Oxford Business Law Blog

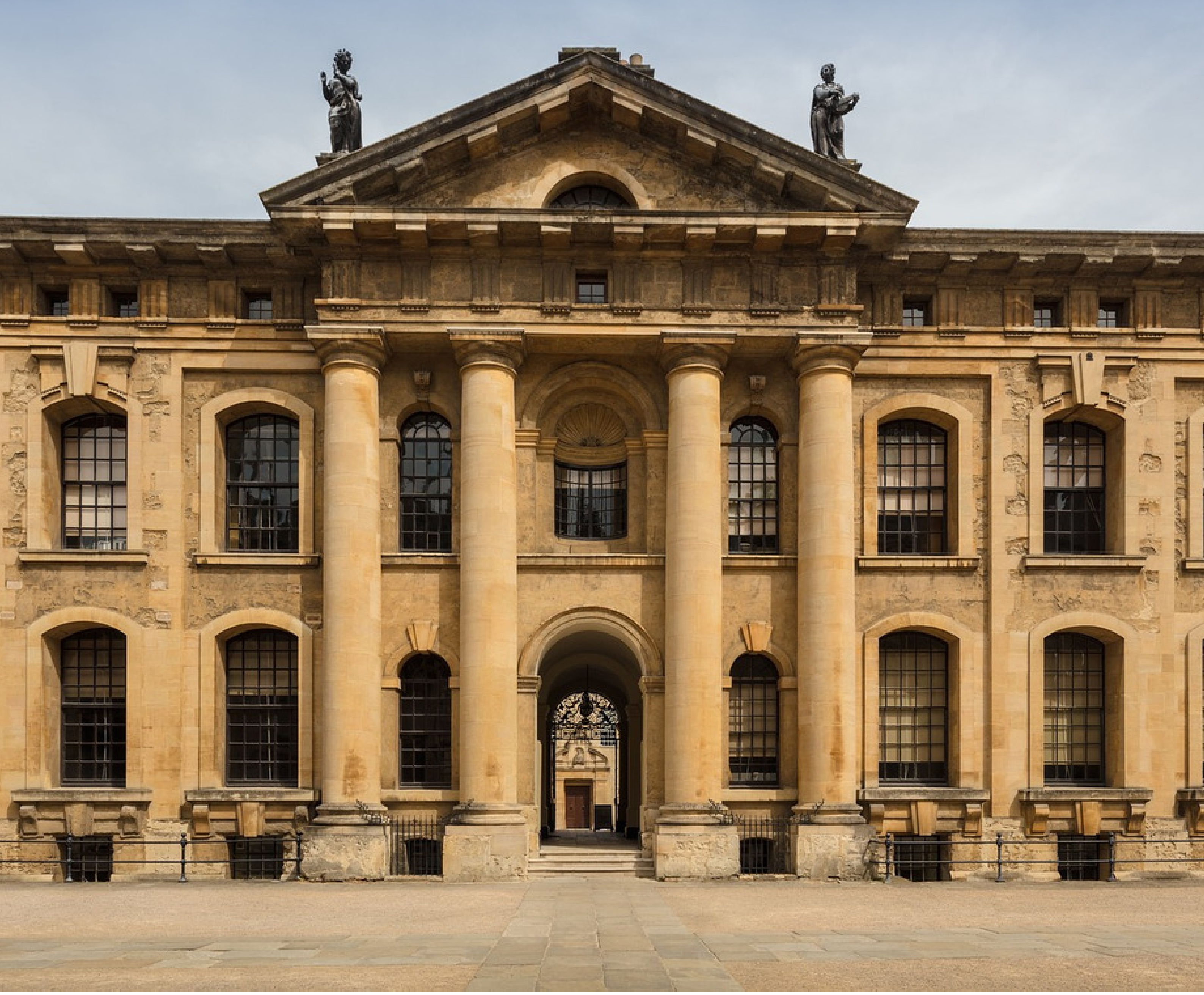
european corporate governance institute

University of Oxford | CLC Commercial Law Centre, Harris Manchester College

Institute of European and Comparative Law, Faculty of Law

University of Oxford

CENTROS AND EUROPEAN COMPANY LAW: TWENTY YEARS OF LIVING DANGEROUSLY



3rd Annual Conference of the Oxford Business Law Blog

HOSTED BY
UNIVERSITY OF OXFORD
15 MARCH 2019

REPORT BY ALVARO PEREIRA

Conference Report

March 2019 marked the twentieth anniversary of the landmark *Centros* case. It was the first of three judgments in which the (then) European Court of Justice (the Court) affirmed companies' freedom of establishment, creating the conditions for (often-feared) regulatory arbitrage and competition in corporate law. Recognising its continued relevance for comparative company law, the editors of the Oxford Business Law Blog selected the case to be the focus of its third annual conference, held on March 15 at St Hugh's College.

The conference gathered leading experts to reflect on the decision and its impact, just a few days before Brexit's original date. The papers presented and discussed at the conference revealed that *Centros*' influence extends far beyond European company law. This report covers the main deliberations in three broader themes: regulatory arbitrage; the scope of company law in the context of regulatory competition; and creditor protection before and after Brexit. It then concludes with an overview of a Roundtable discussion of *Centros*' legacy.

Regulatory Arbitrage

Regulatory arbitrage is one of *Centros*' immediate and most commented upon consequences. The Court's decision to grant companies the previously unavailable freedom of incorporation within the EU was perceived as a peril. It constrained states' ability to control companies headquartered within their borders and, more generally, authorized a practice that has traditionally had a negative connotation.

Anne-Lise Sibony (Université Catholique de Louvain) presented a critical approach to the first concern. In her analysis, *Centros* is part of a broader debate on how private parties (not only companies) use EU fundamental freedoms to circumvent the application of national laws and, crucially, on the extent to which member states might prevent abuses. Her review of the Court's case law in fundamental freedoms demonstrates that *Centros* is more restrictive of states' defences than other cases involving natural persons, such as Chen (2002) or Zambrano (2009). According to her proposed 'minimalist framework of comparison,' a decisive factor explaining *Centros*' higher restrictiveness is that, unlike other rights of natural persons (ie, equal treatment of workers or citizens), freedom of establishment is more precisely defined in the treaty and the definition excludes states' ability to impose conditions for its exercise, such as scrutinising the existence of a genuine link between the company and the state of incorporation.

The discussant, Andreas Engert (Freie Universität Berlin), partially supported the conclusions but noted that the structural differences between the schemes used by natural and legal persons to circumvent domestic law weaken the accuracy and utility of comparisons among them. For example, while companies attempt to avoid the laws of the state of origin, individuals typically pursue benefits in the host state. Hence, from a policy perspective, he found that the *Centros* decision correctly limited states' ability to invoke abuse-of-law arguments, as the opposite outcome would deter legitimate uses of the freedoms. He warned, however, that it is yet to be determined whether large-scale regulatory arbitrage is positive or not.

Elizabeth Pollman (Loyola Law School, Los Angeles) addressed the latter issue from a broader perspective. Her research reveals that, because the practice is frequently perceived as negative, most efforts are centered on preventive measures such as harmonization. However, Pollman reminded participants that regulatory arbitrage is a global business practice: as long as there are differences in regulations, there will be opportunities for companies to strategically select the legal regimes that better support their goals, which might or might not align with those of society. If that is the case, then, why is there not more regulatory arbitrage? To answer this question, Pollman considered recent experiences in the technology industry. Due to its faster adaptation to legal and business changes, as well as its sustained budget and power expansion, technology companies are particularly well positioned to engage in this practice. Building on Victor Fleischer's taxonomy of constraints to regulatory arbitrage, she identified three additional forces that hamper the practice. First, the lack of public trust (or 'social license'), which often pressures companies not to use the law as advantageously as they could. Second, the difficulties of simultaneously arbitraging various regulations. Finally, the possibility to successfully induce legal changes that support business goals, which she has previously referred to as 'regulatory entrepreneurship'.

In his discussion of the paper, Luca Enriques (University of Oxford) noted that regulatory arbitrage is not necessarily negative or dangerous. In fact, states themselves – often intentionally – leave room for choice when, for instance, they permit the coexistence of different legal forms or tax schemes. He also made the point that selecting optimal rules is one of many decisions that are subjected to legal, ethical and other types of boundaries. In that sense, Pollman's proposed constraints are not only useful to understand the frontiers of regulatory arbitrage but more generally of business choices, more broadly.

The scope of company law in the context of regulatory competition

Since *Centros*, the scope of company law determines, on the one hand, the rules that companies can select when incorporating (regulatory arbitrage); and, on the other hand, the reforms that states might implement to either attract companies from other member states or retain their own (regulatory competition). Three papers approached the latter issue from complementary angles.

In the first paper, Martin Gelter (Fordham University School of Law) presented the results of various econometrics tests measuring the impact that post-*Centros* company law reforms had on cross-border firm formation. The tests focused on legislation aimed at deterring Continental European businesses from incorporating in the UK, which several studies found to be a consequence of its simpler and less expensive incorporation process. Gelter considered reforms reducing registration requirements and creating simplified corporate forms in 31 European jurisdictions from 1990 to 2016. Using difference-in-difference and fixed effects models, he found that reforms reducing minimum capital and minimum pay-in requirements consistently curbed entrepreneurs' willingness to incorporate in the UK. The evidence on other reforms, however, was not significant, which is consistent with results of earlier studies. Gelter's findings suggest that, given entrepreneurs' preferences, *Centros* mainly incentivized competition in the reduction of business registration procedures.

Discussing Gelter's findings, Steven Davidoff Solomon (Berkeley Law) first noted that there is no longer regulatory competition in US company law. While Delaware attracts both public corporations and those attempting to engage in venture capital deals, private companies tend to incorporate in their state of business. For Davidoff Solomon, the latter trend suggests that businesses that are not attempting to raise funds from investors prioritize specific aspects of local jurisdictions over the cost of registration or even the reputation of the judiciary — for instance, having direct access to the local legal network and an enhanced ability to reach preferential private agreements. Europe has greater differences in culture and language that might further explain the incorporation choices of private companies, beyond registration costs. Accordingly, he insisted on the need to consider the preferences of different types of entrepreneurs when exploring the impact of reforms, such as those studied by Gelter, that aim to play with their incentives.

In a separate panel, Carsten Gerner-Beuerle (University College London) presented a paper co-authored with Federico M. Mucciarelli, Edmund-Philipp Schuster and Mathias Siems. They contend that, notwithstanding increases in UK incorporations by Continental European firms, *Centros* did not produce significant corporate mobility, which is explained by both the narrow scope of corporate law in Europe as well as of states' defensive mechanisms. Gerner-Beuerle began by questioning the impact of *Centros* and its progeny of cases on two grounds. First, corporate mobility is low in Europe compared to the US. Second, regulatory competition has not produced significant changes in corporate statutes.

Gerner-Beuerle argued that beyond economic differences between the US and Europe, the scope of the laws that regulate corporate behaviour greatly influenced these outcomes: in Europe, the benefits that a rather thin company law framework offers to companies that incorporate out of their state of main office are outweighed by the costs of complying with other legal regimes, such as insolvency or tort. Their study finds evidence of states introducing legal reforms in those areas as defensive mechanisms, further limiting the scope of company law and the advantages of incorporating in alternative jurisdictions.

In response, Georg Ringe (University of Hamburg) submitted that the wave of company law reforms in continental Europe between 2003 and 2008 demonstrates that *Centros* did trigger some albeit limited regulatory competition. He also argued that the lack of comprehensive evidence of corporate mobility does not disprove the practice, but rather reveals, inter alia, that the methods to measure it are still developing and that there are not enough incentives to compete. Finally, behavioural issues as well as psychological acceptance and reputation problems may account for some of the disappointing impact of the *Centros* case law.

Finally, Jill Fisch (University of Pennsylvania) presented a paper co-authored by Steven Davidoff Solomon, discussing how California's recently enacted 'Women in Boards' Statute (SB 826) conflicts with the doctrinal basis for US regulatory competition in company law and the implications for Europe. To the extent that *Centros* created an ostensibly similar competition, the paper contributes to resolving a pressing question: what specific regulation are companies choosing when making the incorporation decision? In the US, she explained, the consensus is that the state of incorporation's law governs the internal affairs of the legal entity. The scope of 'internal,' however, is still debated. According to Fisch and Davidoff's proposed theory, the scope is constrained to pure corporate governance matters, rules oriented to enhancing firm economic value, such as voting rights or payment of dividends. Hence, SB 826, which requires publicly traded companies based (not incorporated) in California to have a minimum number of female directors, is incompatible with the internal affairs doctrine in two crucial aspects. First, it applies to publicly traded companies with principal executive offices in California, not only those incorporated there. Second, it creates social welfare obligations that are outside the economic scope of the internal affairs theory, as evidenced by both the legislative history of the statute and empirical studies.

Fisch concluded that SB 826's implied shift of the internal affairs doctrine could increase conflicts in US corporate law. She acknowledged, however, that European corporate law is not as shareholder-oriented and does not distinguish internal from external affairs as sharply as the US. Consequently, the discussed doctrine might be insufficient to constrain EU member states' attempts to control corporations registered in other states through statutes similar to SB 826. To prevent the risks imposed by similar legislative initiatives, then, harmonization would be a more appropriate measure. Fisch noted that a variety of factors have limited harmonization efforts in the EU including nationalist values that are less significant between US states.

The commentator, Tobias H. Tröger (Goethe University Frankfurt), supported the annotated differences between European and US company law but emphasized that shareholders in both contexts might also have non-monetary preferences (ie, having gender quotas or codetermination) that could be expressed in the incorporation decision. In that sense, the internal affairs theory should not be limited to economic matters.

If, as acknowledged by Fisch and Tröger, European company law is more diverse and broader in scope than that of the US, *Centros* might have authorized states to compete with statutes such as SB 826. Nonetheless, the preceding discussions suggest that such a competition is rather unlikely. Gelter only found evidence of a demand for reduced capital requirements for incorporation. On the supply side, Gerner-Beuerle and others identified a trend towards shrinking the scope of company law and hampering regulatory competition. Hence, it seems that the potential dangers created by *Centros* are confined in the economic features of company law.

Creditor protection before and after Brexit

By prompting regulatory arbitrage and competition, *Centros* increased the UK's influence in the legal determinants of corporate behaviour in the EU. Two papers considered how the UK-EU relation impacted creditor protection and what Brexit could entail for creditors.

Eilís Ferran (University of Cambridge) considered the post-Brexit future of UK rules on legal capital. Her paper contends that due to EU constraints, the latest comprehensive company law reform in the UK (Companies Act 2006) did not sufficiently adjust the system to contemporary needs. The 2006 Act replaced the court-approved capital reduction requirement for a solvency declaration by directors, in line with international trends. To ensure compliance, it also established criminal liability in case of default. According to Ferran, that amendment was appropriate but untenably excluded public companies and did not cover dividend payments, which are still subjected to costly and complex accounting rules, such as profit realisation. The legislative freedom provided by Brexit, she argued, could be leveraged to amend UK capital rules. For example, abolishing the profit realisation requirement, as happens in Singapore.

In response, Gerald Hertig (ETH Zurich) highlighted that the distinction between private and public companies could indeed be redundant since industry and systemic risks have proven to be more relevant for creditor protection. He noted, however, that a comprehensive reform of legal capital, both in the UK and in the EU, should rely on data, which is unfortunately not available.

Horst Eidenmüller (University of Oxford) discussed the evolution of corporate insolvency law in Europe and how specific events, including Brexit, affect the market for corporate restructurings. His main claim was that the recasting of the European Insolvency Regulation (EIR, 2017), the European Restructuring Directive (ERD, 2019) and Brexit (2019) are going to reduce regulatory competition in corporate insolvency law in the EU and that the UK will lose its dominant market position.

Eidenmüller argued that the main challenge for appropriate regulatory competition in corporate insolvency law is preventing negative effects on creditors who do not participate in the forum selection decision. From this perspective, regulatory arbitrage would be relatively unproblematic if the choice could be made in a corporation's charter (ex ante) because the information would then be available for (contract) creditors in advance. However, such ex ante choice is not legally permissible. When corporations select their insolvency regimes ex post, by reincorporating in a different jurisdiction or changing their centre of main interests (COMI) without such reincorporation, it is necessary to consider safeguards. The latter situation is especially relevant in the EU, where greater divergences in insolvency regimes incentivize hazardous forum shopping. The seemingly practical solution has been to promote harmonization.

The European approach to the ex post selection of insolvency law has varied over the past 20 years, but remains insufficient for effective credit protection, according to Eidenmüller. He argued that both the 'original' 2002 and the recast 2018 EIR failed to neutralize schemes increasing creditor vulnerability, which remained common. The 2019 ERD attempts to harmonize pre-insolvency proceedings, allowing small and medium enterprises to access the procedure in domestic legislations, thereby deterring forum shopping. To him, that solution is inappropriate because it includes Chapter 11-inspired rules and requirements that appear to be particularly challenging for small and medium enterprises and might be unevenly applied in different jurisdictions. Eidenmüller concluded that Brexit will exclude automatic recognition of UK judicial decisions, effectively eliminating the dominant competitor in the European restructuring market and a pressing incentive for reform. He presented data on the decline of the popularity of the UK Scheme of Arrangement for foreign firms that he interpreted as a first piece of evidence to support this hypothesis.

Sarah Paterson (London School of Economics) offered an alternative vision of UK's prospective influence on European insolvency law after Brexit. She argued that a review of the restructuring market shows that the UK has become a prevalent jurisdiction after the financial crisis because of its capacity to adapt to the particular demands of restructuring complex leveraged capital structures. Paterson analysed why current changes in the financial market may mean that restructurings do not take the same shape over the course of the next decade. She argued that these changes may yet lead debtors to seek out English restructuring law's adaptive capacity. She concluded that it was too early to decide definitively that corporations would not access English restructuring law after Brexit.

The Legacy of *Centros*: A Roundtable Discussion

A roundtable discussion on the legacy of *Centros* closed the conference. Most participants evaluated regulatory competition as a positive development in EU company law. Marco Becht (Solvay Business School), for instance, noted that it had prompted improvements in company law such as the German UG, which significantly facilitated entrepreneurs' access to limited liability. For Vanessa Knapp (Queen Mary University), the case also correctly clarified that incorporating in a different jurisdiction is not an abusive use of freedom of establishment, since such an approach would entail a presumption against the receiving state. An open question, thus, is the extent to which the freedom also covers cross-border conversion.

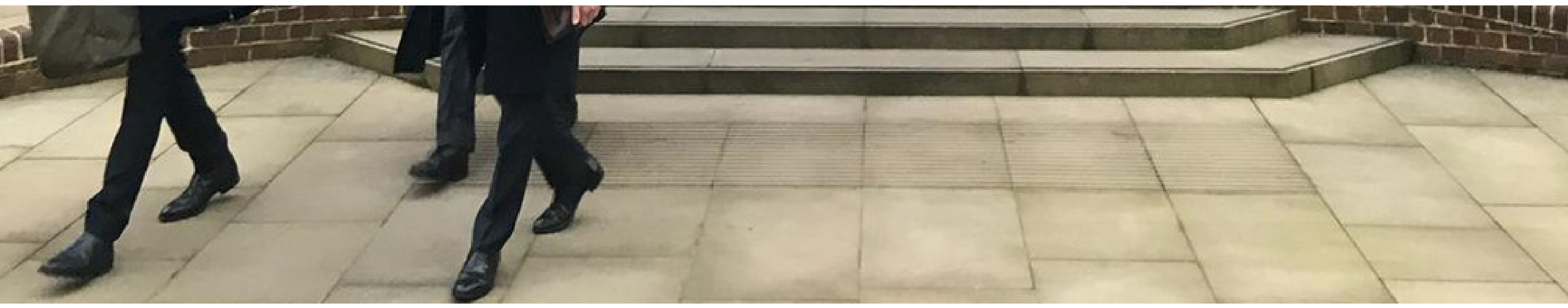
As a means to distinguish legitimate from abusive transactions of this nature, Paul Davies (University of Oxford) proposed considering the 'varieties of capitalism' framework. Davies suggested that because complete harmonization of legal systems is not realistic or desirable, companies should be allowed to seek regulatory advantages but also accept the costs of those decisions. A more sceptical approach was submitted by Edmund-Philipp Schuster (London School of Economics), who noted that regulatory competition in incorporation requirements has not meaningfully affected economic activity. Furthermore, beyond registration costs, companies do not have many incentives to choose among jurisdictions because the differences in other areas, such as antitakeover, are not as salient.

As for the incidence of Brexit, panellists noted that certain EU countries are working to occupy the space of the UK as a dominant jurisdiction in corporate and bankruptcy law. Jennifer Payne (University of Oxford) noted that it might still be possible to access UK restructuring proceedings by choosing English law and echoed Sarah Patterson's view that, because of its adaptive capacity, English is likely to remain appealing for corporations and creditors. John Armour (University of Oxford) concluded that, regardless of the specific outcome, Brexit will promote further competition. According to him, Ireland would have an advantage if it tried to replace the UK as the corporation state of choice: it might easily adopt innovations from the UK thanks to its proximity and commonality of legal tradition and language.

To conclude, *Centros* generated fears of abusive regulatory arbitrage and a potentially inconvenient competition in company law. Yet, after twenty years, it seems that legal systems have adapted, debunking most of the perceived risks. Given the UK's prevalence in the European market for corporate law, its withdrawal from the EU creates new challenges for *Centros*' legacy. Despite uncertainty on the terms of the separation, it is clear that fundamental developments in European business law belong to a post-Brexit future. In company law, a pervasive challenge is defining the standards for cross-border conversion, and, in insolvency law, the protection of creditors in ex-post forum selection.

Author:

Alvaro Pereira is a doctoral candidate at the University of California, Berkeley, School of Law and a Junior Academic Visitor at the University of Oxford, Faculty of Law.



About the European Corporate Governance Institute (ECGI)

www.ecgi.global

The ECGI is an international scientific non-profit association which provides a forum for debate and dialogue focusing on major corporate governance issues and thereby promoting best practice. It is the home for all those with an interest in corporate governance offering membership categories for academics, practitioners, patrons and institutions.

Its primary role is to undertake, commission and disseminate research on corporate governance. Based upon impartial and objective research and the collective knowledge and wisdom of its members, it can advise on the formulation of corporate governance policy and development of best practice. In seeking to achieve the aim of improving corporate governance, ECGI acts as a focal point for academics working on corporate governance in Europe and elsewhere, encouraging the interaction between the different disciplines, such as economics, law, finance and management.

About The Oxford Business Law Blog

The Oxford Business Law Blog is a forum for the exchange of ideas and the reporting of new developments in all aspects of business law. Its editorial board is comprised of Luca Enriques, Dan Awrey, Genevieve Helleringer, Horst Eidenmüller, Kristin van Zwieten, Umakanth Varottil and Andreas Engert. They are assisted by Roderic Kermarec, Vaclav Janecek, Jonathan Chan, Felix Pflücke, Bojana Vitanova, Leah Grolman and Jason Fu.

The 3rd Annual Conference of the OBLB was generously supported by Travers Smith, the European Corporate Governance Institute, the Oxford Law Faculty, the Commercial Law Centre at Harris Manchester College and the Oxford Institute of European and Comparative Law.

Contact

membership@ecgi.org

Prof. Marco Becht
Executive Director and Fellow
European Corporate Governance Institute
Tel: +32 2 550 2340
GSM: +32 478 406156
marco.becht@ecgi.org
www.ecgi.global

c/o The Royal Academies of Belgium
Palace of the Academies
Rue Ducale 1 Hertogsstraat
1000 Brussels
Belgium

Elaine McPartlan
General Manager
European Corporate Governance Institute
Tel: +32 2 550 2340
elaine.mcpartlan@ecgi.org
www.ecgi.global