of the exam will call for multiple-choice responses and short essays demonstrating your knowledge and understanding of the principal topics of all three areas covered in the course – civil law, European law and comparative company law. Following the written exam, I also anticipate that there will be an oral component in which I will ask follow-up and more general questions based on the written exam. You should expect these events will happen in late September.

Italian students. For Italian students taking the course for a grade, I will base your grade on class participation (25%) and a course paper to be sent me by email by September 30 (75%). The paper (between 10-15 pages in length) should identify a court decision in Italy or elsewhere in Europe. It should compare the actual outcome in the case to what would have been the outcome had the case been litigated in an identified US jurisdiction (such as Delaware). Your paper should have the following parts: (1) an introduction that identifies the case, the issues it raises, and the main points of the paper; (2) a section that describes the case and its outcome, including excerpts (translated) of the important passages from the court’s opinion or judgment; (3) a section that analyzes how the case would have been decided in a US jurisdiction, with specific reference to relevant statutes (legislation), cases (jurisprudence) and law review articles (doctrine); (4) a comparison of the two approaches, including any relevant references to the course materials; and (5) your conclusion on this comparative law project.

Please keep your materials and notes from the course.
I. COMPANY LAW – AN EXERCISE IN COMPARISON

Companies – or corporations as Americans call them – are really quite fascinating. What is a company? Simply stated, it is a group of persons who join together in a business enterprise to make money. The company includes those who provide capital (investors and creditors) and those who provide labor (managers and employees).

Company law constitutes the public and private rules that govern the relationships of the company’s constituents. What does company law specify?

- **Structure for doing business** – the method for organizing a company, the duration of the company, and the circumstances for the company’s dissolution.
- **Rights of investors** – financial rights, voting powers, limits on their liability, rights to information, and the ability to sell their shares.
- **Role of business managers** – the discretion of the board of directors to run the business, the responsibilities of corporate managers, and their ability to adapt to business change.
- **Protection of those who deal with company** – personhood (recognition of company contracts, property ownership, litigation status) and creditor recourse to company assets.
- **Process for changing rules** – management initiatives, shareholder proposals, and the restructuring and combination of companies, such as in a merger or sale of assets.

Some company law rules might seem prosaic. Who cares when the shareholders’ meeting must be held? Or how much money must be contributed to start a limited liability company? Or whether shareholders can vote by proxy? But the rules, pixels in a larger picture, are important to how companies operate in the economy and in society. In large and small ways, company law reflects fundamental policy and social choices about market capitalism – *company law is private constitutional law*.

For example, a rule that a company’s employees must be represented on the board of directors reflects a view of capitalism dramatically different from one that compels directors to maximize the wealth of the company’s shareholders. Or a rule that foreign businesses that operate in a country become subject to that country’s company laws affects (even defines) the country’s business climate. Or a rule that directors are liable for negligent business decisions if the company becomes insolvent creates incentives to avoid risks that reverberate through the whole economy.

And sometimes company law even makes the headlines. Company law is the sentinel watching over insider trading; it motivates (or fails to motivate) institutional shareholders to be active, and it mediates adaptation through hostile takeovers. How sleepy or alert, company law says a lot about a country’s fundamental views on protecting old oligarchies and fomenting new ones.

So company law deserves our study. And that study is all the richer when it is done comparatively, not in isolation – in this course, by looking at the United States and Europe. Company law allows us to study how managers and investors are answerable to each other and to third parties, and thus to gain insights into varying views on capitalism and society.
Why bother studying comparative company law? After all, company law reflects basic attitudes about the relationship of private enterprise and government regulation – something unique to every country and legal system. Here’s an answer by Robert Drury and Peter Xuereb, a couple of British solicitors (transactional lawyers).

As you read their explanation for comparative company law, consider their reasons for making the comparison. Are you persuaded? Can you think of any others?

Introduction - Comparative Company Law

The idea that no one nation has a monopoly of wisdom applies just as strongly to law as it does to any other field of human endeavour. It is one of the motives that have sent lawyers over the years in search of the ways of other jurisdictions, and has provided the foundations of a discipline of comparative law.

So what is comparative law? It’s “the comparison of the spirit or style of different legal systems, of different legal institution, or of solutions of comparable legal problems in different systems.” The benefits that can be derived from a comparative study of the laws of other systems are many:

Comparative legal study provides a tool for lawyers to discover some of the things they take for granted. By discovering what are the foreigner’s assumptions we can work backwards and see what are our own.

When we see the ways in which other countries deal with the problems that confront us in our own system, we have access to a range of different solutions in a given problem, and hence in the hands of a good critical scholar it can guide a potential legislator towards the 'better solution' to the particular problem that is being confronted. Indeed, the mere existence of this 'gene pool' of solutions call prompt the legislators to initiate the task of seeking to improve the solution that is current in their own particular system.

In order to identify rules or mechanisms which fulfill the same function, it is necessary to approach each system with an open mind, and to use considerable imagination coupled with common sense. If, for example, one is looking for rules which fulfill the same function as those which require a minimum capital for a company on its incorporation, it is necessary to articulate the creditor guarantee function of the minimum capital rules. Then it becomes possible to perceive that this function can be performed by a requirement of disclosure of the actual capital position of a company at any given time, allowing a prudent creditor to take steps to protect himself.

Company law, as a branch of legal discipline, is particularly well suited both in the application of the comparative approach and to the production of useful and highly-practical results from the analysis that has been done. This is because the company is called upon to fulfill a similar function in most legal systems. If the system in question knows the use of the commercial company, it will usually attribute a corporate personality to it. If so, then this leads on to the heartland of company law, which is a study of the ways in which the system has framed the external and internal dynamics of the organization, and thus the relationships within the company and between the company and the outside world.

In carrying out research in this area, the wide range of influences that have been brought to bear on company law becomes apparent. In some countries, the subject is classified as a compartment of commercial law. Thus it is a natural and logical step to apply to company law, concepts such as the
security of transactions, which in other systems are normally associated with the law of sale. In other jurisdictions, company law is dealt with as part of 'business law', and hence it becomes closely associated with, and influenced by, labour law and revenue law. In many countries it is easy to see that these last factors, linked with areas such as securities regulation, have led jurists to question the label of company law itself.

Where any group of nations is actively seeking to reform their laws together in order to achieve a joint objective, there is tremendous scope for the operation and positive deployment of comparative law. The skills of the comparativist are at a premium, both in discovering and comparing the laws of the different systems and, more particularly in evaluating the results of the analytical comparison. The Community par excellence is a legislator looking for the 'best solution' to a particular problem or range of problems. This is precisely what the comparativist can help to provide. The existence of this harmonization programme is a major ground for the importance of comparative European company law at the present time.

NOTES

1. So is this course worth the effort? What might you gain from it?
   a. What are the reasons identified by Drury and Xuereb for studying comparative company law? What does “external and internal dynamics of the organization” mean?
   b. Can comparative study create value – besides an excuse for exotic travel? That is, would a US client ever care if her lawyer had a comparative perspective?

2. It turns out that the study of comparative company law has been in the vogue. Some scholars believe that company law systems can be transplanted to beneficial effect. For example, a group of Harvard and Columbia law professors in the early 1990s came up with a company law code for post-communist Russia, using their theories about corporate law. But the project was a dismal failure. Their company law code failed to control Russian corruption.

   Why had the new Russian company law, modeled on a successful US corporate law system, been a failure? The law professors explained why they flopped:

   In Russia and elsewhere, proponents of rapid, mass privatization of state-owned enterprises (ourselves among them) hoped that the profit incentives unleashed by privatization would soon revive faltering, centrally planned economies. The revival didn't happen. Why not? First, rapid mass privatization led to massive self-dealing by managers and controlling shareholders, and Russia lacked a good infrastructure for controlling self-dealing. Russia sold control of its largest enterprises to crooks, who applied their skimming talents to the enterprises they acquired, and used their wealth to further corrupt the government and block reforms. Second, profit incentives to restructure privatized businesses were swamped by a punitive tax system, official corruption, organized crime, and an unfriendly bureaucracy. Third, the self-dealing that accompanied privatization politically discredited privatization as a reform strategy and undercut other institutional reforms.


3. Offering a somewhat cynical view on comparative law studies, a US law professor recently commented:
Comparative law is in a state of disorientation; inside and outside of legal academia, it appears irrelevant and outdated. Comparative law scholars seem unable to define and develop comparative law as a coherent field that serves any social purpose.

Comparative law has traditionally served two overarching purposes. First, comparative law promised to provide insights on our own legal order through a comparison with other legal systems. However, modern jurisprudential doctrines, such as critical legal studies, legal feminism, law and economics, and critical race studies, have replaced comparative law in a more challenging, provocative and appealing way.

The second purpose of comparative law was to illuminate the structures and internal processes of foreign legal systems, either for the purpose of legal harmonization, or to facilitate negotiations with foreign lawyers and business entities. However, these goals appear outdated in light of the convergence within the international legal system. With the export of U.S. business laws and procedure, foreign legal systems increasingly resemble our own. If that is the case, why compare these systems to our own at all?

What is needed is real engagement with different ideas, different views that put "our own most deeply held beliefs . . . always at risk." Ultimately, only that approach of comparative law will bring us from more accurate knowledge of "the other" to "empathy and respect in a pluralistic world."

Nora V. Demleitner, *Combating Legal Ethnocentrism: Comparative Law Sets Boundaries*, 31 *ARIZ. ST. L. J.* 737 (1999). Aren’t you glad there are American and Italian students in this class together – maybe that’s the real reason for this course!

A. **What is a company?**

So we’re in Venice, a remarkable place and once the most successful commercial center in Europe. What were companies like in medieval Venice, when Venetian merchants dominated trade in the Mediterranean? Did merchants operate as sole proprietorships, where both capital and management came from one person or family? Or did they operate as partnerships, in which a number of entrepreneurs combined their capital and managerial skills? Or did they specialize, as does the modern corporation, where one group provided the capital and the other the management?

The choice of structure often determines the success of a business. Not enough capital and the business can fail. Capital that demands immediate returns can stifle the business. Too much management (like too many cooks in the kitchen) and the business collapses. Sufficient capital, but poorly-supervised management, and again the business fails. What’s the right mix? What was the mix that worked in Venice? Here’s an excerpt from a classic history of the Most Serene Republic.

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**VENICE’S MARITIME REPUBLIC**

*(Johns Hopkins Press - 1973)*

Frederic C. Lane

One might venture to guess that Venice, with its optimal location, was an extremely successful maritime republic. But its location was only part of its allure. Private financing, government involvement, and the Venetian banking system all contributed to Venice’s maritime success.
In 12th century Venice, *colleganze* were the most prevalent forms of financing for commercial ventures. In a *colleganza* one party contributed labor in return for the other party’s contribution of capital; the capital provider received no fixed percentage of interest but rather three-fourths of the total profit from the venture.

In the 14th century the transition from *colleganze* to commission agents began. A *colleganza* was most beneficial in risky foreign ventures since it offered those who stayed in Venice a three-fourths claim of profits. But during the 14th century merchants who stayed at home in Venice began to turn to commission agents who were paid a percentage of revenue, regardless of profit. Whereas in a *colleganza* an agent would receive one fourth of the profit, a commission agent received a percentage of the volume of business (usually 3 to 5 percent of turnover).

The Venetian government was directly involved in the maritime commercial affairs of its citizens. In the 13th century Venetian maritime law was codified in what was known as “Zeno’s Code,” which required seamen’s obedience to the law as citizens of the state before obedience as employees. As the dogeship was transformed from a traditional monarchy to a more republican magistry in the 12th to 13th centuries, the government encouraged doges were often commercially affluent leaders. In the 14th to 15th centuries, the Venetian government was overtly capitalistic, encouraging Venetians to make profits through commercial investment. However it should be noted that although the government favored commercial capitalism, it restricted manufacturing capitalism.

In the banking system, the Venetian business definition of usury was much more lenient than the Catholic Church. It approved as non-usurious the payment on commercial investments of a rate of return determined by market conditions. The Venetian banking system was the unique “Banche del Giro” in which bankers were able to turn over or rotate (girare) credit between different accounts. They did their business at tables near the Rialto and transferred credit on the books rather than in coin or by check. The book was an official notarial record, which meant that anyone who had an account could appear at the banker’s table and make or receive payments orally.

In the 16th Century, Venice exhibited conservative business practices. Laws forbid limited liability partnerships and instead required shared profits and shared liability. Joint ventures of limited liability were mostly unions of capital for limited duration and limited purposes, rather than the large joint-stock companies that began to develop in England and Germany at this time.

NOTES

1. So a *colleganze* is a profit-sharing arrangement – just like a corporation. Consider how a *colleganza* worked.
   a. Why would the capitalist in the *colleganza* be willing to share profits with the contributor of labor (management)? Wouldn’t paying a flat salary, rather than one-fourth of profits, have been more profitable to the capitalist?
   b. And why didn’t the capitalist simply lend money and take a flat payment of interest – like a bank. Why did the capitalist instead ask for a share of profits, which in a failed venture would mean no returns at all?
   c. Notice that the Venetian republic encouraged commercial private ventures, but not manufacturing private ventures. In fact, the Republic made itself the principal (if not exclusive) ship builder. Can private enterprise threaten the state?

2. Notice also that Venice forbade limited liability partnerships – that is, partnerships where some of the partners were not responsible to creditors or others dealing with the business enterprise. What is the reason to allow limited liability only for joint ventures – a business for a limited duration
and scope – but not open-ended partnerships? Would corporations have been possible in Venice? What is a “corporation” anyway – read on!

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**CORPORATIONS: EXAMPLES AND EXPLANATIONS**

*(Aspen Law & Business 5th ed. 2009)*

Alan R. Palmiter

**CHAPTER 1**

**THE CORPORATION -- AN OVERVIEW**

What is a “corporation”? It is a framework by which people conduct modern business. It is a convenient legal entity that can enter into contracts, own property, and be a party in court. It comes in assorted sizes, from a publicly held multinational conglomerate to a one-person business.

The corporation is a creature of law — a legal construct. Nobody (not even your law professor) has ever seen one. The corporation’s existence and attributes arise from state-enabling statutes, which give business participants significant freedom to choose their own customized relationships. But the statutory framework is incomplete, and judicial norms fill the many gaps left by the statutes. Other gaps, particularly those involving disclosure to investors, are filled by federal securities law.

Ultimately, the corporation is an investment vehicle for the pooling of money and labor — a grand capitalist tool. *Money capital* comes from shareholders and creditors; *human capital* comes from executives and employees. Both money and labor expect a return on their investment. The corporation defines their legal relationships and mediates their conflicting interests.

**§1.1 Corporation Basics**

**§1.1.1 Five Basic Attributes**

Suppose you are asked to invest in a business. What would you ask? The paradigm corporation answers the five basic questions that arise in every investment relationship —

- **How long does the investment last?** The corporation has an independent, perpetual existence. It is an entity distinct from those who contribute capital (shareholders and creditors) and those who manage the business (directors and officers). The persons who constitute the corporation may change, but the corporation remains. It owns the business assets and is liable for any business debts.

- **Who manages the investment?** The locus of corporate power is the board of directors, which manages and supervises the business. (The board often delegates its power to officers to act and bind the corporation.) In exercising their management powers, the directors are subject to fiduciary duties. Shareholders have only a limited governance role. They can vote to elect directors, approve fundamental corporate changes, and initiate limited reforms, but have no power to act on behalf of the corporation.

- **What is the return on the investment?** The corporation establishes a hierarchy to the financial returns generated by the business. Creditors (including bank lenders, bondholders, trade creditors, and employees) are first in line and receive a return based on their contracts. Shareholders are last in line and receive dividends as declared at the discretion of the board. If the business dissolves, creditors’ claims have priority, and shareholders are residual claimants.

- **How can investors get out?** Ownership interests (shares) are freely transferable. Shareholders can realize the value of their investment by selling to other investors interested in acquiring their financial rights. The corporation, however, has no obligation to repurchase these ownership
Managers (directors and officers) cannot transfer their positions, but can resign at any time.

- **What are investors’ responsibilities to others?** The corporation is liable for its own obligations, but otherwise creates a “nonrecourse” structure. Corporate insiders (directors, officers, shareholders) are not personally liable to outsiders on corporate obligations. Outsiders (such as contract creditors and tort victims) bear the risk of corporate insolvency. Corporate investors and managers risk only their investment.

In effect, the corporation combines five attributes: (1) separate, perpetual legal personality; (2) centralized management under a board structure; (3) shared ownership interests tied to residual earnings and assets; (4) transferability of ownership interests; and (5) limited liability for all participants.

Of course, there are exceptions. For example, shareholders in closely held corporations can agree to manage the business, pay themselves specified dividends, and limit their ability to transfer their stock. In some circumstances courts use equitable principles to hold shareholders personally liable for corporate debts beyond their investment, or lenders may require shareholders to guarantee personally the corporation’s obligations. The corporation is mostly a malleable set of default rules that specifies the terms of the parties’ relationship unless they agree otherwise. This places a premium on the lawyer’s role as creative planner.

**Corporate Constituents.** Many persons participate in the joint economic activities that constitute the corporation. Shareholders — whether individual investors or institutions that invest for their beneficiaries (pension funds, mutual funds, banks, insurance companies, endowments) — provide money capital. Managers (directors and officers) oversee the business and its employees. Lenders supply additional money capital as secured bank loans, unsecured bonds, short-term notes, and suppliers’ trade credit. Suppliers provide inputs for the business under long-term contracts and in market transactions. For some, customers are the reason the business exists. Those injured by the business (whether as employees, customers, or strangers) have claims on the business directly or through governmental enforcement — antitrust, banking, environmental, health, product safety, and workplace safety. As an economic actor in society, the corporation pays federal, state, and local taxes.

Corporate law, however, focuses on the relationship between shareholders and managers — the two constituent groups understood to comprise the “internal” organization of the corporation. “Outside” relationships with creditors, suppliers, customers, employees, and government authorities usually are subject to legal norms that treat the corporation as a person — such as the laws of contract, debtor-creditor, antitrust, labor, and tax.

§1.2 Sources of Corporate Law

§1.2.1 Historical Sketch of the Corporation

The modern corporation did not happen in one blazing moment of inspiration. Instead, we can trace its current attributes to various earlier times and forms. The idea of an amalgamation of persons forming a separate juridical personality moved from Greece, to Rome, to the Continent, and to England. Originally, perpetual separate existence in England was reserved for ecclesiastical, municipal, and charitable bodies whose existence was conferred by sovereign grant. The idea of common ownership by a body of passive investors originates from joint-stock trading companies, such as the East India Company (a monopoly franchise) in the early 1600s. A combination of continuity of life, centralized management, financial interests in profits, transferability of shares, and limited liability for private business existed in the 1700s in the form of complex deeds of settlement — an unincorporated association!
These concepts came to the American colonies. At first private corporations, like political municipalities, had to receive a special charter from the state legislature. Legislatures granted charters on a case-by-case basis to noncommercial associations (such as churches, universities, and charities) that wanted the convenience of perpetual existence and to commercial associations (such as banks, navigation companies, canals, and turnpikes) with special public purposes and large capital needs. As the needs for capital (and thus incorporation) increased during the early 1800s, states began to enact general incorporation statutes for specified, usually capital-intensive, businesses. From the beginning, many feared the concentrated economic power inherent in the corporate device. Eventually, the U.S. corporation evolved in the mid-1800s into a legal form available to all, though subject to significant statutory restrictions.

During the late 1800s two major trends, leading in opposite directions, shaped modern U.S. corporate law. The first trend led to restraints on business activities. In the 1880s Congress created the Interstate Commerce Commission to regulate the railroad monopolies. In 1890 and 1916 Congress passed antitrust legislation (the Sherman and Clayton Acts) to combat concentrations of corporate economic power. In the early 1900s states enacted “blue sky” laws to deal with fraud in the sale of corporate securities. In the 1930s Congress passed a series of securities laws aimed at abusive management practices in national securities markets.

The other trend led to a liberalization of state corporation statutes. In the late 1800s, to attract incorporation revenues, some states amended their statutes to lift limits on the amount of capital that a corporation could raise, to permit corporate ownership of other corporations, and generally to increase the flexibility available to corporate management. Eventually Delaware won this race of laxity, which some have called a scurrilous “race to the bottom” and others an efficiency-producing “race to the top.” Today most large, publicly traded U.S. corporations are incorporated in Delaware.

§1.2.2 Modern State Business Corporation Statutes

The corporation statutes of each state describe the basic corporate attributes —

- how to form a corporation (MBCA Chapters 1, 2, 3, 4, 5)
- the financial rights of shareholders (MBCA Chapter 6)
- the governance roles of shareholders, directors, and officers (MBCA Chapters 7, 8)
- the transferability rights of shareholders (MBCA §6.27)
- limited liability for shareholders (MBCA §6.22)
- structural changes such as charter amendments, mergers, and dissolution (MBCA Chapters 10, 11, 12, 13, 14)

Some of the statutory terms are mandatory, such as the annual election of directors and shareholder voting on dissolution. Others, such as the removal of directors without cause or shareholder action without a meeting, are default terms that apply unless the parties choose different terms. Contractarians often view corporate statutes as providing standardized “off-the-rack” terms that apply unless the parties (usually in the charter) choose different, firm-specific terms. Under the internal affairs doctrine, the law of the state of incorporation governs all shareholder-manager matters in multistate corporations.

Although no two state corporation statutes are identical, there has been a trend toward greater uniformity and modernization. In 1950 the American Bar Association’s invitation-only committee on corporate laws published the first model business corporation act. This model act, and its many revisions, served as the basis for corporation statutes in most states. In 1984 the ABA committee substantially reorganized and rewrote the model act, which follows the enabling structure of Delaware’s corporate statute. The model act has since been revised on a number of occasions. The 1984 revisions, first referred to as the Revised Model Business Corporation Act (RMBCA), has become simply the Model Business
Corporation Act (MBCA). Significant revisions since 1984 include provisions on directors’ conflicting interest transactions (1992), director standards of conduct and liability (1998), and shareholder rights in fundamental transactions (1999). A majority of states (38 as of 2008) have enacted corporate statutes based on the 1984 MBCA.

Not all states, however, have enacted a corporate statute based on the model act. In fact, the most prominent corporate law states — Delaware, California, and New York — have their own idiosyncratic corporation statutes. Delaware’s statute is particularly important in U.S. corporate law because of the leadership of its legislature in being the first to enact corporate law reforms, the sophistication of the state’s corporate bar, and the expertise and influence of its judiciary — and because most large, public corporations are incorporated in Delaware.

State corporation statutes generally treat all corporations the same. Corporations with numerous, widely dispersed shareholders (publicly held corporations) generally are subject to the same statutory rules as corporations with a small group of shareholders who do not have a public market for their shares (closely held corporations).

§1.2.3 Role of Judge-Made Law

Corporation statutes are not all-encompassing; court decisions clarify and fill in the gaps of the statutes and the corporation’s constitutive documents. The most important judicial gap-filling involves the fiduciary duties of directors, officers, and controlling shareholders. Common-law fiduciary principles that regulate abuse by those who control the corporation’s decision-making machinery lie at the heart of corporate law. See Chapter 11 (introduction to fiduciary duties). Lately, many fiduciary rules have turned on the disinterestedness and independence of outside (nonmanagement) directors in making corporate decisions.

§1.2.4 Federal Law

There is no federal corporation statute, despite regular calls for a uniform national law applicable to some or all aspects of publicly traded corporations. Despite the absence of a federal law of corporations, federal statutes add a significant layer of corporate regulation. The Securities Act of 1933 regulates the disclosure when corporations raise capital in public markets, whether by selling stock or taking on debt. The Securities Exchange Act of 1934 imposes periodic reporting requirements and proxy disclosure rules on corporations whose stock is publicly traded. In addition, the Exchange Act regulates the trading of securities in public and private markets, including insider trading — that is, the use of material, nonpublic corporate information to buy or sell stock.

In 2002, responding to a spate of corporate and accounting scandals, Congress passed the Sarbanes-Oxley Act — sweeping new legislation that federalizes specific aspects of corporate law. Among the Act’s reforms are limits on hiring audit firms to do nonaudit work for the company, rules governing the composition and functions of the board’s audit committee, provisions requiring forfeiture of executive pay in companies that restate their financials, bars from holding corporate office of individuals who have committed securities fraud, prohibitions on personal loans to corporate executives, disclosure of the company’s systems of internal controls, and new SEC rules governing professional conduct of corporate/securities lawyers.

NOTES

1. So now you know the basics of US corporate law. Notice the motivations of people who join together in a for-profit enterprise. Is there any basic difference between a Venetian colleganza
and a US corporation?

2. A recent book observes that the basics of the US corporation show up throughout modern developed economies: (1) legal personality, (2) limited liability, (3) transferable shares, (4) centralized management under a board structure, and (5) shared ownership by contributors of capital. R. KRAAKMAN, P. DAVIES, H. HANSMANN, G. HERTIG, K. HOPT, H. KANDA & E. ROCK, THE ANATOMY OF CORPORATE LAW: A COMPARATIVE AND FUNCTIONAL APPROACH 71-99 (2004). You can read the first chapter on SSRN.

The book’s authors identify the animating purposes of corporate law as two-fold: first, to create a structure for business activities and, second, to control conflicts of interest among corporate constituencies – such as shareholders vs. managers, majority shareholders vs. minority shareholders, and insiders (shareholders and managers) vs. creditors. These conflicts are often referred to as “agency problems” since they mimic the conflicts in the principal-agent relationship. For example, consider all the problems you might encounter if you decided to ask somebody to sell your car for you. How can you ensure your agent will be hard-working, honest, trustworthy, loyal – that is, focused on what’s best for you?

How does corporate law regulate principal-agent conflicts? The authors suggest there are 10 strategies to minimize these conflicts, thus to maximize the benefits of the corporate parties and more generally social welfare. Some of these strategies are regulatory (mandatory rules imposed by law to govern the parties’ relationship); others derive from governance by the parties (private rules established by the decision-making hierarchy created through corporate law). In addition, some of the strategies involve constraints that are imposed before the agent undertakes corporate activities (so-called ex ante rules) and others are imposed after the agent has acted (so-called ex post liability). This framework helps identify that corporate law works in many different, though interrelated, ways.

Here is the table (slightly modified) proposed by Professors Kraakman and Hansmann, followed by a short description of each of the entries:

<table>
<thead>
<tr>
<th>Strategies for Protecting Principals</th>
<th>Regulatory Strategies</th>
<th>Governance Strategies</th>
</tr>
</thead>
<tbody>
<tr>
<td>Agent constraints</td>
<td>Affiliation terms</td>
<td>Appointment powers</td>
</tr>
<tr>
<td><strong>EX ANTE</strong></td>
<td><strong>Rules</strong></td>
<td><strong>Selection</strong></td>
</tr>
<tr>
<td></td>
<td><strong>Entry</strong></td>
<td><strong>Initiation</strong></td>
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<tr>
<td><strong>EX POST</strong></td>
<td><strong>Standards</strong></td>
<td><strong>Removal</strong></td>
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<td><strong>Veto</strong></td>
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<td><strong>Punishment</strong></td>
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*Agent constraints:* This is a popular strategy – **rules** by legislative, regulatory and judicial lawmakers that require or prohibit specific conduct and **standards** that leave compliance to adjudication after the fact. Rules tend to be straight-forward (such as the requirement of annual shareholder meetings) while standards deal with more complex situations (such as the nuanced standards for self-dealing by controlling shareholders).

*Affiliation terms:* This strategy focuses on the point at which parties decide to begin or end the corporate relationship. At **entry**, rules mandate that investors receive disclosure to make an informed decision, forcing corporate managers to tell a convincing story. To facilitate **exit**, rules
permit shareholders to sell their shares without management interference and other rules mandate a right to be paid “fair value” in a corporate merger.

Appointment powers. This strategy allows the parties to protect themselves. Shareholders have the power to select directors, a power that sometimes can be exercised by minority shareholders and even employees; directors and managers can also choose what corporation to work for. Or, after the fact, shareholders can vote to remove directors who have not fulfilled expectations. To ensure management continuity, there are limits on when and under what circumstances these powers can be exercised.

Decisions powers. This strategy involves a careful demarcation of who decides what. For example, corporate statutes in the United States allow shareholders to initiate by nominating director candidates, proposing changes to the corporate bylaws (but not the articles), and recommending non-binding resolutions – but no more! The board can propose amendments to the articles, mergers and dissolution – subject to a shareholder veto. Otherwise, the board of directors is the center of the bulk of corporate decision-making.

Agent incentives. This strategy assumes that agents will not respond merely to the call of conscience and reputation, but will need financial incentives. Some incentives come as promises, or rewards, for good behavior – like stock options that rise in value as share prices rise generally. Some incentives come as threats, or punishment, for undesirable behavior, such as criminal penalties for stealing corporate assets. It’s the old story of “carrot and stick.”

4. Where does corporate law come from in the United States?

a. Is corporate law in the United States uniform? What is the MBCA? Who promulgates it and why? What is the process by which the MBCA becomes law? How is it different from uniform laws such as the Uniform Commercial Code?

b. What is the pattern of corporate law-making in the United States? Some have described US corporate law as a “laboratory” of 50 different state jurisdictions. Corporate law innovations in one state tend to spread to other states in a dynamic process in which legal experimentation identifies rules eventually adopted by a majority of states -- creating a de facto uniformity in US corporate law. Delaware is often the first state to adopt reforms, and the MBCA soon follows. Roberta Romano, The States as a Laboratory: Legal Innovation and State Competition for Corporate Charters, SSRN Paper 706522 (Apr. 2005). Lately, however, the MBCA has begun to set its own course with provisions dealing with director standards of liability, safe harbors for director-interested transactions, and functionally equivalent treatment of different forms of corporate combinations.

c. What is the role of federal law in the structure of the corporation? Before 2002 the federal role in US corporate law was largely limited to specifying rules of disclosure for publicly-traded corporations. But the Sarbanes-Oxley Act of 2002, enacted by Congress in response to the accounting and corporate scandals that came to light in the early 2000s, changes the nature of US corporate federalism.

Under Sarbanes-Oxley, some of corporate governance in publicly-traded corporations have been taken from state control and placed under federal oversight: (1) composition of corporate boards, including the board’s audit committee, (2) hiring of outside financial auditors, (3) responsibilities of corporate attorneys toward their public corporation clients, (4) loans by public corporations to corporate insiders, (5) internal
corporate monitoring systems to ensure accurate and honest financial reporting, (6) liability of corporate officers who certify corporate disclosures, (7) protection of whistle-blowers who expose corporate fraud, and (8) corporate codes of ethics.

1. **A European conception of “company”**

Now that we’ve US corporate law under our belts, let’s look at European company law. What is the philosophy of “the company” in Europe? And how does it differ from the philosophy in the United States. Remember that the Venetians saw their commercial enterprises as a tool of the Venetian Republic. Is that still the case in Europe?

The next two readings give you a chance to compare European attitudes about “the company” with American attitudes about “the corporation.” Is the corporation a private contract or a public institution? Does it serve only those inside the company or also those outside the company? As you find the different answers, you’ll also get a sense for the different writing styles of European and American business law academics.

Can you tell who is who? Can you tell which one was a US law professor who became a federal judge? And which one was a law professor before becoming a (well-paid) expert in US securities cases and then dean of a US law school? And which is a debonair European academic?

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**THE NATURE OF THE COMPANY**
Jean Paillusseau (University of Rennes)
(from *European Company Laws: A Comparative Approach*,
edited by Robert Drury and Peter Xuereb)
(Dartmouth Press 1991)

The concept of the company

“Does the company contract still exist?” During the last 30 years or so we have witnessed a veritable revolution in the concept of the company. The previous conceptual approach to the company has been completely overturned, and a new dual approach has arisen. This new approach, while originating in France, is equally capable of applying to the company laws of other European countries.

The main idea of this new approach is that the company provides a ‘legal structure for the enterprise’. Under these conditions therefore, it is no longer possible to deal with the corporate contract according to traditional concepts. When one takes the view that the company is a legal framework for the enterprise, the following questions arise: What are the social and economic characteristics of the enterprise set up by the law? Who organizes that enterprise, the parties or the legislator? What are its aims and objectives? What are the organizational techniques used: law, contract, or both?
The contract theory

There was a time when the corporate contract was extremely important. Indeed, the company was in effect a contract whereby two or more individuals agreed to put something in common, with a view to sharing the possible profits. That was the definition in art. 1832 of the French Civil Code: Similar definitions have been adopted, for example, in Italy under art. 2247 of the Civil Code, in Switzerland under art. 530 of the Code des Obligations and in Belgium under art. 1832 of the Civil Code. This definition had its origins in Roman Law and lasted in France until the law of 4 January 1978 amended it for the first time.

But it was the Act of 11 July 1985, which introduced the one-man company in France, that has brought the most important change to the wording of art. 1832. In place of the old wording which began. ‘The societe is a contract’ the new wording confirms the development towards the concept of the company as an institution:

The societe is instituted by two or more persons who agree by way of a contract to appropriate their assets or their labour to a common enterprise with a view to sharing the profits or benefiting from the savings which result.

Thus, the assertions that the company is a contract (‘between two or more individuals’, according to art. 1832 of the Civil Code), and that it is a legal entity (hence a group of individuals), necessarily impose a certain concept of the company. This is the traditional conception, which has had a profound influence upon everyone’s way of thinking for many centuries and in many countries.

From this point of view then, what is the relationship between the corporate contract and the legal person? First, it is the contract that creates the company. It is through the contract that the group of individuals who wish to be associated is formed. This group then becomes a legal entity when it is registered as a company (societe) at the registre du commerce et des societes.

The second point results from the notion that the company is formed by its members. It seems only natural to assume that the parties themselves constitute the company (societe) and thus their organization can only be contractual. This analysis has given birth to the ‘contract theory’.

The institution theory

The development of company law nevertheless contradicts the contract theory. Indeed, the legislature has intervened over and over again in saying how the company should be organized. An organization based on contract has been replaced by one based on the law. Furthermore, the majority of these rules established by the legislature have been made matters of public policy (ordre publique).

The institutional theory of the company stresses the legal person to the detriment of the contract. The legal entity is:

an enterprise which has a legal existence in a social environment. To implement this idea, an authority is established which provides the enterprise with organs. As between the members of the social group, manifestations of their common will are directed by the duly empowered organs and regulated by their procedures.

Numerous lawyers have been attracted by this concept in France, the Netherlands, and elsewhere. They thought that it enabled them to understand why the legislature has substituted itself for the parties in organizing the company, for example to confer powers on the board of directors which the general meeting of shareholders was not able to exercise.
The company is an institution, at least in part. Everyone agrees on that point, although to varying extents, and the will or influence of the legislature has been emphasized.

The new approach

The traditional conception of company law is no longer relevant and does not correspond to modern company law any more. As soon as the law expressly accepted the existence of the one-person company, it became impossible to assert that if is inherent in the nature of the company to be a group of individuals, a contract or an institution. But if the fundamental nature of the company is not that of a group of individuals and a contract, what is it?

Similarly, when company law takes into account interests other than those of the members, it becomes difficult to assert that the company is only a group of members organized by a contract. Thus, countries where ‘co-management’ or ‘co-supervision’ has been instituted, as in the Federal Republic of Germany for example it is clear that the very idea of co-determination goes completely against the traditional concept of the company. Furthermore, in these companies, it is no longer possible to assert that the general meeting has the supreme power; here again, the traditional concept has failed.

It is not even necessary to have to resort to co-management or co-supervision in order to reach this conclusion. It is enough that interests other than those of the members are taken into account by company law (for example, the interests of the creditors or third parties). But if the company is no longer solely the organization of a group of members, what has it become?

The answer to these questions, as far as I am concerned, is very clear: the company has become a technique for the organization of the enterprise. This doctrine is the basis of what is now called ‘the modern concept of the company’, as opposed to the traditional concept. It is in this direction that the development of company law has gone, as both new statutes and case law show.

In fact, the rise of the enterprise in French law is irresistible and irreversible. One can see this everywhere: in company law, labour law, tax law, the law on enterprises in difficulties, accountancy law, competition law, and so on. There is practically no recent statute in the field of business law in the last few years which has not referred to the ‘enterprise’ expressly, either in the title, or in the actual provisions.

THE CONCEPT OF ENTERPRISE

The enterprise is not a legal concept, it is an economic and social concept. My research has led me to perceive two essential realities in the enterprise: a business and a center of interests.

The enterprise is first and foremost a business

In the competitive economy of the market place, the enterprise is first and foremost a business involving the production, transformation, or distribution of goods, or the supply of services, or some of these functions. It may be a business of producing and selling cars, as well as that of distributing products in a hypermarket or in a small grocery shop, as well as the rendering of insurance and accountancy services, or even of legal services. The business is organized according to the markets chosen by the enterprise as well as by its strategic options.

A business only exists and develops in so far as its customers buy the enterprise’s goods and services so as to make it a ‘going concern’. If it fails to satisfy the requirements for viability, the
continued operation of the enterprise cannot be assured. The effectiveness of the business depends essentially on the quality, the competence, the motivation and the courage of the people who run it.

The enterprise is secondly a focus of interests

The creation and the functioning of an enterprise gives rise to a variety of interests. There are those of its founder – the entrepreneur. It owes him its development, and he bears the risks. But he is not the only one. From the moment of its creation, the enterprise becomes a focus for other interests, such as those of its creditors and its employees. When its development proceeds, the interests of the contributors of capital (partners, shareholders, money tenders, risk-capital companies, institutional investors, depositors, and so on.)

These interests vary according to the size of the enterprise. The bigger it is, the more important they are; the smaller it is, the fewer the people who will be involved, to the extent that it becomes hardly distinguishable as an enterprise. But everything is relative, for the economy of a small provincial town may depend upon the fortunes of an enterprise, whose impact would be negligible in a metropolitan region.

THE LEGAL ORGANIZATION OF THE ENTERPRISE

One of the functions of the law is to provide a legal structure for people’s activities, their position in society and their personal relationships. This function of the law is particularly evident in the field of business law.

There are two fundamental aspects of the enterprise: its business and its center of interests.

The business

The business of the enterprise is organized by the law, which I will try to elaborate with reference to the one-man company. Why did the legislature create the one-person company in France by the Act of 11 July 1985 and in Belgium by the law of 14 July 1987? Quite simply, so that the entrepreneur, for his own reasons, can give a legal autonomy to his commercial, industrial or service providing business; so that he can create a specific legal organization. Thus it is necessary to provide a supporting legal framework for the conduct of activities of this kind.

What characteristics must such a supporting legal structure have? The attribution of legal personality follows directly from the practical necessity of giving some legal form to the business. The consequences of the attribution of legal personality are the existence of a corpus of assets, of some identification of the business (its designation), of a domicile and of a nationality; it involves its legal creation, its duration, and its end.

The running of the business involves a multitude of decisions. This presupposes the organization of a decision-making process. The supporting framework must thus allow for the legal organization of authority and of decision taking organs having the necessary legal competence to run the business with, if needed, a corresponding liability.

A focus of interests

It is obvious that the enterprise operates as a focus for different interests. These interests include those of the founder of the enterprise, of the individual shareholders who provide the capital, of the institutional investors, the employees, the creditors, third parties, and so on. These interests have a common cause, because it is to the benefit of all of them that the enterprise thrives and prospers. The
employees will, however, only profit from this where, as is often the case, there is a profit-sharing plan between the shareholders and the employees.

The interest of the entrepreneur is self-evident; other shareholders have an interest in the dividends; the creditors want to see their money back in due course; third parties have an interest in safeguarding the agreements that they have made with the company; the employees want to get their wages as well as keep their jobs, and so on. However, the interests of these various groups can come quite sharply into conflict.

It follows therefore that there are at least three possible scenarios:

1. The legislature can leave the different interest groups to sort themselves out, and agree among themselves on the way in which they want to organize their relationships and resolve their conflicts. That would be an organization of a contractual nature.

2. Or, rightly or wrongly, the legislature takes the view that this is neither possible or advisable, and thus stipulates the rules of the game generally, in an imperative way. This would be an organization of a legal nature or, in other words, an institution.

3. Or, finally, the legislature may only regulate certain aspects of these relationships, or lay down rules of general guidance, leaving it to the different interest groups to sort out on a contractual basis those matters which are not mandatorily regulated by the law.

The legislature has chosen to intervene in order to determine the respective rights, and levels of protection to be accorded to those who have an interest in the enterprise. This intervention is more or less far-reaching depending upon the form of the enterprise involved, and upon the nature of the interests which it is desired to protect.

The four principal lines of this intervention are: protection by means of information; the increase of the rights of certain interest groups; the protection of these interests through the very concept and structure of the company; and external protection. To these we shall now turn.

The protection of different interest groups by means of the dissemination of information

The legislature’s wish to protect the different interest groups has led it to require companies to communicate and publish a great deal of information addressed to those who could have an interest in its activities. Among this we find, especially, information on a company’s financial position, and this is of paramount importance. A fair number of individuals (contributors, employees, bankers, creditors, and so on) will all base their decisions on this information.

The importance of this information is such that it has been increased in both quantity and quality by numerous legislative provisions relating, for example, to the consolidation of accounts, the establishment of the requirement budgetary and other forecasts to be sent to the directors, the auditors and to the works council. These include the profits forecast and the provisional financial plan.

Increasing the rights and protection afforded to certain categories of individuals

Generally speaking, the rights of members and third parties have been strengthened in the countries of the EC through company law harmonization Directives. Moreover, in France, the rights of the members and minority shareholders in private and public companies have recently been increased by the law of 1 March 1984 which empowers them to initiate an alarm procedure when they learn of facts which might put the continuance of the business in jeopardy.
The rights and the protection given to the employees of the enterprise have also been greatly increased. To give a simple example, the directors of the company are obliged to show to the works council, before their presentation to the general meeting of shareholders, all of the documents which have to be laid before this meeting, together with the auditor’s report. The council has the same right as the members and shareholders to bring an action to require an expert’s report on one or more aspects of the company’s management, and the case law asserts that the object of this exercise is to protect the interest of the company.

The works council has to be informed and consulted on a great number of occasions, for example on questions concerning the organization, management and important operations of the enterprise, on any modifications to the legal and economic organization of the enterprise, especially in the case of merger or sale. This also applies in the case of any important changes in the production structures of the enterprise, as well as to the acquisition or disposal of subsidiary companies, and when the company in which the enterprise is located is made the object of a transfer of the controlling interest.

*The protection of different interest groups through the concept and structure of the company*

The very organization of the company is without doubt a fundamental element in the recognition and protection of the welfare of the different interest groups. Specifically, some protection results from the fact that companies carrying on a particular type of activity, for example banking, finance or insurance, are subjected to special regulations. These regulations are there specifically to protect those interests which can be put at risk by these activities.

To ensure the efficiency of these measures, certain criminal penalties have been laid down. The crime of misusing the assets of the company is, in this respect, very significant. Thus the *Cour d’Appel* in Paris in a decision of 29 May 1986 in the Willot case stated that:

> the object of these restrictions is to safeguard the Property of the company against directors inclined to abuse their powers or dominant position, and also to ensure the protection of the minority shareholders, . . . that of the enterprise as a going concern, that of the creditors and other interested parties in the company.

*The protection of the different interest groups through the interest of the company*

The protection of the enterprise and its interests is the best guarantee of the protection of the different interest groups. The prosperity of the enterprise is the common denominator of the protection of the various interest groups. It is in the perspective of its expansion and viability that the shareholders have contributed their capital, that third parties have given it credit, that the directors manage it, that the workers and the staff work there, that the state or the local authorities provide it with the facilities for setting up in an industrial development area, grants or tax benefits, and so on. If the enterprise fails, all of these interests will be damaged, whatever protection each enjoys.

It is for that reason that a good number of legal rules have as their objective the protection of the enterprise and its interests. The rules can be found in the law governing collective agreements, in tax law, in employment law, in the law of succession and in company law, and so on. The protection of the enterprise can also involve the suspension or suppression of the protection or representation of another interest group. The protection of the enterprise can lead, for example, to the suspension for a time of certain of the rights of the company’s creditors.

It can also lead to putting at risk the financial liability of the company’s directors under the provisions of the French law of 25 January 1985; it may also mean their dismissal where their defaults
have led the company into insolvency. It can lead equally to the justification of certain decisions of the directors of the enterprise taken with regard to all or some of the employees.

CONCLUSION

The extent of the freedom allowed to the parties to organize their own operational structure depends upon many factors. But among these, two are essential: the first stems from the cultural factors dominant in a particular society (or country), the second relates to the variety and the importance of the interests in issue as well as from the determination to protect them.

While in some countries there is an inherent tendency to give a large measure of freedom to the users of the law to organize their relationships (for good or ill), in other countries the tendency is in the opposite direction, and the legislature itself steps in to organize these relationships in whole or in part (again for good or ill). The first tendency is dominant in the Anglo-Saxon countries, while the second prevails in continental Europe. This cultural influence finds its expression in the field of company law.

2. An American conception of “corporation”

*Contractual Freedom in Corporate Law: The Corporate Contract*

89 COLUM. L. REV. 1416 (Nov 1989)

Frank H. Easterbrook¹ and Daniel R. Fischel²

For a long time public and academic discussion of corporations has started from the premise that managers have “control” and use this to exploit investors, customers, or both. The usual prescription is some form of public control. It may take the form of regulation of the securities markets. It may take the form of intervention through corporate law, which establishes minimum voting rules and restricts how managers can treat the firm and the investors.

The argument is simple. In most substantial corporations -- firms with investment instruments freely traded, which we call public corporations -- each investor has a small stake compared with the size of the venture. The investor is therefore “powerless.” The managers, on the other hand, know how the business is running and can conceal from investors information about the firm and their own activities. As a result the managers can divert income to themselves, stealing and mismanaging at the same time. Diversion and sloth may be subtle, but they exist. Only some form of regulation can protect investors.

Yet, although the language of regulation is everywhere, corporate law has developed along a different path. The corporate code in almost every state is an “enabling” statute. An enabling statute allows managers and investors to write their own tickets, to establish systems of governance without substantive scrutiny from a regulator and without effective restraint on the permissible methods of corporate governance. Courts apply the “business judgment doctrine,” a hands-off approach that they would never apply to the decisions of administrative agencies or other entities.

Consider the domain of choice. The founders and managers of a firm choose whether to organize as a corporation, trust, partnership, mutual or cooperative. They choose what the firm will make or do and whether it will operate for profit, not for profit, or hold a middle ground, pursuing profit but not to the

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exclusion of some other objective (as publishers of newspapers do). They choose whether to allow the public to invest or whether, instead, the firm will be closely held. They choose what kinds of claims (debt, equity, warrants) to issue, in what ratios, for what price, with what entitlements, including not only the right to receive payments (how often, in what amounts), but also whether these investments allow their holders to vote -- and if to vote, how many votes, and on what subjects. They choose where to incorporate. Investors select the members of the board of directors, who may be “inside” or “outside,” and the board decides who exercises which powers on the firm’s behalf. With trivial exceptions, all business decisions -- including the managers’ pay, bonuses, stock options, pensions, and perquisites -- are taken by or under the supervision of this board, with no substantial inquiry by anyone else. Anyone who asks a court to inquire will be brushed off with a reference to the business judgment rule.

Why does corporate law allow managers to set the terms under which they will govern corporate assets? Why do courts grant more discretion to self-interested managers than to disinterested regulators? Why do investors entrust such stupendous sums to managers whose acts are essentially unconstrained by legal rules? The answers lie in, and help explain, the economic structure of corporate law. The corporation is a complex set of explicit and implicit contracts, and corporate law enables the participants to select the optimal arrangement for the many different sets of risks and opportunities that are available in a large economy – hence the “enabling” structure of corporate law.

Although managers are self-interested, this interest can be aligned with that of investors through automatic devices, devices that are useless when those in control are “disinterested”; hence the apparent contradiction that self-interested managers have more freedom than disinterested regulators. Of course controls are not free, and much of corporate law is designed to reduce the costs of aligning the interests of managers and investors. Before we explore the nature of the legal rules, however, we develop the framework within which all of our analysis proceeds: the corporate structure is a set of contracts through which managers and certain other participants exercise a great deal of discretion that is “reviewed” by interactions with other self-interested actors. This interaction often occurs in markets, and we shall sometimes call the pressures these interactions produce “market forces.”

I. THE DYNAMICS SHAPING THE CORPORATE FORM

The view one takes of corporations and corporate law is apt to depend on one’s assumptions about how investors, employees, and other players come to be associated in a venture. Those who assume that corporations are born with a complement of managers, employees, and investors are more likely to be driven to a regulatory view of corporations. Suppose the world is static. Everyone awakes one morning to find himself a manager or an investor. The veil of ignorance is suddenly parted. The manager exalts: “Aha! No one can stop me!” The investors gasp: “Woe is me, I’m powerless.” This is the natural view of one who draws a line at a moment in time without asking how the world came to be as it is.

Managers and investors do not wake up in this way. They assume their roles with knowledge of the consequences. Investors part with their money willingly, putting dollars in equities instead of bonds or banks or land or gold because they believe the returns of equities more attractive. Managers obtain their positions after much trouble and toil, competing against others who wanted them. All interested persons participate. Firms are born small and grow. They must attract customers and investors by promising and delivering what those people value. Corporations that do not do so will not survive. When people observe that firms are very large in relation to single investors, they observe the product of success in satisfying investors and customers.

How is it that managers came to control such resources? It is not exactly secret that scattered shareholders can’t control managers directly. If the investors know that the managers have lots of discretion, why did they give their money to these managers in the first place? If managers promise to return but a pittance, the investors will not put up very much money. The investors simply pay less for
the paper the firms issue. There is therefore a limit on managers’ efforts to enrich themselves at investors’ expense. Managers may do their best to take advantage of their investors, but they find that the dynamics of the market drive them to act as if they had investors’ interests at heart. It is almost as if there were an invisible hand.

The corporation and its securities are products to as great an extent as the sewing machines or other things the firm makes. Just as the founders of a firm have incentives to make the kinds of sewing machines people want to buy, they have incentives to create the kind of firm, governance structure, and securities people value. The founders of the firm will find it profitable to establish the governance structure that is most beneficial to investors, net of the costs of maintaining the structure. People who seek resources to control will have to deliver more returns to investors. Those who promise the highest returns -- and make the promises binding, hence believable -- will obtain the largest investments.

The first question facing entrepreneurs is what promises to make, and the second is how to induce investors to believe the promises. Empty promises are worthless promises. Answering the first question depends on finding ways to reduce the effects of divergent interests; answering the second depends on finding legal and automatic enforcement devices. The more automatic the enforcement, the more investors will believe the promises.

What promises will the entrepreneurs make in order to induce investors to hand over more money? No set of promises is right for all firms at all times. No one thinks that the governance structure used for a small business will work well for Exxon or Hydro Quebec. The best structure cannot be derived from theory; it must be developed by experience. We should be skeptical of claims that any one structure -- or even a class of structures -- is best. But we can see the sorts of promises that are likely to emerge in the competition for investments.

Some promises entail submitting to scrutiny in advance of action. Outside directors watch inside ones; inside directors watch other managers; the managers hire detectives to watch the employees. At other times, though, prior monitoring may be too costly in relation to its benefits, and the most desirable methods of control will rest on deterrence, on letting people act as they wish but penalizing certain conduct. Fiduciary obligations and litigation are forms of subsequent settling-up included among these kinds of devices. Still other methods operate automatically. Managers enjoy hefty salaries and perquisites of office; the threat of losing these induces managers to act in investors’ interest.

Managers in the United States must select the place of incorporation. The fifty states offer different menus of devices (from voting by shareholders to fiduciary rules to derivative litigation) for the protection of investors. The managers who pick the state of incorporation that is most desirable from the perspective of investors will attract the most money. The states that select the best combination of rules will attract the most corporate investment (and therefore increase their tax collections). So states compete to offer -- and managers to use -- beneficial sets of legal rules. These include not only rules about governance structures but also fiduciary rules and prohibitions of fraud.

Entrepreneurs make promises in the articles of incorporation and the securities they issue when they go public. The debt investors receive exceptionally detailed promises in indentures. These promises concern the riskiness of the firm’s operations, the extent to which earnings may be paid out, and the domain of managerial discretion. These promises benefit equity investors as well as debt investors. The equity investors usually receive votes rather than explicit promises. Votes make it possible for the investors to replace the managers. (Those who believe that managers have unchecked control should ask themselves why the organizers of a firm issue equity claims that enable the investors to replace the managers.) The managers also promise, explicitly or otherwise, to abide by the standards of “fair dealing” embedded in the fiduciary rules of corporate law. Sometimes they make additional promises as well.
II. MARKETS, FIRMS, AND CORPORATIONS

A. Firms

“Markets” are economic interactions among people dealing as strangers and seeking advantage. The extended conflict among selfish people produces prices that allocate resources to their most valuable uses. A series of short-term dealings in a market may be more useful for trading than for producing goods, however. The firm -- an aggregation of people banded together for a longer period -- permits greater use of specialization.

Teams could be assembled every day, the way casual labor is hired. Some production is organized in this way. The construction and longshore industries assemble separate teams for each project. More often, however, the value of a long-term relation among team members predominates, and to the extent it does recognizable firms grow.

B. Corporations

So far we have been describing the firm as an extra-market, team method of production with certain benefits and costs. Corporations are a subset of firms. The corporation is a financing device and is not otherwise distinctive. A corporation is characterized by a statement of capital contributions as formal claims against the firm’s income that are distinct from participation in the firm’s productive activities. The corporation issues “stock” in exchange for an investment; stock need not be held by the firm’s employees. Investors bear the risk of failure (sometimes we call them “riskbearers”) and receive the marginal rewards of success. Equity investors are paid last, after debt investors, employees, and other investors with (relatively) “fixed” claims. These equity investors have the “residual” claim in the sense that they get only what is left over -- but they get all of what is left over.

Sometimes it is said that the distinctive features of the corporation are limited liability, legal identity, and perpetual existence, but these are misleading descriptions. “Limited liability” means only that those who contribute equity capital to a firm risk no more than their initial investments -- it is an attribute of the investment rather than of “the corporation.” This attribute of investors’ risk is related to the benefits of widely held, liquid investment instruments. It often is altered by contract when these benefits are small. Legal identity and perpetual existence mean only that the corporation lasts until dissolved and has a name in which it may transact and be sued. It is convenient to think of the firm as an “it” so that an order of office furniture by Exxon need not include a list of all of the corporation’s investors.

The “personhood” of a corporation is a matter of convenience rather than reality, however; we also treat the executor of an estate as a legal entity without submerging the fact that the executor of an estate as a legal entity without submerging the fact that the executor is a stand-in for other people. The “corporation” is a collective noun for a group of independent actors, and it acts as an entity only when certain forms have been followed.

C. Corporate Contracts

We often speak of the corporation as a “nexus of contracts” or a set of implicit and explicit contracts. This reference, too, is just a shorthand for the complex arrangements of many sorts that those who associate voluntarily in the corporation will work out among themselves. The form of reference is a reminder that the corporation is a voluntary adventure, and that we must always examine the terms on which real people have agreed to participate.

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3 This is an old story, and Adam Smith’s THE WEALTH OF NATIONS (1776) remains the best exposition.
The agreements that have arisen are wonderfully diverse, matching the diversity of economic activity that is carried on within corporations. Managers sometimes hold a great deal of the firm’s stock and are rewarded for success through appreciation of the prices of their investments; other employees may be paid on a piece-work basis; sometimes compensation is via salary and bonuses. The choice of compensation devices will depend on the size of the firm, the identity of the managers, and the industry (or spectrum of industries) in which the corporation participates.

The organization of finance and control is equally variable. Small, close corporations may have only banks as outside investors, and these banks hold “debt” claims that carry residual rights to control the firm; highly leveraged public firms may concentrate equity investments in managers while issuing tradable debt claims to the public. The public investors in these firms have no effective control, because debt conventionally does not carry voting rights. Mature firms may be more bureaucratic, with boards of directors “independent” of managers and answerable to equity investors. Some managerial teams attempt to insulate themselves from investors’ control in order to carry out programs that they view as more important than profits. Both the New York Times and the Wall Street Journal have established structures that give the managers substantial freedom to produce news at the (potential) expense of profit.

To say that a complex relation among many voluntary participants is adaptive is to say that it is contractual — thus our reference to the corporation as a set of contracts. Voluntary arrangements are contracts. Some may be negotiated over a bargaining table. Some may be a set of terms that are dictated by managers or investors and accepted or not; only the price is negotiated. Some may be fixed and must be accepted at the “going price” (as when people buy investment instruments traded in the market). Some may be implied by courts or legislatures trying to supply the terms that would have been negotiated had people addressed the problem explicitly. Even terms that are invariant — such as the requirement that the board of directors act only by a majority of a quorum — are contractual to the extent that they produce offsetting voluntary arrangements. The result of all of these voluntary arrangements will be contractual.

NOTES

1. So the “company as contract” is dead in Europe and suddenly alive and well in America. Compare the two conceptions of the corporation:
   a. How does Paillusseau conceptualize the company? Who organizes the company: the legislature or the parties? Who specifies the rights and duties of the company participants?
   b. How do Easterbrook and Fischel conceptualize the corporation? Who organizes the corporation: the legislature or the parties? Who specifies the corporate rights and duties?

2. Compare the role of government in the corporation:
   a. What is the function of legislation in the European company? Who is it meant to protect? Who does the legislation fear?
   b. What is the function of statutes (federal and state) in the US corporation? Who are the statutes designed to protect? Is US corporate law “trivial” — in the sense that corporate rules are either what the parties would have chosen for themselves or what they actually chose?

3. What assumptions about the corporation — and about its role in society — do these two different conceptions reflect? Should the corporation be a “social institution” that serves common interests as defined by law, or a “contract” that serves the interests of the contracting parties as they deem best?
The debate is ongoing. Recently, a judge of the Delaware Chancery Court asserted that corporate law policy should seek to encourage shareholder activism and corporate governance to focus on sound business plans and long-term wealth. Leo E. Strine, *Toward Common Sense and Common Ground? Reflections on the Shared Interests of Managers and Labor in a More Rational System of Corporate Governance*, SSRN Paper 989624 (2007). A law professor countered that this was tantamount to making the corporation a “social institution,” and corporate law should stay out of broad social and cultural debates. Stephen M. Bainbridge, *The Shared Interests of Managers and Labor in Corporate Governance: A Comment on Strine*, SSRN Paper 985683 (2007).

4. As we will see throughout our study of corporations in the United States and Europe, there exists a big difference in ownership patterns. In the United States, shareholder owners are dispersed – with any one shareholder (even big institutional shareholders) rarely holding more than 5% of corporate shares. In Europe, ownership is concentrated – with many companies having significant proportions (sometimes a majority) of their shares held by a bank or family. One (predictable) legal effect of this difference is that corporate law in the United States, where US shareholders have relatively little power over management, is mostly about protecting shareholders from management. While in Europe, where shareholders generally have more power over management, company law is significantly about protecting non-shareholder constituents (like creditors and employees) from shareholder-controlled management. Martin Gelter, *The Dark Side of Shareholder Influence: Toward a Holdup Theoy of Stakeholders in Comparative Corporate Governance*, SSRN paper 1329997 (2008). Interesting, huh?

5. So here’s a cute cartoon that captures what we’ve been talking about. Do you see why?
B. Company Typology

So learning the basics of the US corporation and the European company wasn’t that bad. Next it might be interesting to compare the different business organization forms used in the United States and Europe. What are their differences? Are they really all that different?

For some of you, this is the first time you’ve been exposed to terms like limited partnerships, LLPs, LLCs, and S corporations. Making a little table for yourself might help. And later you can use your table to see whether the Italian company forms are similar to their US counterparts.

1. Business Organizations – United States

CORPORATIONS: EXAMPLES AND EXPLANATIONS
Alan R. Palmiter

CHAPTER 2
CHOICE OF ORGANIZATIONAL FORM

Given the advantages of incorporation, it is strange that corporate lawyers often advise their clients, “When in doubt, do not incorporate.” There is a common lay perception that no business can be successful without the CORPORATION mystique. But choosing the organizational form that best suits the needs of the business and its participants is more complicated.

This chapter introduces the various investment vehicles – or business organizations – available for pooling money and labor.

§ 2.1 Business Organization Choices

Suppose Bud and Rudy plan to open a flower shop. Bud will run the shop; Rudy will put in money. The organizational forms they can use to structure their for-profit business exist along a continuum. Each form can be manipulated to approximate the characteristics of the others.

The organizational form determines their legal relationship, their financial rights, their responsibilities for business debts, and their tax liability. Today the organizational choices are mind-boggling:

Sole Proprietorship. A single individual, Rudy, owns the business assets and is liable for any business debts; Bud would be her employee. (Or Bud could be the proprietor and Rudy could lend him money.) Proprietorships usually are small, with modest capital needs that can be met from the owner’s resources and from lenders.

General partnership. If Bud and Rudy arrange to carry on the business while sharing control and profits, they automatically create a partnership. As partners, they are each individually liable for partnership obligations. Partnerships are prevalent in service industries—such as law, accounting, and medicine—where trust must exist among the participants and capital needs are not great. (All states have adopted a version of the Uniform Partnership Act (UPA 1914) or the more recent Revised Uniform...
Partnership Act (RUPA 1997); and most states have also adopted “limited liability partnership” (LLP) statutes.

**Limited partnership.** Bud or Rudy can organize a limited partnership (LP) in which so-called limited partners provide capital and are liable only to the extent of their investment. General partners run the business and are fully liable for partnership debts. Since limited partners need not be general partners, Bud could be the general partner and both of them limited partners. LPs combine tax advantages and limited liability. (Many states have adopted the Uniform Limited Partnership Act (ULPA 1916) or the Revised Uniform Limited Partnership Act (RULPA 1985); many states have also adopted “limited liability limited partnership” (LLLP) statutes).

**Limited liability company.** Bud and Rudy can form a limited liability company (LLC)—a hybrid entity between a corporation and partnership. Like a partnership, the members of the LLC provide capital and manage the business according to their agreement; their interests generally are not freely transferable. Like a corporation, members are not personally liable for debts of the LLC entity. (All states have LLC statutes; a Uniform Limited Liability Company Act (ULLCA) was approved in 1996, but few states have adopted it; Wyoming in 1977 was the first state to adopt an LLC statute.)

**Corporation.** Bud and Rudy can form a legal entity called a corporation. Shareholders provide capital, and directors and officers manage the business. Corporate participants are not personally liable for corporate debts; only the corporation is liable. Corporations are the principal means of organizing businesses with complex organizational structures and large capital needs. The corporate form, however, works for any size business, including a one-person “incorporated proprietorship.” (All states have corporation statutes, many based on the Model Business Corporation Act (1984); but some important states, notably Delaware, have their own idiosyncratic statutes.)

§ 2.2 Choosing between Unincorporated and Incorporated Firm

If Bud and Rudy want to share in the control and profits of the flower shop, they would likely choose between an unincorporated firm (partnership, limited partnership or limited liability company) and a corporation. Although a business planner can adapt each form to suit particular needs, some characteristics are relatively immutable—formation, liability, and tax treatment. Others require planning—duration, financial rights, management, and transferability of ownership interests.

Every business organization serves as an investment vehicle for the pooling of money and labor. Each organizational form must resolve five basic issues:

- How long does the investment last?
- Who manages the investment?
- What is the return on the investment?
- How can investors get out?
- What are investors’ responsibilities to others?

§ 2.2.1 Life Span: Formation and Duration

**General partnership.** A general partnership is created when two or more persons associate to carry on a business as co-owners to share profits and control; it does not require legal documentation. RUPA §202(a). A profit-sharing arrangement creates a presumption of a partnership even if the parties do not intend to be partners. RUPA §202(c)(3). A general partnership without a definite term dissolves upon the withdrawal of any partner. RUPA §801(a). Absent an agreement, the withdrawing partner may demand that the business be liquidated and the net proceeds be distributed to the partners in cash. RUPA §807.
A partnership that seeks the liability shield created by a limited liability partnership (LLP) must file a statement of qualification or registration with state officials and adopt a name that identifies its LLP status. RUPA §1001.

**Limited partnership.** An LP arises when a certificate is filed with a state official. RULPA §201. An LP lasts as long as the parties agree or, absent agreement, until a general partner withdraws. RULPA §801.

**Limited liability company.** An LLC arises with the filing of a certificate or articles of organization with a state official. ULLCA §202. Some LLC statutes require there be at least two members, though increasingly one-member LLCs are possible. Most statutes do not limit the duration of LLCs. ULLCA §203.

**Corporation.** A corporation arises when articles of incorporation are filed with a state official. MBCA §2.03. Corporate existence is perpetual, regardless of what happens to shareholders, directors, or officers. MBCA §3.02.

### §2.2.2 Financial Rights: Claims on Income Stream and Firm Assets

**General partnership.** Unless agreed otherwise, partners share equally in profits and losses. RUPA §401(b). A partner may enforce the right to profits in an action for an accounting. RUPA §405(b). Partners have no right to compensation for their services, unless provided by agreement. RUPA §401(h). On dissolution, after discharging partnership obligations, profits and losses are divided among the partners. RUPA §807.

**Limited partnership.** Limited and general partners share profits, losses, and distributions according to their capital contributions, absent a contrary agreement. RULPA §§503, 504. Pre-dissolution distributions are by agreement, as is compensation of the general partner. RULPA §601.

**Limited liability company.** Most LLC statutes allocate financial rights according to member contributions, though some provide for equal shares. ULLCA §405(a) (equal shares). Under many statutes, members can take share certificates to reflect their relative financial interests. Distributions must be approved by all the members. ULLCA §404(c). Absent agreement, members generally have no right to remuneration. ULLCA §403(d).

**Corporation.** Financial rights are allocated according to shares. MBCA §6.01. Distributions, from surplus or earnings, must be approved by the board of directors. MBCA §6.40. Directors and officers have no right to remuneration, except as fixed by contract.

### §2.2.3 Firm Governance: Authority to Bind and Control the Firm

**General partnership.** Each partner is an agent of all other partners and can bind the partnership, either by transacting business as agreed by the partners (actual authority) or by appearing in the eyes of third parties to carry on partnership business (apparent authority). RUPA §301. Unless otherwise agreed, a majority vote of the partners decides ordinary partnership matters, but anything that is extraordinary or contravenes the agreement requires unanimity. RUPA §401(j).

With the broad powers come duties. Partners have fiduciary duties to each other to act in good faith with due care and undivided loyalty. RUPA §404. Among other things, partners must inform co-partners of material information affecting the partnership and share in any benefits from transactions connected to the partnership. RUPA §404(b). Breaches of fiduciary duty are actionable in court. RUPA §405(b).
Limited partnership. General partners have authority to bind the partnership as to ordinary matters. RULPA §403. Limited partners have voting authority over specified matters, but cannot bind the partnership. RULPA §302. General partners have fiduciary duties akin to those of partners in a general partnership.

Limited liability company. LLCs can be member-managed or manager-managed. ULLCA §203 (manager-managed must be specified). Under most statutes, members in a member-managed LLC have broad authority to bind the LLC in much the same way as partners. ULLCA §301(a). Members have no authority to bind the LLC in a manager-managed LLC. Generally, voting in a member-managed LLC is in proportion to the members’ capital contributions, though some statutes specify equal management rights. ULLCA §404.

Members and managers of LLCs have fiduciary duties of care and loyalty, which vary depending on whether the LLC is member-managed or manager-managed. ULLCA §409. In a member-managed LLC, fiduciary duties parallel those in a partnership. In a manager-managed LLC, only managers have fiduciary duties; a member who is not a manager is said not to owe fiduciary duties as a member.

Corporation. The corporation has a centralized management structure. Its business is under the management and supervision of the board of directors. MBCA §8.01. Officers carry out the policies formulated by the board. MBCA §8.41. Shareholders elect the board, MBCA §8.03, and decide specified fundamental matters; they cannot bind the corporation.

Corporate directors and officers owe fiduciary duties of care and loyalty to the corporation and, in some circumstances, to shareholders. These duties are the bedrock of corporate law. Controlling shareholders also have more limited fiduciary duties, principally in exercising their control when the corporation’s business is sold. Shareholders may seek relief on behalf of the corporation in a derivative suit for breaches of corporate fiduciary duties.

§2.2.4 Withdrawal and Transferability of Ownership Interests

General partnership. A partner cannot transfer her interest in the partnership unless all the remaining partners agree or the partnership agreement permits it. RUPA §401(i). A partner may transfer his financial interest in profits and distributions, entitling the transferee (often a creditor of the partner) to a charging order. RUPA §502.

Limited partnership. A general partner cannot transfer his interest unless all the other general and limited partners agree or the partnership agreement permits it. RULPA §401. Limited partner interests are freely assignable. RULPA §702. Limited and general partners can assign their rights to profits and distributions. RULPA §703.

Limited liability company. Most LLC statutes provide that members cannot transfer their LLC interests unless all the members consent. ULLCA §503. Some LLC statutes permit the articles of organization to provide standing consent for new members. Many LLC statutes also permit transfer of financial rights to creditors, who can obtain a charging order against the member’s interest. ULLCA §504.

Corporation. Corporate shares are freely transferable unless there are specific written restrictions. MBCA §6.27.

§2.2.5 Liability to Outsiders

General partnership. General partners have unlimited liability. Their personal assets are at risk for all partnership obligations, whether they are contractual or arise because of misconduct (torts) of the partners
or partnership employees. RUPA §306. Under some statutes liability on partnership contracts is joint, so that partnership assets must first be exhausted. RUPA §306(a) (joint and several liability).

Limited liability partnership (LLP) statutes, which graft special limitations on liability into the general partnership statutes, limit the liability of partners for partnership obligations -- unless the partner engaged in personal misconduct or, under some statutes, supervised another partner or agent engaged in misconduct. RUPA §306(c) (official comment states “partners remain personally liable for their personal misconduct”).

**Limited partnership.** At least one partner must be a general partner, with unlimited liability. Limited partners are liable only to the extent of their investment so long as they do not “participate in the control” of the business. RULPA §303. Older statutes did not define “participation,” and courts construed the term broadly.

Limited partners were said to participate in control if they shared in operational decisions, retained control of financial matters, and decided the general partner’s tenure. See Holzman v. de Escamilla, 195 P.2d 833 (Cal. App. 1948). Modern statutes clarify that some activities do not constitute participation in control. Limited partners do not lose their limited liability merely by being officers, directors, or shareholders of a corporate general partner, voting on major business matters, or advising the general partner. RULPA §303. Limited liability limited partnership (LLLP) statutes limit the liability of the general partner—creating an LP with the essential attributes of a manager-managed LLC.

**Limited liability company.** LLC members, both in their capacity as capital contributors and managers, are not liable for LLC obligations. ULLCA §303. Some LLC statutes suggest that members can become individually liable if equity or justice so requires—so-called veil-piercing.

**Corporation.** Shareholders have limited liability for corporate obligations. MBCA §6.22. This is also true for directors and officers acting on behalf of the corporation. Corporate participants can lose only what they invested, unless they have contracted for personal liability or there is fraud or an inequity that justifies “piercing the corporate veil.” Often, large creditors of small corporations will demand that corporate participants personally guarantee the corporation’s obligations, thus reducing the significance of corporate limited liability.

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**NOTES**

1. Since 1996 any business, whether formed as a partnership or not, can elect flow-through tax treatment, so long as the business is not incorporated under state law as a “corporation” and the ownership interests of the business are not publicly traded. Treas. Reg. §§ 301.7701-1 to -3 (1996). As a result, LLCs have grown greatly in popularity since they have the tax attributes of a partnership and the limited liability of a corporation.

2. The growth in the use of LLCs, compared to corporations, for closely-held businesses has been remarkable. In 2003, for example, 45.4% of all business filings were for LLCs, and in 29 states more LLCs were formed than corporations. Howard Friedman, *The Silent LLC Revolution - The Social Costs of Academic Neglect*, 38 Creighton L. Rev. 35 (2004) ([SSRN Paper 613022](https://ssrn.com/abstract=613022)) (decrying lack of curricular and academic attention to LLCs).

3. Consider the following two documents, each purporting to create a business organization. Are they valid? Which was filed with a public official? What information do they disclose? What matters are covered in the documents –
Before I forget, I just wanted to jot down on this napkin that Alice had lunch with me today. We agreed to go into business selling costume jewelry on weekends in Central Park. She agreed with me that we’ll make lots of money.

Date Filed: 7/3/2000 12:42 PM
Elaine F. Marshall, NC Secy of State

Limited Liability Company
ARTICLES OF ORGANIZATION

Pursuant to Section 57C-2-20 of the General Statutes of North Carolina, the undersigned does hereby submit these Articles of Organization for the purpose of forming a limited liability company:

1. The name of the limited liability company is AND, L.L.C.
2. The name and address of each organizer are: Maurice S. Hull, Suite 400, High Point Bank Building, 300 Main Street, High Point, NC 27260
3. The street address and county of the initial registered office are: Maurice S. Hull, Suite 400, High Point Bank Building, 300 Main Street, Guilford County, High Point, NC 27260
4. The mailing address if different from the street address of the initial registered office is:
5. The name of initial registered agent is: Maurice S. Hull
6. Check one of the following:
   ____ Member-managed LLC: all of the members by virtues of their status as members shall be managers of this limited liability company.
   _X__ Manager-managed LLC: except as provided by statute, the members of the limited liability company shall not be managers by virtue of their status as members.
7. To the fullest extent permitted by NC LLC Act, no person serving as manager of the limited liability company shall be personally liable to the company or any members for monetary damages for breach of duty as manager.
8. These articles are effective upon filing.
2. Companies (societa) – Italy

Here’s an introduction to “societa” (or companies) in Italy. It’s a bit dated, and where there have been changes in the law, they’re noted. But you’ll notice that the general partnership, limited partnership, limited liability company, and even corporation also exist in Italy. The more esoteric alphabet soup – limited partnership (LLP), limited liability limited partnership (LLLP), and closely held corporation (CHC) still haven’t made it across the Atlantic.

OK, now that you’re getting to talk like a corporate lawyer, did the LLC come first or the SRL? If an SAS falls in the forest, but nobody is there, does it make a sound?

Companies in Italy (le societa)
[mystery book, circa 1995]

INTRODUCTION

A company (societa) is the collective exercise of an enterprise. From an organisational point of view, companies may be divided between (1) companies of persons and (2) share companies. Companies of persons comprise the simple partnership (societa semplice), the partnership (societa in nome collettivo - or SNC), and the limited partnership (societa in accomandita semplice) -- all of which are characterised by the profit motive.

Share companies, the other hand, may have either a profit motive or an object of mutual benefit. Share companies with a profit motive are the public company (societa per azioni - or SpA), the stock company (societa in accomandita per azioni), and the private company (societa a responsibilita limitata - or SRL). Share companies with an object of mutual benefit are the societa cooperativa a responsibilita limitata, the societa cooperativa a responsibilita illimitata and the societa di mutua assicurazione.

Although the legal nature of the formative act of a company has been controversial in the doctrine, the Civil Code specifically regards it as a contract. The parties are free to select the type of company which is to be formed subject to one limitation only, namely, that a company with commercial objects cannot be a simple partnership.

The basic distinction between personal and share companies is that the latter have a perfect patrimonial autonomy, that is, the patrimony of the company is distinct from the patrimonies of its members as a result of which the members are only liable for the company’s debts to the extent of their shareholding and, conversely, the company is not liable for the personal liabilities of its shareholders. In the case of personal companies, on the other hand, there is only an imperfect patrimonial autonomy because there may be the liquidation of a partner's share to meet his personal liabilities and, moreover, there is the unlimited liability of the partners for the obligations of the partnership.

THE SIMPLE PARTNERSHIP (la societa semplice)

This is the most elementary form of company and may be defined, by way of exclusion, is that type of company which cannot be constituted in any of the other forms permitted by law. Its fundamental
characteristic is that it may only have a lucrative non-commercial economic activity. This form of company is, therefore, only available for agricultural activities and management of immovables. An ‘economic activity’ (not just enjoyment of property) is necessary for the company's existence.

No particular form is required in respect of the contract setting up the company and it may, therefore, even be oral. However, because certain contracts are subject to registration, that is, where the contribution of a member consists of immovables or the company is to have a life exceeding nine years, the contract must in these cases be in writing. However, notwithstanding that in such cases the contract must be registered in the registry of deeds, it need not be registered in the registry of enterprises.

The company's capital consists of the contributions of members which may be in cash, kind, credit or services. The contributions or quotas are defined by the company contract or, in its absence, are deemed to be equal. The right of management belongs severally to each partner who has an unlimited responsibility. However, the parties are free to vary the general rule and may provide for a joint management in which case the consensus of all management partners is required. Except for those decisions which are expressly required by the Code to be unanimous, the doctrine is in disagreement as to whether decisions must be unanimous or by majority.

The company name must contain the name of one or more partners. Each partner, after approval of the accounts, has a right to receive his share of the profits. This is a major distinction between personal and share companies, since in the latter the distribution of profits to members is subject to the deliberation of the general meeting. In the absence of definition by the company constitution, the division of profits and losses is presumed to be proportional to the contributions of the partners. If the contract defines the division of profits only, then any losses are presumed to be divisible in the same proportions. The partners are free to vary such criteria with the only limitation being that they cannot totally exclude any partner from participating in the profits and losses of the company as this would strike at the very basis of the existence of the company, that is, the profit motive which is connected with the element of risk.

A company, according to A.2266 cc, acquires rights and assumes obligations through those partners who are authorised to 'represent' it. Where, however, the company constitution does not provide otherwise, each management partner is entitled to represent the company. The liability for obligations assumed on behalf of a company are satisfied in the following manner and order. First, a company creditor may proceed against the company's patrimony (A.2267 cc). Second, a creditor may proceed against the partners who acted for and on behalf of the company. The liability of such partners is direct, unlimited, personal, and joint and several. Third, the creditor may proceed against all other partners who are, subject to any agreement to the contrary, presumed to be personally and jointly and severally liable for the company's liabilities. Any limitation to the liability of a partner may only be raised against those creditors who had notice of any agreement to that effect. The possibility of restricting liability for company obligations to some members only of a simple partnership is a characteristic which distinguishes it from the ordinary partnership in which all of the members are unavoidably liable.

A person may cease to be a partner by death, resignation or exclusion, none of which will, in general, determine a dissolution of the partnership. The death of a partner obliges the surviving partners to liquidate the share of the deceased for the benefit of the latter's heirs. In such an event, the surviving partners may also elect to dissolve the partnership or, if the deceased's heirs agree to continue the company with them. As far as resignation is concerned a partner may resign from a partnership in the following circumstances; at any time upon giving three months' notice, where the duration of the partnership is either indefinite or for the life of one of its members; second, for just cause only where the partnership is of a definite duration; and third, upon the occurrence of any event defined by the contract as entitling resignation. In every case, the resigning member is entitled to the liquidation of his share.
A partner may moreover, be excluded from the partnership either at the instance of the other partners upon the occurrence of certain causes defined by law, e.g. interdiction and the breach of certain provisions of the partnership agreement, or by operation of law where the continuation of the partnership is impeded through an occurrence referable to a partner, that is, the liquidation of a partner's share either at the instance of a personal creditor or pursuant to his bankruptcy.

A simple partnership is dissolved, according to A.2272 cc, in the following instances: lapse of time, where the partnership was for a limited duration and it has not been extended; fulfilment of the objects of the partnership or their supervening impossibility; agreement of all of the partners; a fall in the number of partners to one only unless the position is rectified within six months; and for any other cause provided for in the partnership contract.

PARTNERSHIP (la societa in nome collettivo: SNC)

The ordinary partnership is specifically regulated by Art. 2291–2313 cc. Its fundamental and distinguishing characteristic is the unlimited joint and several personal liability of all of the partners for the partnership liabilities. The partnership agreement, which must contain certain details, must be in writing and registered in the registry of enterprises. In the absence of agreement by the other partners, a partner cannot take part in any activity that competes with the company.

The patrimonial autonomy of an ordinary partnership is more rigid than that of a simple partnership. The liability of the partners for company obligations is both unlimited and joint and several. However, the liability of the partners is a subsidiary liability only in that the company creditors must first execute upon the company assets and only in the case of their insufficiency may the creditors proceed against the personal estate of the partners.

The company is required to prepare annual accounts comprising a balance sheet and a profit and loss account. The company may be dissolved upon the same grounds as for a simple partnership, as well as for bankruptcy or upon an order issued by the relevant government authority.

THE LIMITED PARTNERSHIP (la societa in accomandita semplice)

The basic characteristic of this type of partnership is the existence of two classes of members: first, limited partners whose liability is limited to the extent of their contributions and who cannot participate in the management of the company; and second, unlimited partners who have an unlimited secondary liability for the obligations of the company and are entitled to its management. The existence of both types of partner is essential to the formation of the limited partnership and if either class subsequently becomes non-existent for more than six months the company must be dissolved.

All of the norms on ordinary partnership, as far as applicable, also regulate the limited partnership. However, the limited members cannot include their names in the company name which must be made up of the name of at least one unlimited partner and indicate the type of company. If this restriction, or the prohibition on management, is infringed by a limited partner, the partner loses the advantage of limited liability and, for the latter type of breach, may be excluded from the partnership. Given their limited influence upon the activities of the company, the shares of limited partners may be freely alienated both by will and, subject to contrary agreement, by inter vivos transaction provided that in the latter case the transfer is approved by a number of members representing the majority of the company capital. The transfer of the shares of unlimited members, on the other hand, depends upon the consensus of the partners, subject to any agreement to the contrary.

THE PUBLIC COMPANY (La societa per azioni: SpA)
This is both the principal type of company and the most appropriate company structure for large enterprises which involve a considerable capital and the assumption of a notable risk. [As of 1999 there were 57,000 public companies registered in Italy.] The peculiar characteristic of this type of company is that the relationship between the company and its shareholders is impersonal and anonymous; this explains why it was known as the ‘societa anonima’ under the previous legislation. The three distinguishing features of the SpA are: first, the liability of the shareholders is limited to their contributions; second, the participation of the shareholder in the company is represented by shares of equal nominal value; and finally, the company must have a minimum capital of no less than Lit. 200 million [now €120,000], so that companies with a lesser capital may only incorporate as a societa a responsabilita limitata (SRL).

The SpA is basically regulated by the Civil Code although there have been many recent changes introduced by special legislation. [In particular, there were significant changes to the rules governing publicly-listed SpAs in the Draghi reforms of 1998, and then even more fundamental changes in the company law reforms of 2003.] These changes [as of 1995] comprise the increased publicity required of SpAs which are listed on the stock exchange by the introduction of a series of public controls administered by the newly established National Commission for Companies and the Stock Exchange (“CONSOB”); the introduction of a new type of privileged share, the investment share (azioni di risparmio); the better publicity and regulation of economic concentration; the better information of shareholders on matters of management; an a restriction upon the use of proxies at general meetings.

A public company comes into existence upon the fulfilment of three conditions.  First, the stipulation of the company contract or Memorandum at Association (which is the constituent act) and the Articles of Association (which regulates the operation of the company). The Memorandum of Association must be, upon pain of nullity, in the form of a public deed prepared by a notary. Article 2328 cc [which was amended in 2003] lists those matters which must be specified by the company Constitution: the name, place and date of birth, address, and nationality of shareholders and the number of shares held; the company name which may even be fictional provided that it includes an indication of the type of company; the seat and any branches of the company; the objects of the company which are merely indicative of its activity as there is no doctrine of ultra vires; the subscribed and paid-up capital; the nominal value of shares; the total number of shares; the value of any credits and payments of kind, verified by a court-appointed expert; the criteria for the division of profits (subject to the restriction preventing the exclusion of any member from their enjoyment) in the absence of which there is a presumption is favour of their proportional distribution; the share of profits to be taken by foundation members; the number and powers of directors; the number of supervisory members, and the duration of the company.

The major aspects concerning the pre-incorporation activities of a company (A.2331 cc) are: first, the prohibition on the issue and alienation of shares prior to the registration of the company and second, the joint and several unlimited liability of persons who have acted in the name of the company prior to its incorporation.

The valid formation of a company requires a plurality of subscribers, in whose absence the formative act is null. A shareholding in an SpA gives the right to vote at general meetings as well as certain patrimonial rights: the right to the dividend declared by the general meeting, the right to share in the residue of the company assets upon its dissolution, and the pre-emptive right to subscribe to new share issues. Shares must be nominative (and therefore transferable by entry in the company’s register) except in the case of investment shares which may also be bearer. Shares are, like negotiable instruments, freely transferable although the company constitution may impose certain restrictions such as the requirement of certain subjective or objective conditions in the transferee, the subjection of the transfer to a discretion of a company organ which need not give reasons for its refusal, and pre-emption provisions in favour of existing shareholders.
The Code contains a large number of provisions designed to protect the capital structure of the company. Briefly, these provisions: prohibit the issue of shares or convertible debentures at below their nominal value (Arts. 2346 and 24200 (bis cc); subject to certain exceptions, prohibit a company acquiring its own shares or the shares of a company it controls (Artt. 2357 and 1359 bis cc); prohibit the reciprocal subscription of shares by companies (A.2360 cc); prohibit the distribution of profits not actually received (A.1453 cc); and oblige a reduction in capital in those cases in which the company assets have fallen by more than one-third as a result of losses (A.2446 cc). Moreover, A.2428 cc requires that at least 5% of a company's net annual profits be set aside in a reserve fund until an amount equal to one-fifth of the company's capital is accumulated. This statutory reserve cannot be distributed but may be diminished in exceptional circumstances after which it must be reintegrated when conditions permit. The publication of a company's capital position is ensured through the detailed provisions in the Code which oblige companies to prepare clear and precise accounts at the end of each financial year.

The structure of an SpA consists of the general meeting (l’assemblea), the directors (gli amministratori), and the supervisory auditor council (il collegio sindacale). [In 2003, three management structures became available: (1) the traditional board structure, with a board of auditors to monitor of legal/financial compliance and good management; (2) a monistic board of directors, with the audit function delegated to a board committee; (3) a dualistic structure where members of the management board are chosen by a supervisory board, which serves the function of the statutory auditors.] The general meeting is the deliberative organ of the company although, in practice, the effective centre of power lies with the directors. Depending upon the matter for decision, the general meeting is either ordinary or extraordinary. The ordinary general meeting takes place at least annually and decides all matters of ordinary administration: it appoints the other company organs, approves the annual accounts, takes action in cases of maladministration and decides all other matters reserved to it by the company constitution or submitted to it by the directors. An extraordinary general meeting, on the other hand, decides particular matters such as changes in the constitution and articles of the company, debenture issues and the appointment and powers of liquidators.

The management of the company may be entrusted either to a sole director or to several of them in which case they constitute a board. Directors need not be shareholders and are appointed for three years with eligibility for re-election. Their appointment must be notified to the registry of enterprises which must also receive their specimen signatures within 15 days of their appointment. Moreover, directors must post a security in the form of nominative shares in the company or nominative government bonds. The directors have a tripartite responsibility. First, they are responsible to the company in damages for the in observance of their duties. This is a responsibility which is based upon their contractual relationship with the company. Second, they are responsible to the company creditors for the observance of any obligation inherent in the preservation of the company capital. Finally, they are responsible to the individual shareholders and non-creditor third parties who are directly damaged by their fault or fraud. Moreover, it must be remembered that as there is no doctrine of ultra vires, acts outside the scope of the company objects cannot be raised against a third party acting in good faith (A.2384 bis cc).

THE STOCK COMPANY (La società in accomandita per azioni)

This is an incorporated company in which the members possessing power (the director-members) have as unlimited personal liability for the company’s obligations. It is the SpA except that the power of management belongs to permanent directors who as a quid pro quo for their dominant position bear an unlimited, even if only a secondary, personal liability for the company's obligations. This form of company is today without a future and there are no more than 20 in existence.

THE PRIVATE COMPANY (La società a responsabilita limitata: SRL)
This form of organisation enables smaller enterprises to adopt a non-personal company structure and therefore benefit from a limited liability. In other words, it is a form of organisation midway between an SpA and the personal companies or partnerships. It is regulated by specific Code provisions, some of which reproduce exactly the provisions applicable to the SpA and others of which merely apply, by reference, the norms applicable to the latter. In contrast to the SpA, it is characterised by a more flexible structure and greater participation of members in the company's management.

The company must have a minimum capital of Lit.20 million [now €10,000] which is not divided into shares but 'quotas.' Each member's liability is limited to the extent of his contribution or quota which is normally transferable and divisible. The company constitution must be in the form of a notarised deed (A. 2463 cc) and indicate the name and personal details of members, the company name which must indicate that it is a company with a limited liability, the company seat, the company objects, the amount of subscribed and paid-up capital, the quota of each member together with the value of any property and credits paid towards his contribution, the manner of division of profits, the number and powers of directors, the number of members on the supervisory council (if the company constitution provides for one) and the duration of the company.

The company acquires legal personality upon its registration in the registry of enterprises. Membership of the company ceases by voluntary withdrawal, transfer of the relevant quota, execution upon the member's quota by his creditors, bankruptcy, forced sale of a member’s quota to recoup arrears is contributions, and expulsion of the member. The SRL cannot, in contrast to the SpA, issue debentures. The company organs, like the SpA, comprise the general meeting, the directors, and the supervisory council. However, the management structure of an SRL differs to an SpA in the following ways: the company constitution may provide that the management of the company be entrusted to non-members; directors may be appointed for terms exceeding three years or indefinitely; and the directors are not required to post any security. The nomination of a supervisory council is only mandatory for companies with a capital of Lit. 100 million or over [now €50,000]. Where there is no council, the control over the company is exercised by the individual members through certain rights which are guaranteed by the criminal law, namely, the right to request information of the directors, the right to inspect company books, and the right of one-third of the members, at their own expense, to require an audit.

NOTES

1. Entrepreneurs need capital. What are the choices for a start-up business? Should the entrepreneur borrow from a bank or from trade creditors? In Italy using trade credit is a common form of financing. Is it more expensive than bank loans? See Giuseppe Marotta, Is Trade Credit More Expensive than Bank Loans? Evidence from Italian Firm-level Data, SSRN paper 260064 (Feb. 2001) (finding inter-firm credit received by Italian manufacturing firms to be only slightly more expensive than bank loans).

2. An ambitious entrepreneur has some investors who believe in her. She wants to form a business – a vessel into which she’ll pour her human capital and her investors their money capital.
   a. Make a quick chart of the business forms are available for the business in the United States? in Italy?
   b. What business forms are similar in name and functions? In what ways do these business forms differ?
   c. Who will the entrepreneur consult to form her business – in the United States? In Italy?

3. As you stroll about Venice or travel in Italy, take the time to collect receipts for your many purchases of goods and services. Notice the names of the businesses.
   a. Why do larger businesses use the “SpA” form?
b. What businesses seem to use the “SRL” form? Why not SpA?
c. When do you see an “SNC” – what are the different types?
d. Did you find an “SAS?” What happens if the legislature creates a business form and nobody uses it?

4. Consider the following Articles of Ordinary Partnership for an actual Italian company. From this document, consider how this Italian business organization differs from its US counterparts – namely, a partnership and an LLC? How is the Italian constitutive documents different from a comparable partnership agreement or LLC articles of organization under US law?

5. Compare these documents to their counterparts under US law. Which is more complete? What matters are covered in the Italian constitutive document that is not covered in the US documents?
   - Name of business?
   - Registered office (what is this)?
   - Duration of business? Purpose?
   - Identity of investors? Identify of managers?
   - Size of investment? Return on investment?
   - Who runs business? Who can bind the business?
   - Transferability of interests?
   - Dispute resolution?

6. What is the role of the notary in the following document? Is there a comparable legal professional involved in the formation of US business organizations?

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**ARTICLES OF ORDINARY PARTNERSHIP**

**Italian Republic**

The year one-thousand-nine-hundreds-eighty-eight, the day twenty-seven of the month of July (27th of July 1988). In Venice, in my office in San Marco 1812. Before me Aurelio Minazzi, notary in Venice, registered at the Notary’s College of Venice, without attendance of witnesses, the parties meeting the requirements of law, in agreements between them and with my consent,

**HAVE BEEN CONSTITUTED**

Silvestro Claudio, born in Venice the 9th of July 1952, resident in Venice Lido, Alvisopoli Street no.7, dealer, fiscal code SLV CLD 52L09L736Y and Fabris Monica, Born in Venice the 30th of March 1963, resident in Venice Murano, F.ta Navagerono.24, civilian, fiscal code FBR MNC 63 C70 L736D.

aforesaid, Italian citizens, form an ordinary partnership, regulated as follows:

**PARTNERSHIP TERMS**

**Corporate name:** “Silvestro & Fabris S.N.C.”

**Registered office:** The company is located in Venice, Castello no.1810. Secondary offices, branches and agencies could be constituted whether in Italy or abroad.

**Object:** The partnership’s purpose is the sale and purchase of haberdashery, lingerie, underwear, garments and accessories, leather goods, textiles and costume jewelry. Moreover, the partnership may engage in all appropriate and necessary operations to achieve its purpose and may acquire shares of
other companies having similar or connected purpose, access every kind of credit, and give surety bond to third parties.

**Capital:** The partnership’s capital is ITL.5.000.000 (five millions). The partners deposit it in cash and in equal parts.

**Terms:** The partnership will last until 31 Dec 2000. Thereafter, its term is deferred from year to year without presentation of notice.

**Fiscal year:** The fiscal year is from the January 1 to December 31 of each year. The first fiscal year ends the 31st of December 1988.

**Administration:** The ordinary and extraordinary administration of the partnership belong to Silvestro Claudio and Fabris Monica, the owners. They may represent the partnership with third parties and in judgement severally for the ordinary administration and jointly for extraordinary administration.

**Budget and profits:** At the end of the fiscal year, the managing partners will close the books and the profit and loss account, which will be presented to the other partners within three months for their approval. The profits and the possible loss will be distributed to the partners according to their share of the company. Any amounts deposited by a partner to the budget and/or financial account will not produce any interest.

**Inter vivos trasfer of shares:** The shares can be transferred and considered valid for partnership purposes only under agreement of the other partners.

**Transfer of shares on death:** If one of the partners should die, the heirs will be paid according to the partnership’s assets at death. With agreement of the other partners, the partnership continues with the deceased partner’s heirs.

**Dissolution and liquidation:** In case of dissolution, the partners will nominate one or more liquidators. If the partners cannot agreed, the nomination of the liquidators will be made by the chamber of commerce of Venice on instance of the most diligent partner.

**Arbitration:** Any disputes between the partners and between the partners and the partnership will be submitted to an arbitrator nominated by the partners or in case of disagreement by the president of the court of Venice. The arbitrator’s award will be unappealable and without formalities of procedure.

I delivered this deed to the partners. It has been typed according to the law from a trusted person on two pages of one sheet.

Notaio Aurelio Minozzi

Wow! The constitutive document for an Italian partnership is a much more formal than for a US partnership – which doesn’t even need a document. But there is a lot more clarity: we know where this partnership operates, what its business entails, who manages the partnership and how management powers are assigned, how profits are distributed, and whether the partnership continues after one partner’s death. We even know how disputes are resolved. Are these matters clear in a US partnership – like the one created when Alice and Bob agreed to sell costume jewelry in Central Park?
We have already seen how US law has created corporations (splitting regulation between the states and federal government) and unincorporated entities like partnerships and LLCs. What is the history of the way in which businesses are governed in Italy? It should not surprise you that the answer comes from the economic history of the country and the “codes” – here goes!

Corporate Governance Changes in the 20th Century: A View from Italy
Professor Guido Ferrarini [University of Genoa]
SSRN Paper 695762 (2005)

1 INTRODUCTION

This paper analyzes the Italian experience with corporate governance during the past 150 years, reflecting broadly four stages of development: liberalism, the mixed economy (mounting role of the state in the economy), the welfare state, and the new economic constitution (crisis of the welfare state). Many recent changes were determined by the European Union either directly through legal harmonisation or indirectly from European developments that reflect global pressures favoring convergence.

2 LIBERALISM AND THE COMMERCIAL CODES

During the second half of the 19th Century after Italy’s unification, industrialisation was limited and the country was mainly rural. The liberal State (limited role of the State in the economy) was confronted with industrialisation only at the turn of the century, when the Italian economy joined the second industrial revolution led by the U.S. and Germany. Early industrialisation was accompanied by the creation of a number of public enterprises mainly in the area of public services, insurance and banking.

2.1 The Commercial Codes’ Rules on Companies

A main issue in the new Italian Kingdom concerning company law was whether limited liability companies should be subject to governmental authorisation, as provided by the pre-unification commercial codes. In 1862, a proposal was made to abolish the authorisation regime as incapable of preventing frauds and excessively limiting freedom of trade. However, the proposal was rejected in the first Italian Commercial Code in 1865, which instituted a new Control Office (Uficio di sindacato) both to authorise new companies and to monitor existing ones.

It was only with the second Commercial Code, adopted in 1882, that a more liberal attitude was taken and governmental authorisation was abolished, as had already been done in France in 1867. Consequently, the conditions as to company formation were specified by the Code, and the Civil Tribunal was empowered to ascertain these conditions before the company’s registration.

The Code was the result of a decade-long drafting effort with the participation of Italy’s finest scholars, who drew on European homologues (English Law of 1861, French Law of 1867, German Commercial Code of 1861, Belgian Law of 1873). The Italian Code included, for those times, advanced regulation of limited liability companies (società anonime). Amongst the novelties was the introduction of a board of auditors to monitor the company’s management and accounts on behalf of shareholders and creditors, along the model of English Law, and, as a counterbalance, the abolition of the administrative surveillance regime.

2.2 Industrialisation and Financial Development
With only minor modifications, the Commercial Code of 1882 remained in force for sixty years. However, the economic development that occurred throughout this period strained the Code’s regulation of limited companies – particularly, the formation of company groups, cross-shareholdings, voting limitations and multiple voting shares, controlling minorities and the separation of ownership and control. At the time of the Code’s adoption, Italy was mostly a rural country, but in the first decade of the 20th century, new industrial companies were formed to produce electricity, steel, automobiles, tyres, trains, typewriters -- with the financing from a few large banks and the support of the State.

3 THE “MIXED ECONOMY” AND THE CIVIL CODE

The period defined as “mixed economy” covers approximately thirty years extending from Fascism to the new Republican Constitution (1948). It is characterized by State dirigisme and an increasing role for public ownership of enterprises. Whole sectors of the economy such as shipping lines and telephone services (1922), air transport (1923), mining and broadcasting (1927) and waters (1933) became public monopolies. Access to almost all economic activities (banking, commerce, industry, insurance, export trade) was subjected to authorisation by the government, while the authorisation regimes were often exploited by the incumbents to protect their monopoly profits.

In 1942 the Civil Code and its rules on companies were enacted following numerous attempts at company law reform throughout the whole period.

3.1 The Great Crisis (Fascism in Italy)

The world economic recession of the 1930s jeopardized the Italian banking system and almost half of the country’s large industrial companies. In response, the Government created the Istituto per la Ricostruzione Industriale (IRI), which became the controlling shareholder of several industrial conglomerates and of the main Italian banks. Public ownership of business was originally intended as a temporary measure, but subsequently became a stable solution, characterising our system as a ‘mixed economy’. Not only several industrial conglomerates, but the prevailing part of our banking system, were owned by the State until the wave of privatisations in the 1990s.

3.2 The Civil Code of 1942

The Civil Code of 1942 replaced both the Civil Code of 1865 and the Commercial Code of 1882 – thus unifying private law. The Civil Code’s rules on limited liability companies distinguishes between private companies (società a responsabilità limitata) and joint-stock companies (società per azioni), but dedicates an incomplete regulation to the latter type of companies. In 1956 a leading corporate jurist, Tullio Ascarelli, highlighted the wide existence of ‘controlling minorities’ in listed companies and the ensuing separation of ownership and control.

The Civil Code’s fate was similar to that of the Commercial Code, to the extent that not many years after the Code’s adoption Italy went through a phase of extraordinary economic development, known as the ‘economic miracle.’ Industrial productivity increased substantially, partially a consequence of the Common Market’s liberalisation, and this was reflected by the stock market’s exceptional performance in the post-war period – even though the small number of listed companies remained substantially unchanged.

4 THE WELFARE STATE AND THE RISE OF SECURITIES REGULATION

From the middle of the 20th century to the 1970s, the Italian welfare State kept the ownership of companies concentrated and the securities markets relatively underdeveloped. This was consistent with the story in other social democracies, in Europe and Japan. As found by Professor Mark Roe, "Social
democracies demeaned shareholder primacy, pushing firms to stabilize employment, to expand whether or not expansion was profitable for shareholders, and to avoid change that would disrupt the quality of the work place.”

Reform of company law and stock exchange law took place in 1974, based on the idea that shareholders-investors can protect themselves by “voting with their feet” and selling their shares in underperforming companies. Reformers argued the legislator should protect such investors by introducing mandatory rules, improving disclosure and caring for the investors’ rights to dividends. In addition, a Securities Commission (Consob) was created with competencies on corporate disclosure and stock exchange trading. In addition, information duties were placed on listed companies and companies making recourse to the capital markets.

5 THE NEW ECONOMIC CONSTITUTION AND COMPANY LAW REFORM

The last two decades of the 20th century brought forth in Italy (and Europe) a “new economic constitution”. First of all, the EC’s internal market was completed and a rigorous competition policy was developed by the EU to integrate markets.

5.1 Improving Securities Regulation

Liberalization of capital movements by the EC in the 1980s helped to eliminate resistance to securities market’s development in Italy. In addition, the privatisation program led by the Italian government throughout the 1990s widened the shareholders’ base in large companies and enhanced the stock market’s liquidity.

As a result, Italian securities regulation was radically transformed. In 1991, insider trading was forbidden in compliance with the relevant EC Directive. In the same year, investment companies (società di intermediazione mobiliare) were introduced into our legal system to operate as multifunctional intermediaries replacing individual stock-brokers (agenti di cambio), who could only act in a broking capacity. At the same time, the regional stock-exchanges were merged into a national stock-exchange (the Milan bourse became the Italian Stock Exchange). In 1992, takeovers were regulated and a mandatory bid rule was introduced to protect minority shareholders.

5.2 The Draghi Law

The Financial Markets Consolidated Act of 1998, also known as the Draghi Law after its Drafting Committee’s Chairman, included new rules as to listed companies’ disclosure and governance. The emphasis on corporate governance at the international level, both in practice and academia, rendered the 1974 mini-reform inadequate, since it undervalued the internal governance of listed companies by focusing on disclosure and public regulation.

The Draghi Law strengthened the board of statutory auditors’ (collegio sindacale) powers and responsibilities, so as to enhance its monitoring over the company’s management by the executive directors and the board of directors. This aspect echoed the Anglo-American discussion on the role of non-executive directors, audit committees and internal controls. However, convergence was functional rather than formal. The law reinforced minority shareholders’ powers, introducing, inter alia, the right of a qualified minority (5 per cent) to sue the directors for damages caused to the company.

While in 1994, Italy had been ranked amongst the industrialized countries with the lowest legal protection for investors, with shareholder rights scoring a meagre 1 out of 6, the 1998 reform was improved the shareholder protection score to 5 of 6. The number of listed companies went from 239 in
1997 to 279 in 2003, and the ratio of stock market capitalisation to GDP moved from 30.7% in 1997 to 37.6% in 2003, after reaching 70.3% at the heights of the world equity markets in 2000.

5.3 The 2003 Company Law Reform

With its focus on listed companies, the Draghi Law widened the regulatory differences between listed and unlisted companies. An extensive overhaul of the limited liability company rules, enacted in 2003, distinguished between private companies (società a responsabilità limitata) and joint-stock companies (società per azioni). As to the former, the prior regime was deregulated to simplify the formation of these companies and allow more freedom in their organisation, so as to reflect their nature of closed companies.

As to joint-stock companies, the relevant rules were reformulated on the assumption that companies that make recourse to the equity markets become ‘public companies’ subject to stricter regulation. Moreover, three new governance structures are now available: one reflecting the structure presently in force, which consists of a board of directors and a board of statutory auditors (in addition to external auditors auditing the company’s accounts); another reflecting the German two-tier structure, however adapted to the Italian context; and a third one inspired by the Anglo-Saxon unitary board, with a majority of independent directors and a mandatory audit committee.

A critical assessment of the company law reform concluded that, at least with regard to public companies, the Italian legislator adopted solutions designed to relax, rather than reinforce minority shareholders’ protection. Examples include the transfer of powers from the shareholders’ meeting to the board of directors (for instance, as to issuance of bonds), by the limitations introduced on the ability of minorities to plead for the annulment of shareholders’ resolutions, and by the choice as to governance systems (which could result in a relaxation of internal controls if the unitary model were chosen to the preference of the traditional Italian model).

5.4 Financial Scandals and the Need for Further Reforms

While the company law reform was being enacted, serious financial frauds - including those concerning Parmalat’s false accounts and the ensuing record losses to investors - were widely investigated. The recent scandals showed that corporate governance and disclosure rules, despite their convergence towards international best practices, were insufficiently enforced. The scandals also made clear that Italian regulation of auditors is inadequate to the extent that Consob, the public regulator, almost blindly relies on the work done by auditing companies with respect to audited issuers, rather than periodically controlling the quality of the audit work.

NOTES


   The Reform changes dwarf all other corporate law reforms since the Code's enactment in 1942. Even more significant than its introduction of new instruments and rules, the Reform really revolutionizes some of the underlying principles of Italian corporate law. Prior to the Reform, Italian corporate law contrasted dramatically with the United States and other common law systems (but was consistent with its civil law
cousins) by its systematic preference - in relative terms - for mandatory rules over enabling rules. In post-Reform Italy, by contrast, Italian corporate law is less rigid and the degree of contractual freedom allowed in drafting (or amending) corporate bylaws has increased significantly.

3. The aims of the Italian company law reform have been described as four-fold:

- **Competitiveness.** Consistent with a recurring theme of company law reform in Europe, the Italian company rules are modernized to enhance the creation of new business firms and to make them more competitive in product and capital markets. For example, stock companies gain almost unlimited freedom to create special classes of shares, thus to tailor financial and governance rights for investors – such as venture capitalists who typically ask for convertible preferred stock.

- **Flexibility.** The new reforms give parties greater flexibility to choose their own structure and rules – such as, one-member firms, limits on transferability, easy access to public debt markets. The mantra, borrowed from US corporate law, is “party autonomy.” For example, stock companies (SpA) can now choose one of three corporate governance schemes: (1) a traditional Italian structure in which company management is entrusted to a board of directors, with a board of auditors (so-called statutory auditors) serving as monitors of legal/financial compliance and good management; (2) a one-tier board of directors, which delegates the audit function to a board committee; (3) a two-tier structure where members of the management board are chosen by a supervisory board, which approves business plans of the management board and serves the function of the statutory auditors. And private companies (SRL) can choose to be member-managed or board-managed, much as for LLCs in the US.

- **De-regulation.** The reduction in the scope and number of mandatory rules is particularly noticeable in the SRL, which loosens the requirements on capital formation (permitting any contribution if “economically valuable”) and allows greater freedom to contract for member veto rights, transferability limits, or actions without a meeting. In stock companies (SpA), assets can be segregated within the firm for specific businesses without the need to create separate subsidiaries – thus avoiding the costs of forming new subsidiary entities. In addition, challenges to shareholder resolutions in stock companies (SpA) – once a common way for shareholders to seek judicial recourse – is now limited to shareholders who hold a stated threshold (1% for listed companies, 5% for unlisted companies).

- **Re-regulation.** At the same time that parties have more contractual freedom, the reforms expand the protection of minority shareholders and creditors. Minority shareholders may bring derivative suits against company directors; greater majorities are required to change the company objectives. Nonetheless, the reforms appear to weaken the fiduciary duties of company directors in their information-gathering functions.

*See Guido Ferrarini, Paolo Giudici & Mario Stella Richter, Company Law Reform in Italy: Real Progress?, paper presented at Max Planck Institute for International and Comparative Private Law (June 2004).*
C. **EU Company Law**

However you think of companies – as contracts or social institutions – their importance to modern market capitalism cannot be denied. So when the Europeans looked at their situation in the post-War era and the idea of a European economic community gathered momentum, it made sense to strengthen market capitalism – and thus companies. Toward this end, and consistent with promoting free movement of persons, goods, services and capital, the Treaty of Rome specifically addressed companies:

- **Freedom of establishment.** The Treaty gives European nationals the right “to set up and manage undertakings, in particular companies . . . , under the conditions laid down for its own nationals by the law of the country where such establishment is effected.” Article 52 [now TEU Article 43].

- **Directives on “octopus” business.** Under the Article 54 [TCE 44] mandate to abolish “existing restrictions on freedom of establishment within the Community,” the Council is to enable the “setting up of agencies, branches or subsidiaries in the territory of a Member State.” Article 54(f) [now TEU Article 44(f)].

- **Directives on harmonizing company law.** Under the same Article 54 [TCE 44] mandate, the Council is to “coordinate ... the safeguards which, for the protection of the interests of members and others, are required by Member States of companies . . . with a view to making such safeguard equivalent throughout the Community.” Article 54(3)(g) [now TEU Article 44].

The Commission started out ambitiously to harmonize -- that is, to equalize -- the company law of the Member States as concerns public companies. The assumption, borrowed from other aspects of commercial law, is that differences inhibit free trade.

Harmonizing European company law over the last three decades has proved quite a task since company law in Europe, as in the United States, has been in flux. On both sides of the Atlantic, new legislation sought to keep up with the dizzying structures and uses of modern business organization: short-form mergers, tender offer defenses, incorporated joint ventures -- to name a few. And there were varying approaches to the same issues. In the United States, for example, in reaction to hostile takeovers, many states adopted different kinds of anti-takeover statutes.
Adding to the difficulty of one harmonized body of company law has been the reality that a company is a set of inter-related relationships. Shareholder voting rights are tied to management discretion, which is linked to board responsibilities, which varies according to limits on shareholder litigation, and so on. Implementing EC company law directives bit by bit became like a bodybuilding program limb by limb.

Making matters worse, the process for approval of EC company law proposals has been particularly opaque. Often proposals from the Commission, after comments from the Parliament, tend to sit with the Council for years, and sometimes even decades. Up until recently, the Council has deliberated (with its Committee of Permanent Representatives) in secret, sometimes making radical changes to proposed directives. As a result, the consumers of company law (investors, managers, creditors and employees) have found themselves with little voice in the design of a product intended to make their business/financial lives more harmonious.

Next is a reading that compares the way European company law has developed, compared to corporate law in the United States. Notice that the Europeans did not trust markets – either capital markets (where investors willing to make equity or debt investments operate) or chartering markets (where countries compete for business formation and oversight).

_The European Alternative to Uniformity in Corporation Laws_

89 MICH. L. REV. 2150 (August 1991)
Alfred F. Conard [Professor, University of Michigan Law School]

Although the European Communities chose many patterns of business law that were parallel to the American, they deliberately rejected the American freedom of each state to frame its corporation law to suit itself. They decided to impose not complete uniformity, but a degree of “coordination” of “equivalent safeguards” that they deemed appropriate to the existence of an economic union. Leading commentators have described the process as “harmonization.”

I. WHY COORDINATE?

A. The Silence of the Founders

The Community founders, for whom the United States was a case study yielding both positive and negative lessons, were surely aware of the competition among American states to attract corporations, in a rivalry characterized polemically as a “race for the bottom,” as a “climb to the top,” and more analytically as a “race of laxity.”

Unlike the U.S. Constitution, which made no mention of corporations, the Treaty of Rome not only mentioned corporations (as “companies”) but expressly authorized the Community to establish what Americans might call “minimum standards.” The Treaty called them “safeguards . . . for the protection of the interests of members and others,” and authorized the Community legislature to “coordinate” them “to the necessary extent . . . with a view to making such safeguards equivalent throughout the Community.”

By mid-1991, the Community had issued nine directives on company law, requiring “equivalent safeguards” in regard to incorporation, public filing, and financial reporting by domestic and foreign corporations, creation and maintenance of capital, domestic and interstate mergers, split-ups and split-offs, and accounting and auditing. Other directives on governance (including the voice of labor), on transnational mergers, and on takeovers were on the horizon.
Article 54 of the Treaty [now TEU Article 44] which authorizes the program deepens the mystery. The power to require “equivalent safeguards” is one of eight powers granted for the purpose of implementing “freedom of establishment,” which embraces the freedom of individuals to work, reside, and acquire property in states of which they are not citizens. A related article provides that companies have these rights to the same extent as individuals.

But the imposition of equivalent safeguards is not a grant of freedom. How was it supposed to contribute to freedom of establishment? The question is particularly puzzling to an American, who witnesses freedom of corporate lawmaking without “safeguards” other than those imposed by federal regulation of securities transactions. I will offer some hypotheses based largely on speculation and conversations with various European company law scholars.

B. Balance and Stability

Freedom of establishment was not listed among the primary objectives of the Treaty, but as a means of achieving objectives that were announced in Article 2 of the Treaty of Rome – namely, “a harmonious development of economic activities, a continuous and balanced expansion, an increase in stability, an accelerated raising of the standard of living, and closer relations between the member States.”

While the Community founders may have admired the productivity of the U.S. economy, they surely did not consider it ideal. In the 1950s, when the Treaty was framed, its architects had not forgotten the American depression of the 1930s, which they sometimes blamed for their own economic troubles of the same era. They knew that reckless corporation finance was widely blamed as a contributing cause of the depression, and that the American Congress had rushed in 1933 and 1934 to supplement lax state corporation laws with rigorous federal securities laws.

When the Community founders articulated their aspiration for “continuous and balanced expansion,” and for “an increase in stability,” they may well have been contemplating an economy more balanced and more stable than the one they had observed in America. They may have believed that these objectives could be achieved only by forestalling a race of laxity, and ensuring that company laws throughout the Community would require financial disclosure, fiscal prudence, and managements responsible to their constituents.

C. Gypsies at the Gate

The demand for safeguards may also have been a response to apprehension in each country that less reliable and less responsible companies of foreign countries would invade, and separate citizens from their wealth or their labor.

The position of foreign corporations in pre-Community Europe can be compared to that of out-of-state corporations (also called “foreign”) in the United States of the nineteenth century. The U.S. constitution makers had sought to assure freedom of commerce by discouraging states from imposing import and export taxes, and granting to citizens of each state the rights of citizens in other states that they might enter. But the founders did not mention corporations, which were too rare in the 1780s to attract their attention.

When the right of corporations of one state to enter another was asserted before the Supreme Court, the Court ruled, in an opinion by Chief Justice Taney, that freedom of movement under the Privileges & Immunities Clause could not be claimed by citizens operating through corporations. To do business in more than one state during years in which Taney's ontology of corporate nonexistence

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prevailed, enterprisers commonly formed a separate corporation in each state in which they wanted to operate.

The burdens of being “foreign” in a neighboring state were alleviated in 1888, when the Supreme Court decided that out-of-state corporations were entitled as “persons” to due process under the fourteenth amendment of the U.S. Constitution. The burdens were further diminished in 1910, when the Court invoked the equal protection clause of the fourteenth amendment to outlaw most forms of discrimination against out-of-state corporations.

In the armor of due process and equal protection, enterprises could incorporate in Delaware and do business where they chose. The notion of nonexistence survived only in rules that denied access to justice to an out-of-state corporation that had not been “admitted” to the state. But states now uniformly allow foreign corporations to register and acquire all the rights and powers of domestic corporations.

The Community founders, aware of the tortuous struggle of U.S. corporations for freedom of establishment, inserted in their own constitution an explicit guarantee of freedom of establishment for corporations as fully as for individuals. The Treaty declared:

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

If the doors had been opened to foreign corporations without “safeguards,” citizens of states with relatively rigorous laws, such as France and Germany, might have been exposed to the wiles of corporations of other states whose laws were already more permissive, or might be made more permissive in an effort to attract incorporations. If corporations were permitted to sell securities and make contracts without adequate requirements of disclosure and of financial strength, economic development might fail to attain the goals of “a continuous and balanced expansion” and “an increase in stability,” for which the Communities were formed.

One may reasonably infer that opening the doors to the corporations of other Community states was politically acceptable only on the assurance that there would be “equivalent safeguards” for the protection of Community residents.

D. “Interests of Members”

The first-named function of requiring “safeguards” was “protection of the interests of members,” which would translate in American English as protection of the interests of shareholders. Protecting shareholder interests was probably viewed as a means of promoting, in the words of the Treaty, “a continuous and balanced expansion, an increase in stability, [and] an accelerated raising of the standard of living,” because the swindling of shareholders and the resultant drying up of capital markets were regarded as contributing causes of the Great Depression.

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6 Southern Ry. Co. v. Greene, 216 U.S. 400 (1910). At about the same time, some forms of discrimination against out-of-state corporations were invalidated under the interstate commerce clause. Pullman Co. v. Kansas, 216 U.S. 56 (1910) [invalidating state law requiring foreign corporations doing intrastate business to pay a fee based on percentage of authorized capital]; Western Union Tel. Co. v. Kansas, 216 U.S. 1 (1910) [invalidating state law making payment of fee condition of foreign corporation doing business in the state]. But the Supreme Court did not repudiate the Taney view on corporations' inability to claim the rights of “citizens.”
7 Article 58 [now TEU 48]. Since this article does not refer company ownership, companies owned by Americans or Japanese enjoy freedom of establishment if they are incorporated in member states.
The Community founders could, imaginably, have attacked the danger of reckless financing as the United States had done, by enacting Community Securities Acts and creating a Community Securities Commission. But the American securities laws did not fit the Community's legislative pattern, which favored integration of reforms in existing codes, rather than adding uncoordinated regulations. The two largest members of the original Communities, France and Germany, had tackled securities fraud by inserting rigorous provisions for disclosure and auditing of financial statements in their corporation laws.

Besides, the Community founders were not concerned only with “truth in securities,” the prime objective of the U.S. securities laws. They were concerned with many other forms of shareholder protection, including the maintenance of capital, the equal treatment of shareholders, and the proportionality of voting rights, all of which fit better in corporation laws than in securities laws on the American pattern.

E. The Interests of “Others”

The “others” whom the Community founders envisioned as subjects of protection were presumably customers, suppliers, and money-lenders, including investors in bonds. All of them would be helped by regulations requiring public filing of the addresses and the officers of corporations, by standard accounting practices and disclosures, and by capital requirements designed to maintain firm solvency.

In what respects employees were contemplated by the Community founders as among the “others” for whose safeguards were to be provided is unclear. They were doubtless intended to benefit in the same way as suppliers and shareholders from provisions designed to assure financial solvency. Whether the Treaty makers intended also to authorize their protection by means of a voice in corporate governance is debatable.

Employee representation in governance was already known in Europe through Germany's codetermination law, introduced in 1952. But it was not, when the Communities were founded, embedded in the German corporation law, which still declared that the supervisory board should be elected by the shareholders. Employee representation was, however, included in the 1972 proposal of a fifth directive on corporate governance, and in revised form in the 1983 revision. The difficulty in reaching agreement on the terms of employee representation suggests that some Community members do not consider it a safeguard that is essential to attaining the objectives of the Communities.

F. National Interests

Beyond the interests of shareholders, customers, suppliers, moneylenders, and employees, a significant source of pressure for conformity in corporation laws was probably the interest of each state in retaining as its “nationals” those corporations whose operations are centered in the state. The founders of the Community had no intention of letting one of the member states become the “Delaware of Europe.”

This may have been related to a sense of national loyalty. European states were sensitive to the implications of their giant corporations defecting to other states. And Community members would not want a one-member state to siphon off a disproportionate fraction of corporation filing fees and attorneys’ fees as Delaware does in the United States.

If there is anything surprising about the decision to standardize European corporation law, it is the absence of any organized effort of European industrialists to create in Europe a free trade in corporation laws like that which flourishes in the United States. There is no evidence, however, that the captains of European industry perceived a “race of laxity” as advantageous to them. If they contemplated it at all,
they probably recognized that a free market in corporation laws could not prevail in the political climate of Europe.

II. THE INSTRUMENTS OF COORDINATION

A. The Rejection of American Models

The Community founders adopted none of the principal methods by which nationwide conformity of laws has sometimes been achieved in the United States – the “uniform act,” the “model act,” and the “federal act.”

The “uniform act” and the “model act,” as known in the United States, were inappropriate because their adoption is voluntary. Although the American Commissioners have been successful with uniform laws on commercial transactions, and even with laws as close to corporations as the partnership and limited partnership acts, their only attempt to unify corporation laws was abandoned. There was no prospect of Delaware’s abandoning its program of attracting incorporations by being nonuniform. So long as Delaware attracted corporations by laxity, other states were sure to follow along to avoid losing incorporations. Europeans had no reason to believe that voluntary conformity in corporation laws would succeed in the Communities any more than it had succeeded in the United States.

Likely reasons for the Communities’ forgoing the enactment of a Community corporation act, which would be comparable to a federal corporation act in the United States, were of a different kind. One reason, which would have been sufficient even if there had been no others, was the enormity of the task of devising a complete corporation act that would be acceptable to the many members of the Community, with their differing languages and traditions. Much more feasible was the gradual coordination of particular elements, starting with registration and then proceeding to capital maintenance, then to accounting, and so on.

A second plausible reason for forgoing a single Community corporation act may have been a desire to minimize the inconvenience caused, and the disparagement of national traditions implied, by a displacement of existing corporation laws. Compatible with these possible considerations, the Treaty authorized coordinating only “safeguards,” and coordinating these only “to the necessary extent.”

A third reason, one may guess, is avoiding displacement or duplication of the bureaucracies of state officials employed in keeping corporate records. A Community bureaucracy to administer a Community law would have the added complication of dealing with documents in many languages.

B. The Directive

What the Community needed to coordinate safeguards without imposing a whole new corporation act in multiple languages was a means of causing the member states to modify their own acts in selected respects. For this purpose they adopted an instrument that they called a “directive,” which is binding as to result, but “leaves to the national authorities the choice of form and methods.”

Although the idea of a federal government ordering member states to legislate seems strange to an American, it is not very different in reality from the practice by which U.S. federal agencies grant highway money to states on condition of the states adopting and enforcing uniform speed limits. In form, it resembles the process by which an international treaty requires signatory states to modify their laws to match the treaty.

Unsympathetic parliamentarians, however, could regard the directives as an unconstitutional infringement of parliamentary supremacy. The imaginable sensitivity of national parliaments to
Community dictation was alleviated by long delays between proposal and adoption, during which a directive could be adapted to national differences, and national parliaments could adapt or prepare to adapt their laws to the prospective directive. Even the first company law directive, which seemed to do little more than to standardize basic disclosure, spent four years in the form of a proposal before it could be enacted without vigorous objection.

NOTES

1. How does EU company law affect company law in the European members?
   a. What is harmonization? Its purpose?
   b. What would be so wrong with different corporate standards in each country?

2. Is harmonization consistent with the Maastricht’s theory of “subsidiarity”?
   a. What would happen if each country adopted its own set of corporate standards?
   b. What political philosophy seemed to drive the company law policy of harmonization?

You might be wondering whether this is all a tempest in a teapot. It seems that Europe has companies and they are subject to more regulation – for the protection of shareholders, creditors, managers, employees, even member states. But isn’t protection of these interest groups also relevant in the United States? How do these various interest groups find protection in the United States?

The following reading looks at the “political economy” – that is, how interest groups get their interests represented in legal regimes – of both Europe and the United States. You will discover that the Europeans do not trust markets; but Americans are more trusting. Which approach do you favor?

The Political Economy of Competition for Corporate Charters
26 J. LEGAL STUD. 303 (1997)
William J. Carney

IV. TWO SYSTEMS OF CORPORATE LAW

Mandatory provisions of European company laws far exceed those of the United States in the extent of regulation they provide. They also provide evidence of the participation of interest groups in the law-making process. The U.S. system, on the other hand, with its long-standing common market, has a remarkable absence of such interest-group-inspired rules in its corporation laws.

A. The European Experience

For purposes of comparison, I use the European Community's company law directives as evidence of the general shape of European company law. The directives on company law were designed to provide essential uniformity, or at least compliance with minimum standards of protection for interest groups, throughout the community, in order to facilitate a common market. The directives go very far beyond what the American experience suggests is necessary for that purpose.

8 Charles Howard Candler Professor, Emory University Law School.
An American corporate lawyer reading the directives will be struck by how mandatory they are. Even the language of European company law differs from that in the United States. References to an “enterprise” or “enterprise law” signify something quite different from U.S. corporate law, generally implicating relationships with stakeholders or constituencies whose interests are protected by company law.


I have categorized the legal rules that appear in the eight company law directives adopted by the European Community (EC), together with information on frequency of adoption of similar provisions in the United States. The EC directives contain 131 provisions. I then used LEXIS to search U.S. corporate statutes in 50 states for similar provisions.

The most striking result of this inquiry is the bipolar nature of the distribution: either virtually all U.S. states have similar provisions or none do. On the one hand, of 131 EC provisions, 95 were in effect in no U.S. jurisdiction. On the other hand, 14 were in effect in all 50 states. The remaining 22 provisions were adopted by what appears to be a random number of states.

I found 67 mandatory rules in the directives. Fifty-four of these rules have not been adopted in any U.S. state, while four have been adopted in all 50, with a random distribution for the remaining nine. The mandatory provisions employed in all 50 states are hardly surprising—a requirement that a corporation have a registered office, identify its incorporators, amend its articles of incorporation to reduce authorized capital, and have board approval of a merger.

The provisions adopted by some significant group of states, but less than all, reflect the direction of change in U.S. laws. Most relate to older requirements concerning legal capital that are gradually being abandoned—requiring publication of subscribed capital (7 states); requiring minimum capital to be paid in at the time of incorporation or the beginning of business (6 states); setting a statutory minimum for subscribed capital before beginning business (5 states); prohibiting receipt of promises of future services for shares (23 states); prohibiting issuance of shares for less than par value (16 states); permitting dividends to be paid only from retained earnings and previous year's profits (28 states); and prohibiting corporate loans to finance the purchase of the corporation's shares (24 states).

More revealing than the commonality of adoptions is the nature of the EC provisions that have not been employed in the United States. These include provisions requiring publication of financial statements, purpose clauses in articles of incorporation, that all shares must be subscribed before beginning business, that at least 25 percent of the subscription price must be paid in before beginning, that a shareholders' meeting must be called to consider dissolution when capital becomes impaired, preemptive rights to acquire newly authorized shares, rights to security for existing creditors in the case of a capital reduction, and shareholder votes for redemption of shares.

2. Creditor Protection.

Much of the regulation provided by the EC directives involves creditor protection. Some are substitutes for the disclosure required by securities laws in the United States, but they include substantive regulation that goes beyond the role of securities laws. More details are required in articles of incorporation, and minimum capital is required before business can begin, an anachronism still present in only a few U.S. state laws. Par value appears to be taken as seriously in Europe as it was in the United States in the late nineteenth and early twentieth centuries, although American lawyers have come to believe such protections are largely illusory.
The directives require all shares to be subscribed at the time of incorporation. Such legal capital rules preclude the kind of financing flexibility made possible by concepts of authorized but unissued shares and blank preferred shares, both of which delegate to the board of directors total discretion over new financings. Provisions requiring experts to report on the value of consideration other than cash received for shares and for publication of these reports also provide a benefit to creditors. Distributions to shareholders are strictly regulated using concepts similar to the old legal capital rules of the Model Act, which were eliminated as useless in 1980, and attempt to protect local creditors that have not obtained contractual protections.

The directives also limit repurchases of shares to no more than 10 percent of subscribed capital and require a shareholders' meeting to consider winding up the company whenever capital is impaired. Similarly, capital reductions are constrained by rules requiring existing creditors to have security in the event of a capital reduction. These rules provide the strongest evidence of interest group influence, because they provide unsecured creditors with security without bargaining for it.

Publication plays a much larger role in Europe than in the United States. The publication rules seem designed to protect third parties, by providing a ready public source of information not required by shareholders. There is no discrete requirement for disclosures only to prospective investors, as in U.S. securities laws, or for delivery of financial statements to known shareholders, as in U.S. corporation laws.


Managers gain increased job security in a system that discourages shareholder activism and hostile takeovers. The evidence from Europe in this respect is mixed but does contain more examples of protection of managers than are found in the United States. Cross-border mergers were not contemplated by some European laws [something addressed by the 2005 directive on cross-border mergers]; indeed, in some cases even domestic mergers were not contemplated. Acquisition of a control, or even significant, block of shares, was restricted in some European states. Many states require advance notice of takeover bids and advance administrative approval [something addressed by the 2004 directive on takeovers]. The common use of bearer shares in Europe means that it is difficult for an insurgent shareholder to communicate with other shareholders to seek proxies.

B. The American Experience

Interest groups have played a smaller role in American corporate law, and some of the evidence is provided by the failures of interest groups. During the 1970s proposals were made to federalize corporation law to eliminate the effects of the competition among the states. One set of proposals would have federalized corporate law, thus avoiding competitive forces, and would have given a variety of interest groups board representation, in a variation on codetermination. These attempts failed.

The dominant evidence of the role of interest groups in U.S. corporate law involves antitakeover legislation designed to protect incumbent managers. The role of management in sponsoring these laws is well documented. There are numerous anecdotes that describe the process of adoption of these statutes; usually they involve lobbying by a local company that has become the target of a takeover bid, to which sympathetic legislators respond with protective legislation.

In a state such as Delaware, where managers of large corporations neither reside nor conduct major operations, their ability to provide political support for local legislators is limited. Their only bargaining chip is the threat of exit, which is costly to exercise and hence not credible on most issues. It is thus not surprising that Delaware has been reluctant to adopt antitakeover laws. Its relatively weak business combination statute was only adopted in 1988, well after other states had adopted various anti-takeover statutes.
NOTES

1. Professor Carney asserts that European company law, as reflected in the EC directives, is more mandatory than US corporate law. But is this really so? Do the EC directives actually mandate results in member states’ company law that are different from what they would be without EU-wide harmonization?

2. Consider the conclusion by Professor Luca Enriques that EC company law is essentially “trivial” -- that is, that it adds little:

   What role does EC legislation in the corporate law area play within the EU? How much does it shape Member States' corporate laws? And how relevant is it for the corporate governance of EU companies and their management? At first sight, the EC appears to have played and to be playing a central role in shaping EC corporate law, with the high number of directives and regulations covering a wide range of corporate law issues. One might then think that EC institutions have a strong influence upon Member States' corporate laws, whether because they have intervened in the area or because they may do so. Quite to the opposite, EC company law directives and regulations appear to have had thus far very little impact on national company laws and, more to the point, on EU businesses' governance and management. First, EC corporate law does not cover core corporate law areas such as e.g. fiduciary duties and shareholder remedies. Second, EC corporate law rules are under-enforced. Third, in the presence of very sporadic judiciary interpretation by the European Court of Justice, EC corporate law tends to be implemented and construed differently in each Member State, i.e. according to local legal culture and consistently with prior corporate law provisions. Fourth, when it has introduced new rules, it has done so with respect to issues on which Member States would have most probably legislated even in the absence of an EC mandate. Last but not least, most EC corporate law rules can be categorized as optional, market mimicking, unimportant or avoidable.


Over time, the Europeans have begun to wonder whether their company laws have too many restrictions. Maybe, as many European company law scholars have concluded, it would be good for company law to be less regulatory. Remember this de-regulatory philosophy was the impetus behind the 2003 reforms to Italian company law. Less may be more.

The next reading describes the conclusions of a group of experts on European company law and the reforms they think would modernize company law. In what ways do they imagine a company law system more like that of the United States? In what ways do they imagine a European approach?

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**Report of the High Level Group of Company Law Experts on a Modern Regulatory Framework for Company Law in Europe**

Brussels, 4 November 2002

CHAPTER I – “Introduction”

This document constitutes the High Level Group of Company Law Experts’ Final Report. The Group was set up by the European Commission to provide independent advice, first on issues related to pan-European rules for takeover bids, and subsequently on key priorities for modernising company law in the EU.

CHAPTER II – “General Themes”

The EU approach to company law harmonisation has focused on the protection of members and third parties. Several instruments have been adopted, with a view to establishing an equivalent level of protection throughout the EU. Company law should primarily concentrate on the efficiency and competitiveness of business. Proper protection of shareholders and creditors is necessary, but not all existing mechanisms are effective. This Report contains some recommendations to simplify current rules. Particular attention should be given to the elimination of obstacles for cross-border activities. There have also been calls for a freedom of choice between alternative forms of organisation and structure.

EU company law, once harmonised through Directives, is not easy to modify, whereas there is a growing need for continuous adaptation. Fixed rules in primary legislation offer both advantages and disadvantages, and we can see a movement in Member States to use alternatives for primary legislation, which include secondary regulation, standard setting and monitoring, and model laws. Directives should be restricted to setting principles and general rules, and that detailed rules should be left to secondary regulation and mechanisms for standard setting.

Disclosure can be a powerful regulatory tool: it creates an incentive to comply with best practice, and allows members and third parties to take necessary actions. Disclosure requirements can be more efficient, more flexible and easier to enforce. Information and disclosure requirements are at the intersection of company law and securities regulation, and responses to the consultation confirmed that disclosure was particularly suited in the area of corporate governance.

Company law traditionally distinguished between public and private companies, but this is often not fully relevant in practice. In today’s reality, the Group sees three basic types of companies: listed companies (whose shares are regularly traded), open companies (whose shares could be regularly traded), and closed companies. The regulatory approach may vary for each type of companies, taking national differences into account.

Company law should provide a flexible framework for competitive business. Using company law for other regulatory purposes may lead to an undesirable tightening of rules. The development and use of efficient company law structures should not be hindered by anti-abuse provisions.

Due to its profound impact on our society, modern technology may require various types of changes to company law. Company information is currently filed and disclosed at various places, which creates efficiency problems for both companies and interested parties. It has been suggested that companies could be required to maintain a specific section on their website, and/or a link with the register. Easy and cheap access to core information stored in public registers and filing systems should be ensured on a cross-border basis.

On the basis of these observations, the Group makes the following recommendations.

**Facilitating efficient and competitive business in Europe** An important focus of the EU policy in the field of company law should be to develop and implement company law mechanisms that enhance the efficiency and competitiveness of business across Europe. Where mechanisms
established so far to protect shareholders and creditors appear to be inappropriate impediments, they should be replaced by ones that are at least as -- and preferably more -- effective, and less cumbersome. Where various alternative systems exist in Member States for elements of the company’s organisation and structure, the EU should as much as possible facilitate freedom of choice for companies across Europe.

Modern Company Law The EU should consider a broader use of alternatives to primary legislation (secondary regulation, standard setting and monitoring, model laws). The Group recommends that wide and expert consultation should be an integral part of any future initiative taken at EU level in the area of company law. There is a case for setting up a permanent structure which could provide the Commission with independent advice on future regulatory initiatives.

Disclosure of information as a regulatory tool The EU, in considering new – and amending existing – regulation of company law, should carefully consider whether disclosure requirements are better suited to achieve the desired effects than substantive rules. Any disclosure requirement should be based on the obligation to provide fair, relevant and meaningful information.

Distinguishing types of companies The regulatory approach should be different for the three types of companies identified by the Group. Listed companies should be subjected to a certain level of uniform and compulsory detailed rules, whereas closed companies should benefit from a much higher degree of autonomy. The balance may be somewhere in between for open companies.

Increased flexibility vs. tightening of rules The objective of combating fraud and abuse of companies should be achieved through specific law enforcement instruments outside company law, and should not be allowed to hinder the development and use of efficient company law structures and systems.

Modern technology Listed companies should be required to maintain and continuously update a company information section on their websites, and maintain links with public registers and other relevant authorities. Other types of companies could be allowed to fulfill their filing and disclosure obligations by including such information on their websites, if appropriate links with public registers are established. Existing private initiatives to link the various registries that now contain formal company information should be encouraged by the EU. With respect to listed companies, the EU should at the minimum actively support Member States in their efforts to create national central electronic filing systems, and ensure that national systems are properly linked.

NOTES

1. Is Europe trying to look more like America with its version of “incorporation-based private choice”? That is, does the Report of Experts contemplate that European business firms should be allowed to choose the company law rules that apply to them, subject only to disclosure?

2. Notice also the Report’s recommendation that the way to combat fraud and abuse is not through additional ex ante regulations that seek to prevent abuse before it happens, but instead to use “specific law enforcement instruments outside of company law.” What does the Report have in mind? Restore the Inquisition for errant company executives? Or perhaps impose heavy money penalties on majority shareholders who abuse minority shareholders?
3. And what about the company as social institution? Are the Experts suggesting that Europe should worry more about company profitability – that is, “efficiency and competitiveness” – and no longer about protecting corporate constituents from wrenching change? Or is this “liberalization” aimed just at closed companies, while listed companies remain instruments of “statist policy”?

We wrap up this look at the EU approach to company law by considering a long-awaited set of EU laws (a regulation and directive) that permit the creation and use of a “European Company.” At first, you might think that the Europeans have done what Americans never were able to do – that is, create a system for “federal incorporation.” But you’ll soon see the “European Company” is far less ambitious. It simply makes it possible for existing European companies to adopt a form (based on national norms) that can operate across Europe without separate incorporation in each country where it does business–something US corporations have been able to do for more than a century.

But maybe there’s a silver lining – can the “European Company” be used by business firms to choose their country of incorporation? Let’s see how well established the European Company is becoming.

The Creation of the European Company
Andreas Kellerhals & Dirk Truten
17 TUL. EUR. & CIV. L.F. 71 (2002)

I. INTRODUCTION: AGREEMENT ON THE EUROPEAN COMPANY

In a meeting on December 20, 2000, the Council of the European Union, after decades of disagreement, reached an accord on the European Company (Societas Europea, SE). The vision to create a pan-European, uniform statute on companies goes back to preliminary work by the Council of Europe in the year 1952, which was the beginning of a legislative tale of woe.

The resulting legislation makes it possible for an SE to relocate its residence throughout Europe without dissolution and liquidation. An SE will therefore be able to operate in different Member States and be active in the entire EU on the basis of one uniform legal and administrative regulation.

IV. THE REGULATION OF THE EUROPEAN COMPANY

A. The Company Law Regulation

The SE is a company that has a fixed capital of €120,000 minimum, divided into limited liability shares. The SE has the status of a legal person. Its registered office must be located within the EU and must be identical with the location of its headquarters. A fundamental advantage of the SE lies in the fact that a relocation of its registered office within the EU is easily possible without dissolution or liquidation and without effect upon its identity. As a supranational company, therefore, it is not formed on the basis of a Member State company statute.

9 The authors, Andreas Kellerhals, LL.M., S.J.D., and Dirk Truten, LL.M., direct the Europa Institut at the University of Zurich, Switzerland.
It is important to know that the SE cannot be formed directly but has to emerge from already-existing (national) companies. There is a conclusive list of four means by which a SE may be formed:

1. Formation through merger of pre-existing national companies registered in different Member States.
2. Formation through the establishment of a holding company. This form is open to all companies, including limited liability companies, with registered offices in different Member States.
3. Formation in the form of a common subsidiary through public or private law companies. The same conditions apply for this form of incorporation as for the incorporation through the establishment of a holding company.
4. Formation through the conversion of an existing company under national law. The formation of the SE complies with the law of the state of the registered office.

The SE is subject to minimum capital requirements, recognition of the general meeting of shareholders, and the choice between a dualistic board (German model) or monistic board. The SE must prepare annual accounts, including the balance sheet and the profit and loss statement, as well as an annual report on the business development and the situation of the company.

B. Directive on Employee Involvement

The first part of the Directive regulates employee information and consultation in the SE regarding matters that affect the company, subsidiaries or plants. Employee information and consultation are exercised through a special representative body.

The second part of the Directive concerns the workers' participation in management. First, a workers' participation regulation individually tailored to the company concerned is to be sought by way of open negotiations between the management of the company and the employee negotiation committee. This will force some Member States, whose company law is based on one of the models, to amend their company law.

If the negotiations definitively fail, subsidiary rules become applicable. Insofar as there was no workers' participation model in the founding companies before the creation of the SE, then the SE is subject only to the information and consultation procedures. If there were already mechanisms of workers' participation in one of the founding companies, workers' participation mandatory, if:

1. The majority of the members representing the employees in the negotiations committee decide in favor of workers' participation.
2. The SE evolved from a common subsidiary or holding company, in which fifty percent of the employees already were part of a workers' participation model.
3. The SE was established through a merger and twenty-five percent of the employees already were part of a workers' participation model before the merger.

V. CONCLUSION

Among others, the following points seem to be unsatisfactory in regard to the practical implementation of the SE Statute:

- The mandatory multi-nationality of the founding companies limits a priori the circle of potentially participating companies.
- The Directive aims de facto exclusively at large companies, which already mostly have an
international structure; in addition, a simpler European legal form, which aims at smaller and medium-sized companies, would be at least equally necessary.

• The abandonment of the goal of coherent regulation of the organization statute led to an unclear, confusing situation with regard to the law applicable to a specific company. The failure to regulate the law relating to activities in company groups appears particularly problematic since almost every SE will have a group structure.

NOTES

1. So, as you see, the SE seeks to allow a business (1) to operate in multiple European countries without the difficulties of creating a holding company structure (with separate operating subsidiaries in each country) and (2) to resolve the uncertainty of which norms govern its internal operations away from its home country.

2. But there may be additional advantages to the SE, including the possibility that existing companies organized in one country may choose company rules under the European Company Statute – thus opting out of local law:

Following the skimming process that led to its final approval in October 2001, the European Company Statute provides only a patchy set of uniform rules applying to the new legal form, the Societas Europaea or SE. The Statute covers a limited range of issues, most of them only partially and often leaving options open to Member States or to companies themselves. Matters not covered by the Statute are governed by the law on public limited-liability companies of the Member State in which the SE has its registered office and central administration. The very lack of a uniform regime may prove to be a key factor for the success of this new legal form. First, the European Company may turn out to be an attractive vehicle for company-law shopping within the EU. Then, the absence of rules on shares, and to a lesser degree on legal capital and financing enhances the appeal of the European Company Statute as a vehicle for company law shopping. Finally, regulatory arbitrage (and competition) may be promoted with rules concerning deviations from the one-share-one-vote principle.


4. One interesting, perhaps anomalous, aspect of the SE is that the EU regulation contemplates that the SE will be governed by the company law of its headquarters. This dilutes the flexibility of this company form, since choosing a new “legal home” comes at the high price of relocating company headquarters. See Stefano Lombardo & Piero Pasotti, The Societas Europaea: A Network Economistic Approach, SSRN Paper 493422 (2004).

4. In the end, the rigid nature of the SE may be a last-gasp effort to keep alive the European philosophy, manifested in the EC’s company law project, that the state should provide the “best solution” – rather than the parties themselves. Academic writers and policy makers are beginning to turn to an “options approach,” similar to that of the United States. See Gerard Hertig & Joseph A. McCalhery, Optional Rather than Mandatory EU Company Law: Framework and Specific Proposals, SSRN Paper 958247 (Jan 2007) (arguing that bringing options to the forefront of EU company law may significantly reduce costs for small and medium-sized firms and provide clear benefits to public companies – along step-by-step adoption of legal options, beginning with the implementation of a limited number of specific EU provisions that firms can select as an
alternative to the corresponding Member State statutory or case law). See also Theodor Baums, *European Company Law Beyond the 2003 Action Plan*, 8 *European Bus. Org. L. Rev.* ___ , SSRN Paper 973456 (2007) (describing the current EC agenda to simplify existing laws and assess the impact of existing and proposed legislation to determine the most appropriate regulatory instruments, whether a uniform law or a menu of options).
II. FORMATION OF BUSINESS

You now have the basics: what corporations/companies are and how they are regulated in the United States and Europe. We've discovered a basic tension of whether companies are simply “contracts” (a form of private property used by their owners to extract profits) or whether companies are a “social institution” (a collective good that serves the many constituents affected by the business).

We've also discovered that the United States gives a lot of flexibility to companies, with mostly enabling structures and very few mandatory rules. On the other hand, the European approach has been much more regulatory and protective, with many rules aimed at protecting shareholders, creditors, managers, employees and even countries.

Next we turn to how these different approaches play out in different contexts. That is, we look at a handful of company law topics to illustrate our comparison of two different legal systems. The first topic is the responsibility of entrepreneurs (sometimes known as promoters) who begin a business and engage in business activities before the business is incorporated. Are they personally liable? What is your guess on how this is handled under “business friendly” corporate law in the United States, compared to “creditor protective” company law in Italy?

A. Shareholder Liability for Defective Incorporation

1. Defective incorporation rules -- United States

_Cantor v. Sunshine Greenery, Inc._
Superior Court of New Jersey, Appellate Division
165 N.J. Super. 411; 398 A.2d 571 (1979)

This appeal involves the propriety of a personal judgment against defendant William J. Brunetti for the breach of a lease between plaintiffs and a corporate entity known as Sunshine Greenery, Inc., and more particularly whether there was a de facto corporation in existence at the time of the execution of the lease.

Plaintiffs brought suit for damages for the breach of the lease against Sunshine Greenery, Inc. and Brunetti. Default judgment was entered against the corporation and a nonjury trial was held as to the liability of the individual. The trial judge in a letter opinion determined that plaintiffs were entitled to judgment against Brunetti individually on the theory that as of the time of the creation of the contract he was acting as a promoter and that his corporation, Sunshine Greenery, Inc., was not a legal or de facto corporation.

The undisputed facts reveal the following: Plaintiffs prepared the lease naming Sunshine Greenery, Inc. as the tenant, and it was signed by Brunetti as president of that named entity. Mr. Cantor, acting for plaintiffs, knew that Brunetti was starting a new venture as a newly formed corporation known as Sunshine Greenery, Inc. Although Cantor had considerable experience in ownership and leasing of commercial property to individuals and corporations, he did not request a personal guarantee from Brunetti, nor did he make inquiry as to his financial status or background. Without question, he knew and expected that the lease agreement was undertaken by the corporation and not by Brunetti individually, and that the corporation would be responsible thereunder.
At the time of the signing of the lease on December 16, 1974 in Cantor's office, Brunetti was requested by Cantor to give him a check covering the first month's rent and the security deposit. When Brunetti stated that he was not prepared to do so because he had no checks with him, Cantor furnished a blank check which was filled out for $1,200, with the name of Brunetti's bank and signed by him as president of Sunshine Greenery, Inc. The lease was repudiated by a letter from counsel for Sunshine Greenery, Inc. dated December 17, 1974, which in turn was followed by a response from Cantor to the effect that he would hold the "client" responsible for all losses. The check was not honored because Brunetti stopped payment, and in any event because Sunshine Greenery, Inc. did not have an account in the bank.

The evidence is clear that on November 21, 1974 the corporate name of Sunshine Greenery, Inc. had been reserved for Brunetti by the Secretary of State, and that on December 3, 1974 a certificate of incorporation for that company was signed by Brunetti and Sharyn N. Sansoni as incorporators. The certificate was forwarded by mail to the Secretary of State on that same date with a check for the filing fee, but for some unexplained reason it was not officially filed until December 18, 1974, two days after the execution of the lease.\(^\text{10}\)

In view of the late filing, Sunshine Greenery, Inc. was not a de jure corporation on December 16, 1974 when the lease was signed. See N.J.S.A. 14A:2-7(2). Nevertheless, there is ample evidence of the fact that it was a de facto corporation in that there was a bona fide attempt to organize the corporation some time before the consummation of the contract and there was an actual exercise of the corporate powers by the negotiations with plaintiffs and the execution of the contract involved in this litigation. When this is considered in the light of the concession that plaintiffs knew that they were dealing with that corporate entity and not with Brunetti individually, it becomes evident that the de facto status of the corporation suffices to absolve Brunetti from individual liability. Plaintiffs in effect are estopped from attacking the legal existence of the corporation collaterally because of the nonfiling in order to impose liability on the individual when they have admittedly contracted with a corporate entity which had de facto status. See Vanneman v. Young, 52 N.J.L. 403 (E. & A. 1890). In fact, their prosecution of the claim against the corporation to default judgment is indicative of their recognition of the corporation as the true obligor and theoretically inconsistent with the assertion of the claim against the individual.

The trial judge's finding that Sunshine Greenery, Inc. was not a de facto corporation is unwarranted under the record facts herein. The mere fact that there were no formal meetings or resolutions or issuance of stock is not determinative of the legal or de facto existence of the corporate entity, particularly under the simplified New Jersey Business Corporation Act of 1969, which eliminates the necessity of a meeting of incorporators. See N.J.S.A. 14A:2-6 and Commissioners’ Comment thereunder. The act of executing the certificate of incorporation, the bona fide effort to file it and the dealings with plaintiffs in the name of that corporation fully satisfy the requisite proof of the existence of a de facto corporation. To deny such existence because of a mere technicality caused by administrative delay in filing runs counter to the purpose of the de facto concept, and would accomplish an unjust and inequitable result in favor of plaintiffs contrary to their own contractual expectations.

Since the trial judge erred in negating the de facto existence of the corporation herein, the consequent imposition of individual liability on the thesis that Brunetti was a "promoter" is also unwarranted. Since plaintiffs looked to the corporation for liability on the lease, and since we find that Sunshine Greenery, Inc. had a de facto existence, there can be no personal liability of Brunetti on the theory that he was a "promoter." See Fletcher, Cyclopedia of Corporations, 215.

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\(^{10}\) We note that the letter enclosing the certificate of incorporation is addressed to "Mortimer G. Newman, Jr., Secretary of State, State House Annex, Trenton, New Jersey." Whether this misidentification of the person holding the office of Secretary of State accounts for the filing delay we are unable to say from the record.
In view of the foregoing, the judgment entered against defendant William J. Brunetti is reversed and set aside, and the matter is remanded to the Law Division to enter judgment on the complaint in favor of William J. Brunetti.

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**MODEL BUSINESS CORPORATION ACT**

§ 2.01 Incorporators

One or more persons may act as the incorporator or incorporators of a corporation by delivering articles of incorporation to the secretary of state for filing.

§ 2.02 Articles of Incorporation

(a) The articles of incorporation must set forth:
   (1) a corporate name for the corporation that satisfies the requirements of section 4.01;
   (2) the number of shares the corporation is authorized to issue;
   (3) the street address of the corporation's initial registered office and the name of its initial registered agent at that office; and
   (4) the name and address of each incorporator.

(b) The articles of incorporation may set forth:
   (1) the names and addresses of the individuals who are to serve as the initial directors;
   (2) provisions not inconsistent with law regarding:
      (i) the purpose or purposes for which the corporation is organized;
      (ii) managing the business and regulating the affairs of the corporation;
      (iii) defining, limiting, and regulating the powers of the corporation, its board of directors, and shareholders;
      (iv) a par value for authorized shares or classes of shares;
      (v) at the imposition of personal liability on shareholders for the debts of the corporation to a specified extent and upon specified conditions;
   (3) any provision that under this Act is required or permitted to be set forth in the bylaws; and
   (4) a provision eliminating or limiting the liability of a director to the corporation or its shareholders for money damages for any action taken, or any failure to take any action, as a director, except liability for (A) the amount of a financial benefit received by a director to which he is not entitled; (B) an intentional infliction of harm on the corporation or the shareholders; (C) a violation of section 8.33; or (D) an intentional violation of criminal law.

(c) The articles of incorporation need not set forth any of the corporate powers enumerated in this Act.

**Official Comment**

Section 2.02(a) sets forth the minimum mandatory requirements for all articles of incorporation while section 2.02(b) describes optional provisions that may be included. A corporation that is formed solely pursuant to the mandatory requirements will generally have the broadest powers and least restrictions on activities permitted by the Model Act. The Model Act thus permits the creation of a “standard” corporation by a simple and easily prepared one-page document.
No reference is made in section 2.02(a) either to the period of duration of the corporation or to its purposes. A corporation formed under these provisions will automatically have perpetual duration under section 3.02(1) unless a special provision is included providing a shorter period. Similarly, a corporation formed without reference to a purpose clause will automatically have the purpose of engaging in any lawful business under section 3.01(a). The option of providing a narrower purpose clause is also preserved in sections 2.02(b)(2) and 3.01, with the effect described in the Official Comment to section 3.01.

§ 2.03 Incorporation

(a) Unless a delayed effective date is specified, the corporate existence begins when the articles of incorporation are filed.

(b) The secretary of state's filing of the articles of incorporation is conclusive proof that the incorporators satisfied all conditions precedent to incorporation except in a proceeding by the state to cancel or revoke the incorporation or involuntarily dissolve the corporation.

Official Comment

Under section 2.03(b) the filing of the articles of incorporation as evidenced by return of the stamped copy of the articles with the fee receipt is conclusive proof that all conditions precedent to incorporation have been met, except in proceedings brought by the state. Thus the filing of the articles of incorporation is conclusive as to the existence of limited liability for persons who enter into transactions on behalf of the corporation. If articles of incorporation have not been filed, section 2.04 generally imposes personal liability on all persons who prematurely act as or on behalf of a "corporation" knowing that articles have not been filed. Section 2.04 may protect some of these persons to a limited extent, however: see the Official Comment to that section.

§ 2.04 Liability for Preincorporation Transactions

All persons purporting to act as or on behalf of a corporation, knowing there was no incorporation under this Act, are jointly and severally liable for all liabilities created while so acting.

Official Comment

Earlier versions of the Model Act, and the statutes of many states, have long provided that corporate existence begins only with the acceptance of articles of incorporation by the secretary of state. Many states also have statutes that provide expressly that those who prematurely act as or on behalf of a corporation are personally liable on all transactions entered into or liabilities incurred before incorporation. A review of recent case law indicates, however, that even in states with such statutes courts have continued to rely on common law concepts of de facto corporations, de jure corporations, and corporations by estoppel that provide uncertain protection against liability for preincorporation transactions. These cases caused a review of the underlying policies represented in earlier versions of the Model Act and the adoption of a slightly more flexible or relaxed standard.

Incorporation under modern statutes is so simple and inexpensive that a strong argument may be made that nothing short of filing articles of incorporation should create the privilege of limited liability. A number of situations have arisen, however, in which the protection of limited liability arguably should be recognized even though the simple incorporation process established by modern statutes has not been completed.
The strongest factual pattern for immunizing participants from personal liability occurs in cases in which the participant honestly and reasonably but erroneously believed the articles had been filed. In *Cranson v. International Business Machines Corp.*, 234 Md. 477, 200 A.2d 33 (1964), for example, the defendant had been shown executed articles of incorporation some months earlier before he invested in the corporation and became an officer and director. He was also told by the corporation's attorney that the articles had been filed, but in fact they had not been filed because of a mix-up in the attorney's office. The defendant was held not liable on the "corporate" obligation.

Another class of cases, which is less compelling but in which the participants sometimes have escaped personal liability, involves the defendant who mails in articles of incorporation and then enters into a transaction in the corporate name; the letter is either delayed or the secretary of state's office refuses to file the articles after receiving them or returns them for correction. E.g., *Cantor v. Sunshine Greenery, Inc.*, 165 N.J.Super. 411, 398 A.2d 5,1 (1979). Many state filing agencies adopt the practice of treating the date of receipt as the date of issuance of the certificate even though delays, and the renew process may result in the certificate being backdated. The finding of nonliability in cases of this second tape can be considered an extension of this principle by treating the date of original mailing or original filing as the date of incorporation.

A third class of cases in which the participants sometimes have escaped personal liability involves situations where the third person has urged immediate execution of the contract in the corporate name even though he knows that the other party has not taken any steps toward incorporating. E.g., *Quaker Hill v. Parr*, 148 Colo. 45, 364 P.2d 1056 (1961).

In another class of cases the defendant has represented that a corporation exists and entered into a contract in the corporate name when he knows that no corporation has been formed, either because no attempt has been made to file articles of incorporation or because he has already received rejected articles of incorporation from the filing agency. In these cases, the third person has dealt solely with the "corporation" and has not relied on the personal assets of the defendant. The imposition of personal liability in this class of case, it has sometimes been argued, gives the plaintiff more than he originally bargained for. On the other hand, to recognize limited liability in this situation threatens to undermine the incorporation process, since one then may obtain limited liability by consistently conducting business in the corporate name. Most courts have imposed personal liability in this situation. E.g., *Robertson v. Levy*, 197 A.2d 443 (D.C.App.1964).

A final class of cases involves inactive investors who provide funds to a promoter with the instruction, "Don't start doing business until you incorporate." After the promoter does start business without incorporating, attempts have been made, sometimes unsuccessfully, to hold the investors liable as partners. E.g., *Frontier Refining Co. v. Kunkels, Inc.*, 407 P.2d 880 (Wyo.1966). One case held that the language of section 146 of the 1969 Model Act ["persons who assume to act as a corporation are liable for preincorporation transactions"] creates a distinction between active and inactive participants, makes only the former liable as partners, and therefore relieves the latter of personal liability. Nevertheless, "active" participation was defined to include all investors who actively participate in the policy and operational decisions of the organization and is, therefore, a larger group than merely the persons who incurred the obligation in question on behalf of the "corporation." *Timberline Equipment Co. v. Davenport*, 514 P.2d 1109, 1113-14 (1973).

After a review of these situations, it seemed appropriate to impose liability only on persons who act as or on behalf of corporations "knowing" that no corporation exists. Analogous protection has long been accorded under the uniform limited partnership acts to limited partners who contribute capital to a partnership in the erroneous belief that a limited partnership certificate has been filed. *Uniform Limited
While no special provision is made in section 2.04, the section does not foreclose the possibility that persons who urge defendants to execute contracts in the corporate name knowing that no steps to incorporate have been taken may be estopped to impose personal liability on individual defendants. This estoppel may be based on the inequity perceived when persons, unwilling or reluctant to enter into a commitment under their own name, are persuaded to use the name of a nonexistent corporation, and then are sought to be held personally liable under section 2.04 by the party advocating that form of execution. By contrast, persons who knowingly participate in a business under a corporate name are jointly and severally liable on "corporate" obligations under section 2.04 and may not argue that plaintiffs are "estopped" from holding them personally liable because all transactions were conducted on a corporate basis.

§ 14.20 Grounds for administrative dissolution.

The Secretary of State may commence a proceeding to dissolve administratively a corporation if:
(1) The corporation does not pay within 60 days after they are due any penalties, fees, or other payments due under this Chapter;
(2) The corporation is delinquent in delivering its annual report;
(3) The corporation is without a registered agent or registered office in this State for 60 days or more;
(4) The corporation does not notify the Secretary of State within 60 days that its registered agent or registered office has been changed, that its registered agent has resigned, or that its registered office has been discontinued;
(5) The corporation's period of duration stated in its articles of incorporation expires; or
(6) The corporation knowingly fails or refuses to answer truthfully and fully within the time prescribed in this Chapter interrogatories propounded by the Secretary of State in accordance with the provisions of this Chapter.

§ 14.30 Grounds for judicial dissolution.

The superior court may dissolve a corporation:
(1) In a proceeding by the Attorney General if it is established that
   (i) the corporation obtained its articles of incorporation through fraud; or
   (ii) the corporation has, after written notice by the Attorney General given at least 20 days prior thereto, continued to exceed or abuse the authority conferred upon it by law . . . .

NOTES

1. What is necessary to form a corporation in the United States?
   a. What information must be provided in the articles of incorporation?
   b. Where are the articles filed?
   c. What information need not be, but may be, included in the articles?

2. What are the repercussions of not incorporating properly?
a. What does the MBCA say about persons acting as a nonexistent corporation? Who is protected – creditors who believe they are dealing with a corporation? those who believe in good faith they are acting as a corporation?
b. What is the case law on the subject?
c. Why are there so many exceptions and excuses for not having complied with the incorporation requirements?

3. The rules on liability for acting as a nonexistent corporation are a subset of the rules on creditor protection. The liability rules give lenders, suppliers and even employees access to the personal assets of those who purport to act as a corporation, if the corporation has not been formed.

Credit protection is marbled throughout US corporate law. Besides the rules on defective incorporation, there are (1) rules on preincorporation agreements that generally create personal liability for anybody acting for a yet-to-be formed corporation, unless the parties agree otherwise, (2) rules against corporate insiders making payments to themselves (as dividends or other distributions) unless the corporation has sufficient “legal capital,” (3) rules of personal liability for directors who approve business activities, such as improper distributions when the business faces insolvency, that put creditors at risk, (4) rules for liability of corporate owners who sell their business to new owners without first satisfying creditor claims, and (5) rules for liability of purchasers of business assets if the owners of the corporation retained insufficient assets to pay the corporation’s creditor claims.

In public US corporations, there are detailed disclosure requirements whenever a corporation issues debt in public markets (that is, borrows money from unsophisticated investors) and all public corporations whose equity shares are traded on stock markets must provide intrusive, periodic accounting information to the public on their financial condition. (These are the famous SEC disclosure requirements applicable to US public companies.) For non-public companies in the United States – such as closely-held corporations or limited liability companies – there are no mandatory rules on public disclosure. Creditors, such as banks or other lenders, that want access to accounting and other firm-specific information must obtain it by contract from such companies.

In some countries, corporate law is dominated by creditor-protection rules. One immediate question is why corporate law should care about this particular non-shareholder constituency. Why don’t corporate creditors find sufficient protection by contract or through the general law on debtor-creditor relations? For some the answer is that corporate creditors face unique risks of debtor opportunism (by corporate owners) owing to limited liability. Gerard Hertig & Hideki Kanda, Creditor Protection, in R. KRAAKMAN, P. DAVIES, H. HANSMANN, G. HERTIG, K. HOPT, H. KANDA & E. ROCK, THE ANATOMY OF CORPORATE LAW: A COMPARATIVE AND FUNCTIONAL APPROACH 71-99 SSRN Paper 568823 (2004). But this answer seems unpersuasive given the risks of opportunism faced by other non-shareholder constituents – such as employees, customers, users of the environment, and so on. Limited liability also distorts the incentives of corporate insiders to disregard the interests of these other non-shareholder constituents. Perhaps, the banks got to the legislative door before anyone else. But why haven’t the others shown up?

4. Now for some real fun. The following cartoon captures the essence of what we’re talking about. In what ways does corporate law in the United States protect creditors from management (and controlling shareholders) seeking to do what the characters in the cartoon are contemplating?
2. Defective incorporation rules -- Europe

You now see that in the United States courts have come up with a number of doctrines to recognize limited liability, even when parties have not complied fully with the statutory rules that permit limited liability in business firms only upon incorporation. These doctrines reflect the idea that “party expectations” may be more important than legal formalities.

What about legal formalities in Europe? What happens when parties fail to comply with legislative mandates? What is the attitude when “party expectations” and “legislative expectations” come into conflict?

We start our readings with the Second Company Law Directive, followed by the relevant provisions in the Italian Civil Code that implement the directive. In the prior section, you learned how to read US corporate statutes. Now you get to become familiar with reading European directives and Italian codes. (Remember this is first and foremost a comparative law course, with a focus on company/corporate law.) We do not have an Italian court decision to compare, so the question throughout is how the Sunshine Greenery case would come out under European and Italian law.

SECOND COMPANY LAW DIRECTIVE
(68/151/EEC)

The Council of the European Communities, having regard to the treaty establishing the European Economic Community, and in particular article 54(3)(g) [TCE 44] thereof; having regard to the general programme for the abolition of restrictions on freedom of establishment ...

whereas the co-ordination provided for in article 54(3)(g) [TCE 44] and in the general programme for the abolition of restrictions on freedom of establishment is a matter of urgency, especially in regard to companies limited by shares or otherwise having limited liability, since the activities of such companies often extend beyond the frontiers of national territories;

whereas the co-ordination of national provisions concerning disclosure, the validity of obligations entered into by, and the nullity of, such companies is of special importance, particularly for the purpose of protecting the interests of third parties;
whereas in these matters community provisions must be adopted in respect of such companies simultaneously, since the only safeguards they offer to third parties are their assets; whereas the basic documents of the company should be disclosed in order that third parties may be able to ascertain their contents and other information concerning the company, especially particulars of the persons who are authorized to bind the company; whereas the protection of third parties must be ensured by provisions which restrict to the greatest possible extent the grounds on which obligations entered into in the name of the company are not valid; whereas it is necessary, in order to ensure certainty in the law as regards relations between the company and third parties, and also between members, to limit the cases in which nullity can arise and the retro-active effect of a declaration of nullity, and to fix a short time limit within which third parties may enter objection to any such declaration;

has adopted this directive:

Article 1
The co-ordination measures prescribed by this directive shall apply to the laws, regulations and administrative provisions of the member states relating to the following types of company:

_ in Germany: die aktiengesellschaft, die kommanditgesellschaft auf aktien, die gesellschaft mit beschraenker haftung;
_ in France: la societe anonyme, la societe en commandite par actions, la societe a responsabilite limitee;
_ in Italy: societa per azioni, societa in accomandita per azioni, societa a responsabilita limitata;

Article 2
1. Member states shall take the measures required to ensure compulsory disclosure by companies of at least the following documents and particulars:
   (a) the instrument of constitution, and the statutes if they are contained in a separate instrument;
   (b) any amendments to the instruments mentioned in (a), including any extension of the duration of the company;
   (c) after every amendment of the instrument of constitution or of the statutes, the complete text of the instrument or statutes as amended to date;
   (d) the appointment, termination of office and particulars of the persons who either as a body constituted pursuant to law or as members of any such body:
      (i) are authorized to represent the company in dealings with third parties and in legal proceedings;
      (ii) take part in the administration, supervision or control of the company. It must appear from the disclosure whether the persons authorized to represent the company may do so alone or must act jointly;
   (e) at least once a year, the amount of the capital subscribed, where the instrument of constitution or the statutes mention an authorized capital, unless any increase in the capital subscribed necessitates an amendment of the statutes;
   (f) the balance sheet and the profit and loss account for each financial year. The document containing the balance sheet shall give particulars of the persons who are required by law to certify it. [requirement delayed for non-public limited liability companies]
   (g) any transfer of the seat of the company;
   (h) the winding up of the company;
   (i) any declaration of nullity of the company by the courts;
   (j) the appointment of liquidators, particulars concerning them, and their respective powers, unless such powers are expressly and exclusively derived from law or from the statutes of the company;
   (k) the termination of the liquidation and, in member states where striking off the register entails legal consequences, the fact of any such striking off.

2. [Definition of non-public companies, which are exempted from the disclosure of financial information]
Article 3
1. In each member state a file shall be opened in a central register, commercial register or companies
register, for each of the companies registered therein.
2. All documents and particulars which must be disclosed in pursuance of article 2 shall be kept in the file
or entered in the register; the subject matter of the entries in the register must in every case appear in the
file.
3. A copy of the whole or any part of the documents or particulars referred to in article 2 must be
obtainable by application in writing at a price not exceeding the administrative cost thereof. Copies
supplied shall be certified as "true copies", unless the applicant dispenses with such certification.
4. Disclosure of the documents and particulars referred to in paragraph 2 shall be effected by publication
in the national gazette appointed for that purpose by the member state, either of the full or partial text, or
by means of a reference to the document which has been deposited in the file or entered in the register.
5. The documents and particulars may be relied on by the company as against third parties only after they
have been published in accordance with paragraph 4, unless the company proves that the third parties had
knowledge thereof. However, with regard to transactions taking place before the sixteenth day following
the publication, the documents and particulars shall not be relied on as against third parties who prove that
it was impossible for them to have had knowledge thereof.
6. Member states shall take the necessary measures to avoid any discrepancy between what is disclosed
by publication in the press and what appears in the register or file. However, in cases of discrepancy, the
text published in the press may not be relied on as against third parties; the latter may nevertheless rely
thereon, unless the company proves that they had knowledge of the texts deposited in the file or entered in
the register.
7. Third parties may, moreover, always rely on any documents and particulars in respect of which the
disclosure formalities have not yet been completed, save where non-disclosure causes them not to have
effect.

Article 7
If, before a company being formed has acquired legal personality, action has been carried out in its name
and the company does not assume the obligations arising from such action, the persons who acted shall,
without limit, be jointly and severally liable therefor, unless otherwise agreed.

SECTION III
NULLITY OF THE COMPANY

Article 11
The laws of the member states may not provide for the nullity of companies otherwise than in accordance
with the following provisions:
1. Nullity must be ordered by decision of a court of law;
2. Nullity may be ordered only on the following grounds:
   (a) that no instrument of constitution was executed or that the rules of preventive control or the
       requisite legal formalities were not complied with;
   (b) that the objects of the company are unlawful or contrary to public policy;
   (c) that the instrument of constitution or the statutes do not state the name of the company, the
       amount of the individual subscriptions of capital, the total amount of the capital subscribed or the
       objects of the company;
   (d) failure to comply with the provisions of the national law concerning the minimum amount of
       capital to be paid up;
   (e) the incapacity of all the founder members;
   (f) that, contrary to the national law governing the company, the number of founder members is
       less than two. Apart from the foregoing grounds of nullity, a company shall not be subject to any
       cause of non-existence, nullity absolute, nullity relative or declaration of nullity.
Article 12
1. The question whether a decision of nullity pronounced by a court of law may be relied on as against third parties shall be governed by article 3. Where the national law entitles a third party to challenge the decision, he may do so only within six months of public notice of the decision of the court being given.
2. Nullity shall entail the winding up of the company, as may dissolution.
3. Nullity shall not of itself affect the validity of any commitments entered into by or with the company, without prejudice to the consequences of the company’s being wound up.
4. The laws of each member state may make provision for the consequences of nullity as between members of the company.
5. Holders of shares in the capital shall remain obliged to pay up the capital agreed to be subscribed by them but which has not been paid up, to the extent that commitments entered into with creditors so require.

SECTION IV
GENERAL PROVISIONS

Article 13
Member states shall put into force, within eighteen months following notification of this directive, all amendments to their laws, regulations or administrative provisions required in order to comply with provisions of this directive and shall forthwith inform the Commission thereof.

Article 14
This directive is addressed to the member states.

NOTES

1. What is necessary to form a company in the Europe, according to the EC Second Company Law Directive?
   a. What information must be provided in the formation document?
   b. Where must the document be filed? the information circulated?
   c. What information need not be, but may be, included in the articles?

2. What, according to the Directive, are the repercussions of not incorporating properly?
   a. What does the Directive say about persons acting as a nonexistent corporation?
   b. What is the purpose of the Directive’s exclusive list of grounds for nullification?
   c. Are there any exceptions and excuses for not having complied with the incorporation requirements?

3. One ground that can be used to nullify the formation of a European company is lack of minimum capital (Second Directive, article 11.2.d). Minimum capital requirements have virtually vanished from US corporate law, where they were once prevalent. What purposes do they serve? Their value in protecting creditors has been questioned, given the pliability of the rules on what consideration must be paid and the freedom to use (and dissipate) paid-in capital. Schen, The Future of Legal Capital, 5 EURO. BUS. ORG. L. REV. 429 (2004). Some argue that they serve no purpose and unnecessarily burden business formation.

   Nonetheless, legal capital requirements imposed privately as a condition to obtaining credit (such as provisions in the articles that limit when cash dividends can be paid to shareholders) serve as an important protective device. Likewise, legal capital rules that specify when dividends may be paid by a going concern can provide clear guidance and some protection,
arguably making them more useful than open-ended rules that prevent dividends when a company “is near insolvency.”

An important, and withering, attack on European minimum capital rules by Professors Luc Enriques and Jonathan Macey questioned the EU legal capital rules as stated in the Second Company Law Directive. *Creditors versus Capital Formation: The Case Against the European Legal Capital Rules*, 86 CORNELL L. REV. 1165 SSRN Paper 291471 (2001). The authors identified the fundamental differences between US and EU approaches to the conflict between fixed and equity claimants and argued that the EU should abandon its inefficient rule-based approach. They asserted that “the costs associated with the European legal capital rules - particularly costs to shareholders, creditors, and society as a whole - significantly outweigh any benefits accrued by creditors.” Instead, they suggested that public choice best explains the existence of the EU legal capital rules, in that influential interest groups benefit from the rules despite their inefficiency. The authors urged the EU to abandon its current legal capital rules in favor of more flexible, contractarian rules to facilitate entrepreneurship and business development in European markets.

4. Notice that the EU company law directives do not seek to create EU-wide company forms from which businesses can choose, but instead to mandate bare minima that all EU members must incorporate into their company laws. Should the EU undertake the role of “business form provider”? Consider the following argument:

Close corporations have become the preferred vehicle for small and medium-sized enterprises in Europe. [Some scholars] suggest that lawmakers devise new business organization statutes that are more varied, less complex, and can potentially enhance efficient outcomes. Indeed, since in most jurisdictions close corporations are a mirror image of their publicly held counterpart, small and medium-sized enterprises are burdened by a number of regulatory requirements, which cause them to incur substantial costs in carrying out their normal business activities. In particular, the imposition of many of the European Community's harmonized corporate law provisions on smaller firms is viewed as disproportionate and over-regulatory, and tends to impede the development of an efficient supply of legal rules. Reform-minded scholars, supported by product and capital market pressures to supply the most competitive business statute for small and medium-sized enterprises, point to the success of the US Limited Liability Company (LLC), a flexible business form that combines the best features of partnership and corporate law.

It is submitted that the combination of organized interest group pressure and the significant switching costs are an important barrier to the creation of new business statutes. Hence an important question is whether the introduction of competition pressures could limit the difficulties encountered in creating a flexible business form with few mandatory rules. We argue that a model statute could be a contributing factor in the introduction of an LLC-type business form within the European Union.


Now that you’ve considered what the Second Company Law Directive is supposed to accomplish, let’s look at the Italian Civil Code, which contains the “company law” of Italy. As you read through the code provisions, ask yourself what is required to form a limited liability company (or SRL) in Italy, what
happens when there are pre-registration transactions, what is the liability of promoters, and how do your answers change from the pre-reform to the post-reform code?

| **Italian Civil Code**  
| **Article 2328 (2005)** |
| Articles of association. The company may be established by contract or unilateral deed. The articles of association shall be drafted by public deed and shall indicate: |
| (1) the name and surname or the denomination, the place and date of birth or the State of incorporation, the domicile or the registered office ... of the shareholders, as well as the number of subscribed shares of each ... |
| (2) the name and the municipality where the registered office of the company is located and branch offices, if any. |
| (3) the company purpose |
| (4) the amount of subscribed and paid-in capital |
| (5) the par value and the number of shares, their characteristics and their modalities of issue and circulation |
| (6) the value attributed to the claims and of the property contributed in kind |
| (7) the rules under which profits are to be distributed |
| (8) the profit participation eventually accorded the promoters, or to the founder shareholders |
| (9) the management system adopted, the number of directors and their powers, indicating those among them who have the power of representation of the company |
| (10) the number of members of the board of auditors |
| (11) the appointment of the initial directors and auditors ... |
| (12) the aggregate approximate amount of incorporation costs |
| (13) the duration of the company or if the company has an unlimited duration, the period of time, no longer than one year, after which the member will be entitled to resign. |

The by-laws containing the rules regarding the functioning of the company are considered an integral part of the articles of association.

| **Italian Civil Code**  
| **Article 2328 (pre-reform)** |
| Articles of association. The company shall be constituted by public instrument, which shall indicate: |
| (1) the name, place and date of birth, domicile and citizenship of the shareholders and eventual promoters, as well as the number of subscribed shares of each shareholder. |
| (2) the type of company, the home seat of the company and the secondary seats |
| (3) the company purpose |
| (4) the amount of subscribed and paid-in capital |
| (5) the par value and the number of shares, and whether these are in nominative or bearer form |
| (6) the value of loans and goods in kind paid for the shares |
| (7) the rules under which profits are to be distributed |
| (8) the profit participation eventually accorded the promoters, or to the founder shareholders |
| (9) the number of managers and their powers, indicating which of them is the company representative |
| (10) the number of the members of the board of union representatives |
| (11) the duration of the company |
| (12) the total amount paid in, at least approximate, of the expenses for the formation of the company |

The by-laws contain the rules regarding the functioning of the company, along with separate resolutions, and they are considered an integral part of the instrument of constitution and shall be enclosed therein.
In the event of inconsistency between the provisions of the articles of association and those of the by-laws such latter provisions prevail.

**Article 2330**

**Deposit of the articles of association and registration of the company.** The notary who has drawn up the articles of association shall deposit them within 20 days in the official company registry, in the district which has been established for the company seat, attaching the documents showing the existence of the conditions referred to in Article 2329 [capital subscribed in entirety, contributions in kind are valid, special authorizations satisfied].

**Article 2330 (pre-reform)**

**Deposit of the articles of association and registration of the company.** The notary who has received the articles of association shall deposit them within 30 days in the official company registry, in the district which has been established for the company seat, attaching the documents showing the proper payment of one-tenth in cash, along with the deposit of tangible assets and credit, as required in Article 2343, or as required by the company articles of association.

**Article 2330 bis**

Deleted

**Article 2330 bis (pre-reform)**

**Publication of the articles of association.** The articles of association and by-laws shall be published in the official Bulletin for corporations (SpA) and limited liability companies (SRL).

**Article 2331**

**Effects of registration.** On registration in the registry, the company acquires legal personality.

For any transactions carried out in the name of the company before registration, any persons who have so transacted are jointly and severally liable, without limit, to third parties with whom they have transacted.

If subsequent to the registration, the company approves a transaction contemplated in the preceding paragraph, the company is also liable and it is required to indemnify those who transacted.

[Directors are forbidden from receiving sums deposited when the company is formed.]

Prior to registration, the issue of shares is forbidden and the shares... cannot be the object of solicitation.

**Article 2331 (pre-reform)**

**Effects of registration.** For any transactions carried out in the name of the company before registration, any persons who have so transacted are jointly and severally liable, without limit, to third parties with whom they have transacted.

The issue or sale of shares before registration of the company is null.
### Article 2332
**Nullity of the Company.** Once a registration in the register of companies has taken place, a declaration of nullity of the company can be rendered only in the following cases:

1. Failure to have stipulated the articles of association in the form of a public act;
2. Unlawfulness of the company’s purpose;
3. Lack in the articles of association of any indication relating to the name of the company, or the contributions, or the amount of capital subscribed, or the company’s purpose.

A declaration of nullity does not prejudice the effect of transactions completed in the name of the company after the registration in the registry of companies. Shareholders are not freed of the duty to pay their contribution until the company’s creditors are satisfied.

### Article 2332 (pre-reform)
**Nullity of the Company.** Once a registration in the register of enterprises (Article 2188) has taken place, a declaration of nullity of the company can be rendered only in the following cases:

1. Lack of articles of association (2328);
2. Failure to have stipulated the articles of association in the form of a public act;
3. Non-observance of the provisions set forth in article 2330 relating to prior review;
4. When the company’s purpose is unlawful or contrary to public policy;
5. Lack in the articles of association or in the by-laws of any indication relating to the name of the company, or the contributions (2342), or the amount of capital subscribed or the company’s object;
6. Non-observance of the provision set forth in article 2329, number 2 [at least three tenths of the money contributions to be deposited at a banking institution];
7. Incapacity (428) of all founding members;
8. Lack of plurality of founding members.

A declaration of nullity does not prejudice the effect of transactions completed in the name of the company after the registration in the registry of companies. Shareholders are not freed of the duty to pay their contribution until the company’s creditors are satisfied.

### NOTES

1. Notice that the Italian company law reform of 2003 amends the provisions on company formation, sometimes in significant ways. Identify three ways in which the post-reform provisions are different from the pre-reform provisions.
   a. Consider whether the 2003 reforms that you identified are consistent with the EC Second Company Law directive.
   b. Are any of the 2003 reforms that you identified mandated the EC directive?

2. Notice the steps required for forming a company in Italy.
   a. How is a company formed in Italy? How does this differ from corporate formation in the United States?
b. What is the effect of acting as a company before proper inscription by a notary? How would a case like *Canter v. Sunshine Greenery* come out under Italian law?

3. Italian company law must comply with the EC company law directives.
   a. Consider whether the pre-reform and post-reform provisions on promoter liability comply with EC law – see Article 7, EC Second Company Law Directive. For example, would it make any difference in Italy if a person purporting to act for a not-yet-formed company obtained the third party’s agreement that liability would run only to the company once properly formed?
   b. Why has Italy amended its provisions on nullity? Does this imply that creditors have less protection? Consider Italy’s original approach toward nullity, described below.

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**Nullity of Companies**

Robert Drury

*(from EUROPEAN COMPANY LAWS: A COMPARATIVE APPROACH, edited by Robert Drury and Peter Xuereb) (Dartmouth Press 1991)*

The concept of nullity, when applied to companies, is something of an exercise in legal prestidigitation. Now you see it—now you don’t! As nullity frequently renders the incorporation of a company void, its application results in the disappearance of what might have seemed at first sight to be a perfectly valid and functioning company. The uncontrolled use of this doctrine could have the most devastating consequences for third parties, shareholders and employees alike. Nullity is a phenomenon which occurs, under various names, throughout the length and breadth of the European Community, and its potential for havoc excited the intervention of the Community’s legislators in their very first foray into the field of company law harmonization.

The function of nullity is a fairly limited one. It is used in most states as a doctrine of last resort, to prevent the continued existence of a company which has signal success to comply with certain essential rules governing the creation of a valid corporation. The severity of the results flowing from the operation of the concept has led to its use being restricted to those matters which a jurisdiction feels are essential.

**The effect of the [Second] Directive**

It was the desire to obviate the potentially catastrophic effects of nullity, that led the Commission to deal with the matter in this Directive which concentrates its efforts on protecting third parties in their dealings with a company. The Directive in pursuing this stated goal, contains provisions co-ordinating the laws of the Member States which regulate the publication of certain essential information about a company, and which limit as far as possible the grounds upon which contractual obligations entered into in the name of a corporate body may be repudiated by that body. The Directive aims to protect third parties from the effects of nullity in several ways. First, it deals with the issue of pre-constitution control of incorporations. Then it limits the grounds upon which nullity may be invoked, and in providing that nullity can only be pronounced by a court, ensures that it cannot arise *ipso jure*. Nullity is permitted only to have a prospective effect, and must be effected by the liquidation of the enterprise concerned. Furthermore, the preference for the interests of third parties over shareholders is reinforced by requiring the latter to remain liable to contribute non paid-up subscribed capital as far as is needed to pay the creditors of the company.

**THE GROUNDS FOR NULLITY**

*Italy*
In Italy, both the public company - *societa per azioni* or SpA - and the private company - *societa a responsabilita limitata* or SRL - are regulated by the Civil Code (arts 2245-2510). The formation procedure and the grounds for nullity are the same for the private company as for the public.

**Comment:** The Italian system exhibits some interesting dualist features. It makes extensive use of the doctrine of nullity, and incorporates all of the grounds permitted by art. 11 of the First Directive. These grounds, not unsurprisingly in view of their Community-wide origin, show the influence of the contract theory of companies, as well as the approach which used nullity as a sanction to compel companies to comply with the most essential elements of the formation requirements, including those relating to capital. What is particularly distinctive of the Italian structure is that its provisions constitute a network of devices on different levels geared to achieving essentially the same end. Some systems emphasize the pre-constitution control and have few grounds for nullity. Others may have more grounds for nullity, but they have a system of regularization aimed at reducing the likelihood of any but the most extreme defects resulting in a declaration of nullity. Italian law has the lot!

There are copious provisions for ensuring compliance with the various formalities at the formation stage, such as those requiring the participation of a notary in both the drafting stage, and in the application for registration. Then there is a fairly rigorous preventive supervision exercised by the court, with the involvement of the public prosecutor. There are also many grounds upon which a declaration of nullity can be made in order to prevent the continuance of a company which has contravened what the law presumably considers the essential elements in the formation process. In addition to this there is the provision allowing for the regularizing of any defective articles before a declaration of nullity is made by the court (art. 2332 para. 5). Altogether the system comprises a multi-tiered protection against the consequences of human error or fraud.

You may remember during our EU week that one of the cases (actually the last case) we read on the “direct effects” of EU law in member states was the *Marleasing* case laid out below. For purposes of our discussion of EU law, the case was remarkable because it essentially created the mechanism for unimplemented directives to have “horizontal effects” (that is, legal ramifications between private parties) even though an unimplemented directive raises compliance issues between the EU and member countries, not necessarily private parties.

But now we are reading the case to get a sense for what aspects of EU company law can be seen as having direct effects in member countries, where the country’s legal system has not been revised to accommodate them. That is, the question you should think about is whether the language of the Second Company Law Directive is applicable in Italy, even when the post-2005 reforms have different language. Which language is the “law of the land”?

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*Marleasing SA v. La Comercial Internacional De Alimentacion SA*

EUROPEAN COURT OF JUSTICE

(Case C-106/89)

[1990] ECR I-4135

*Marleasing* sued *La Comercial* in a Spanish court for an order declaring the nullity of *La Comercial’s* contract of incorporation. *Marleasing* alleged that the contract lacked "cause" (a requirement for validity under Spanish corporate law) and had been procured to defraud creditors. Specifically, *Marleasing* claimed that *La Comercial* had been formed by a third company *Barviesa*, solely to place *Barviesa’s* assets beyond the reach of *Marleasing* and its other creditors. *All three companies had been formed under Spanish corporate law, which permits a court to declare the nullity of a contract*
in the case of fraud. La Comercial, on the other hand, claimed that the Second Company Law Directive (Council directive 68/151) governed the question of nullity.

Article 11 of the Second Directive specifies that national courts can declare companies to be null only for the reasons listed in the Directive. These reasons include that the corporate purposes are unlawful or contrary to public policy, but not that the corporation will be used to defraud the founding shareholder's creditors. At the time, Spain had not yet implemented the Second Company Law Directive.

The Spanish court asked the Court of Justice whether it could nullify La Comercial's incorporation for reasons other than those mentioned in Article 11.

6. With regard to the question whether an individual may rely on the directive against a national law, it should be observed that, as the Court has consistently held, a directive may not of itself impose obligations on an individual and, consequently, a provision of a directive may not be relied upon as such against such a person: Case 152/84, MARSHALL v SOUTHAMPTON AND SOUTH-WEST HAMPSHIRE AREA HEALTH AUTHORITY.

7. However, it is apparent from the documents before the Court that the national court seeks in substance to ascertain whether a national court hearing a case which falls within the scope of Directive 68/151 is required to interpret its national law in the light of the wording and the purpose of that directive in order to preclude a declaration of nullity of a public limited company on a ground other than those listed in Article 11 of the directive.

8. In order to reply to that question, it should be observed that, as the Court pointed out in Case 14/83, VON COLSON AND KAMANN v LORD NORDRHEIN-WESTFALEN, the member-States' obligation arising from a directive to achieve the result envisaged by the directive and their duty under Article 5 EEC to take all appropriate measures, whether general or particular, to ensure the fulfillment of that obligation, is binding on all the authorities of member-States including, for matters within their jurisdiction, the courts. It follows that, in applying national law, whether the provisions in question were adopted before or after the directive, the national court called upon to interpret it is required to do so, so far as possible, in the light of the wording and the purpose of the directive in order to achieve the result pursued by the latter and thereby comply with the third paragraph of Article 189 EEC.

9. It follows that the requirement that national law must be interpreted in conformity with Article 11 of Directive 68/151 precludes the interpretation of provisions of national law relating to public limited companies in such a manner that the nullity of a public limited company may be ordered on grounds other than those exhaustively listed in Article 11 of the directive in question.

10. With regard to the interpretation to be given to Article 11 of the directive, in particular Article 11(2)(b), it should be observed that that provision prohibits the laws of the member-States from providing for a judicial declaration of nullity on grounds other than those exhaustively listed in the directive, amongst which is the ground that the objects of the company are unlawful or contrary to public policy.

11. According to the Commission, the expression "objects of the company" must be interpreted as referring exclusively to the objects of the company as described in the instrument of incorporation or the articles of association. It follows, in the Commission's view, that a declaration of nullity of a company cannot be made on the basis of the activity actually pursued by it, for instance defrauding the founder's creditors.

12. That argument must be upheld. As is clear from the preamble to Directive 65/151, its purpose was to limit the cases in which nullity can arise and the retroactive effect of a declaration of nullity in order to ensure 'certainty in the law as regards relations between the company and third parties, and also between
members' (sixth recital). Furthermore, the protection of third parties 'must be ensured by provisions which restrict to the greatest possible extent the grounds on which obligations entered into in the name of the company are not valid.' It follows, therefore, that each ground of nullity provided for in Article 11 of the directive must be interpreted strictly. In those circumstances the words 'objects of the company' must be understood as referring to the objects of the company as described in the instrument of incorporation or the articles of association.

13. The answer to the question submitted must therefore be that a national court hearing a case which falls within the scope of Directive 68/151 is required to interpret its national law in the light of the wording and the purpose of that directive in order to preclude a declaration of nullity of a public limited company on a ground other than those listed in Article 11 of the directive.

NOTES

1. What was the transaction that Marleasing sought to have declared null and void?
   a. How did Barviesa seek to avoid its creditors?
   b. Should corporate law permit this kind of commercial activity? Is this a matter of concern to corporate law? Does the MBCA address this?

2. According to the European Court, can an unimplemented directive have direct horizontal effects - that is, direct effect between two private parties involved in national court litigation?
   a. What was the purpose of the Second Company Law Directive?
   b. Is the purpose satisfied in this case? Is company law better or worse in Spain after this ruling?

3. Imagine that you are a Spanish lawyer asked to structure a corporate sale of assets. Company A will sell all of its assets to Company B, which has been formed by the shareholders of Company A and some new investors. In consideration, Company B will transfer to Company A a portion of its stock, which Company A will declare as a dividend to its shareholders.
   a. After the transaction, the creditors of Company A will discover that they have extended credit to a shell of a company. Does this mean the creditors have no protection?
   b. You discover provisions of the Spanish civil code (dating from 1889) that make fraudulent contracts illegal. Was the sale of assets a fraudulent contract?
   c. What law will you look to in structuring this transaction? Spanish legal codes? Spanish court decisions? European directives? ECJ decisions?
   d. In answering the question about the applicable law, does it make a difference if you find recent legislation that invalidates the kind of avoidance of creditors Company A’s shareholders have in mind.

4. Assume the owners of Solid SpA would like to have access to their business assets, without having to worry about creditor claims. They would like to form a new entity, Shell SRL, whose stated purpose would be to hold assets and engage in commercial transactions. The owners’ real purpose, however, is to leave Solid as a shell without meaningful assets, so their creditors will have no recourse. To do this, the owners have Solid transfer its property to Shell in exchange for 20% of Shell’s shares (the other 80% will go to Solid’s owners). As a result, the creditors of Solid, which once had the security of Solid assets, can now look only to much-diluted Shell shares.
   a. You will notice that this is essentially the transaction in Marleasing. What are the protections against this transaction occurring in Italy?
b. Even if the transaction occurs, can an Italian court nullify Shell SRL – under the pre-reform provisions? the post-reform provisions? the European Court of Justice interpretation of the Second Company Law Directive?

5. As we finish this section, which considers “nullity” as a tool against wrong-doing by company insiders, it’s useful to remember that sometimes legal systems adopt different instruments to deal with common problems. We comparativists should be aware (and sensitive) to this phenomenon:

All jurisdictions supply corporations with legal tools to prevent or punish asset diversion by those, whether managers or dominant shareholders, who are in control. But these rules, doctrines and remedies are far from uniform across jurisdictions. Comparative research in this field is wrought with difficulty. It is tempting to compare corporate laws by taking one benchmark jurisdiction, typically the US, and to assess the quality of other corporate law systems depending on how much they replicate some prominent features. We take a different perspective and describe how three major continental European countries (France, Germany, and Italy) regulate dominant shareholders’ self-dealing by looking at all the possible tools available there. Some of these doctrines and remedies, namely the German prohibition against concealed distributions, the role of minority shareholders in the prosecution of abus de biens sociaux in France, and nullification suits in all three countries have not received the attention they deserve.

B. Choice of Law in the Corporation

In our look at the basic differences between US corporate law and European company law, you noticed a markedly different approach to how we identified what laws regulate the internal relationships of the business firm. In Europe the prevailing rule is that companies are regulated by the country where they are located (that is, where they have their headquarters or main offices). In the United States, the corporation’s internal regulation comes from the state where it is incorporated, even if its headquarters and main operations are in another state. This US choice of law rule permits corporate participants (management and shareholders) to choose the state law to which they are subject.

The next readings look first at the operation of US “foreign corporations” (corporations that are incorporated in one state and do business in another) and a famous Delaware case involving the so-called “internal affairs doctrine.” We then look at a classic explanation for why the inter-jurisdictional corporate system in the United States is efficient, an explanation that assumes the operation of a market in corporate chartering. For many, this market is less than fully efficient, a view reflected in the recent federal legislation regulating certain aspects of corporate law.

After looking at the US side of the equation, we move to Europe where we will discover that there has been a revolution in thinking about company law and its regulatory function. The European Court of Justice has decided that the basic EU freedoms encompass the freedom of EU citizens to form companies in one member state and then operate them in another member state – similar to foreign corporations in the United States. The European limits of this incorporation-based private choice have not yet been fully defined. Is Europe approximating the United States, even as the United States has begun to displace state-based corporate law? Read on to find out.

1. Choice of law in United States: internal affairs doctrine

The following typical statute specifies how “foreign corporations” are regulated. What must a foreign corporation, such as California-incorporated Apple Inc., do to set up an Apple store in North Carolina? Is the registration process difficult? What if it is not registered in North Carolina?

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MODEL BUSINESS CORPORATION ACT
Chapter 15. Foreign Corporations
Subchapter A. Certificate of Authority

§ 15.05 Effect of certificate of authority

(a) A certificate of authority authorizes the foreign corporation to which it is issued to transact business in this state subject, however, to the right of the state to revoke the certificate as provided in this chapter.
(b) A foreign corporation with a valid certificate of authority has the same but no greater rights under this chapter and has the same but no greater privileges under this chapter as, and except as otherwise provided by this chapter is subject to the same duties, restrictions, penalties, and liabilities now or later imposed on, a domestic corporation of like character.
(c) This chapter does not authorize this state to regulate the organization or internal affairs of a foreign corporation authorized to transact business in this state.

OFFICIAL COMMENT
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A certificate of authority authorizes a foreign corporation to transact business in the state subject to the right of the state to revoke the certificate. The privileges of this status are defined in section 15.05(b): a qualified foreign corporation has the same (but no greater) privileges as a domestic corporation.

Section 15.05(b), by granting to qualified foreign corporations all of the rights and privileges enjoyed by a domestic corporation, avoids discrimination that might otherwise be subject to constitutional challenge. On the other hand, section 15.05(b) also contains a restriction or limitation: a qualified foreign corporation is subject to the same restrictions as a domestic corporation, including the same duties, penalties, and liabilities.

Section 15.05(c) preserves the judicially developed doctrine that internal corporate affairs are governed by the state of incorporation even when the corporation’s business and assets are located primarily in other states.

§ 15.03 Application for certificate of authority.

(a) A foreign corporation may apply for a certificate of authority to transact business in this State by delivering an application to the Secretary of State for filing. The application must set forth:
   (1) The name of the foreign corporation or, if its name is unavailable for use in this State, a corporate name that satisfies the requirements of G.S. 55-15-06;
   (2) The name of the state or country under whose law it is incorporated;
   (3) Its date of incorporation and period of duration;
   (4) The street address, and the mailing address if different from the street address, of its principal office;
   (5) The street address, and the mailing address if different from the street address, of its registered office in this State, the county in which the registered office is located, and the name of its registered agent at that office; and
   (6) The names and usual business addresses of its current officers.

(b) The foreign corporation shall deliver with the completed application a certificate of existence (or a document of similar import) duly authenticated by the secretary of state or other official having custody of corporate records in the state or country under whose law it is incorporated.

(c) If the Secretary of State finds that the application conforms to law he shall, when all fees have been tendered as prescribed in this Chapter:
   (1) Endorse on the application and an exact or conformed copy thereof the word “filed” and the hour, day, month, and year of the filing thereof;
   (2) File in his office the application and the certificate of existence (or document of similar import as described in subsection (b) of this section);
   (3) Issue a certificate of authority to transact business in this State to which he shall affix the exact or conformed copy of the application; and
   (4) Send to the foreign corporation or its representative the certificate of authority, together with the exact or conformed copy of the application affixed thereto.

NOTES

1. You may recall from the Conard article you read for Day 2 that before the US civil war, the US Supreme Court took the view that “foreign corporations” were not “citizens” under the privileges and immunities clause of the US Constitution, and thus each state had full regulatory power over
out-of-state corporations that sought to operate within the state’s borders. *Bank of Augusta v. Earle*, 38 U.S. 519 (1839) (Taney, J.) (rejecting that a Georgia bank could collect from an Alabama citizen on a contract in Alabama, since the bank was not a “citizen” but instead a creature of state law). In the late 1800s, the Supreme Court – without overruling this view – ruled that out-of-state corporations are “persons” under the due process clause of the 14th Amendment. *Santa Clara County v. Southern Pac. RR Co.*, 118 U.S. 394 (1888). And then in 1910 the Court held that foreign corporations were also protected from discrimination under the equal protection clause of the 14th Amendment. *Southern Ry. Co. v. Greene*, 216 US 400 (1910).

Today all states permit foreign corporations to do business in the state, subject to a simple registration process – outlined in the provisions above.

2. OK. Let’s think about US corporate federalism – that is, how the horizontal (state-state) legal system in the United States deals with interstate corporations. Suppose a “foreign corporation” incorporated in Delaware seeks to operate in North Carolina. What are the regulatory burdens for this “foreign corporation”?
   a. What must the corporation do to operate in North Carolina? Look at the requirements in the MBCA, which North Carolina has adopted.
   b. Could North Carolina refuse to allow this out-of-state business to register or operate in the state?
   c. What are the penalties for a business incorporated in another state operating without requisite authority?

3. What rules govern the corporation when it operates in another state?
   a. Suppose our foreign corporation (incorporated in Delaware but operating in North Carolina) has an internal dispute. A North Carolina shareholder claims that she has been denied voting rights. Does North Carolina corporate law apply?
   b. Suppose California shareholders bring a lawsuit in California against the corporation’s directors arguing they have violated the corporate bylaws. What standards apply if the corporation is incorporated in Delaware and operates mainly in North Carolina?
   c. Why would a California court respect that parties, mostly from North Carolina, have chosen to be governed by Delaware law?

4. The “internal affairs doctrine” originated in the early era of US corporate law, when state legislatures chartered corporations to foster local economic development. Most corporations, sometimes required by law, operated within their incorporating state. Early courts echoed the notion that states have sovereignty over their corporations and reached the logical conclusion that whatever the corporation’s constituency or wherever its operations, it was a creature of the state of incorporation. The courts pointed to their own jurisdictional incapacity to enforce judgments against out-of-state courts, as well as the practical problems of conflicting decisions and inconsistent obligations. State legislators, desirous of maintaining control of local corporations, deferred to the power of sister legislatures over their corporations – each state focusing on its own economic development. Tung, *Origins of the Internal Affairs Doctrine*, Journal of Corp. L., SSRN Paper 686592 (2005) (“strong sense that they were territorially and conceptually bound to their incorporating state”).

6. Some believe the “internal affairs” doctrine to have constitutional dimensions. That is, the federalism and liberty principles of the US Constitution prevent states from imposing their rules on out-of-state corporations in a discriminatory or burdensome way.

Here are some esoteric questions that the following case actually addresses to some extent.
a. Suppose a California judge, compelled by a California statute, applied California corporate law to an intra-corporate dispute involving a Delaware corporation. What U.S. constitutional arguments can be made that a California judge must respect Delaware’s law? What would happen if there were no “internal affairs” rule?

b. Under what circumstances can an out-of-state corporation be subject to internal corporate rules different from those of its state of incorporation? For example, could California subject “pseudo foreign corporations” (those with their headquarters, most of their business, and most of their shareholders in California, though incorporated out of state) to rules that protect minority shareholders, such as by ensuring representation on the corporation’s board of directors, even though the corporation’s state of incorporation does not?

c. Assume creditors sue in California claiming that a “pseudo foreign” corporation paid excessive dividends—remember the legal capital rules that protect creditors from rapacious corporate insiders. What state’s standards apply to the corporation’s liability to creditors?

McDermott Inc. v. Lewis
Supreme Court of Delaware
531 A.2d 206 (1986)

We confront an important issue of first impression whether a Delaware subsidiary of a Panamanian corporation may vote the shares it holds in its parent company under circumstances which are prohibited by Delaware law, but not the law of Panama. Necessarily, this involves questions of foreign law, and applicability of the internal affairs doctrine under Delaware law.

 Plaintiffs, Harry Lewis and Nina Altman, filed these consolidated suits in the Court of Chancery in December, 1982 seeking to enjoin or rescind the 1982 Reorganization under which McDermott Incorporated, a Delaware corporation (“McDermott Delaware”), became a 92%-owned subsidiary of McDermott International, Inc., a Panamanian corporation (“International”). Lewis and Altman are stockholders of McDermott Delaware, which emerged from the Reorganization owning approximately 10% of International’s common stock. Plaintiffs challenged this aspect of the Reorganization, and the Court of Chancery granted partial summary judgment in their favor, holding that McDermott Delaware could not vote its stock in International.

We conclude that the trial court erred in refusing to apply the law of Panama to the internal affairs of International. There was no nexus between International and the State of Delaware. Moreover, plaintiffs concede that the issues here do not involve the internal affairs of McDermott Delaware. * * * Accordingly, we reverse. In so doing, we reaffirm the principle that the internal affairs doctrine is a major tenet of Delaware corporation law having important federal constitutional underpinnings.

I.

International was incorporated in Panama on August 11, 1959, and is principally engaged in providing worldwide marine construction services to the oil and gas industry. Its executive offices are in New Orleans, Louisiana, and there are no operations in Delaware. International does not maintain offices in Delaware, hold meetings or conduct business here, have agents or employees in Delaware, or have any assets here.

McDermott Delaware and its subsidiaries operate throughout the United States in three principal industry segments: marine construction services, power generation systems and equipment, and engineered materials. McDermott Delaware’s principal offices are in New Orleans.
Following the 1982 Reorganization, McDermott Delaware became a 92%-owned subsidiary of International. The public stockholders of International hold approximately 90% of the voting power of International, while McDermott Delaware holds about 10%.

[At the time of the reorganization, International’s prospectus] admitted the 10% voting interest given to McDermott Delaware would be voted by International, “and such voting power could be used to oppose an attempt by a third party to acquire control of International if the management of International believes such use of the voting power would be in the best interests of the stockholders of International.”

The applicable Panamanian law is set forth in the record by affidavits and opinion letters of Ricardo A. Durling, Esquire, and the deans of two Panamanian law schools, to support the claim that McDermott Delaware’s retention of a 10% interest in International, and its right to vote those shares, is permitted by the laws of Panama. Significantly, the plaintiffs have not offered any contrary evidence.

Mr. Durling, an expert on Panamanian corporate law,11 stated:

12. Based upon the foregoing, I am of the opinion that: (a) McDermott Delaware can lawfully vote its shares in International at any of International’s shareholders meetings; (b) the provisions contained in Section 17 of Panama’s General Corporation law are not applicable to shares held by McDermott Delaware, one of International’s subsidiaries; and (c) the retention by McDermott Delaware of a 10% interest in the voting power of International pursuant to the reorganization is lawful under applicable Panama law.

Appendix to Appellant’s Opening Brief at A-178 to A-181. * * * This evidence of Panamanian law is uncontroverted. Plaintiffs have offered no proof whatever on the subject. * * *

II.

We note at the outset that if International were incorporated either in Delaware or Louisiana, its stock could not be voted by a majority-owned subsidiary. 8 Del.C. § 160(c)12; La. Rev. Stat. Ann. § 12:75(G).13 No United States jurisdiction of which we are aware permits that practice.

[The] trial court * * * concluded that since both Delaware and Louisiana law prohibit a majority-owned subsidiary from voting its parent’s stock, the device was improper. We consider this an erroneous application of both Delaware and Panamanian law.

11 Mr. Durling has been a practicing lawyer in Panama since 1955 and is currently completing what will be the first treatise on the subject of Panama Corporate Law.

12 8 Del.C. § 160(c) provides:
Shares of its own capital stock belonging to the corporation or to another corporation, if a majority of the shares entitled to vote in the election of directors of such other corporation is held, directly or indirectly, by the corporation, shall neither be entitled to vote nor be counted for quorum purposes. Nothing in this section shall be construed as limiting the right of any corporation to vote stock, including but not limited to its own stock, held by it in a fiduciary capacity.

Neither (1) treasury shares, nor (2) unissued shares, nor (3) shares of a parent corporation held by a subsidiary corporation in which the parent holds a majority of the shares entitled to vote for the election of directors, shall be voted, or counted in calculating the voting power of shareholders of a corporation.
It is apparent that under limited circumstances the laws of Panama permit a subsidiary to vote the shares of its parent. Article 35 of Panamanian Cabinet Decree No. 247 of July 16, 1970, which is part of the General Corporation Law of Panama, restricts the exercise of voting rights on shares of certain Panamanian corporations, but Article 37 limits the scope of Article 35 to “corporations registered in the National Securities Commission [of Panama] and those whose shares are sold on the market”.

The uncontroverted evidence clearly and unambiguously rejects the contention that Panamanian law prohibits all conduct not otherwise expressly permitted. All three legal experts agreed that McDermott Delaware could vote the shares it held in International. Further, Dean Fernandez specifically stated that it “is a principle of law that in matters of public law one can only do what is expressly allowed by the law; while in private law all acts not prohibited by law can be performed.” This fully accords with basic principles of Delaware corporate law.

Given the uncontroverted evidence of Panamanian law, establishing that a Panamanian corporation may place voting shares in a majority-owned subsidiary under the limited circumstances provided by Article 37, we turn to the fundamental issues presented by application of the internal affairs doctrine.

III.

Internal corporate affairs involve those matters which are peculiar to the relationships among or between the corporation and its current officers, directors, and shareholders. Edgar v. MITE Corp., 457 U.S. 624, 645, 102 S.Ct. 2629, 2642, 73 L. Ed. 2d 269 (1982). Restatement (Second) of Conflict of Laws § 313, Comment a (1971). It is essential to distinguish between acts which can be performed by both corporations and individuals, and those activities which are peculiar to the corporate entity.

Corporations and individuals alike enter into contracts, commit torts, and deal in personal and real property. Choice of law decisions relating to such corporate activities are usually determined after consideration of the facts of each transaction. See Reese and Kaufman, The Law Governing Corporate Affairs: Choice of Law and the Impact of Full Faith and Credit, 58 Colum. L. Rev. 1118, 1121 (1958) (hereinafter “Reese and Kaufman”). In such cases, the choice of law determination often turns on whether the corporation had sufficient contacts with the forum state, in relation to the act or transaction in question, to satisfy the constitutional requirements of due process. The internal affairs doctrine has no applicability in these situations. Rather, this doctrine governs the choice of law determinations involving matters peculiar to corporations, that is, those activities concerning the relationships inter se of the corporation, its directors, officers and shareholders.

The internal affairs doctrine requires that the law of the state of incorporation should determine issues relating to internal corporate affairs. First Nat’l City Bank v. Banco Para el Comercio Exterior de Cuba, 462 U.S. 611, 621, 103 S.Ct. 2591, 2597, 77 L. Ed. 2d 46 (1983). Under Delaware conflict of laws principles and the United States Constitution, there are appropriate circumstances which mandate application of this doctrine.

A.

The traditional conflicts rule developed by courts has been that internal corporate relationships are governed by the laws of the forum of incorporation. See Macey & Miller, Toward an Interest-Group Theory of Delaware Corporate Law, 65 Tex. L. Rev. 469, 495 (1987). As early as 1933, the Supreme Court of the United States noted:

It has long been settled doctrine that a court state or federal sitting in one state - will, as a general rule, decline to interfere with, or control by injunction or otherwise, the management of the internal affairs of a corporation organized under the laws of another state but will leave controversies as to such matters to the courts of the state of the domicile . . . .


A review of cases over the last twenty-six years * * * finds that in all but a few, the law of the state of incorporation was applied without any discussion.

The policy underlying the internal affairs doctrine is an important one, and we decline to erode the principle:

Under the prevailing conflicts practice, neither courts nor legislatures have maximized the imposition of local corporate policy on foreign corporations but have consistently applied the law of the state of incorporation to the entire gamut of internal corporate affairs. In many cases, this is a wise, practical, and equitable choice. It serves the vital need for a single, constant and equal law to avoid the fragmentation of continuing, interdependent internal relationships. The lex incorporationis, unlike the lex loci delicti, is not a rule based merely on the priori concept of territoriality and on the desirability of avoiding forum-shopping. It validates the autonomy of the parties in a subject where the underlying policy of the law is enabling. It facilitates planning and enhances predictability. In fields like torts, where the typical dispute involves two persons and a single or simple one-shot issue and where the common substantive policy is to spread the loss through compensation and insurance, the preference for forum law and the emphasis on the state interest in forum residents which are the common denominators of the new conflicts methodologies do not necessarily lead to unacceptable choices. By contrast, applying local internal affairs law to a foreign corporation just because it is amenable to process in the forum or because it has some local shareholders or some other local contact is apt to produce inequalities, intolerable confusion, and uncertainty, and intrude into the domain of other states that have a superior claim to regulate the same subject matter. . .

Kozyris, Corporate Wars and Choice of Law, 1985 Duke L.J. 1, 98.

B.

Given the significance of these considerations, application of the internal affairs doctrine is not merely a principle of conflicts law. It is also one of serious constitutional proportions -- under due process, the commerce clause and the full faith and credit clause -- so that the law of one state governs the relationships of a corporation to its stockholders, directors and officers in matters of internal corporate governance. The alternatives present almost intolerable consequences to the corporate enterprise and its
managers. With the existence of multistate and multinational organizations, directors and officers have a significant right, under the fourteenth amendment’s due process clause, to know what law will be applied to their actions. Stockholders also have a right to know by what standards of accountability they may hold those managing the corporation’s business and affairs. That is particularly so here, given the significant fact that in the McDermott Group reorganization, and after full disclosure, 89.59% of the total outstanding common shares of McDermott Delaware were tendered in the exchange offer.

Under the commerce clause *Pike v. Bruce Church, Inc.*, 397 U.S. 137, 142, 90 S.Ct. 844, 844, 25 L. Ed. 2d 174 (1970), determined that a state may regulate interstate commerce indirectly, but emphasized that the burden placed upon interstate commerce may not be excessive in relation to the local interests served by the regulation. In *Edgar v. MITE Corp.*, 457 U.S. 624, 102 S.Ct. 2629, 73 L. Ed. 2d 269 (1982), the Supreme Court ruled that under the commerce clause a state “has no interest in regulating the internal affairs of foreign corporations.” Id. at 645-46, 102 S.Ct. at 2642. If that is so, then a court or state which attempts to displace the internal affairs doctrine carries a heavy burden to justify its actions.

The recent decision in *CTS Corp. v. Dynamics Corp. of America*, 481 U.S. 69 (1987), seems to support this interpretation of MITE:

This Court’s recent Commerce Clause cases also have invalidated statutes that adversely may affect interstate commerce by subjecting activities to inconsistent regulations . . . The Indiana Act poses no such problem. *So long as each State regulates voting rights only in the corporations it has created, each corporation will be subject to the law of only one state.* No principle of corporation law and practice is more firmly established than a State’s authority to regulate domestic corporations, including the authority to define the voting rights of shareholders . . . This beneficial free market system depends at its core upon the fact that a corporation -- except in the rarest situations -- is organized under, and governed by, the law of a single jurisdiction, traditionally the corporate law of the state of its incorporation.

*CTS Corp.*, 481 U.S. 69(citations omitted) (emphases added). Thus, we conclude that application of the internal affairs doctrine is mandated by constitutional principles, except in “the rarest situations.”

Addressing the facts originally presented to the trial court and to us, we must conclude that due process and the commerce clause, in addition to principles of Delaware conflicts law, mandate reversal. Due process requires that directors, officers and shareholders be given adequate notice of the jurisdiction whose laws will ultimately govern the corporation’s internal affairs. Under such circumstances, application of 8 Del.C. 160(c) to International would unfairly and, in our opinion, unconstitutionally, subject those intimately involved with the management of the corporation to the laws of Delaware.

Moreover, application of Section 160(c) to International would violate the commerce clause. Delaware and Panama law clearly differ in their treatment of a subsidiary’s voting rights under the facts originally presented here. For Delaware now to interfere in the internal affairs of a foreign corporation having no relationship whatever to this State clearly implies that International can be subjected to the differing laws of all fifty states on various matters respecting its internal affairs. Such a prohibitive burden has obvious commerce clause implications, and could not pass constitutional muster.

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**Notes**

1. Where is Delaware? How can such a tiny state be so important to the economy of the United States?
2. Next is a classic explanation of the reason Delaware has been successful in providing corporate law to most large companies in the United States. Notice Professor Romano’s great faith in markets and her abhorrence of federal regulation. What would she think about the European approach to company law with harmonizing directives and each member state in control of company law under the siege social rule (the company’s headquarters determines the law governing its internal affairs).

THE GENIUS OF AMERICAN CORPORATE LAW
(American Enterprise Institute Press 1993)
Roberta Romano

Chapter 1
Introduction

THE GENIUS OF AMERICAN CORPORATE LAW is in its federalist organization. In the United States, corporate law, which concerns the relation between a firm’s shareholders and managers, is largely a matter for the states. Firms choose their state of incorporation, a statutory domicile that is independent of physical presence and that can be changed with shareholder approval. The legislative approach is, in the main, enabling. Corporation codes supply standard contract terms for corporate governance. These terms function as default provisions in corporate charters that firms can tailor more precisely to their needs. Firms therefore can particularize their charters under a state code, as well as seek the state whose code best matches their needs so as to minimize their cost of doing business.

Provisions in corporation codes run the gamut from trivial housekeeping to the fundamental fashioning of shareholder-manager relations. They range from specifying that a corporation’s name be placed in its charter to specifying fiduciary duties of managers and voting rights of shareholders, and when they can be waived, and procedures for corporate combinations, including when managers’ as opposed to shareholders’ decisions are controlling. States provide a different set of governance defaults...
for small, privately held firms, which are called close corporation codes. The variety in corporation codes and in their enabling approach readily accommodates the diversity in organization, capital structure, and lines of business among business firms.

The master problem animating corporation codes is the separation of ownership from control in the modern public corporation. Large firms typically have numerous shareholders with small holdings who cannot actively exercise control over the firm or monitor management. The holdings of managers running such firms are also usually infinitesimal. This creates an agency problem, in which the managers’ operation of a firm may deviate from the shareholders’ wishes to maximize the firm’s value. Managers, for example, may implement a policy that makes their jobs more secure, such as engaging in defensive tactics to thwart a corporate takeover, even though the policy reduces the firm’s value. Or, because the bulk of the managers’ wealth is tied up in the firm in present and future compensation, they may adopt a corporate strategy that reduces firm-specific risk, such as diversifying corporate acquisitions, even though shareholders do not benefit from the policy because they hold diversified stock portfolios that are subject to market, and not firm-specific, risk.

A primary function of corporation codes in this regard is to establish corporate governance devices that can mitigate the agency problem by better aligning manager incentives with shareholder interests. The more prominent examples of such devices are (1) shareholder-elected boards of directors who monitor managers, (2) shareholder voting rights for fundamental corporate changes, and (3) fiduciary duties that impose liability on managers and directors who act negligently or with divided loyalty (favoring their own financial interest over that of shareholders).

National Controls

In addition to state corporation codes, shareholder-manager relations in public corporations are also subject to an array of national controls under the federal securities laws, which regulate the issuance and trading of securities and the continuing disclosure responsibilities to investors of public firms. In contrast to state corporation laws, federal regulations are mandatory. The reach of federal securities laws into traditional spheres of state jurisdiction, such as officers’ and directors’ fiduciary duties to shareholders, has over time been expanded and contracted, like an accordion, by federal courts. But even here the national legislation is not preemptive: it expressly preserves a role for states in securities regulation. The relation, however, is one-sided; the federal securities regime establishes minimum disclosure requirements, which states can expand but not diminish.

Federalism and Corporate Law

A federal system of government produces a number of benefits for its citizens. It protects the individual from the immense power of government, as the states are a counterweight to the national government. It can allocate public goods and services more efficiently, as well as increase individual utility, compared with a centralized government because of its superior ability to match specific government policies with diverse citizen preferences regarding such policies: in a federal system, states and municipalities compete for citizens who choose to reside in the jurisdiction offering their preferred package of public goods and services. Finally, federalism spurs innovation in public policy because of the incremental experimentation afforded by fifty laboratories of states competing for citizens and firms. A policy improvement identified by one state is quickly enacted by other states.

But just as the benefits from federalism are axiomatic in American politics, it is also well recognized that a federal system can impede the administration of government and thereby diminish individual welfare. In particular, if the costs and benefits of a specific public policy do not fall within the boundaries of one jurisdiction, the optimal quantity and quality of public goods and services will not be produced. A state will not want to pay for benefits experienced by nonresidents, for example, and thus
will underprovide a public good or service (such as a mosquito-spraying program that will benefit adjoining jurisdictions or highways that are used by interstate travelers). Similarly, states may export the cost of providing goods and services for their residents to nonresidents, for instance, by adopting taxes that are more likely to be paid by out-of-state than in-state individuals or firms, severance taxes in natural resource states, gaming taxes in Nevada, and in Iowa a single-factor corporate tax formula based on sales, which gives advantages to local firms that sell the bulk of their products out of state.

A more adverse consequence of federalism is the potential for interjurisdictional competition that is not even zero-sum but a negative-sum game. Many commentators have characterized state economic development policies as such a game, in which competing states offer subsidies to firms that exceed the revenue from the local jobs they create. Finally, by tolerating overlapping jurisdictional authority or requiring intergovernmental coordination, federalism raises the cost of implementing public policy, even when there is consensus on the policy objective.

The corporate law literature is a microcosm of this tension in the policy debate over federalism because an important theme in the literature focuses on the effect of competition among the states for tax revenues generated by corporate charters. Corporation codes can be viewed as products, whose producers are states and whose consumers are corporations. A key question is whether there is any reason to suppose that the code provisions produced by state competition benefit investors. The concern arises because one state within the federal structure, Delaware, which is a small state by any measure population, geography, industrial or agricultural production has dominated all the rest.

**Delaware and Competition for State Charters**

Approximately one-half of the largest industrial firms are incorporated in Delaware, and of the corporations listed on national exchanges, more are incorporated in Delaware than in any other state. Moreover, the vast majority of reincorporating firms move to Delaware. As a result, a substantial portion of the state’s tax revenue averaging more than 15 percent from 1960 to 1990 is derived from incorporation fees. (In 1990, Delaware had revenues from franchise taxes of $200,201,000, which accounted for 17.7% of total tax collected. The estimated cost for the state to run its incorporation system in the state was $6.5 million.) While the absolute dollars raised from franchise fees in large commercial states are greater than in Delaware, the amount is an infinitesimal proportion of their total tax revenue. These data provide a conservative estimate of the profitability of Delaware’s chartering business; revenues are understated by ignoring the increased income taxes paid by state residents who service Delaware corporations, and expenditures are overstated by including the entire state court budget although only a fraction of cases involves corporation law. Delaware’s dominance is a stable and persistent phenomenon: it has been the leading incorporation state since the 1920s.

The dynamic business environment in which firms operate places a premium on a state’s responsiveness to corporations’ legislative demands, that is, on a state’s ability to adapt its corporation code to changing business circumstances. It also places a premium on a decentralized regime: the trial-and-error process of interjurisdictional competition enables a more accurate identification of optimal corporate arrangements when there is fluidity in business conditions. Delaware excels in both dimensions. It has consistently been the most responsive state: if Delaware is not the pioneer for a corporate law innovation, it is among the first to imitate.

The extraordinary success of tiny Delaware in the corporate charter market due to its responsiveness to changing corporate demands is the source, then, of a recurrent corporate law debate on the efficacy of federalism. Who benefits from the laws produced in a federal system, and, in particular, from Delaware’s corporation code: managers, who select the state of incorporation, or shareholders, who ratify that selection? Does state competition produce corporation codes that mitigate the agency problem or exacerbate it? If state codes favor managers over shareholders, then from the objective of corporate law
itself, the output of state competition is undesirable. Whether the current allocation of authority between the state governments and the national government should be maintained under such circumstances depends on whether the outcome would differ under a national corporation code.

The best assessment of the evidence is that state chartering is for the better and that Delaware’s code, for the most part, benefits shareholders. Indeed, the debate’s focus in the late 1980s shifted away from Delaware toward the actions of other states, with the widespread enactment of state laws regulating takeovers (corporate acquisitions that take the form of a tender offer to shareholders and thereby, in contrast to mergers, avoid the need for incumbent management’s consent). In this important area of statutory innovation, an interesting role reversal occurred: Delaware was a laggard rather than a leader.

Chapter 2
The Federalism Debate

THE CLASSIC POSITIONS in the modern debate on whether state corporation codes benefit shareholders were formulated in the 1970s by William Cary, professor at Columbia Law School and former commissioner of the Securities and Exchange Commission, and Ralph Winter, professor at Yale Law School (currently a federal appeals court judge). Cary contended that Delaware’s heavy reliance on incorporation fees for revenue led it to engage in a “race for the bottom” with other states to adopt laws that favor managers over shareholders! He therefore advocated national corporate law standards to end state competition. Cary’s position was, for many years, the consensus view of commentators on corporate law, and his agenda still attracts support.

A Race for the Bottom or to the Top?

Winter identified a crucial flaw in Cary’s analysis, which, when corrected, suggested that the race was more to the top than the bottom: Cary had overlooked the many markets in which firms operate the capital, product, and corporate control markets and that constrain managers from choosing a legal regime detrimental to the shareholders’ interests. While agreeing with Cary’s characterization of the power of competition in producing laws that firms demand, Winter’s important point was that firms operating under a legal regime that did not maximize firm value would be outperformed by firms operating under a legal regime that did and the former would therefore have lower stock prices. A lower stock price could subject a firm’s managers to either employment termination, as the firm is driven out of business because of a higher cost of capital than that of competitors operating under a value-maximizing regime, or replacement by a successful takeover bidder that could increase a firm’s value by reincorporating (the term of art for a change in statutory domicile). Winter concluded that this threat of job displacement would lead managers to demand a value-maximizing regime for their shareholders and that states would provide it, as such a strategy maintains, if not enhances, a state’s incorporation business. Winter’s critique forced adherents of the Cary position to amend it. The contention became that markets are imperfect constraints on managers and, hence, there is sufficient slack in the system to produce non-value-maximizing state laws.

In both the Cary and the Winter positions, the goal of maximizing revenues functions as an invisible hand guiding the decentralized system of state corporation laws to codify the arrangements that firms desire. The crux of their disagreement concerns whose demand schedule for corporate charters is driving the system. Cary and the proponents of a national corporation code consider the demand function to be derived from managers’ preferences. They view the state legislative process as a political market failure in which managers are better organized than the more numerous but dispersed shareholders, and they characterize managers’ preferences for codes as diametrically opposed to those of shareholders’. Winter and advocates of state chartering conclude that shareholders’ preferences determine firms’ demand because of the constraining influence on managers of the many markets in which firms operate, which reduces or eliminates the agency problem. They further maintain that even if there is slack in the
system (there is, as shown in subsequent chapters), it does not follow that national legislation would do a better job than state competition at mitigating the agency problem. Of course, in the absence of conflict between shareholder and manager preferences, the debate is moot, since the substantive content of state laws would be invariant with whoever, managers or shareholders, makes the incorporation decision or lobbies state legislators. The choice of incorporation state would therefore automatically enhance the value of the firm and, accordingly, shareholder wealth.

Since the publication of the Cary and Winter articles, empirical studies have sought to arbitrate the debate over who benefits from state competition, shareholders or managers, by measuring the economic impact of managerial discretion to choose among alternative corporation codes by changing a firm’s state of incorporation. They conclude that the choice benefits rather than harms shareholders.

The conclusion rests on widely accepted financial econometric techniques known as event studies, which examine whether particular information events (discrete public events introducing new information to financial markets), such as a firm’s decision to change its state of incorporation, significantly affect a firm’s stock price (technically, they examine whether the average residuals of a regression of observed stock prices on predicted prices are statistically significantly different from zero). If an information event, in this instance, reincorporating in Delaware is considered beneficial for shareholders (that is, if it enhances the value of their equity investment), then stock prices will rise significantly above their expected value on the public announcement of the event. If the event is perceived as detrimental to shareholder wealth, then stock prices will significantly decline. Given the regression methodology, such stock price effects are referred to as average residuals or abnormal returns. The posited relationships between changes in stock price and reincorporation announcements restate the Winter and Cary theses in testable form: Cary’s thesis that shareholders are harmed by Delaware’s code implies that firms should experience a significant negative price effect when they announce a reincorporation in Delaware. Similarly, Winter’s hypothesis predicts a positive effect.

There have been five event studies of reincorporation. While several have found significant positive stock price effects on firms’ reincorporation to Delaware, no study has found a negative stock price effect as Cary would predict. The data are most consistent with Winter’s hypothesis of the efficacy of competition.

- Allen Hyman, *The Delaware Controversy-The Legal Debate*, 4 DEL. J. CORP. L. 368 (1979) (1.8% to 2.9% positive returns during the two weeks surrounding announcement of reincorporation)
- Roberta Romano, *Law as Product: Some Pieces of the Incorporation Puzzle*, J. L. ECON & ORGAN. at 269-70 (4.1% positive abnormal returns for all reincorporations during sample period, within 99 days before and after event).
- Jeffry Netter & Annette Poulsen, *State Corporation Laws and Shareholders: The Recent Experience*, 18 FIN. MGMT (No. 3) 29, 36 (1989) (5.67% abnormal returns in interval around event)

NOTES

1. Why does Romano assert that American corporate law reflects a “genius?”
a. Is there any one person or jurisdiction that has been a genius, or is it the process that she praises?
b. What are the arguments in the “race of laxity” debate? Does either side disagree that the history of US corporate law has been one of increasing laxity? What is the Cary thesis? the Winter thesis?
c. Which is more credible? How does Romano attempt to measure the effects of state competition for charters?

2. Most US corporations – public and closely-held – are not incorporated in Delaware. In fact, of all recent incorporations only 5% have occurred in Delaware. Yet about 80% of new incorporations of companies that have or are to have public shareholders occur in Delaware. Why?

a. Corporate lawyers give a number of reasons for choosing Delaware: the Delaware statute is flexible and detailed; the Delaware legislature is responsive to corporate needs (such as allowing new financing techniques or electronic communications); the Delaware courts have created an impressive body of interpretative caselaw; the Delaware courts have also been law-makers, creating a dynamic body of law in such changing areas as takeovers and shareholder voting; the Delaware corporate lawyers are expert in public corporation issues.

b. In the 1980s, Nevada attempted to replicate Delaware’s corporate law success by copying the Delaware statute and providing that Delaware caselaw was fully applicable in Nevada. The attempt flopped. Without Delaware legislators, courts and lawyers, Nevada was seen as a cheap and inadequate imitation.

c. The intuition that good legal institutions improve shareholder returns has been confirmed in studies of shareholder returns in different countries. For example, total stock market returns correlate positively with the quality of legal institutions (judicial efficiency and rule of law). Curiously, shareholder rights protection does not correlate with shareholder returns. In other words, good courts may be much more important than good laws! See Davide Lombardo & Marco Pagano, Legal Determinants of the Return on Equity, SSRN Paper 209310 (1999).

3. Rarely do public corporations migrate from Delaware to another state. In a study of reincorporations from 1982 to 1994, less than 10% of all public reincorporations were from Delaware; more than 90% were to Delaware. This is so even though Delaware has a higher franchise tax (annual cost of keeping Delaware incorporation) than any other state. Note, Is Delaware Still a Haven for Incorporation?, 20 DEL. J. CORP. L. 965, 1011 (1995)

4. Given the apparent advantages of incorporation in Delaware, why would managers of public corporations choose a non-Delaware jurisdiction? The principal reason seems to be that other states are more pliant. The state where the company’s principal offices are located offers the advantage that the state legislature is more likely to respond to the local firm’s needs -- particularly in an anxiety-producing takeover.

For example, when the negotiated merger in 2003 between two North Carolina banks (Wachovia and First Union) was jeopardized by an uninvited bid from a Georgia bank (SunTrust), the North Carolina legislature interceded enthusiastically on behalf of local management. In a week of hurried legislative activity, it revised the North Carolina statutory provision concerning when shareholders can call a special meeting, thus preventing SunTrust from seeking a shareholder vote to gain control of the Wachovia board. Delaware, as Romano points out, has been far less willing to adopt anti-takeover provisions and rarely acts at the request of a single corporate constituent. Protecting its valuable reputation for even-handedness, and thus its corporate law franchise, is far too important!
5. Later in her book Romano discusses competition for close corporation charters -- that is, for incorporation by firms whose shares are not publicly traded. She accepts that close corporations, whose shares are not traded on public markets, are largely immune from the optimizing pressures created by capital markets and that close corporations tend to be incorporated locally. In fact, most US corporate lawyers advise their corporate clients to “stay local” if the business will not have public shareholders. State legislatures, it would seem, do not have the same incentives to provide corporate statutes that best mediate the conflicts between shareholders and managers. Or do they?

a. What forces might compel state legislatures (or state courts) to provide optimal close corporation solutions? For example, what would happen in a state that does not protect minority shareholders?

b. Has the recent experience with LLCs, which may be formed in any state even if their operations are local, provide any insight into the competition for closely-held business forms? As Romano points out, “Legislators tend to function more as firemen than police: they need to be told by constituents something is wrong (pull the fire alarm) than search to find a problem (patrol a neighborhood).” How have state legislatures responded to the LLC revolution?

6. Romano also describes that state corporation law is really the product of lawyer groups -- for example, the North Carolina Bar Association’s business law section. Lawyers have an incentive to maximize their fees -- adding provisions to state law that favor their roles as litigators and planners. In fact, Delaware lawyers seem to do a good job of collecting more fees in corporate law cases than lawyers in other states! Perhaps lawyers who draft corporate codes are taking advantage of shareholders.

2. Choice of law in Europe: seige social under attack

So America really believes in its markets – even its markets in law. In Europe things have been different. There is much less trust of markets and the private choice they reflect. Instead, regulation is usually assumed to be necessary to protect the weak from the powerful, even when the weak are capitalists, such as wealthy investors and banks.

We start with a summary of the prevailing understanding of how companies and their internal relationships are regulated in Europe. We then look at a curious Italian law regarding choice of law for companies, first adopting the incorporation doctrine and then restating the siege social principle for Italian companies. After this confused state of affairs, we turn to a series of decisions by the European Court of Justice – starting with the famous case of Centros. The line of cases revolutionizes company law in Europe by compelling EU member states to abide by the incorporation decision of private parties.

Europe’s come a long way! But how long is still not clear. Is there going to be a Delaware of Europe? Will it be Britain? These are speculative questions and we will read the tea leaves.

Company Law in the European Single Market
Richard D. English

Corporations operating in more than one country must comply with the laws of every nation in which they do business. To avoid confusion, each jurisdiction’s law must have rules --

- for recognizing the foreign corporate personality and business activities,
for determining the nationality, domicile, and residence of corporations,
for identifying the legal system that will provide the rules for governing the corporation’s internal affairs (the multiple relationships among managers and shareholders), ** **

In American corporate law, it is a long-standing and well-established rule that the shareholder-manager relationships are governed by the law of the state of incorporation -- the famous “internal affairs” doctrine. In continental Europe, the prevailing rule is that the internal affairs are subject to the law of the state where the company has its headquarters -- the “siege social” rule. (Siege social is essentially equivalent to the English terms “head office” or “headquarters.” THE OXFORD PAPERBACK FRENCH DICTIONARY 215 (1989).) Except for Ireland, UK and the Netherlands, all the EC countries recognize the siege social rule. The siege social is required to be the real central office (siege real) and not just a formal registered office (siege statutory). In Italy, companies incorporated abroad that have their principal place of business or activity in Italy are regarded as Italian companies, and they must comply with the provisions of Italian law. G. CERTOMA, THE ITALIAN LEGAL SYSTEM 94 (1985).

Articles 52 and 58 of the Treaty of Rome, which call for the free movement of persons and the right of establishment, are at odds with the siege social rule, since the rule can result in non-recognition of a company’s legal capacity, even though the company is incorporated in another Member State. This issue was addressed by the Convention on the Mutual Recognition of Legal Persons, which provided as a general principle that a company incorporated in one Member State but having its registered office anywhere in the Community would be recognized in all other Member States and have the validity and capacities provided by the state of incorporation. The Convention has never come into force because of the Netherlands’ failure to ratify it. In anticipation of EC harmonization, many non-EC companies have formed subsidiaries organized under the laws of the Member States to take advantage of the Treaty of Rome’s right of establishment.

Reform of the Italian System of Private International Law
(Law No. 218 of 31 May 1995 - effective 1 Sep 1995)

Chapter III: Legal Persons
Article 25 (Companies and other entities)

1. Companies ... shall be governed by the law of the State in which they are organized. Nevertheless, Italian law shall apply if the head office is in Italy as well as if the principal operation of the [company] is situated in Italy.

2. The law governing the [company] shall in particular apply to: (a) legal nature; (b) trade or company name; (c) incorporation, transformation and dissolution; (d) capacity; (e) establishment, powers and operational modalities of the organs; (f) agency; (g) modalities to acquire or lose membership status in the body as well as rights and obligations resulting therefore; (h) liability for obligations undertaken by the entity; (i) consequences resulting from breach either of law or of the articles of incorporation.

NOTES

1. The first sentence of the 1995 Italian choice-of-law law seems to replace the traditional “siege social” rule with the “internal affairs doctrine” for businesses incorporated outside of Italy. But then, in the second sentence, it says that the “siege social” rule still applies if the business has its

a. Does this provision mean that a US firm incorporated in Delaware could do business in Italy and not become subject to Italian company law?

b. Does this allow an Italian firm to reincorporate in Luxembourg or Delaware, and thus avoid the provision of Italian company law?

2. Until recently the “siege social” rule meant there was no American-style race of laxity in Europe. Why not? Was it the law or the business culture? In particular, why didn’t Luxembourg seek to raise some revenues by offering flexible company law to those European businesses who might want it?

3. Why have Europeans shunned an “incorporation” rule? Consider the following answer:

   Even though company law is regulated primarily at the state level in the United States and Europe, the American debate focuses on the interests of the shareholders, and the relationships between shareholders and directors. In contrast the European approach, at least in continental Europe, is that company law should also be concerned with the interests of creditors and employees. For example, Second Company Law Directive seeks to protect creditors through capital requirements.

   The interests of the employees are also included in the national company law. Denmark, the Netherlands, Austria, and Germany require employee representation in their company laws. In Denmark, a company with at least 35 employees must include employee-elected representatives constituting up to one half of the supervisory board. In the Netherlands, it is mandatory for large companies to have employee representation on the supervisory board. In German companies with more than 500 employees, employees can elect one third of the members of the supervisory board, and if more than 2000 employees, the employees can elect half of the supervisory board.

   The situation feared in the European Union is a market for company incorporations that will undermine protection of shareholders, creditors, and employees.


In the past several years, the European Court of Justice has decided a series of cases that reflect a transformation in the attitude toward companies and company law in Europe. No longer viewing companies as “creatures of state law” subject to the regulatory regime of each state in which they operate, the Court has come to see companies as private instruments of business, whose freedom of movement, establishment and activities are comparable to “real persons.”

The following three cases resolve the following issues –

1. **Recognition of foreign branch** (*Centros Ltd v Erhvervs-og Selskabsstyrelsen* - 1999): whether a company formed in the UK must be recognized in Denmark, even though the company owners who plan to operate the business in Denmark sought to avoid the more burdensome minimum capital rules of Denmark by forming the company in the UK;

2. **Authority of foreign company to sue** (*Uberseering BV v Nordic Construction Company Baumanagement GmbH* - 2002): whether a company formed in the Netherlands, but later purchased by German owners who operated it in Germany, has
“legal personality” to enforce a contract in German court (where German case law uses *siege social* to determine a company’s power to sue);

(3) **Avoidance of domestic creditor-protection rules** (*Kamer van Koophandel en Fabrieken voor Amsterdam v Inspire Art Ltd. – 2003*): whether a company formed in the UK by Dutch owners, to avoid the minimum capital requirements of the Netherlands, is subject to the rules imposed on “pseudo foreign companies” operating in the Netherlands (an exception to the usual Dutch choice of law that foreign companies are governed by the law of their place of incorporation)

In each case, you will notice that the Court has not only found in favor of free establishment of European companies, but has narrowed the grounds under which EU member states can impose restrictions on companies that operate domestically but are organized elsewhere in the EU. Neither the failure of the EU member states to agree on a universal choice of law principle for companies nor the absence of a complete regime of company law harmonization has been treated as an impediment to the Court accomplishing indirectly what the EU member states have failed to do directly.

Before you read the cases it may be helpful to review the EU law on which the Court has based its rulings. Here is a summary of the relevant treaty provisions from the *Inspire Art* decision of 2003.

**Article 43 EC** provides that ‘Within the framework of the provisions set out below, restrictions on the freedom of establishment of nationals of a Member State in the territory of another Member State shall be prohibited. Such prohibition shall also apply to restrictions on the setting-up of agencies, branches or subsidiaries by nationals of any Member State established in the territory of any Member State.’

**Article 48 EC** extends entitlement to freedom of establishment, subject to the same conditions as those laid down for individuals who are nationals of the Member States, to 'companies or firms formed in accordance with the law of a Member State and having their registered office, central administration or principal place of business within the Community'.

**Article 46 EC** permits the Member States to restrict the freedom of establishment of foreign nationals by adopting 'provisions laid down by law, regulation or administrative action', in so far as such provisions are justified 'on grounds of public policy, public security or public health'.

**Article 44(2)(g) EC** empowers the Council of the European Union, for the purpose of giving effect to freedom of establishment, to coordinate 'to the necessary extent the safeguards which, for the protection of the interests of members and others, are required by Member States of companies or firms within the meaning of the second paragraph of Article 48 of the EC Treaty with a view to making such safeguards equivalent throughout the Community.'

In addition, it’s useful to consider the important EU company law directives and what they have sought to accomplish for companies operating in different European countries:

**The First Council Directive** [Second Company Law Directive 68/151/EEC of 9 March 1968 on coordination of safeguards which, for the protection of the interests of members and others, with a view to making such safeguards equivalent throughout the Community (OJ, English Special Edition 1968 (I), p. 41, 'the First Directive'), applies to companies with share capital. It provides for three measures calculated to protect the interests of other persons dealing with those companies: obligatory information for each company registered in the relevant commercial register, harmonisation of the national rules on the validity and enforceability of obligations entered into in the name of the company, and the drawing up of a list exhaustively setting out the cases entailing the nullity of a company.
The Second Council Directive 77/91/EEC of 13 December 1976 on coordination of safeguards which, for the protection of the interests of members and others, with regard to the formation of public limited liability companies and the maintenance and alteration of their capital, with a view to making such safeguards equivalent (OJ 1977 L 26, p. 1, ‘the Second Directive’), specifies the information which must mandatorily be given in the statutes or the instrument of incorporation of public limited companies and the minimum amount of share capital required for such companies and it provides for harmonised rules concerning contributions to assets, paying up of shares, the nominal value of shares and the distribution of dividends to shareholders.


- Article 2(1) of the Eleventh Directive provides a list of the information which must be disclosed in the Member State in which the branch is established.

- Article 2(2) of the Eleventh Directive permits the Member State in which the branch has been opened to provide for additional disclosure requirements.

- Article 12 of the Eleventh Directive requires the Member States to provide for appropriate penalties for failure to comply with the disclosure requirements.

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**Centros Ltd v Erhvervs-og Selskabsstyrelsen.**

European Court of Justice

1999 ECJ CELEX LEXIS 2723

March 09, 1999

[Mr. and Mrs. Bryde, Danish residents, wanted to incorporate a business in Denmark. Danish law requires a substantial capital input on formation of a closely held limited liability company, amounting to 200,000 Danish crowns (about 28,000 Euro, then more than US$ 27,000). They therefore set up a UK private limited company, with a minimum capital of £100 and, without any business activity in the UK, applied for registration at the Danish registry office, the Styrelse. The application was turned down on the ground that as Centros, Ltd. had not established a trade or business in the UK, it was in fact seeking to establish not a branch, but a principal establishment and was thereby circumventing Danish rules, specifically those on minimum capital.

On appeal, the administration’s arguments were upheld, leading to a referral before the ECJ for a preliminary ruling on whether it is compatible with the rules on freedom of establishment (EC 52, 56 and 58 -- TCE 43, 46 and 48) to refuse registration of a branch of a company with a registered office in another Member State where it had been formed according to that state’s applicable laws, but with the intention to set up its entire business in the state in which the branch is applying for registration.
The European Court reframed the question as follows: “is it contrary to article 52 and 58 [TCE 43 and 58]... to refuse to register a branch of a company formed in accordance with the legislation of another Member State in which it has its registered office but where it does not carry on any business when the purpose of the branch is to enable the company concerned to carry on its entire business in the State in which the branch is to be set up, while avoiding the formation of a company in that State, thus evading application of the rules governing the formation of companies which are, in that State, more restrictive so far as minimum paid-up capital is concerned.”

JUDGMENT:

11 According to Centros the fact that it has never traded since its formation in the United Kingdom has no bearing on its right to freedom of establishment. In its judgment in Case 79/85 Segers v Bedrijfsvereniging voor Bank- en Verzekeringswegen, Groothandel en Vrije Beroepen 1986 ECR 2375, the Court ruled that Articles 52 and 58 of the Treaty prohibited the competent authorities of a Member State from excluding the director of a company from a national sickness insurance scheme solely on the ground that the company had its registered office in another Member State, even though it did not conduct any business there.

12 The Board submits that its refusal to grant registration is not contrary to Articles 52 and 58 of the Treaty since the establishment of a branch in Denmark would seem to be a way of avoiding the national rules on the provision for and the paying-up of minimum share capital. Furthermore, its refusal to register is justified by the need to protect private or public creditors and other contracting parties and also by the need to endeavour to prevent fraudulent insolvencies.

13 In those circumstances, the Hojesteret has decided to stay proceedings and to refer the following question to the Court for a preliminary ruling:

Is it compatible with Article 52 of the EC Treaty, in conjunction with Articles 56 and 58 thereof, to refuse registration of a branch of a company which has its registered office in another Member State and has been lawfully founded with company capital of GBP 100 (approximately DKK 1,000) and exists in conformity with the legislation of that Member State, where the company does not itself carry on any business but it is desired to set up the branch in order to carry on the entire business in the country in which the branch is established, and where, instead of incorporating a company in the latter Member State, that procedure must be regarded as having been employed in order to avoid paying up company capital of not less than DKK 200,000 (at present DKR 125,000)?

14 By its question, the national court is in substance asking whether it is contrary to Articles 52 and 58 of the Treaty for a Member State to refuse to register a branch of a company formed in accordance with the legislation of another Member State in which it has its registered office but where it does not carry on any business when the purpose of the branch is to enable the company concerned to carry on its entire business in the state in which that branch is to be set up, while avoiding the formation of a company in that State, thus evading application of the rules governing the formation of companies which are, in that State, more restrictive so far as minimum paid-up share capital is concerned.

15 As a preliminary point, it should be made clear that the Board does not in any way deny that a joint stock or private limited company with its registered office in another Member State may carry on business in Denmark through a branch. It therefore agrees, as a general rule, to register in Denmark a branch of a company formed in accordance with the law of another Member State. In particular, it has added that, if Centros had conducted any business in England and Wales, the Board would have agreed to register its branch in Denmark.
According to the Danish Government, Article 52 of the Treaty [TCE 43] is not applicable in the case in the main proceedings, since the situation is purely internal to Denmark. Mr and Mrs Bryde, Danish nationals, have formed a company in the United Kingdom which does not carry on any actual business there with the sole purpose of carrying on business in Denmark through a branch and thus of avoiding application of Danish legislation on the formation of private limited companies. It considers that in such circumstances the formation by nationals of one Member State of a company in another Member State does not amount to a relevant external element in the light of Community law and, in particular, freedom of establishment. ***

It is true that according to the case-law of the Court a Member State is entitled to take measures designed to prevent certain of its nationals from attempting, under cover of the rights created by the Treaty, improperly to circumvent their national legislation or to prevent individuals from improperly or fraudulently taking advantage of provisions of Community law (see, in particular, regarding freedom to supply services, [cases cited])

However, although, in such circumstances, the national courts may, case by case, take account - on the basis of objective evidence - of abuse or fraudulent conduct on the part of the persons concerned in order, where appropriate, to deny them the benefit of the provisions of Community law on which they seek to rely, they must nevertheless assess such conduct in the light of the objectives pursued by those provisions (Paletta II, paragraph 25).

The fact that a national of a Member State who wishes to set up a company chooses to form it in the Member State whose rules of company law seem to him the least restrictive and to set up branches in other Member States cannot, in itself, constitute an abuse of the right of establishment. The right to form a company in accordance with the law of a Member State and to set up branches in other Member States is inherent in the exercise, in a single market, of the freedom of establishment guaranteed by the Treaty.

In this connection, the fact that company law is not completely harmonised in the Community is of little consequence. Moreover, it is always open to the Council, on the basis of the powers conferred upon it by Article 54(3)(g) of the EC Treaty, to achieve complete harmonisation.

The final question to be considered is whether the national practice in question might not be justified for the reasons put forward by the Danish authorities.

Referring both to Article 56 of the Treaty [TCE 46] and to the case-law of the Court on imperative requirements in the general interest, the Board argues that the requirement that private limited companies provide for and pay up a minimum share capital pursues a dual objective: first, to reinforce the financial soundness of those companies in order to protect public creditors against the risk of seeing the public debts owing to them become irrecoverable since, unlike private creditors, they cannot secure those debts by means of guarantees and, second, and more generally, to protect all creditors, whether public or private, by anticipating the risk of fraudulent bankruptcy due to the insolvency of companies whose initial capitalisation was inadequate.

The Board adds that there is no less restrictive means of attaining this dual objective. The other way of protecting creditors, namely by introducing rules making it possible for shareholders to incur personal liability, under certain conditions, would be more restrictive than the requirement to provide for and pay up a minimum share capital.

It should be observed, first, that the reasons put forward do not fall within the ambit of Article 56 of the Treaty [TCE 46]. Next, it should be borne in mind that, according to the Court’s case-law, national measures liable to hinder or make less attractive the exercise of fundamental freedoms guaranteed by the Treaty must fulfil four conditions: they must be applied in a non-discriminatory manner; they must be
justified by imperative requirements in the general interest; they must be suitable for securing the attainment of the objective which they pursue; and they must not go beyond what is necessary in order to attain it [see cases cited].

35 Those conditions are not fulfilled in the case in the main proceedings. First, the practice in question is not such as to attain the objective of protecting creditors which it purports to pursue since, if the company concerned had conducted business in the United Kingdom, its branch would have been registered in Denmark, even though Danish creditors might have been equally exposed to risk.

36 Since the company concerned in the main proceedings holds itself out as a company governed by the law of England and Wales and not as a company governed by Danish law, its creditors are on notice that it is covered by laws different from those which govern the formation of private limited companies in Denmark and they can refer to certain rules of Community law which protect them, such as the Fourth Council Directive 78/660/EEC of 25 July 1978 based on Article 54(3)(g) of the Treaty [TCE 54] on the annual accounts of certain types of companies (OJ 1978 L 222, p. 11), and the Eleventh Council Directive 89/666/EEC 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 (OJ 1989 L 395, p. 36).

37 Second, contrary to the arguments of the Danish authorities, it is possible to adopt measures which are less restrictive, or which interfere less with fundamental freedoms, by, for example, making it possible in law for public creditors to obtain the necessary guarantees.

38 Lastly, the fact that a Member State may not refuse to register a branch of a company formed in accordance with the law of another Member State in which it has its registered office does not preclude that first State from adopting any appropriate measure for preventing or penalising fraud, either in relation to the company itself, if need be in cooperation with the Member State in which it was formed, or in relation to its members, where it has been established that they are in fact attempting, by means of the formation of the company, to evade their obligations towards private or public creditors established on the territory of a Member State concerned. In any event, combating fraud cannot justify a practice of refusing to register a branch of a company which has its registered office in another Member State.

39 The answer to the question referred must therefore be that it is contrary to Articles 52 and 58 of the Treaty [TCE 43 and 48] for a Member State to refuse to register a branch of a company formed in accordance with the law of another Member State in which it has its registered office but in which it conducts no business where the branch is intended to enable the company in question to carry on its entire business in the State in which that branch is to be created, while avoiding the need to form a company there, thus evading application of the rules governing the formation of companies which, in that State, are more restrictive as regards the paying up of a minimum share capital. That interpretation does not, however, prevent the authorities of the Member State from adopting any appropriate measure for preventing or penalising fraud, either in relation to the company itself, if need be in cooperation with the Member State in which it was formed, or in relation to its members, where it has been established that they are in fact attempting, by means of the formation of a company, to evade their obligations towards private or public creditors established in the territory of the Member State.

Centros: A landmark decision in European Company Law
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SSRN Paper 190431

The ECJ decision in the Centros case is provoking great waves of unrest on the continent: some see it as a breakthrough of the incorporation doctrine, the seat doctrine having been thrown overboard;
others fear the introduction of the Delaware rule in Europe and the much dreaded “race to the bottom” as states will lose one of their main instruments to prevent abuse of the company form.

ANALYSIS OF THE JUDGEMENT

_Centros_ does not deal with an issue of company law: the decision is entirely set in the tune of the Treaty’s freedom of establishment, articles 43 to 48.

The treaty only marginally deals with issues of company law: it considers company law rules as impediments to the freedom of establishment, and therefore orders harmonisation, by directive, of the “safeguards required for the protection of the interest of members and others . . . to make these safeguards equivalent throughout the Community” (art. 44.3(g)). Art. 220 invites member states, as far as necessary, to enter into negotiations on the mutual recognition of companies, on the transfer of the seat, and on cross border mergers.” A treaty was prepared on mutual recognition in 1968 (Treaty of 29 February 1968), but did not enter into force for lack of ratification by the Netherlands, which had in the meantime changed from the seat to the incorporation technique.

1. Qualification of the company

The _Centros_ court, in ¶ 17, recalling what it said in the _Segers_ case, declared that whether a company qualified under the legal order of another member State can invoke freedom of establishment privileges is a question of community law, not of national law: “the situation in which a company formed in accordance with the law of a member state, in which it has its registered office desires to set up a branch in another member state falls within the scope of community law”. In this reasoning was more explicit: for the application of article 48, it is only required that the company has been formed according to the law of a member state and that its registered office, central administration or principal place of business be established within the Community. This is in fact nothing more than the wording of art. 48, §1.

For example, a German registrar could check whether a Belgian company, opening a branch in Germany, has been validly constituted according to Belgian law: in fact he would apply a European law technique, checking whether the company was set up “in accordance with the national law”. But the preliminary qualification, i.e. whether that company is Belgian will be governed by the three criteria of article 48 §1.

2. Circumvention of host state rules v. circumvention of the Treaty freedom

Once it had been established that with respect to the application of the rules on freedom of establishment, the company law elements to be taken into account – such as “company” and “formation in accordance with” – have to be read exclusively in accordance with the Treaty provisions, a necessary and well established limitation to this freedom flows from the risks of circumvention.

The Court has repeatedly decided that Member States “are entitled to take measures to prevent certain of its nationals from attempting, under cover of the rights created by the Treaty, improperly to circumvent their national legislation or to prevent individuals from improperly or fraudulently taking advantage of the provisions of community law.” To this standard formulation, the court adds a further qualification: not any form of potential evasion of national rules nor any type of abuse can be invoked by members states to limit the free establishment of companies. For the purposes of community law, conduct would be improper, - the Court says “abusive or fraudulent” – only to the extent that this impropriety - having been assessed on a case by case basis, and on the basis of objective evidence - has been established in the light of the objectives pursued by the provisions of which circumvention is alleged.
This reading of the *Centros* case illustrates the relationship between community law and national rules in this field: The court stated that “the fact that company law is not completely harmonised . . . is of little consequence”: the non-harmonisation of certain company law provisions cannot constitute an excuse for Member states to deny entry to companies from other Member States, that comply with the provision of art. 58. This rather bold expression came as a great shock to all those having been involved in the company law harmonisation process.

3. The “general interest” reservation

To the argument that the Danish authorities were entitled to impose restrictions or refuse access on the basis that these were justified on the basis of the general interest, the court repeated its traditional holding, i.e. that the reservation, allowing states to impose or maintain additional requirements on the basis of their “general interest,” is subject to meeting four conditions:

- non-discriminatory application
- justified by imperative requirements in the general interest
- suitable for securing the attainment of the objective pursued
- not go beyond what is necessary to attain that objective (“proportionality”).

This fourfold touchstone is based on rules of European law, not on rules of conflicts of laws. Therefore they constitute not a further qualification of the incorporation theory, but the effects of rules that belong to a different, higher legal order, the European one.

The court found that under each of these headings, the host state had not met the test

- creditors would not have been better protected if the company had traded in the UK with the same legal capital and had merely established a branch in Denmark
- creditors were informed that it was a UK company: reference was made to the Fourth and the eleventh directive, applicable to private companies limited and imposing disclosure as to the financial situation of the company;
- the host state might have imposed less restrictive measures, e.g. the law could have stipulated that “public creditors” could have obtained guarantees
- rather than refusing access, the member states may act against actually occurring fraud, or trying to prevent it.

The nature and type of measures that could be imposed will be the subject of much discussion: the requirement to be domiciled in the host state would constitute an unwarranted condition for the exercise of the freedom of establishment. To subject the branch to branch specific accounting obligations would be allowed, provided these do not lead to restrictions that are disproportionate to the objective to be achieved.

In Germany, the issue of co-determination will receive much attention, as German companies may be tempted to incorporate abroad, in a jurisdiction where no co-determination rules apply. To apply the co-determination rules to a German branch of a foreign company is apart from being contrary to German law, difficult to effectuate. Also, co-determination being linked to the company statute itself, it does not seem feasible to change the structure of the company on the basis of the location of its branch. On the other hand, Germany could take “comparable” measures insuring some form of co-decision making at the branch level. Indeed, the court allows member states to introduce legislation at the level of a company’s operations, provided these do meet the four pronged criterion.
The *Centros* case will stir legal debate in several directions. There are political issues involved. One can expect an extensive debate as whether the instruments indicated by the Court would offer valid instruments against companies that are taking advantage

**FURTHER PERSPECTIVES**

1. **Is the “Seat Doctrine” overruled?**

   Some legal scholars have boldly declared the seat doctrine dead. This was also the opinion of the Austrian Supreme Court, in a case in all respects similar to *Centros*, where it held that the provision of the Austrian code that lies at the basis of the seat doctrine was contrary to European law.

   As soon as a company meets one of the three criteria mentioned in article 48, it will be deemed a “European company” and therefore will enjoy free access to all member states. State A could not refuse access to a company with registered office in state B, and seat of direction in state C. This does not mean that it will have to modify its rules on qualifying that company as subject to the jurisdiction of state B or C, according to its own legal order. As stated before, *Centros* merely deals with freedom of establishment, not with company law, and therefore the question whether state A adheres to one or the other system is irrelevant as far as community companies are concerned.

2. **The transfer of the seat after *Centros***

   *Centros* does not deal with issues related to the transfer of the seat, but may indirectly affect the solutions that can be adopted in case of a transfer of the seat.

3. **Does *Centros* lead to Delaware type of competition between regulations?**

   The court adopted a positive attitude towards the idea that it is not abusive to take advantage of differences in regulation, and therefore to choose for the least restrictive regime. Although the court limited its observation to the circumvention of the right of establishment, it is clear that this reference to regulatory competition has a broader policy purport. Some will certainly invoke the spectre of the “race to the bottom,” sometimes identified with the race for laxity, unjustifiably identified with Delaware.

   First and foremost, differently from the United States, competition between states for corporate charters is not based on considerations of company law, which often play only a minor role, but on considerations of taxation, and many other elements. Tax laws, labour laws, environmental laws, and numerous other regulations differ considerably from state to state that effective competition is taking place on the basis of these difference, whereby company law usually will not play a significant role. On the other hand there is no doubt that *Centros*, and some other recent cases will call attention of the practitioners to the advantages of regulatory arbitrage.

4. **Effect on harmonisation**

   *Centros* contains a disappointing consideration relating to the poor record of the community in the field of company law harmonisation. The judgement can also be read as introducing a powerful alternative to harmonisation, i.e. broadening the ambit of mutual recognition rules. In that respect the reasoning of the court is a further variation on the theme of *Cassis de Dijon*. Does harmonisation therefore become superfluous? Some member states, confronted with the threat of regulatory competition, will certainly prefer to halt the tide by pleading for further harmonisation. Only by harmonising will these states be able to protect their present system. They may consider pleading for the UK to introduce a minimum capital for the private company limited. But as mentioned above, this will not suffice: a large part of company law is affected. As an alternative approach is would seem more workable to identify the...
specific points where the application of the present system creates dangers, especially the fields in which abuses or fraud can be feared. In these fields, the states could usefully develop techniques to combat abuses, without jeopardizing the entire system.

NOTES

1. Will Europe develop a “corporate federalism” similar to that of the United States? As you might imagine, this question is on many Europeans’ minds. In fact, the first issue of the first volume of the new European Business Organization Law Review dealt with “International Company Law in View of Centros” (http://www.asser.nl/ebor.htm).

2. Can a European member state, such as Luxembourg, become the new Delaware of Europe? At first blush, the conditions seem ripe. First, it is a small country that could become dependent on incorporation revenues, thus assuring consumers of its company law that it will pay attention to their needs. But there is more. Will it be able to develop a judiciary versed in company law? Will its bar develop sufficient expertise? Will its legislature and judges be sufficiently dynamic and flexible? See Jill Fisch, The Peculiar Role of the Delaware Courts in the Competition for Corporate Charters, -- Cin. L. Rev. -- SSRN Paper 219550 (2000) (asserting that Delaware’s law-making judges have provided flexibility, responsiveness, reduced political influence and transparency, which allows Delaware to adjust its corporate law to business changes).

4. Notice that Centros answered a relatively narrow question: must EU member state A recognize the legal existence of companies organized in member state B, even though the company is organized by residents of member state A and to be operated in member state A? Consider some additional situations after Centros. See Werner F. Ebke, Centros - some realities and some mysteries, 48 AM. J. COMP. L. 623-660 (2000).
   a. A British LLC has a one-person board, as allowed under British law. The company enters into a transaction in Denmark, which does not allow one-person boards, and the Danish party claims the transaction is null since its approval by the sole director is invalid under Danish law. What law governs the transaction? What does the Centros court say about the Danish party’s interests in commercial certainty?
   b. Assume a British LLC, with its principal operations in Britain, operates in Denmark where it does business with Danish suppliers who lend on credit. When the British firm goes bankrupt, is there any problem that it never established the minimum capital required by Danish company law? Does the “abusive or fraudulent” exception mentioned in Centros apply here?
   c. A company that had been formed in Spain is declared null and void under the Spanish company code because its charter allowed for shareholder veto rights. This ground for nullity is inconsistent with the First Company Law Directive. See Marleasing. Can the Spanish company operate in Denmark with full corporate attributes, including limited liability?
   d. The managers and shareholders of a German company, dissatisfied by the German corporate rules that require participation by employee representatives on the company’s supervisory board, decide to reincorporate the company in Britain. There are no co-determination requirements in Britain. Does this allow German companies to avoid this aspect of German social engineering?
e. A family in Italy has a cell phone company organized as an SRL. They transfer the SRL’s assets to a British company that in turn transfers the assets to a trust formed under British law. Italy’s commercial law does not recognize trusts. Is the trust, which does not pay company income taxes, valid under Italian law? Is this an “abusive or fraudulent” transaction that would permit the Italian tax authorities to disregard the Italian owners’ machinations?

f. Does your answer change if the Italian family transfers the company assets to a Delaware corporation, with the family members owners of the shares of a Delaware corporation operating in Italy? What law governs the internal affairs of their business?

5. Is Centros the end to the “siege social” rule in Europe - are we headed to a new race of laxity and “Delawarization of Europe”?

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European Court of Justice
2002 ECJ CELEX LEXIS 3664
5 November 2002.

[Uberseering BV, a limited liability company incorporated in the Netherlands whose shares were held by two German nationals, acquired land in Germany and entered into a contract with Nordic Construction Company Baumanagement GmbH (NCC), a German company, to refurbish a garage and a motel on the site. After the work was finished, Uberseering claimed that the paint work was defective. Uberseering sued NCC in German court, but the court dismissed the action on the ground Uberseering lacked legal capacity.

According to settled German case-law, approved by most German legal commentators, a company's legal capacity is determined by reference to the law where its actual center of administration is established (the seat principle), as opposed to the incorporation principle. That rule also applies where a company has been validly incorporated in another State and has subsequently transferred its actual centre of administration to Germany.

The Oberlandesgericht (Higher Regional Court), Dusseldorf, upheld the decision to dismiss the action. It found that Uberseering had transferred its actual center of administration to Dusseldorf once its shares had been acquired by two German nationals. The Oberlandesgericht found that, as a company incorporated under Netherlands law, Uberseering did not have legal capacity in Germany and, consequently, could not bring legal proceedings there.]

13 Although it notes that the [German] case-law [on the seat principle] is disputed in various respects by certain German legal commentators, the Bundesgerichtshof considers it preferable, in view of the current state of Community law and of company law within the European Union, to continue to follow that case-law for a number of reasons.

14 First, [the Bundesgerichtshof concluded that without a decision by the European Court there would be] legal uncertainty, since it is impossible to segregate clearly the areas of law to be governed by the various legal orders.

15 Second, [under the incorporation principle], the company's founding members have an advantage, since they are able, when choosing the place of incorporation, to choose the legal system which suits them best, which the German court saw as “the fundamental weakness of the incorporation principle, which fails to take account of the fact that a company's incorporation and activities also affect the interests of
third parties and of the State in which the company has its actual centre of administration, where that is located in a State other than the one in which the company was incorporated.”

16 Third, *** the interests which German law is seeking to safeguard are notably those of the company's creditors: the legislation relating to Gesellschaften mit beschränkter Haftung (GmbH)' (limited liability companies under German law) provides such protection by detailed rules on the initial contribution and maintenance of share capital. ***

17 The Bundesgerichtshof nevertheless wonders whether, on the basis that the company's actual centre of administration has been transferred to another country, the freedom of establishment guaranteed by Articles 43 EC and 48 EC does not preclude connecting the company's legal position with the law of the Member State in which its actual centre of administration is located. The answer to that question cannot, according to the Bundesgerichtshof, be clearly deduced from the case-law of the Court of Justice.

Findings of the Court

As to whether the Treaty provisions on freedom of establishment apply

52 In limine and contrary to the submissions of both NCC and the German, Spanish and Italian Governments, the Court must make clear that where a company which is validly incorporated in one Member State (A') in which it has its registered office is deemed, under the law of a second Member State (B'), to have moved its actual centre of administration to Member State B following the transfer of all its shares to nationals of that State residing there, the rules which Member State B applies to that company do not, as Community law now stands, fall outside the scope of the Community provisions on freedom of establishment.

54 As the Advocate General maintained at point 42 of his Opinion, Article 293 EC does not constitute a reserve of legislative competence vested in the Member States. Although Article 293 EC gives Member States the opportunity to enter into negotiations with a view, inter alia, to facilitating the resolution of problems arising from the discrepancies between the various laws relating to the mutual recognition of companies and the retention of legal personality in the event of the transfer of their seat from one country to another, it does so solely so far as is necessary', that is to say if the provisions of the Treaty do not enable its objectives to be attained.

55 More specifically, it is important to point out that, although the conventions which may be entered into pursuant to Article 293 EC may, like the harmonising directives provided for in Article 44 EC, facilitate the attainment of freedom of establishment, the exercise of that freedom can none the less not be dependent upon the adoption of such conventions.

56 In that regard, it must be borne in mind that, as the Court has already had occasion to point out, the freedom of establishment, conferred by Article 43 EC on Community nationals, includes the right for them to take up and pursue activities as self-employed persons and to set up and manage undertakings under the same conditions as are laid down by the law of the Member State of establishment for its own nationals. Furthermore, according to the actual wording of Article 48 EC, companies or firms formed in accordance with the law of a Member State and having their registered office, central administration or principal place of business within the Community shall, for the purposes of the provisions of the Treaty concerning the right of establishment , be treated in the same way as natural persons who are nationals of Member States'.

As to whether there is a restriction on freedom of establishment
80 Uberseering, which is validly incorporated in the Netherlands and has its registered office there, is entitled under Articles 43 EC and 48 EC to exercise its freedom of establishment in Germany as a company incorporated under Netherlands law. It is of little significance in that regard that, after the company was formed, all its shares were acquired by German nationals residing in Germany, since that has not caused Uberseering to cease to be a legal person under Netherlands law.

81 Indeed, 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. The requirement of reincorporation of the same company in Germany is therefore tantamount to outright negation of freedom of establishment.

As to whether the restriction on freedom of establishment is justified

84 The German Government has argued in the alternative, should the Court find that application of the company seat principle entails a restriction on freedom of establishment, that the restriction applies without discrimination, is justified by overriding requirements relating to the general interest and is proportionate to the objectives pursued.

85 In the German Government's submission, the lack of discrimination arises from the fact that the rules of law proceeding from the company seat principle apply not only to any foreign company which establishes itself in Germany by moving its actual centre of administration there but also to companies incorporated under German law which transfer their actual centre of administration out of Germany.

87 In the German Government's submission, the German rules of private international company law enhance legal certainty and creditor protection. There is no harmonisation at Community level of the rules for protecting the share capital of limited liability companies and such companies are subject in Member States other than the Federal Republic of Germany to requirements which are in some respects much less strict. The company seat principle as applied by German law ensures that a company whose principal place of business is in Germany has a fixed minimum share capital, something which is instrumental in protecting parties with whom it enters into contracts and its creditors. That also prevents distortions of competition since all companies whose principal place of business is in Germany are subject to the same legal requirements.

88 The German Government submits that further justification is provided by the protection of minority shareholders. In the absence of a Community standard for the protection of minority-shareholders, a Member State must be able to apply to any company whose principal place of business is within its territory the same legal requirements for the protection of minority shareholders.

89 Application of the company seat principle is also justified by employee protection through the joint management of undertakings on conditions determined by law. The German Government argues that the transfer to Germany of the actual centre of administration of a company incorporated under the law of another Member State could, if the company continued to be a company incorporated under that law, involve a risk of circumvention of the German provisions on joint management, which allow the employees, in certain circumstances, to be represented on the company's supervisory board. Companies in other Member States do not always have such a body.

90 Finally, any restriction resulting from the application of the company seat principle can be justified on fiscal grounds. The incorporation principle, to a greater extent than the company seat principle, enables companies to be created which have two places of residence and which are, as a result, subject to taxation without limits in at least two Member States. There is a risk that such companies might claim and be granted tax advantages simultaneously in several Member States. By way of example, the
German Government mentions the cross-border offsetting of losses against profits between undertakings within the same group.

92 It is not inconceivable that overriding requirements relating to the general interest, such as the protection of the interests of creditors, minority shareholders, employees and even the taxation authorities, may, in certain circumstances and subject to certain conditions, justify restrictions on freedom of establishment.

93 Such objectives cannot, however, justify denying the legal capacity and, consequently, the capacity to be a party to legal proceedings of a company properly incorporated in another Member State in which it has its registered office. Such a measure is tantamount to an outright negation of the freedom of establishment conferred on companies by Articles 43 EC and 48 EC.

94 Accordingly, the answer to the first question must be that, where a company formed in accordance with the law of a Member State (A) in which it has its registered office is deemed, under the law of another Member State (B), to have moved its actual centre of administration to Member State B, Articles 43 EC and 48 EC preclude Member State B from denying the company legal capacity and, consequently, the capacity to bring legal proceedings before its national courts for the purpose of enforcing rights under a contract with a company established in Member State B.

The second question referred to the Court

95 It follows from the answer to the first question referred to the Court for a preliminary ruling that, where a company formed in accordance with the law of a Member State (A) in which it has its registered office exercises its freedom of establishment in another Member State (B), Articles 43 EC and 48 EC require Member State B to recognise the legal capacity and, consequently, the capacity to be a party to legal proceedings which the company enjoys under the law of its State of incorporation (A).

NOTES

1. Does Uberseering signal the end of “siege social” in Europe, or will the Court of Justice stop short of saying that full corporate personality follows a company wherever it does business? Professor Wymeersch, who wrote the article above analyzing Centros, made some preliminary observations on Uberseering:

   After the Centros case in 1999, the Europe Court of Justice has again delivered a significant case dealing with the legal situation of EU companies establishing themselves in other Member States. In the Uberseering case of November 5, 2002, the Court considered incompatible with the Treaty freedoms, the German rule, based on the real seat doctrine, whereby foreign companies with a seat on the German territory were refused to appear in German courts unless they proceeded to re-incorporation.

   This was considered an outright negation of the freedom of establishment. Member states should allow companies that have been incorporated in other Member states to freely enter their territory, according to the rules under which they have been formed in their state of origin.

   The case constitutes another landmark on the road towards the more free circulation of companies in Europe. Whether it introduces the incorporation theory as the European rule, is open to doubt, as the Court has exclusively relied on the Treaty rules on
free establishment. It seems that the Court has rather developed a new approach that could allow to bridge the differences between incorporation and real seat techniques.


2. The reform movement begun by *Centros* has even captured the imagination of the EU legislators. Recently, the European Commission proposed a new fourteenth company law directive that would facilitate the cross-border transfer of the registered office of companies in the EU. The effect would be that EU company law, going beyond US corporate law, would not only accept private choice of company law, but actually and formally facilitate it.

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**Kamer van Koophandel en Fabrieken voor Amsterdam v Inspire Art Ltd.**
European Court of Justice
2003 ECJ CELEX LEXIS 444
30 September 2003

[Inspire Art Ltd. was formed in July 2000 as a “private company limited” under UK law. It began business in August 2000 in Amsterdam selling art objects. Inspire Art registered in the commercial register of the Dutch Chamber of Commerce, without indicating it was a “foreign company” under the Dutch foreign company law (WFBV).

The Chamber of Commerce then sought a court order requiring Inspire Art to register as a “foreign company,” defined as one formed outside of the Netherlands but carrying on its activities “entirely or almost entirely in the Netherlands” and without any real connection with the state where formed. Such foreign companies must register in the commercial registry, disclose their foreign status, become subject to initial and ongoing minimum capital requirements (18,000 euros), and file annual documents. Failure to comply subjects company directors to joint and several liability for acts carried out in the name of the company during their directorship.

Inspire Art argued these provisions of the WFBV are contrary to Community law, in particular Articles 43 EC and 48 EC. The Dutch court held that Inspire Art was a “foreign company” under Dutch law, but stayed its proceedings to refer two questions to the Court of Justice for a preliminary ruling: (1) whether Articles 43 and 48 should be interpreted to preclude restrictions on the establishment of a Dutch branch of a “pseudo foreign” UK company set up solely to avoid the stricter Dutch rules on company formation, and (2) if so, whether Article 46 EC nonetheless should be interpreted to justify the Dutch rules by overriding reasons of public interest.]

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49 Although the issue at the heart of the dispute in the main proceedings is whether or not Inspire Art must be registered as a formally foreign company in the business register, the fact remains that that registration automatically and inextricably entails a number of legal consequences provided for by Articles 2 to 5 of the WFBV [described above].

The existence of an impediment to freedom of establishment

95 The Court has held that it is immaterial, having regard to the application of the rules on freedom of establishment, that the company was formed in one Member State only for the purpose of establishing itself in a second Member State, where its main, or indeed entire, business is to be conducted (Segers, paragraph 16, and Centros, paragraph 17). The reasons for which a company chooses to be formed in a
particular Member State are, save in the case of fraud, irrelevant with regard to application of the rules on freedom of establishment (Centros, paragraph 18).

96 The Court has also held that the fact that the company was formed in a particular Member State for the sole purpose of enjoying the benefit of more favourable legislation does not constitute abuse even if that company conducts its activities entirely or mainly in that second State (Segers, paragraph 16, and Centros, paragraph 18).

97 It follows that those companies are entitled to carry on their business in another Member State through a branch, and that the location of their registered office, central administration or principal place of business serves as the connecting factor with the legal system of a particular Member State in the same way as does nationality in the case of a natural person (Case 270/83 Commission v France [1986] ECR 273, paragraph 18; Segers, paragraph 13, and Centros, paragraph 20.

98 Thus, in the main proceedings, the fact that Inspire Art was formed in the United Kingdom for the purpose of circumventing Netherlands company law which lays down stricter rules with regard in particular to minimum capital and the paying-up of shares does not mean that that company's establishment of a branch in the Netherlands is not covered by freedom of establishment as provided for by Articles 43 EC and 48 EC. As the Court held in Centros (paragraph 18), the question of the application of those articles is different from the question whether or not a Member State may adopt measures in order to prevent attempts by certain of its nationals improperly to evade domestic legislation by having recourse to the possibilities offered by the Treaty.

100 The effect of the WFBV is, in fact, that the Netherlands company-law rules on minimum capital and directors' liability are applied mandatorily to foreign companies such as Inspire Art when they carry on their activities exclusively, or almost exclusively, in the Netherlands.

101 Creation of a branch in the Netherlands by companies of that kind is therefore subject to certain rules provided for by that State in respect of the formation of a limited-liability company. The legislation at issue in the case in the main proceedings, which requires the branch of such a company formed in accordance with the legislation of a Member State to comply with the rules of the State of establishment on share capital and directors' liability, has the effect of impeding the exercise by those companies of the freedom of establishment conferred by the Treaty.

Whether there is any justification

133 It must be borne in mind that, according to the Court's case-law, national measures liable to hinder or make less attractive the exercise of fundamental freedoms guaranteed by the Treaty must, if they are to be justified, fulfil four conditions: they must be applied in a non-discriminatory manner; they must be justified by imperative requirements in the public interest; they must be suitable for securing the attainment of the objective which they pursue, and they must not go beyond what is necessary in order to attain it (see, in particular, Case C-19/92 Kraus [1993] ECR I-1663, paragraph 32; Case C-55/94 Gebhard [1995] ECR I-4165, paragraph 37, and Centros, paragraph 34).

134 In consequence, it is necessary to consider whether those conditions are fulfilled by provisions relating to minimum capital such as those at issue in the main proceedings.

135 First, with regard to protection of creditors, and there being no need for the Court to consider whether the rules on minimum share capital constitute in themselves an appropriate protection measure, it is clear that Inspire Art holds itself out as a company governed by the law of England and Wales and not as a Netherlands company. Its potential creditors are put on sufficient notice that it is covered by legislation other than that regulating the formation in the Netherlands of limited liability companies and,
in particular, laying down rules in respect of minimum capital and directors' liability. They can also refer, as the Court pointed out in Centros, paragraph 36, to certain rules of Community law which protect them, such as the Fourth and Eleventh Directives.

136 Second, with regard to combating improper recourse to freedom of establishment, it must be borne in mind that a Member State is entitled to take measures designed to prevent certain of its nationals from attempting, under cover of the rights created by the Treaty, improperly to circumvent their national legislation or to prevent individuals from improperly or fraudulently taking advantage of provisions of Community law (Centros, paragraph 24, and the decisions cited therein).

137 However, while in this case Inspire Art was formed ... for the purpose in particular of evading the application of Netherlands company law, ... the fact remains that the provisions of the Treaty on freedom of establishment are intended specifically to enable companies formed in accordance with the law of a Member State and having their registered office, central administration or principal place of business within the Community to pursue activities in other Member States through an agency, branch or subsidiary (Centros, paragraph 26).

138 That being so, as the Court confirmed in paragraph 27 of Centros, the fact that a national of a Member State who wishes to set up a company can choose to do so in the Member State the company-law rules of which seem to him the least restrictive and then set up branches in other Member States is inherent in the exercise, in a single market, of the freedom of establishment guaranteed by the Treaty.

139 [Third, it] is clear from settled case-law (Segers, paragraph 16, and Centros, paragraph 29) that the fact that a company does not conduct any business in the Member State in which it has its registered office and pursues its activities only or principally in the Member State where its branch is established is not sufficient to prove the existence of abuse or fraudulent conduct which would entitle the latter Member State to deny that company the benefit of the provisions of Community law relating to the right of establishment.

140 Last, as regards possible justification of the WFBV on grounds of protection of fairness in business dealings and the efficiency of tax inspections, it is clear that neither the Chamber of Commerce nor the Netherlands Government has adduced any evidence to prove that the measure in question satisfies the criteria of efficacy, proportionality and non-discrimination mentioned in paragraph 132 above.

141 To the extent that the provisions concerning minimum capital are incompatible with freedom of establishment, as guaranteed by the Treaty, the same must necessarily be true of the penalties attached to non-compliance with those obligations, that is to say, the personal joint and several liability of directors where the amount of capital does not reach the minimum provided for by the national legislation or where during the company's activities it falls below that amount.

NOTES

1. The three decisions of the European Court of Justice have two common threads: (1) national laws cannot impose impediments to the recognition of a company established in another member state (whatever the reason for being so organized and whatever its ownership), and (2) generalized concern for creditor protection cannot justify impediments to free establishment of companies.

2. If the Centros line of cases signals that company law is a matter of private choice, what is to keep European companies from re-incorporating in jurisdictions (such as the UK) where company law rules are more flexible. In practice, this has not yet happened. At most, a few newly-formed
businesses have chosen to incorporate in other jurisdictions – such as Centros and Inspire Art. But reincorporation of established businesses has been rare.

Why is this? One explanation for the absence of full-fledged market in company formation is that the mechanism for US-style reincorporation – the cross-border merger of the original corporation into a newly-formed corporation in the jurisdiction of choice – is not as easy in Europe. EC law does not sanction transnational mergers. And although Member States can choose to allow cross-border mergers that do not involve a move of the corporation’s headquarters, many Member States have not allowed this maneuver. Germany and Austria flatly prohibit their domestic corporations from merging with foreign corporations. And in other jurisdictions, such as Spain, France, the United Kingdom, Ireland, Portugal, and Italy, there is much uncertainty as to whether the merger would allow domestic companies to escape the application of domestic law. Even if cross-border mergers could be accomplished to change a company’s governing law, it is unclear whether the new state of incorporation would have a judicial system to handle the “incorporation” doctrine. Pseudo-foreign corporations might discover they would have to litigate their internal affairs at home – hardly the advantage they sought. See Jens C. Dammann, *Freedom of Choice in European Corporate Law*, 29 YALE J. INT’L L. 477 (2004).

3. Even if a European company is able to incorporate in one member state, while operating in another (or various others), the problem remains that this “foreign company” must obtain legal recognition in each of the member states where it does business. Remember that in the United States this is accomplished through the (easy) process of registration of foreign corporations – file a paper and pay a small fee in the state where you want to do business and you’re ready. But in Europe the foreign company must establish a “branch” in the member state where it wants to do business. This, it turns out, is not always that easy. In an interesting study in which the authors actually had lawyers go through the process of having a real company obtain branches and measured the branching costs (legal assistance, bureaucratic delays and filing costs), the authors found and concluded:

<table>
<thead>
<tr>
<th>Country</th>
<th>Total costs (one year)</th>
<th>Total professional time</th>
<th>Total filing time</th>
</tr>
</thead>
<tbody>
<tr>
<td>Austria</td>
<td>€698</td>
<td>13 hours</td>
<td>5 weeks</td>
</tr>
<tr>
<td>Germany</td>
<td>€1,302</td>
<td>n/a</td>
<td>10 weeks</td>
</tr>
<tr>
<td>Italy</td>
<td>€5,007</td>
<td>19 hours</td>
<td>7.5 weeks</td>
</tr>
<tr>
<td>Ireland</td>
<td>€551</td>
<td>2/3 hour</td>
<td>5 weeks</td>
</tr>
<tr>
<td>Netherlands</td>
<td>€759</td>
<td>8 hours</td>
<td>2 weeks</td>
</tr>
<tr>
<td>Norway</td>
<td>€947</td>
<td>4 hours</td>
<td>3 weeks</td>
</tr>
<tr>
<td>Poland</td>
<td>€1,631</td>
<td>25 hours</td>
<td>9 weeks</td>
</tr>
<tr>
<td>Sweden</td>
<td>€2,146</td>
<td>12 hours</td>
<td>4 weeks</td>
</tr>
</tbody>
</table>

The cost of setting up a UK Limited (the favorite place of incorporation after *Centros*) is directly observable in the market while the cost of branching is not. We have run field experiments to measure the cost of branching. Our analysis reveals that branching remains costly or impractical in many cases.

Marco Becht, Luca Enriques and Veronika Korom, *Centros and the Cost of Branching*, 9 J. Corp. L. Stud. 171, SSRN paper 1433311 (April 2009). Interesting methodology, no?

4. After the *Centros* line of cases, it is possible to imagine an “incorporation-based” regime of company law similar to that of the United States. European firms could choose their state of organization, each member state subject to the harmonizing rules of the EC directives on transparency, creditor protection, and takeover defenses. But recall that Delaware’s allure in the
United States is more than its facilitative corporate statute, but instead its expert and speedy court system. Can Europe replicate Delaware in this regard? Consider the following proposition, by three American and German law professors:

The decisions of the European Court of Justice in *Centros* and most recently in *Inspire Art* will change the business landscape by opening up Europe to legislatory competition in corporate law. This potentially could enable some Member States to enact and enforce corporate law that is preferable for shareholders and managers and thus lure corporate charters away from other Member States with less attractive corporate law.

The European debate after *Inspire Art* will in some part be modeled after the U.S. debate over the "Delaware effect" on American corporate law for well over the past seventy years. Implicit in much of this debate, however, is the assumption, based on the American experience, that legislatory competition in corporate law necessarily means that Member States, after *Centros* and *Inspire Art*, will offer both their corporate law and their judicial process for resolving corporate law disputes to managers and investors in other Member States that choose to incorporate abroad. Legislatory competition under this assumption requires the successful offeror of corporate law to offer both an attractive corporate statute and specialized courts that can be relied upon to interpret the law in a predictable manner, thereby inducing managers and investors to incorporate in that jurisdiction.

The European experience with jurisdictional competition, at least in the short term and perhaps permanently, could be quite different from that in the United States. In the United States, incorporation in Delaware means that corporate law litigation in most cases takes place in Delaware, so that Delaware not only sells corporate charters but also its case law. The buyer has to buy (and is well advised to buy) a bundled product including substantive law (statutory and case law) together with procedural law. This type of bundling of statutory law and adjudication, however, might cause difficulties in Europe. The thesis of this article is that Member States are most likely to survive in the legislatory competition following *Centros* and *Inspire Art* if they debundle the corporate law product. Buyers of corporate charters thus should be allowed to choose corporate law of the Member State of incorporation (home country) but have disputes under that law be adjudicated elsewhere, preferably by arbitration panels.

A number of factors make it difficult for Member States to offer adjudication to managers and investors in other Member States. These include (i) language barriers (particularly for Member States whose courts do not do business in English), (ii) differences between common law and civil law approaches to adjudication, (iii) procedural differences between courts of Member States that are greater than those between Delaware and other US states, which in turn discourage lawyers from recommending that clients incorporate in Member States outside their own, (iv) the cost to a Member State of building specialized judicial expertise in corporate law, (v) incomplete information about real or perceived judicial bias, (vi) uncertainty concerning conflict of laws within the EU, (vii) uncertainty about mutual recognition of judgments within the EU, and (viii) the fact that an effective adjudication system will require a learning process and that national judges are "poor learners" about the implications of applying national corporate law to international managers and investors.

Developing strategies to overcome these barriers to entering the market for a bundled product of corporate statutes plus adjudication may be a realistic long-term strategy for one or more Member States. This article suggests, however, that Member
States should also explore strategies to offer their corporate statutes without adjudication by national courts and instead facilitate alternative methods of adjudicating corporate law disputes. Although allowing resolution of disputes under one Member State's corporate law by the local courts of another Member State (probably the "seat" of the corporation) is a possibility, for a variety of reasons we find this to be an unattractive alternative. A more attractive alternative is adjudication by panels of professional arbitrators who specialize in the corporate law of a particular Member State, but who could be citizens of different Member States, and who would apply uniform procedural rules determined by an arbitration association rather than by national courts. This alternative requires that Member States allow corporate charters to provide for arbitration of disputes over corporate internal affairs. A home country, offering its corporate law for corporations having a seat elsewhere (the host country) even could change its national corporate law explicitly to allow for arbitration. If the host country would then try to make that clause unworkable under its own conflict of laws principles this might not be in compliance with the right of establishment as interpreted by the ECJ in Centros and Inspire Art.


4. If European companies can choose the law of one Member State for purposes of incorporation (substantive law) and another Member State for purposes of dispute resolution (procedural law), what is to keep European companies from choosing the law of Delaware, as do so many publicly-traded US corporations? Although the EC Treaty provisions that guarantee free movement assume an anchor (incorporation) in an EU Member State, there still exists the possibility of the Delaware judiciary offering their corporate dispute-resolution services. Henry Hansmann & J.C. Dammann, *Extraterritorial Courts for Corporate Law*, SSRN Paper 724165 (May 2005) (suggesting that Delaware judges could hold hearings and trials worldwide, thus offering Delaware’s expertise and encouraging national courts to match the competition).

5. The Centros line of cases also raises doubts about the legitimacy of the European company law harmonization effort. If party choice and protection through markets is inherent in the freedom-of-establishment provisions of EC Treaty, the importance of equalizing company law protections for creditors and shareholders wanes, if not evaporates. Werner F. Ebke, *The European Conflict-of-Corporate-Laws Revolution: Uberseering, Inspire Art and Beyond*, 38 Int’l Law. __ (2004). As Professor Ebke points out, Uberseering and Inspire Art suggest that Member States can no longer prevent corporations from circumventing national legislation under cover of EC Treaty rights. If so, where does harmonization stand?

6. The big question in the EU, however, continues to linger on the horizon: Could a company organized and operating in Germany (a staunch “headquarters” state with a dualistic board requirement for larger companies) set up a subsidiary in the UK (a strong “incorporation” state with a monistic board default)? Could the German company merge with a UK subsidiary – accomplishing a “change of domicile” much in the way US corporations move to Delaware?