Abuse of Companies through Choice of Incorporation?

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The authors would like to thank Summer Kim for sharing her research on corporate long-arm statutes in the United States.

Abstract

This paper explores the concept of abuse of law in the context of the choice of the state or country of incorporation: Can the choice of a particular jurisdiction constitute "abuse"? The case law of the Court of Justice of the European Union (CJEU) on the freedom of establishment for companies has in principle left open the possibility for the Member States to take measures against "abuse" at least in specific cases. We explore two scenarios. First, we highlight cross-border incorporations of private limited companies and look at the systemic consequences of a line of judicial decisions that started with *Centros* and compare them to regulatory competition and the role of 'pseudo-foreign incorporation statutes' in the United States. Second, we look at cross-border mergers, comparing them with 'reverse mergers' in the US, a phenomenon that some scholars and practitioners have considered problematic and that allows an ex post choice of jurisdiction for established corporations. While the number of firms making use of these opportunities has remained relatively small, the changes had a systemic effect. Restrictions on the choice of incorporation are often not designed to protect specific stakeholders of the firm (such as shareholders, employees, or creditors), but rather to protect the state's lawmaking authority concerning companies (corporations) primarily active in its territory. Member States have historically employed restrictions on the choice of incorporation to discourage cross-border incorporations and to protect their laws from regulatory competition. Overall, the CJEU's case law has left us with a vision for corporate law without space for a doctrine of abuse. The court's vision is rooted in the idea that informed market participants are informed actors that understand that different laws govern forms of companies from different countries and adjust their expectations accordingly. This 'self-protection' model may be at odds with many Continental European traditions but was likely an inevitable consequence of the freedom of establishment. Nevertheless, Member States have been able to able to compensate for the loss of control over some aspects of the law of business organization through insolvencification. Consequently, there does not appear to be a strong need to extend abuse of law as a doctrinal mechanism.

Keywords: Abuse of Law, Centros, Überseering, Inspire Art, Polbud, Kornhaas, Regulatory Competition, Insolvencification, Regulatory Arbitrage, Internal Affairs, Pseudo-Foreign Incorporation Statutes, Cross-Border Mergers, Reverse Mergers, Cross-Border Transfer of Seat, Eu Company Law

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April 2019

Abstract: *This paper explores the concept of abuse of law in the context of the choice of the state or country of incorporation: Can the choice of a particular jurisdiction constitute "abuse"? The case law of the Court of Justice of the European Union (CJEU) on the freedom of establishment for companies has in principle left open the possibility for the Member States to take measures against "abuse" at least in specific cases. We explore two scenarios. First, we highlight cross-border incorporations of private limited companies and look at the systemic consequences of a line of judicial decisions that started with Centros and compare them to regulatory competition and the role of 'pseudo-foreign incorporation statutes' in the United States. Second, we look at cross-border mergers, comparing them with 'reverse mergers' in the US, a phenomenon that some scholars and practitioners have considered problematic and that allows an ex post choice of jurisdiction for established corporations. While the number of firms making use of these opportunities has remained relatively small, the changes had a systemic effect. Restrictions on the choice of incorporation are often not designed to protect specific stakeholders of the firm (such as shareholders, employees, or creditors), but rather to protect the state's lawmaking authority concerning companies (corporations) primarily active in its territory. Member States have historically employed restrictions on the choice of incorporation to discourage cross-border incorporations and to protect their laws from regulatory competition. Overall, the CJEU's case law has left us with a vision for corporate law without space for a doctrine of abuse. The court's vision is rooted in the idea that informed market participants are informed actors that understand that different laws govern forms of companies from different countries and adjust their expectations accordingly. This 'self-protection' model may be at odds with many Continental European traditions but was likely an inevitable consequence of the freedom of establishment. Nevertheless, Member States have been able to able to compensate for the loss of control over some aspects of the law of business organization through insolvencification. Consequently, there does not appear to be a strong need to extend abuse of law as a doctrinal mechanism.*

Keywords: Abuse of law, Centros, Überseering, Inspire Art, Polbud, Kornhaas, regulatory competition, insolvencification, regulatory arbitrage, internal affairs, pseudo-foreign incorporation statutes, cross-border mergers, reverse mergers, cross-border transfer of seat, EU Company Law.

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1. Introduction

Abuse of law is sometimes understood to refer to a situation where someone employs a legal entitlement to gain an advantage. In doing so, this person follows the letter of the law, but not its spirit.[1] In other words, the legal entitlement is used not for the purpose for which it was intended.[2] Abuse thus introduces a corrective element to the purely literal application of the law.[3]

Our task in this chapter is to explore whether the choice of incorporation can be considered an abuse of law or an abuse of the corporate form as such. This issue has often been raised in the

[1] For example. Annekatrien Lenaerts, *The General Principle of the Prohibition of Abuse of Rights: A Critical Position on Its Role in a Codified European Contract Law*, (2010) Eur. Rev. Priv. L. 1121, 1122. More generally, definitions of abuse abound. Some emphasize objective, others subjective elements. *See, e.g.*, Anna di Robilant, *Abuse of Rights: The Continental Drug and the Common Law,* 61 Hastings L.J. 687, 691-692 (2010) (surveying definitions and identifying at least five categories).

[2] The CJEU has found that: "abuse requires, first, a combination of objective circumstances in which, despite formal observance of the conditions laid down by the Community rules, the purpose of those rules has not been achieved." *Emsland-Stärke, Emsland-Stärke GmbH v. Hauptzollamt Hamburg-Jonas,* Case C-110/99, para. 52.

[3] Lenaerts, *supra* n. 1, at 1122.

context of the case law of the Court of Justice of the European Union (CJEU) on the freedom of establishment of companies. Countries have traditionally often maintained an interest in controlling the internal and external affairs of business organizations operating within their territory and have thus taken measures to prevent circumvention by incorporating elsewhere. The CJEU's case law permitting establishment in other EU Member States has generally left open the possibility of measures against "abuse" at least in specific cases. Specifically, the choice of incorporation is sometimes intended to circumvent legal requirements meant to protect particular stakeholders of the company, such as shareholders or creditors.

In this chapter, we seek to highlight the core difficulty with the conception of abuse based on the choice of incorporation. Restrictions on the choice of incorporation are not primarily intended to protect particular stakeholders of the firm (such as shareholders, employees, or creditors), but rather to sanction the state's lawmaking authority concerning companies (corporations[4]) primarily active in its territory. In other words, restrictions on the choice of incorporation create a shield against regulatory arbitrage. Within a federal or supranational system that relies on some level of comity between its constituent parts and some degree of mutual 'faith and credit' concerning the legal system,[5] it may be an inherent contradiction to say that the choice of jurisdiction as such constitutes abuse. Our chapter addresses two key scenarios. First, we look at *ex ante* cross-

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[4] Under the law of the United States, to which this chapter refers *infra*, the 'Corporation' was traditionally the only type of business association that was legally distinct from its equityholders (unlike partnerships). The past few decades saw the emergence of the Limited Liability Company (LLC). It is tempting to compare the corporation with the Public Limited Company form in Europe, and the LLC with the Private Limited Company. However, in the US the LLC is typically considered a modification of the partnership form (albeit with limited liability for all of its members), and under most circumstances taxed like a partnership.

[5] US Const. Art. IV, § 1, provides: "Full Faith and Credit shall be given in each State to the public Acts, Records, and judicial Proceedings of every other State. And the Congress may by general Laws prescribe the Manner in which such Acts, Records and Proceedings shall be proved, and the Effect thereof."

border incorporations of privately limited companies in section 2. Here, we take the European debate starting with *Centros* and its progeny in the case law as a starting point in section 2.1 and look at the systemic effects the court's jurisprudence has had. Then, we explore the question under the law of the United States in section 2.2 and explore 'pseudo-foreign incorporation statutes' in key states. Whereas this issue concerns primarily small, newly founded firms, in section 3 we look at cross-border mergers, comparing them, in particular, with 'reverse mergers' in the US, a phenomenon that some scholars and practitioners have considered problematic and that allows an *ex post* choice of jurisdiction for established corporations. A choice of jurisdiction *ex post* tends to create greater difficulty because individuals interacting with the firm are not in a position to adjust to the changed circumstances from the beginning, which creates a more considerable justification for mechanisms intended to protect them. Section 4 briefly addresses the debate about cross-border transfers of seat. Section 5 attempts to draw some broader lessons and concludes.

2. Cross-border incorporation of privately held firms

In this section, we look at the incorporation choices taken by privately held, typically small firms at the original inception of business activities. Subsection 2.1.1 looks at the situation in the EU and the debate triggered by the *Centros* case, which in practice concerns mainly "private limited companies".[6] Subsection 2.1.2 surveys the development in the US, where the analogous debate on

[6] Directive (EU) 2017/1132 of the European Parliament and of the Council of 14 June 2017 relating to certain aspects of company law (Codification), O.J. (L 169) 46 (hereinafter 'Codified Company Law Directive' or 'CCLD') provides two lists of national company forms in its Annexes I and II. By 'private limited company', we mean those forms listed only in Annex II, but omitted in Annex I, such as the German *Gesellschaft mit beschränkter Haftung*, French *société à responsabilité limitée*, or Italian *società a responsabilità limitata*.

incorporation choices of privately held firms in question has typically revolved around firms organized as corporations. Limited Liability Companies (LLCs), which are considered a modification of the partnership form, have become available and popular for privately held firms only in recent decades.[7]

2.1. Cross-border incorporations in Europe

2.1.1. No abuse after *Centros*?

In the 1999 case of *Centros*, the CJEU explicitly had to deal with the question of abuse. The Danish authorities had refused the registration of a branch office for an English private limited company that had been set up by Danish nationals. In defending the Danish Trade and Companies Board refusal of the registration, the Danish authorities explicitly stated that:

> "The sole purpose of the company formation [in the UK] is to circumvent the application of the national law governing formation of private limited companies and therefore constitutes abuse of the freedom of establishment."[8]

The CJEU left one possibility open when it said that:

> "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."[9]

However, it flat-out rejected the argument that foreign incorporation as such could constitute abuse, stating that:

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[7] *See supra* n. 4.
[8] *Centros Ltd v. Erhvervs- og Selskabsstyrelsen,* Case C-212/97, para. 23.
[9] *Ibid.,* para. 25.

> "[t]he 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."[10]

In the 2003 case of *Inspire Art*, the CJEU assessed the compatibility of the Dutch 'law on formally foreign entities' with the freedom of establishment. This law did not entail a classification of abusive conduct by any authority, but instead set up specific criteria defining a company as meaningfully connected to the Netherlands. Consequently, certain liability rules under Dutch law applied. Again, the CJEU determined the Dutch law to be incompatible with the freedom of establishment, reiterating its reasoning that:

> "The reasons for which the company was formed in that other State, and the fact that it carries on its activities exclusively or almost exclusively in the Member State of establishment, do not deprive it of the right to invoke the freedom of establishment guaranteed by the Treaty, save where abuse is established on a case-by-case basis."[11]

The CJEU's case law in these cases and others, most notably in *Überseering*,[12] was widely understood to invalidate Member States' attempts to apply the 'real seat theory' to corporations from other EU and European Economic Area (EEA) countries,[13] thus ushering in an era of regulatory competition. Several authors attempted to predict what the effects of such competition would be.[14]

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[10] *Ibid.*, para. 27.

[11] *Kamer van Koophandel en Fabrieken voor Amsterdam v. Inspire Art Ltd*, Case C-167/01, (2003) ECR 10155, para. 105.

[12] *Überseering BV v. Nordic Construction Company Baumanagement GmbH*, Case C-208/00, (2002) ECR 9919.

[13] For example, Thomas Bachner, *Freedom of Establishment for Companies: A Great Leap Forward*, 62 Cambridge L.J. 47, 49 (2003) ('this *is* the end of the theory of the real seat').

[14] For example, Luca Enriques, *EC Company Law and the Fears of a European Delaware*, 15 Eur. Bus. L. Rev. 1259-1274 (2004); Jens C. Dammann, *Freedom of Choice in European Corporate Law*, 29 Yale J. Int'l L., 477-544 (2004); Eva-Maria Kieninger, *The Legal Framework of Regulatory Competition Based on Corporate Mobility: EU and US Compared*, 6 German L.J. 741-770 (2004); John Armour, *Who Should Make Corporate Law? EC Legislation v. Regulatory Competition*, 58 Curr. Leg. Probs. 370-413 (2005); Martin Gelter, *The Structure of Regulatory Competition in European Corporate Law*, 5 J. Corp. L. Stud. 247-284 (2005); Tobias H. Tröger, *Choice of Jurisdiction in European Corporate Law – Perspectives of European Corporate Governance*, 6 Eur. Bus. Org. L. Rev. 3-64 (2005);

Ultimately, the debate turned mainly toward creditor protection and legal capital. On much of the Continent, the legal capital system had long been considered a vital instrument to protect creditors, and minimum capital was thought to be part of that system. The EU's Second Company Law Directive harmonized legal capital requirements to a certain extent, but only for public limited companies.[15] While for public limited companies the minimum capital of the Directive was € 25,000 (some Member States required an even higher figure), the amount of minimum capital for private limited companies, if any was required, varied among the Member States. Some entrepreneurs used the opportunity to incorporate in the United Kingdom, which did not require a minimum capital. Consequently, the CJEU's attack on the real seat theory contributed to a growing debate about the merits and demerits of the legal capital system.[16] Besides creating a level playing field in the common market, the prevention of regulatory arbitrage appears to have been one of the original motivations of EC company law harmonization.[17] The failure of an extension of the directive to private limited companies may at least indirectly have served as a justification in the eyes of some (but indeed not the court) of maintaining the real seat theory.[18]

Hanne S. Birkmose, *A 'Race to the Bottom' in the EU?*, 13 Maastricht J. Eur. & Comp. L. 35-80 (2006); Marco Ventoruzzo, *'Cost-Based' and 'Rules-Based' Regulatory Competition: Markets for Corporate Charters in the U.S. and the E.U.*, 3 NYU J.L & Bus. 91-153 (2006).

[15] Second Council Directive of 13 Dec. 1976, 1977 O.J. (L 26) 1. The directive was subsequently recodified as Directive 2012/30/EU of 25 Oct. 2012. Most recently, it has been integrated into the CCLD, Chapter IV.

[16] For example, Luca Enriques & Jonathan R. Macey, *Creditors Versus Capital Formation: The Case Against the European Legal Capital Rules*, 86 Cornell L. Rev. 1165 (2001); Peter O. Mülbert & Max Birke, *Legal Capital – Is There a Case Against the European Legal Capital Rules?* 3 Eur. Bus. Org. L. Rev. 695, 732 (2002); Jonathan Rickford (ed.), *Reforming Capital. Report of the Interdisciplinary Group on Capital Maintenance,* 2004 Eur. Bus. L. Rev. 919; John Armour, *Legal Capital: An Outdated Concept?* 7 Eur. Bus. Org. L. Rev. 5, 11 (2006).

[17] On the purposes of company law harmonization, *see*, *e.g.*, Martin Gelter, *EU company law harmonization between convergence and varieties of capitalism*, in Harwell Wells (ed.), *Research Handbook on the History of Corporate and Company Law* (Cheltenham: Edward Elgar, 2018), 323, 325-330.

[18] On this debate, *see, e.g.*, Marcus Lutter, *A Mini-Directive on Legal Capital*, in Harm-Jan De Kluiver & Walter Van Gerven (eds.), *The European Private Company*? (Antwerp: Maklu, 1995), 201, 207; Vanessa Edwards, *EC Company*

2.1.2. *Ex ante* hurdles against the choice of jurisdiction as justifiable shields against abuse?

The real seat theory never served the purpose of protecting specific shareholders or creditors of a company. To the contrary, creditors attempting to enforce a particular claim against a pseudo-foreign corporation might in fact run into the hurdle that a court would find it not to be a suitable defendant due to lack of legal capacity.[19] Instead, the real seat theory's purpose is protectionism: founders are compelled to select the law of the real seat state. Consequently, creditors are never in the position to sue a firm of questionable legal status, which is why the Member States largely retained the power to govern the corporate law of firms within their territory without having to fear regulatory arbitrage while the real seat theory lasted. Consequently, the question of whether any individual choice of incorporation is abusive may miss the point; the actual important issue is the systemic effects of permitting or prohibiting regulatory arbitrage. Consequently, whether incorporation in a non-seat jurisdiction is abusive is in part a function of the pervasiveness of the phenomenon.

Obtaining data on cross-border incorporations in Europe is complicated, and the available methods are not entirely precise. The canonical, although imperfect approach for measuring the number of such pseudo-foreign incorporations is to identify firms with certain characteristics in

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Law (Oxford: Clarendon Press, 1999), 54-55; Stefan Grundmann, *European Company Law* (Cambridge – Antwerp – Portland: Intersentia, 2nd ed. 2012) 208; Martin Gelter & Alexandra M. Reif, *What is Dead May Never Die: The UK's Influence on EU Company Law*, 40 Fordham Int'l L.J. 1413, 1424-1426 (2017).

[19] For example, Klaus J. Hopt, *European Company and Financial Law: Observations on European Politics, Protectionism, and the Financial Crisis*, in Ulf Bernitz & Wolf-Georg Ringe (eds.), *Company Law and Economic Protectionism*, eds. (Oxford: Oxford University Press, 2010), 13, 16; Martin Gelter, *Centros, the Freedom of Establishment for Companies and the Court's Accidental Vision for Corporate Law*, in Fernanda Nicola & Bill Davies (eds.), *EU Law Stories* (Cambridge: Cambridge University Press, 2017), 309, 310, 317.

one of the Bureau van Dijk databases.[20] Firms are then classified as pseudo-UK incorporations if they are registered in the UK and a certain number of their directors are either citizens or residents of a particular other EU/EEA jurisdiction. Figure 1 shows the timelines of such firms by year of incorporation for Austria, Belgium, Denmark, Germany, Italy, and the Netherlands.[21] Each chart comprises three timelines, namely one where all directors are citizens of the country in question, one where the majority of directors are residents of the country, and one where the majority of directors are citizens and where the firm uses an incorporation agent.[22] Each of these methods has advantages and disadvantages in capturing the population of "Centros" firms empirically. Citizenship data appear to be complete, but a considerable number of firms clearly must have been incorporated by migrants to the UK. Residency data would exclude these founders, but apparently residency data is only voluntarily submitted by the UK Companies House. Using citizenship data and limiting the number of possible pseudo-UK firms by looking only at those using an incorporation agency thus probably best captures the time trend.

[20] The core British database is called FAME (UK), which provides a subset of the data of AMADEUS (Europe) and ORBIS (worldwide). This data source and method has been used in several variations by Marco Becht, Colin Mayer & Hannes F. Wagner, *Where do firms incorporate? Deregulation and the cost of entry*, 14 J. Corp. Fin. 241-256 (2008); Reiner Braun, Horst Eidenmüller, Andreas Engert & Lars Hornuf, *Does Charter Competition Foster Entrepreneurship? A Difference-in-Difference Approach to European Company Law Reforms*, 51 J. Common Mkt. Stud. 399-415 (2013); Wolf-Georg Ringe, *Corporate Mobility in the European Union – a Flash in the Pan? An empirical study on the success of lawmaking and regulatory competition*, Eur. Company & Fin. L. Rev. 230-267 (2013); Carsten Gerner-Beuerle, Federico Mucciarelli, Edmund Schuster & Mathias Siems, *Why Do Businesses Incorporate in other EU Member States? An Empirical Analysis of the Role of Conflict of Laws Rules*, 56 Int'l Rev. L. & Econ. 14-27 (2018).

[21] The data were collected for a research project by one of the authors from ORBIS in Dec. 2017. For details, *see* Martin Gelter, *The Effects of Defensive Regulatory Competition and Minimum Capital: A Panel Analysis of Cross-Border Incorporations in Europe* (work in progress). In short, the timelines show the number of firms registered in the UK that meet specific criteria connecting the respective directors to the country.

[22] Firms using an incorporation agent were defined as firms that shared their registered office address in the UK with 100 or more other firms. This method follows Ringe, *supra* n. 20, at 247.

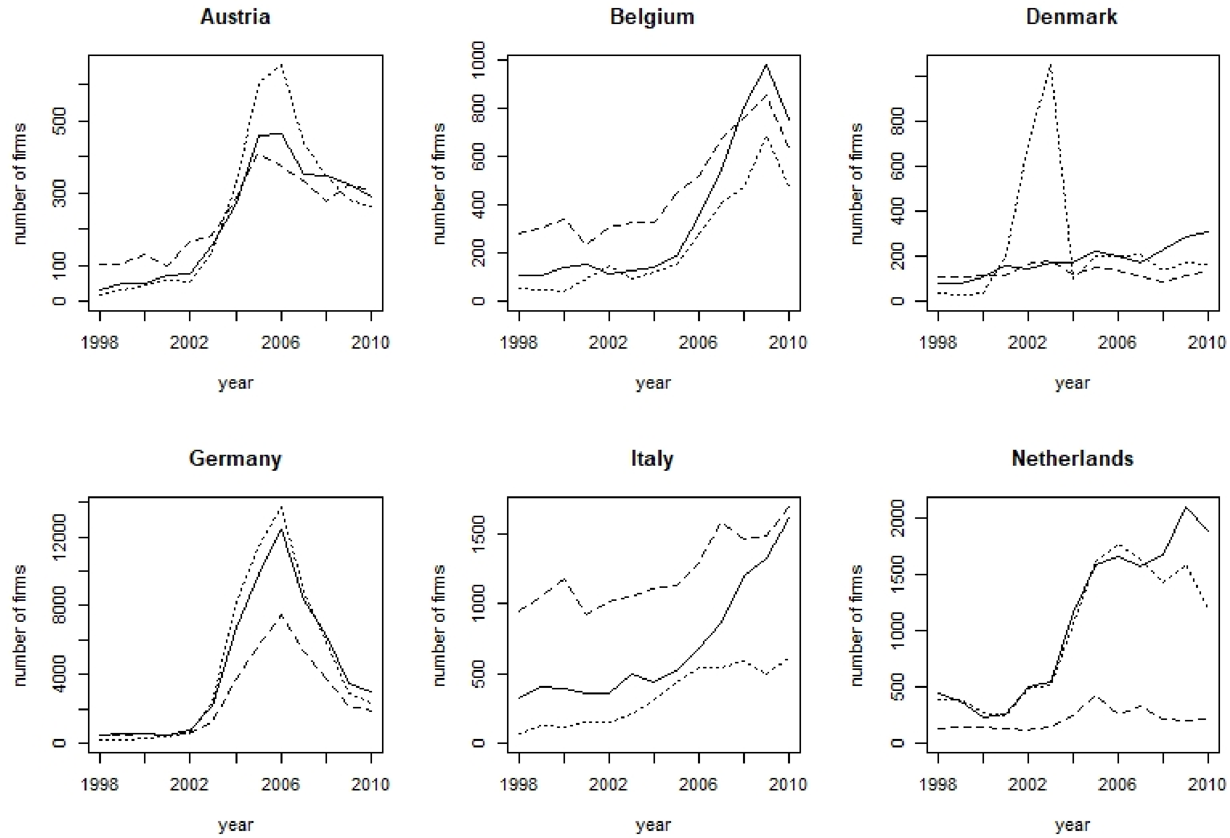

Figure 1: Number of Pseudo-UK incorporations in selected countries
Solid line: Firms where all directors are citizens of the country
Dashed line: Firms where the majority of directors are residents of the country
Dotted line: Majority of directors are citizens of the country and firm uses an agent

As shown in Figure 1, when we thus look at firms using an agent (shown with the dotted line), five countries exhibited a considerable trend toward UK incorporation, with Italy being the exception, at some point after the *Centros-Überseering-Inspire Art* triad. Austria, Germany, the Netherlands, and possibly Denmark show increases soon after the cases, followed by downturns in these countries except for the Netherlands.[23] There are other Member States where the cases seem not to have

[23] *See also* Becht et al., *supra* n. 20 (showing an increase in the number of UK incorporations across countries in a panel).

had much of an effect, or at least not an immediate one (*see* the example of Belgium in Figure 1), most likely because the respective national law and legal practice still maintained formal and informal hurdles.[24]

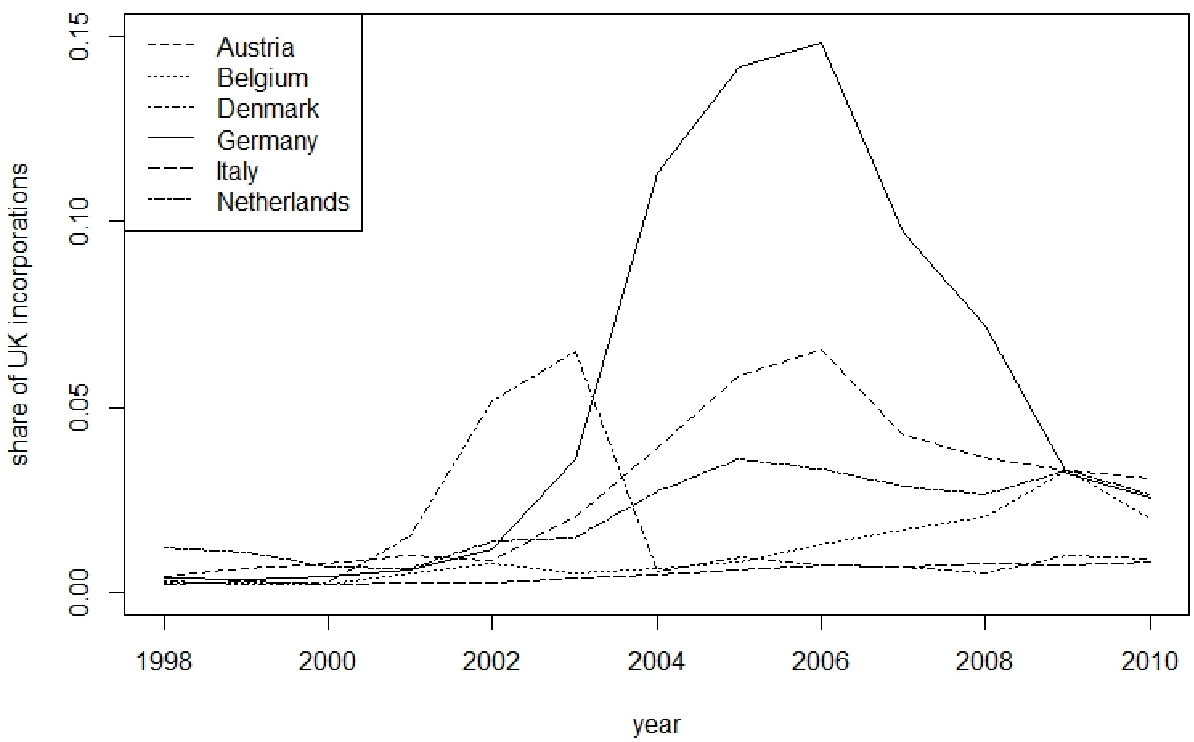

Figure 2: Share of Pseudo-UK incorporations among private limited companies

Figure 2 shows the percentage of Pseudo-UK incorporations measured as the number of firms using an agent as the share of private limited companies set up in the respective country.[25] Germany is the only jurisdiction where the share reached approximately 15 % in two years, and only in

[24] For an experimental analysis of such hurdles in several countries, *see* Marco Becht, Luca Enriques & Veronika Korom, *Centros and the Cost of Branching*, 9 J. Corp. L. Stud. 171-199 (2009).
[25] The denominator includes both ‘regular’ private limited companies set up in the country and firms incorporated in the UK and matching the search criteria.

Denmark and Austria did the share exceed 5 % in a single year.[26] Otherwise, one could argue that the effect on the national market of incorporation was only minor, and that the loss of control by respective national legislatures cannot seriously be considered more than negligible.

The perceived flow of new incorporations led to at least two strategies by the Member States that took measures to retain control over corporate law within their territory. The first one has sometimes been called "defensive regulatory competition".[27] This term refers to the elimination or reduction of features making domestic firms unattractive to founders. An example would be the reduction of minimum capital requirements, which has been a general trend among the Member States. For example, France allowed a merely nominal minimum capital in the SARL as early as 2003.[28] The German MoMiG Law of 2008[29] created a new legal form, the *Unternehmergesellschaft (haftungsbeschränkt)*, which is a modified version of the traditional GmbH. It does not require a minimum capital, but which must retain all of its profits until the regular minimum capital is reached.[30] Meanwhile, several Member States have introduced a variety of "capital-less" private limited companies, and a growing number is eliminating minimum capital for private limited companies entirely.[31]

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[26] Moreover, these figures include both active and inactive firms; many of the firms founded during the height of the wave are no longer active.
[27] For example, Luca Enriques & Martin Gelter, *How the Old World Encountered the New One: Regulatory Competition and Cooperation in European Corporate and Bankruptcy Law*, 81 Tul. L. Rev. 577, 600 (2007); Ringe, *supra* n. 20, at 243; Gelter, *supra* n. 19, at 310.
[28] For example, Pierre-Henri Conac, *The Societas Unius Personae (SUP): A "Passport" for Job Creation and Growth*, 2015 Eur. Comp. & Fin. L. Rev. 139, 149-150 (2015).
[29] Gesetz zur Modernisierung des GmbH-Rechts und zur Bekämpfung von Missbräuchen, 23. Oktober 2008, BGBl. I S. 2026.
[30] GmbHG § 5a (Germany).
[31] *See, e.g.*, Alessio Bartolacelli in Ch. 9 of this book, Alessio Bartolacelli, The *New Italian Almost Capital-less Private Companies: A Brand New Tile in the Mosaic*, (2016) Eur. Comp. & Fin. L. Rev. 665-707; Alessio Bartolacelli, *Almost Capital-less Companies in Europe: Trends, Variations, Competition*, (2017) Eur. Comp. & Fin. L. Rev., 187-

The second strategy can be described as "insolvencification".[32] This term refers to the attempt to transfer creditor protection doctrines out of the ambit of the firm's place of incorporation, and into the European Insolvency Regulations 'Center of Main Interest' criterion[33] that is at least not explicitly subject to free choice. For example, Germany's 2008 MoMiG law is known for having 'insolvencified' director liability for failure to file for insolvency as well as the subordination of shareholder loans.[34] In the 2016 *Kornhaas* opinion, the CJEU even went so far as to 'insolvencify' the pre-MoMiG German directors' liability for failure to file for insolvency under a functional analysis and finding that the director of an English private limited company could be held liable under German law.[35]

Germany's changing veil piercing doctrine might also be seen as part of the phenomenon. Up to the early 2000s, the primary mechanism was rooted in the law of corporate groups, which allowed creditors to hold parent companies in a 'de facto GmbH' liable under certain circumstances. During the 2000s, the German Federal Supreme Court (*Bundesgerichtshof* or BGH) transitioned to a tort doctrine titled *Existenzvernichtungshaftung*, which would hold shareholders liable

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233; Conac, *supra* n. 28, at 149-150; Günter H. Roth & Peter Kindler, *The Spirit of Corporate Law* (Munich: C.H. Beck, 2013), 39-40.

[32] Enriques & Gelter, *supra* n. 27, at 642-645; Loes Lennarts, *EU Corporate Insolvency Law in the Wake of the ECJs Deko Marty Judgment*, 7 Eur. Comp. L. 106, 106 (2010).

[33] Art. 3 of the European Insolvency Regulation (EC Council Regulation 1346/2000 on Insolvency Proceedings (EIR)) implements a version of the real seat theory for bankruptcy law, under which the courts of the country where a debtor's Center of Main Interests (COMI) is competent to open the main insolvency proceedings.

[34] MoMiG, *supra* n. 29; InsO §§ 15a, 39 (Germany); *see, e.g.*, Loes Lennarts, *Directors in the Twilight Zone - Kornhaas and "Beyond" – some Observations from a Dutch Perspective*, in Jennifer Gant (ed.), *Harmonisation of European Insolvency Law* (Nottingham/Paris: INSOL Europe, 2017), 113, 114-115, 117-118.

[35] *Simona Kornhaas v. Thomas Dithmar*, Case C-594/14.

to the bankruptcy estate for destroying the basis for the firm's business existence.[36] With this type of liability being functionally set up as a tort law instrument rather than as a corporate law doctrine, it is not easy to see why it would not apply to firms incorporated in other Member States, but doing most of their business in Germany.[37]

Looking at the empirics and the legal strategies to counter the effects, can we truly say that such measures were necessary? Given the small effect of *Centros* and its prodigy, one could argue that practically speaking, the Member States never effectively lost control over the law of business organizations within their territory. That is not to say that the CJEU cases did not affect national company laws. Though the CJEU has undercut Member States' efforts to prevent founders from going abroad by choosing the state of incorporation *ex ante*, it has encouraged them to hold directors liable *ex post* under insolvency law. Thus, it has shifted legal protections from a roughly cut *ex ante* system of legal capital to *ex post* mechanism such as veil piercing, criminal penalties, as well as bankruptcy doctrines holding managers and shareholders liable for trading in insolvency.[38] Besides, where the Member States came close to losing control, insolvencification – which has received the court's blessing in *Kornhaas,* seems to have contributed to the solution.

[36] BGH 16.7.2007, II ZR 3/04, DStR 2007, 1586. *See, e.g.*, Charles Zhen Qu, *Recent German developments in company controllers' liability in rescue situations: a comparative evaluation*, (2011) J. Bus. L. 330, 337-344 (comparing the different types of actions under German law).
[37] For example, Wolf-Georg Ringe, *Kornhaas and the Challenge of Applying Keck in Establishment*, 42 Eur. L. Rev. 270, 278 (2017); contra Michael Schillig, *Creditor Protection for German GmbHs: The Next Installment*, 29 Comp. Law. 251, 253 (2008) (suggesting that the German doctrine could not apply to English firms because English law provides adequate remedies).
[38] For example, Gelter, *supra* n. 19, at 335-336.

Admittedly, there have been two effects. First, to a certain extent the transition implies a changeover from a more rules-based system to a more standards-based system that requires courts to assess the actions of firms, shareholders, and directors on an individual basis *ex post*.[39] This change may require a more sophisticated investigation by the courts, a deeper inquiry into the facts, and a less mechanical application of the law. But there is no reason to believe that European courts today would not be able to handle this task. Second, the court's vision for the law of private limited companies appears to envision more sophisticated creditors able to engage in some degree of self-help. The *Centros* decision explicitly refers to public creditors' ability to obtain guarantees when they are on notice that they are dealing with a low-capital legal form.[40] Overall, the change is not sufficiently extensive to be considered a real paradigm shift.

2.2. Abuse by the choice of jurisdiction in the US?

Regulatory arbitrage opportunities such as the ones created by *Centros* have existed in the US for more than a century, which makes it worthwhile to look at US law. Both for publicly traded firms and private held firms, the debate has centered on the corporate form, which serves both purposes in the US economy; the LLC has emerged as an alternative providing similar choice of law opportunities (predominantly for privately held firms) only in the past decades.

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[39] For the canonical treatment of the rules-standard distinction, *see* Louis Kaplow, *Rules Versus Standards: An Economic Analysis*, 42 Duke L.J. 557 (1992).

[40] *Centros Ltd v. Erhvervs- og Selskabsstyrelsen*, Case C-212/97, para. 37; *see* Gelter, *supra* n. 19, at 334-335.

2.2.1. The internal affairs rule

US corporate choice of law is dominated by the internal affairs rule. Under this principle, which can be traced to the nineteenth century, the relationships between the corporation and its directors, managers, and shareholders (the 'internal affairs') are governed by the law of the state of incorporation.[41] The regulation of the internal affairs of the corporation by the law of the state of incorporation has led to a situation where it has long been possible for firms and their shareholders to choose the state best suited to their needs. For large, publicly traded firms, this situation has resulted in a debate about the merits and demerits of regulatory competition, represented by the 'race to the top'[42] and 'race to the bottom'[43] perspectives.[44] Just as it is for large firms, the top jurisdiction of choice for privately held corporations and LLCs is Delaware.[45] The choice of Delaware as the leading jurisdiction for closely-held firms has not resulted in quite as much debate, but

[41] *See* Frederick Tung, *Before Competition: Origins of the Internal Affairs Doctrine*, 34 J. Corp. L. 33-101 (2006).

[42] Ralph K. Winter, *State Law, Shareholder Protection, and the Theory of the Corporation*, 6 J. Leg. Stud. 251 (1977); Ralph K. Winter, *The 'Race to the Top' Revisited* 89 Col. L. Rev. 1526 (1989); Frank H. Easterbrook & Daniel R. Fischel, *The Economic Structure of Corporate Law* (Cambridge MA: Harvard University Press, 1991) 212-27; Roberta Romano, *The Genius of American Corporate Law* (Washington: AEI Press, 1993).

[43] *Louis K. Liggett Co. v Lee*, 288 US 517, 559 (1933); William L. Cary, *Federalism and Corporate Law: Reflections Upon Delaware,* 83 Yale L.J. 663 (1974); Lucian A. Bebchuk, *Federalism and the Corporation: The Desirable Limits on State Competition in Corporate Law*, 105 Harv. L. Rev. 1442 (1992); Lucian A. Bebchuk & Allen Ferrell, *Federalism and Corporate Law: The Race to Protect Managers from Takeovers*, 99 Colum. L. Rev. 1168 (1999).

[44] Other scholars doubt the importance of regulatory competition, e.g., Marcel Kahan & Ehud Kamar, *The Myth of State Competition in Corporate Law,* 55 Stan. L. Rev. 679 (2002), or suggest that the interaction between federal and Delaware law had the most definite impact on the development of corporate law. Mark J. Roe, *Delaware's Competition*, 117 Harv. L. Rev. 588 (2003).

[45] Jens Dammann & Matthias Schündeln, *The Incorporation Choices of Privately Held Corporations*, 27 J. L. Econ. & Org. 79 (2011); Jens Dammann & Matthias Schündeln, *Where Are Limited Liability Companies Formed? An Empirical Analysis*, 55. J. L. & Econ. 741 (2012).

according to the available empirical literature, directors' liability risk and the risk of veil piercing play a role in this choice.[46]

In light of the internal affairs rule, the idea that the choice of jurisdiction may constitute abuse has not become part of the general vocabulary of the US debate. Generally abusive conduct can contribute to a court 'piercing the corporate veil', that is, to holding shareholders liable to creditors. Courts frequently explain veil piercing in terms of the corporation being a mere shell, or the shareholders' alter ego.[47] There are, of course, many differences in the details under what circumstances a court will pierce the veil. The possibility that a specific choice of jurisdiction as such could be considered abusive and thus contributed to a veil-piercing analysis, however, seems not to have come up.

An interesting threshold question is what law governs the veil piercing claim. Some courts apply the internal affairs rule and hence the law of the state of incorporation, which is arguably confirmed by a literal reading of § 307 of the Restatement of Conflict of Laws.[48] There are even cases where courts have shown respect to the law of a non-US jurisdiction, specifically the law of

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[46] Dammann & Schündeln, id.; Franklin A. Gevurtz, *Why Delaware LLCs?* 91 Oregon L. Rev. 57 (2012); but see Bruce Kobayashi & Larry Ribstein, *Delaware for Small Fry: Jurisdictional Competition for Limited Liability Companies*, 2011 University of Illinois Law Review 91 (2011) (finding that the quality of the courts and of the Delaware legal system overall matter more).
[47] For example, Franklin A. Gevurtz, *Corporation Law* (St. Paul: West, 2nd ed. 2010), 69-70.
[48] Restatement (Second) of Conflict of Laws, § 307 ("The local law of the state of incorporation will be applied to determine the existence and extent of a shareholder's liability to the corporation for assessments or contribution and to its creditors for corporate debts."); *see, e.g.*, Robert B. Thompson, *Piercing the Corporate Veil: An Empirical Study*, 76 Cornell L. Rev. 1036, 1053-54 (1991). *See also Stromberg Metal Works, Inc. v. Press Mechanical, Inc.* 77 F.3d 928, 933 (7th Cir. 1996); *Gourdine v. Karl Storz Endoscopy-Am., Inc.*, 223 F. Supp. 3d 475, 490 (D.S.C. 2016) (all applying the state of incorporation's law to veil piercing).

Panama, which appears to be extremely restrictive.[49] But this may neither be the best reading of the Restatement, which might be understood differently when taking into account the broader context of this provision, nor the best policy.[50] Moreover, an argument can be made that the language of the restatement only applies to shareholders who failed to make their stipulated contributions.[51] Following this line of reasoning, one could thus treat veil piercing as an issue of tort rather than corporate law, which would often allow the forum jurisdiction to apply its own veil piercing doctrine.[52] For example, Tennessee courts have considered veil piercing claims to be separate causes of action not linked to the state of incorporation, and therefore apply the law governing the underlying claim.[53] Massachusetts courts have noted that the internal affairs rule only extended to internal governance issues, but not to a veil-piercing claim as the one in question.[54] Other courts have avoided commitment on the issue.[55] For our purposes, this leaves us to conclude that at least some

[49] *Panam Mgmt. Grp., Inc. v. Pena*, 2011 WL 3423338, at *2 (E.D.N.Y. Aug. 4, 2011); *Jonas v. Estate of Leven*, 116 F. Supp. 3d 314, 330 (S.D.N.Y. 2015).
[50] *See, e.g.*, Henry Hansmann & Reinier Kraakman, *A Procedural Focus on Unlimited Shareholder Liability*, 106 Harv. L. Rev. 446, 450-453 (1992) (suggesting that the internal affairs doctrine should apply to tort claims); Gregory Scott Crespi, *Choice of Law in Veil-Piercing Litigation: Why Courts Should Discard the Internal Affairs Rule and Embrace General Choice-of-Law Principles*, 64 NYU Ann. Survey Am. L. 85, 109-125 (2008) (suggesting that courts should be able to apply their own law to impose liability on the shareholders of out-of-state corporations).
[51] Mark R. Patterson, *Is Unlimited Liability Really Unattainable: Of Long Arms and Short Sales*, 56 Ohio St. L.J. 815, 863 (1995).
[52] Patterson, *id.*, at 865-68.
[53] *Oceanics Schools, Inc. v. Barbour*, 112 S.W.3d 135, 146 (Tenn. Ct. App. 2003) (piercing the veil of a Panama corporation applying Tennessee law); *Boles v. Nat'l Dev. Co.*, 175 S.W.3d 226, 236 (Tenn. Ct. App. 2005) (piercing the veil of Texas and Delaware corporations).
[54] *John T. Callahan & Sons, Inc. v. Dykeman Elec. Co.*, 266 F. Supp. 2d 208, 230 (D. Mass. 2003); *Cahaly v. Benistar Prop. Exch. Trust Co.*, 864 N.E.2d 548, 558 n.16 (Mass. App. Ct. 2007), aff'd, 885 N.E.2d 800 (Mass. 2008). For more examples, *see* Sam F. Halabi, *Veil-Piercing's Procedure*, 67 Rutgers U. L. Rev. 1001, 1045-46 (2015).
[55] For example, *Pister v. State, Dept. of Revenue*, 354 P.3d 357, 363-364 (Alaska 2015).

courts may pierce the corporate veil in the case of an abusive scheme involving a corporation set up under the law of another state or country.

2.2.2. Pseudo-foreign incorporation statutes

Two of the most economically important US states, California and New York, have enacted so-called pseudo-foreign incorporation statutes or long-arm statutes that apply certain aspects of the state's corporate law to corporations from outside the state, but with a qualifying connection to it. The more limited New York statute grants inspection rights to the shareholders of certain foreign corporations,[56] and it applies several provisions relating to the enforcement directors liability, indemnification, and derivative suits to them, among other, more technical issues.[57] Maybe most notably, New York applies its statute establishing liability of the ten largest shareholders for wages due to labors, servants, and employees to foreign corporations.[58] Californian law is a lot more expansive in the sections it applies, which include those on directors' duties and director elections, such as the frequency of election, removal without cause, cumulative voting, reporting requirements and shareholder inspection rights.[59] Although New York includes a more limited list of statutory provisions, its definition of pseudo-foreign corporations is more expansive.[60] Both statutes, however, mostly exempt publicly traded corporations.[61]

[56] N.Y. Bus. Corp. L. § 1315.
[57] *Ibid.*, L. § 1319.
[58] *Ibid.*, L. § 1319(4), § 630.
[59] Cal. Corp. Code § 2115, § 1501(g), § 1601(a).
[60] For a discussion, *see* Summer Kim, *Corporate Long-Arms* (2018), available at https://ssrn.com/abstract=3080446, 16.
[61] N.Y. Bus. Corp. L. § 1320(1); Cal. Corp. Code § 2115(c).

In Fall 2018, California added a new provision to its code requiring publicly held corporations with its principal executive offices in California to have a certain minimum number of female directors on the board from 2019 onwards.[62] As this provision explicitly applies to corporations regardless of their choice of incorporation, the question to what extent these ‘long-arm statutes’ are compatible with the constitution is again becoming salient. While the federal courts have not decided the issue, it has come up in the state courts. In *Wilson*, the California Court of Appeal upheld the constitutionality of California’s application of its cumulative voting requirement to a Utah corporation.[63] In *VantagePoint*[64], plaintiffs requested a class vote in a merger, to which they were entitled under California’s outreach statute, but not under the law of Delaware, where the corporation in question was incorporated. The Delaware Supreme Court held that ‘Delaware’s well-established choice of law rules and the federal constitution’ mandate that the internal affairs must be adjudicated ‘exclusively in accordance with the law of its state of incorporation’.[65] The *VantagePoint* court, like many commentators, referred to the US Supreme Court’s decision in *CTS* for support.[66] In this decision, the Supreme Court approvingly cited the internal affairs doctrine and found that the states had broad latitude in governing corporations’ internal affairs. It did so, however, in the context of upholding a state anti-takeover statute whose compatibility with federal securities was in question; the court found that the two were not in conflict and did not address horizontal regulatory conflicts between states. Somewhat more pertinently, in *Edgar v. MITE* the court

[62] Cal. Corp. Code §§ 301.3, 2115.5.
[63] *Wilson v. Louisiana-Pacific Resources, Inc.*, 138 Cal. App. 3d 216 (1983).
[64] *VantagePoint Venture Partners 1996 v. Examen, Inc.*, 871 A.2d 1108 (Del. 2005).
[65] *Ibid.*, 871 A.2d 1108, 1116 (Del. 2005).
[66] *CTS Corp. v. Dynamics Corp. of America*, 481 U.S. 69 (1987).

struck down a more intrusive Illinois anti-takeover statute that applied to firms of which Illinois residents owned 10% of shares.[67] Again, the court addressed a vertical (and not a horizontal regulatory conflict) and cited multiple reasons why the statute violated the constitution's commerce clause, but one argument was that: "Illinois has no interest in regulating the internal affairs in foreign corporations." While the federal courts may apply a more nuanced analysis to horizontal conflicts in future cases, some commentators contend that California's new requirements for the board of directors of publicly traded firms are flat-out unconstitutional. As Joseph Grundfest explains, California law "cannot over-ride the internal affairs doctrine, which is of constitutional dimension. Therefore, to the extent that Section 2115 also interferes with the internal affairs of a corporation chartered outside of California, Section 2115 is also unconstitutional."[68]

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We can tentatively conclude that the law on outreach statutes in the US is not entirely clear, maybe due to the lack of practical significance of the issue. Regarding 'internal affairs' between shareholders, directors, and officers, US states have been giving each other full faith and credit, which has resulted in the dominance of Delaware but has led to widespread concern only in particularly salient situations; this may change with California's new requirements for boards. Regarding creditors, US law, on the one hand, relies on the fact that the bankruptcy law is federal law, and

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[67] *Edgar v. MITE Corp.*, 457 U.S. 624, 645-646 (1982).

[68] Joseph A. Grundfest, *Mandating Gender Diversity in the Corporate Boardroom: The Inevitable Failure of California's SB 826*, Rock Center for Corporate Governance at Stanford University Working Paper No. 232 (2018), https://ssrn.com/abstract=3248791, 3-4; contra Jill E. Fisch & Steven Davidoff Solomon, *Centros, California's "Women on Boards" Statute and the Scope of Regulatory Competition*, ECGI Law Working Paper No. 454/2019, https://ssrn.com/abstract=3384768, 17-18 (arguing that California's statute is not unconstitutional because it seeks to address a broader societal question outside of the scope of the internal affairs doctrine).

that related aspects of debtor-creditor law, particularly the law on fraudulent conveyances, is homogenous across states.[69] Besides, the flexibility of veil piercing law has enabled state courts to continue to create some benefit for creditors *ex post*, with the applicable law being unclear and effectively left to the courts to decide themselves.

3. Cross-border mergers, including "reverse mergers"

Cross-border mergers have long been an issue in cross-border mobility of companies. EU primary law requires that Member States permit cross-border mergers when they allow domestic ones,[70] and the EU Directive on Cross-Border Mergers ('CBM Directive') created a framework for companies to execute this type of transactions across borders.[71] The purpose of this directive was to enhance the freedom of movement of limited liability companies on the European market by permitting cross-border mergers of different types of limited liability companies governed by the laws of different Member States. An *ex post* choice of applicable corporate law by an existing firm implemented through a cross-border merger (or cross-border transfer of seat[72]) might also raise questions of abuse of law. In theory, a cross-border merger could, for example, be used to evade

[69] *See* in particular the *Uniform Voidable Transactions Act* (UVCA), formerly *Uniform Fraudulent Transfer Act.*
[70] *SEVIC Systems AG*, Case C-411/03.
[71] Directive 2005/56/EC of the European Parliament and of the Council of 26 Oct. 2005 on cross-border mergers of limited liability companies, 2005 O.J. L 310/1 (hereinafter 'CBM Directive'). In 2017, the directive was integrated into the 'codified' Company Law Directive. *See* CCLD, Art. 118 to 134.
[72] The Commission's proposed 'Company Law Package' seeks to implement a legal structure for cross-border conversions for the first time. Proposal for a Directive of the European Parliament and of the Council amending Directive (EU) 2017/1132 as regards cross-border conversions, mergers, and divisions, Art. 86a, COM (2018) 241 final (hereinafter 'Company Law Package').

employee participation.[73] However, the CBM Directive provides for a negotiation mechanism designed to preserve employee participation in the combined entity analogous to the one implemented for the process of forming a European Company (*Societas Europaea* or SE).[74] Thus, it seems unlikely that courts or regulators could wield the blunt instrument of 'abuse' against cross-border mergers. The Member States must ensure that employee participation rights are protected in the case of subsequent domestic mergers for three years after the cross-border merger.[75] For follow-up mergers, it would seem to be up to the Member State to decide whether to enact a more extended period of protection.[76] Again, the instrument of protection would be the negotiation system set up by the Directive, and not abuse of law.

Similarly, a cross-border merger could be used to harm creditors by subjecting them to a less favorable corporate law, or to move the company to a different 'Center of Main Interest' (COMI)[77] to apply a different insolvency law. In this case, however, the safeguards of the former (Third) Company Law Directive[78], which – depending on the Member State – either allow a creditor to veto the merger, be paid off, or request security.[79] While these harmonizing provisions only

[73] *See, e.g.*, Martin Gelter, *Tilting the Balance between Capital and Labor? The Effects of Regulatory Arbitrage in European Corporate Law on Employees*, 33 Fordham Int'l L.J. 792, 810-818 (2010) (outlining possible 'codetermination arbitrage' opportunities). *See also* the discussion by Christoph Teichmann in Ch. 5.
[74] CCLD, Art. 133.
[75] CCLD, Art. 133(7).
[76] Gelter, *supra* n. 73, at 854.
[77] Regulation (EU) 2015/848 of the European Parliament and of the Council of 20 May 2015 on insolvency proceedings, 2015 O.J. (L 141) 19, Art. 3.
[78] Now CCLD, Art. 99.
[79] John Armour, *Abuse of European Insolvency Law? A Discussion*, in Rita de la Feria & Stefan Vogenauer (eds), *Prohibition of Abuse of Law* (Oxford: Hart Publishing 2011), 157, 160-1.

apply to public limited liability companies, Member States can certainly apply analogous instruments to private limited liability companies. Consequently, there should be no need for a separate doctrine of abuse.

Given that mechanism to shield employees and creditors against the effects of an *ex post* choice of jurisdiction appear to be firmly in place, there seems to be little need to resort to abuse of law to protect them. This leaves shareholders as the last group that might, in theory, benefit from the qualification of a cross-border transfer as abusive, in particular when the CBM Directive is used by corporations to change the relationship with their shareholders or to implement intra-group restructurings. The most famous case involves the iconic Italian car manufacturer, Fiat S.p.a.,[80] which 'reincorporated' to the Netherlands. Fiat S.p.a. owned a 100% share in its subsidiary Fiat-Chrysler N.V.[81] In 2014, using the mechanism established by the CBM Directive, it merged with its 100% subsidiary Fiat Chrysler N.V. The whole group was restructured because of the acquisition – Fiat S.p.a turned into Fiat Chrysler Automobiles N.V. with its corporate seat in the Netherlands and its registered office and principal place of business in England. In addition, the principal stock market quotation of the entire group shifted to the New York Stock Exchange.[82] Three important factors were inherent to the merger – (i) positive market perception, (ii) capitalization, and (iii) a more favorable legal and tax environment in the Netherlands and England than in Italy – the availability of loyalty shares under Dutch law was a major factor motivating the merger. Italy subsequently

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[80] In Italy, S.p.a. stands for *Società per azioni*, which is the same as 'public limited company' in Italian.
[81] *Società per azioni (s.p.a.)* and *naamloze vennootschap (NV)* are the respective Italian and Dutch public limited company forms.
[82] *See*, *e.g.*, Federico Pernazza, *Fiat Chrysler Automobiles and the New Face of the Corporate Mobility in Europe,* (2017) Eur. Comp. & Fin. L. Rev. 37, 38-40.

introduced such shares to prevent the departure of further companies to other Member States of the EU.[83]

In the UK, cross-border mergers where firms are merged into subsidiaries in other EU countries have recently been discussed as an option to remain EU-incorporated companies after Brexit.[84] This technique elicits another comparison with the US, where a similar strategy has been dubbed 'reverse merger'. A reverse merger is a transaction by which a private company merges with a public shell company over which it has typically acquired control. When the merger occurs, the business of the private company gains access to the US stock market after the shell company absorbs the formerly private company through the merger. Once the merger is executed, the shareholders of the private company acquire and subsequently control the majority of surviving public company's stock.[85]

[83] *See* Pernazza, id., 47-64; on the prevalence of such shares, *see* Marco Ventoruzzo, *The Disappearing Taboo of Multiple Voting Shares: Regulatory Responses to the Migration of Chrysler-Fiat*, 114 Zeitschrift für vergleichende Rechtswissenschaft 192, 198-203 (2015).

[84] *See* Formenta Limited and Newco Immobiliare S.R.L. (In this case, the English Higher Court allowed a reverse merger for the first time). To this point, this opinion is not public. However, we had access to a certificate issued by the United Kingdom's High Court of Justice, Chancery Division, Companies Court, dated 9 Nov. 2016. That certificate provides that: "In the matter of the Companies (Cross-border Mergers) Regulations 2007 "the Regulations", upon the application of Formenta (the 'Company') made by a Claim Form issued on 28th Oct. 2016 […], it is certified that pursuant to Regulation 6 of the Regulations the Company has completed properly the pre-merger acts and formalities for the purpose of those regulations in relation to the cross-border merger of Formenta Limited with and into Newco Immobiliare S.R.L., a company governed by the laws of the Republic of Italy". In Italy, S.R.L means società a responsabilità limitata, which is the same as a private limited company. *See,* e.g., https://uk.practicallaw.thomsonreuters.com/7-639-2692 (accessed 22 May 2019).

[85] *See* William K. Sjostrom, *The Truth about Reverse Mergers*, 2 Entrepreneurial Bus. L. J. 743 (2008) (generally describing the operation of a reverse merger); Erik P.M. Vermeulen, *High-Tech Companies and the Decision to "Go Public": Are Backdoor Listings (Still) an Alternative to "Front-Door" Initial Public Offerings?*, 4 Penn St. J. L. & Int'l Aff. 421, 422, 427 (2015); David M. Smith, Doron S. Goldstein & Joshua Heideman, *Reverse Mergers and Nanotechnology*, 4 Nanotechnology L. & Bus. 87, 88 (2007) (defining reverse merger as the operation "whereby a private company is merged with a "shell" company that has already gone public").

For many private companies, going public is not an option, as they are not typically designed to capture public investment.[86] For a private business to grow or even internationalize, its shareholders and managers must delineate a plan that is likely to attract highly qualified managers, boost the company's brand on the market, capitalize on its shareholders' and managers' network, and raise considerable amounts of capital. Given that becoming public is not straightforward for a lot of these companies, a reverse merger may be a safer alternative to growing and internationalizing. However, growth and internationalization are far from being the only motivation these companies have for engaging in a reverse merger. Companies may use this type of operation to avoid an initial public offering (IPO), and to skirt securities law and taxation.[87] Reportedly, reverse mergers have been often used by Chinese companies that seek a more accessible entrance into the American stock market.[88] It is important to note that, in these operations, companies are based in China and access the US stock market through a reverse merger or cross-border merger. China-

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[86] *See* Lécia Vicente, *The Tale of the Silver Fox: The Co-Evolution of Property Rights and Contractual Arrangements in Limited Liability Companies,* 26 S. Cal. Interdisc. L.J. 189 (2016); Lécia Vicente, *The Hohfeldian Concept of Share in Limited Liability Companies: A View from the Common and Civil Law Traditions*, 33 Tul. Eur. & Civ. L.F. 41 (2018); Wolfgang Schön, Horst Eidenmüller, Holger Fleischer, Andreas Engert & Gregor Bachmann, *Regulating the Closed Corporation* (Berlin: De Gruyter. 2013), 1.

[87] *See* Sjostrom, *supra* n. 85, at 748 (arguing that it is not always the case that a reverse merger is cheaper and quicker than an IPO, and that for many companies that idea is irrelevant); Smith et al., *supra* n. 85, at 88 (explaining the reason that from a practical perspective a reverse merger may be the most advantageous option for nanotechnology companies – these companies do not typically attract the interest of underwriters for an IPO because they are either too small or incapable of raising enough capital); Vermeulen, *supra* n. 85, at 421, 422 (including reverse mergers in the group of operations he defines as backdoor listing); Gariel Nahoum, *Small Cap Companies and the Diamond in the Rough Theory: Dispelling the IPO Myth and Following the Regulation A and Reverse Merger Examples,* 35 Hofstra L. Rev. 1865 (2007) (dwelling upon the decrease number of IPOs in the American market and the choice of other alternatives such as reverse mergers).

[88] *See* Leslie A. Gordon, *Red-Flagging China: Regulators Eye Chinese Companies Using Reverse Mergers to Enter U.S.,* 97-OCT A.B.A. J. 17 (2011); Katherine T. Zuber, *Note: Breaking Down a Great Wall: Chinese Reverse Mergers and Regulatory Efforts to Increase Accounting Transparency*, 102 Geo. L.J. 1307, 1308-1309 (2014); Paul R. Bessette, Royale Price & Sandra Gonzalez, *Securities Litigation in 2011 by the Numbers, and a Look Behind the Rise in Securities Cases Against U.S. Listed Chinese Companies,* 59 The Advoc. (Texas) 40 (2012).

based companies do not have to adopt a US corporate form to proceed with the merger as a first step.

Unlike a traditional merger, which is often motivated by advantages such as synergies between the two firm's businesses, reverse mergers do not result in an influx of equity capital, and also usually do not considerably increase the liquidity of the shares.[89] The rise in popularity of these operations in recent years[90] may be explained with the fact that a private company can directly be absorbed into an SEC reporting company with registered securities without having to file a registration statement, and with more limited disclosures and SEC approval requirements.[91] As a result of the lack of registration formalities, foreign companies are more likely to resort to these types of transactions to access the US' stock market. These transactions may also facilitate the repatriation of a company to the US, if the main business of the corporation is located therein.

A lot of criticism has been levied against reverse mergers in the US involving Chinese companies, which have reportedly raised problems of transparency, specifically accounting problems. It may be difficult to track whether US-based accounting firms are apt to adequately audit US

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[89] Sjostrom, *supra* n. 85, at 744 (saying that: "Although RMs are often pitched as IPO substitutes, they provide neither a large infusion of equity capital nor share liquidity, the two primary benefits of an IPO").

[90] David N. Feldman, *Reverse Mergers + Pipes: The New Small-Cap IPO Reprinted and Updated from Pipes: Revised and Updated Edition – A Guide to Private Investments in Public Equity* (Bloomberg Press, 2005), 3 Bus. L. Brief (Am. U.) 34 (2007) (explaining the confluence of factors that have caused the market of reverse mergers to take off in recent years). For empirical evidence of reverse mergers in the US with the participation of Chinese firms, *see* Public Company Accounting Oversight Board, Research Note # 2011-P1, *Activity Summary and Audit Implications for Reverse Mergers Involving Companies from the China Region: Jan. 1, 2007 through Mar. 31, 2010,* 3 (2011).

[91] Despite the lack of registration with the SEC, the SEC has taken several steps that may affect reverse mergers. Particularly, SEC Rule 144, 37 Fed. Reg. 596 (1972) requires that anyone reselling securities that have been privately placed must meet some objective requirements to be able to resale those securities to the public without registration. *See* Feldman, *supra* n. 90, at 35 (referring to the steps taken by the SEC from 2004 onwards to turn reverse mergers into more credible transactions).

corporations that conduct most of their operations in another country or region and comply with the standards of the Public Company Accounting Oversight Board (PCAOB) or SEC requirements.[92] The lack of reporting and the existence of oversight problems not only blinds out other market actors such as foreign companies and investors that are not based in China, but also opens the door to situations of fraud. It may be challenging to scrutinize the financial status of the company after the merger or ensure investors that they will recover from their losses when disclosures are inaccurate or fraudulent. In addition, given that reverse mergers typically do not lead to the strengthening of the economic potential of the acquiring company, this transaction may constitute a strategic way to avoid the taxation of increases in capital or to avoid the payment of debts in case of bankruptcy of the corporate debtor's publicly listed shell.[93] In the US, despite the criticism yielded by SEC, the stock market, and relevant stakeholders such as shareholders, regulators, and agencies toward reverse mergers involving Chinese companies, courts have not tended to approach these operations through a general theory of abuse. The bulk of the legal actions stems from the breach of fiduciary duties, which comprises the breach of the duties of loyalty, care, and good faith.

Turning back to Europe, the main question is whether the choice of law of incorporation by the company surviving merger can be abusive *per se*. Cross-border mergers may be strategically used to face challenging and uncertain economic and political environments, or they may reflect merely as a less risky form of internationalization. At the same time as it facilitates freedom of

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[92] *See* Public Company Accounting Oversight Board, *supra* n. 90.

[93] *See* Anthony E. Hope, *Publicly Listed Shells of Corporate Debtors and Reverse Mergers: Recycling Shells in Spite of Anti-Shell Trafficking Provisions*, 32-JUL Am. Bankr. Inst. J. 52 (2013); Philip C. Cook & John L. Coalson, Jr., *The 'Substantially all of the Properties' Requirement in Triangular Reorganizations – A Current Review*, 35 Tax Law. 303 (1982); Stephanie Hoffer & Dale A. Oesterle, *Tax-Free Reorganizations: The Evolution and Revolution of Triangular Mergers*, 108 Nw. U. L. Rev. 1083 (2014).

movement, the Directive aims at protecting the interests of the Member States by sanctioning 'back door' mergers between different types of limited liability companies that would be against the public interest. The Preamble of the Directive states that: "[i]n order to protect the interests of members and others, the legal effects of the cross-border merger, distinguishing as to whether the company resulting from the cross-border merger is an acquiring company or a new company, should be specified."[94] Under what is now Art. 121(1)(b) CCLD,[95] "the laws of a Member State enabling its national authorities to oppose a given internal merger on grounds of public interest shall also be applicable to a cross-border merger where at least one of the merging companies is subject to the law of that Member State." Member States generally cannot discriminate between domestic and cross-border mergers,[96] but they may introduce additional protections for minority shareholders that opposed the cross-border transaction.[97] Some Member States have therefore introduced special particular or withdrawal rights.[98] The commission's proposed 'Company Law Package' aims at harmonized protections for company members in cross-border mergers in the form of an exit right;[99] which will likely weaken justifications for the Member States to intervene with limitations on specific types of mergers. The mergers involving Fiat S.p.a. thus spells out the idea that the more consolidated corporate mobility becomes in the EU the less likely is a Member State to flat-out consider a cross-border reverse merger 'abusive' under the CBM Directive and block it. Again,

[94] Formerly para. 8 of the preamble of the CBM Directive, now para. 61 in CCLD.
[95] Formerly Art. 4(1)(b) of the CBM Directive.
[96] Grundmann, *supra* n. 18, p. 704.
[97] Art. 121(2) CCLD.
[98] *See, e.g.*, Gögçe Kurtulan, *Minority Shareholder Protection in Cross-Border Mergers: A Must for or an Impediment to the European Single Market?* 18 Eur. Bus. Org. L. Rev. 101, 118 (2017).
[99] Company Law Package, *supra* n. 72, Art. 126a.

the fact that Member States are permitted to enact safeguards for cross-border mergers further militates against any leeway for a doctrine of abuse.

4. A brief note on cross-border transfers of seat

Although in the US, mergers across state lines are the typical method of 'reincorporation', European firms may also employ a transfer of seat for this purpose. In the recent *Polbud* case, the court found that the freedom of establishment covers cross-border conversions, that is, the transfer of a company's registered office to another Member State, which implies a switch from a legal form governed by one country's corporate law to another. The court reiterated that the choice of another Member State's law could not in itself constitute abuse, which means a transfer of registered office 'cannot be the basis for a general presumption of fraud and cannot justify a measure that adversely affects the exercise of a fundamental freedom guaranteed by the Treaty'.[100] While there is currently no common legal framework for transfers of seat, the commission's 2018 'Company Law Package' includes a section on cross-border conversions.[101] The proposal envisions an exit right for objecting members[102] and protections analogous to those in cross-border mergers for creditors and employees.[103] Again, this seems to leave no need or space for a classification as abuse. At present, with no common legal framework for cross-border conversions in place, there is no reason to see why Member States should not be permitted to implement one without being required to do so without being compelled by a directive. In doing so, they would be in the position to create

[100] *Polbud – Wykonawstwo sp. z o.o.*, Case C-106/16, paras 62 and 63.
[101] Company Law Package, *supra* n. 72, Art. 86a(1), 86b(2) (defining cross-border conversions).
[102] Art. 86j.
[103] Art. 86k, 86l.

protective mechanisms similar to those proposed in the draft Directive. However, a general prohibition of cross-border conversions, or a presumption of abuse is ruled out by *Polbud*.

By contrast, the transfer of a company's real seat to another country is at present not a protected exercise of the freedom of establishment as far as the state of origin is concerned. As the court held in *Daily Mail* and *Cartesio*, "companies are creatures of national law and exist only by virtue of the national legislation which determines its incorporation and functioning."[104] The outgoing state may thus prohibit the transfer of the real seat, but it could also take more limited measures, including applying a doctrine of abuse to a subset of outgoing transfers.[105]

5. Conclusion

Where does this leave European company law? Overall, we conclude that limitations on the choice of incorporation have a systematic purpose rather than individual one. Member States employ them to discourage cross-border incorporations and to protect their laws from regulatory competition. In a federal or supranational system where Member States or states are expected to give 'full faith and credit' to the law of their peers, it is difficult to classify a choice of another jurisdiction as inherently abusive.

This is confirmed by the comparison with the US, where a debate about whether such a choice can be abusive seems to have never emerged. Interestingly, as we have seen, the US states have not entirely avoided applying their own law to corporations governed by the law of another

[104] *H.M. Treasury and Commissioners of Inland Revenue ex parte Daily Mail and General Trust PLC*, Case C 81/87, para. 19; *Cartesio Oktató és Szolgáltató bt*, Case C-210/06, para. 104.
[105] *See also* Wolf-Georg Ringe, *Sparking Regulatory Competition in European Company Law: The Impact of the Centros Line of Case Law and its Concept of 'Abuse of Law'*, in Rita de la Feria & Stefan Vogenauer (eds), *Prohibition of Abuse of Law* (Oxford: Hart Publishing 2011), p. 107, 111.

state, either because of a pseudo-foreign incorporation statute, or in the context of judicial veil piercing.

Overall, it seems that the CJEU's case law has left us with a vision without a need for a doctrine of abuse. First, when we look at the *ex ante* formation of companies, the court's vision seems to be based on the view of informed market participants that understand that different laws govern forms of companies from different countries and adjust their expectations accordingly. This 'self-protection' model may be at odds with many Continental European traditions, but it is how the court understood the treaty.[106] One could likely come up with scenarios where such a choice of the law of incorporation would contribute to fraud or abuse, compare when creditors or investors were misled, but in such a case choice of jurisdiction is only one factor among others. The example is not to deny that *Centros* and the subsequent developments in the CJEU's case law have inflicted some systemic changes in EU company law. However, in terms of the sheer number of cross-border incorporations the effects have been relatively minor. Member States have been able to compensate for the loss of control over some aspects of the law of business organization through insolvencification.[107] Consequently, there does not appear to be a strong need to extend abuse of law as a doctrinal mechanism in this area significantly.

When we look at *ex post* transfers of seat, either through mergers or conversions, the need for a doctrine of abuse seems questionable. In most cases, directives provide (or will provide) for mechanism intended to protect members and other stakeholders in a form compatible with the freedom of establishment. The freedom of establishment does not protect the transfer of the company's

[106] *See, e.g.*, Gelter, *supra* n. 19, at 335.
[107] On the term, *see supra* section 2.1.2.

principal place of business or ‘real seat’ to another Member State. Member States can allow or prohibit it, and they should also be able to prohibit only where they would consider it abusive. A transfer of the company’s principal place of business may be the only area where the concept of abuse may continue to play a noticeable role in the choice of incorporation.

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