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HOW THE OLD WORLD ENCOUNTERED THE NEW ONE: REGULATORY COMPETITION AND COOPERATION IN EUROPEAN CORPORATE AND BANKRUPTCY LAW

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How the Old World Encountered the New One: Regulatory Competition and Cooperation in European Corporate and Bankruptcy Law

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Abstract

The European framework for creditor protection has undergone a remarkable transformation in recent years. While the ECJ's Centros case and its progeny have given EU businesses free choice with respect to the state of incorporation, and hence to the substantive corporate law regime, the European Insolvency Regulation has introduced uniform conflict of laws rules for insolvencies. However, this regime has opened up some forum shopping opportunities for corporate debtors. Both regulatory competition in corporate law and forum shopping in bankruptcy law have been discussed in the US for years, while they are relatively new territory in the EU. This article attempts to pull together the two emerging discussions and analyzes possible consequences for the relationship between shareholders, managers and creditors in European corporations. We argue that, in the absence of evidence of either a race to the top or the bottom, we cannot rule out adverse consequences of either regulatory competition in corporate law or forum shopping in bankruptcy. However, the discussion so far has largely considered only the consequences of the first type of regulatory arbitrage while neglecting the second. Hence, the issue of the "insolvencification" of corporate law rules has been brought up in order to enable national policymakers to impose their respective ideas about creditor protection on firms. We suggest that such attempts may be futile. First, relabeling is possible only to a rather limited degree, and second, while restricting the scope for corporate law arbitrage, it increases the incentives for forum shopping in bankruptcy. Ultimately, it may even backfire, leading to a higher degree of bankruptcy forum shopping to avoid the very rules that have been insolvencified.

Keywords: Bankruptcy, Centros case, company law, corporate law, creditor protection, European Insolvency Regulation, European Union, European Community, forum shopping, insolvency, regulatory competition, Harmonization

JEL Classifications: G32, G33, G34, K19, K22, K29, K41

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1. Introduction

The debate about regulatory competition and interaction between different legislative and regulatory levels has a long pedigree in US corporate law scholarship. Scholars have argued for more than 30 years that states vying for incorporations have caused corporate law to race to the top[1], to the bottom[2], or to nowhere in particular.[3] Since the early 1990s, following empirical evidence of forum shopping by large corporate debtors,[4] a related debate has developed with respect to bankruptcy law, with some scholars suggesting that forum shopping between different federal bankruptcy courts has allowed corporate debtors to ensure that bankruptcy proceedings are conducted in the most efficient way possible,[5] and the opposing camp arguing that forum shopping is essentially destroying the bankruptcy system, to the detriment of creditors and to the benefit of the managers who have led firms into bankruptcy.[6]

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[1] William L. Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 YALE L. J. 663 (1974); Lucian Arye Bebchuk, *Federalism and the Corporation: The Desirable Limits on State Competition in Corporate Law*, 105 HARV. L. REV. 1442 (1992) (arguing that there is a race to the bottom with respect to certain issues); Lucian Arye Bebchuk & Allen Ferrell, *Federalism and Corporate Law: The Race to Protect Managers from Takeovers,* 99 COLUM. L. REV. 1168, 1185 (1999).

[2] Ralph K. Winter, *State Law, Shareholder Protection, and the Theory of the Corporation,* 6 J. LEGAL STUDIES 251 (1977); Ralph K. Winter, *The ‚Race to the Top' Revisited*, 89 COLUM. L. REV. 1526 (1989); FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 212-227 (1991); ROBERTA ROMANO, THE GENIUS OF AMERICAN CORPORATE LAW (1993).

[3] William W. Bratton, *Corporate Law's Race to Nowhere in Particular*, 44 U. TORONTO L.J. 401 (1994). For revisionist views denying the relevance of interstate competition, *see* Marcel Kahan & Ehud Kamar, *The Myth of State Competition in Corporate Law,* 55 STAN. L. REV. 679 (2002); Mark J. Roe, *Delaware's Competition,* 117 HARV. L. REV. 588 (2003); Id., *Delaware's Politics,* 118 HARV. L. REV. 2491 (2005).

[4] Lynn M. LoPucki & William C. Whitford, *Venue Choice and Forum Shopping in the Bankruptcy Reorganization of Large, Publicly Held Companies,* 1991 WIS. L. REV. 11.

[5] David A. Skeel, jr., *Bankruptcy Judges and Bankruptcy Venue: Some Thoughts on Delaware,* 1 DEL. L. REV. 1 (1998); Robert K. Rasmussen & Randall S. Thomas, *Timing Matters: Promoting Forum Shopping by Insolvent Corporations,* 94 NW. U. L. REV. 1357 (2000); David A. Skeel, jr., *What's So Bad About Delaware,* 54 VAND. L. REV. 309 (2001); Marcus Cole, *"Delaware is Not a State": Are We Witnessing Jurisdictional Competition in Bankruptcy?* 55 VAND. L. REV. 1845, 1859-76 (2002); Kenneth M. Ayotte & David A. Skeel, Jr., *Why Do Distressed Firms Choose Delaware? An Empirical Analysis of Venue Choice in Bankruptcy,* U. PENN., INST. FOR LAW & ECON. RESEARCH PAPER NO. 03-29*, at* http://ssrn.com/abstract=463001 (2004).

[6] Lynn M. LoPucki & Sara D. Kalin, *The Failure of Public Company Bankruptcies in Delaware and New York: Empirical Evidence of a "Race to the Bottom",* 54 VAND. L. REV. 231 (2001); LYNN M. LOPUCKI, COURTING FAILURE (2005).

Good old Europe, as so often, is different. Little was heard about regulatory competition in either field from the other side of the Atlantic Ocean until recently, since the regulatory environment in the European Union simply did not allow any. However, this has changed drastically during the last few years. In March 1999, the European Court of Justice (ECJ)'s *Centros* decision paved the way for corporate law arbitrage within the EU, by granting European businesses the right to incorporate in any EU Member State no matter where their business is run and correspondingly preventing Member States from imposing their own corporate law to such businesses, other than under very limited conditions.[7] In the last few years, newly incorporated businesses have soon started to take advantage of this new development, choosing English law in relatively high numbers.[8]

Independently of this corporate law development, the EC adopted an important piece of legislation on bankruptcy law a year later: Council Regulation (EC) No. 1346/2000 on insolvency proceedings[9] (hereinafter: EIR). The EIR identifies the Member State(s) having jurisdiction to open main proceedings that have a universal effect (at least within the EU, and with some important exceptions) where the debtor has its "centre of main interests" (COMI). Most importantly, it identifies the law applicable to insolvency proceedings as the law of the State of the court opening the proceedings. However, the "fuzziness of the COMI standard"[10] has allowed some forum shopping, which can be observed in the emerging case law on the EIR.

In short, both *Centros* and the EIR have increased the scope of private parties' free choice in determining the law applicable to companies and their insolvency. By allowing corporate law arbitrage and bankruptcy forum shopping, Europe has become similar to the US. Yet, there is still one crucial difference: while creditors are a concern

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[7] *Centros Ltd v Erhvervs- og Selskabsstyrelsen* (Case C-212/97) [1999] ECR 1459 (hereinafter: *Centros*); see also *infra* text corresponding to notes 32-35.

[8] *See* John Armour, *Who Should Make Corporate Law? EC Legislation versus Regulatory Competition*, 58 CURRENT LEGAL PROBS. 369, 386 (2005) (providing data on so called "GmbH limited," i.e. German businesses incorporated as English privated limited companies); Alexander Schall, *The UK Limited Company Abroad – How Foreign Creditors are Protected after Inspire Art (Including a Comparison of UK and German Creditor Protection Rules),* 2005 EUR. BUS. L. REV. 1534, 1535 (reporting estimates that there are more than 20000 UK Limited Companies with their "real seat" in Germany).

[9] 2000 O.J. (L 160) 1.

of corporate law only to a very limited degree in the US, EU Member States have traditionally tried to protect corporate creditors by corporate law. And while the US debate on regulatory competition is almost exclusively focused on the relationship between shareholders and managers, the relationship with creditors cannot be ignored in its European analogue. At the same time, since both corporate law and bankruptcy law are concerned with creditors, the two levels of regulatory arbitrage need to be dealt with as two sides of the same coin. Our paper attempts to pull the two issues together and to analyze how they shape the relationship between corporate debtors and their creditors. In order to so, we first sketch out how different jurisdictions may interact with each other in regulating the relationship between companies and their creditors, first in general and then within the EC framework (Part 2). The emphasis will be on the varying degree of deference to private parties' choices that derives from States' private international law rules and on its implications for regulatory competition.

After showing that past efforts at positive harmonization of corporate law by the EC have failed to make EU corporate laws equivalent in terms of creditor protection, so that some jurisdictions may be more attractive than others to those who make the (re)incorporation choice, we argue that, while it cannot be ruled out altogether that companies reincorporate in order to exploit some categories of creditors, a race to the bottom is unlikely to develop within the EU, implausible as it is that a European Delaware emerges, and that there is currently no evidence of a conclusive race to the bottom or to the top (Part 3).

We then turn to the EIR and its implications for the relationship between EU companies and their creditors. After briefly describing its main provisions, we turn to regulatory arbitrage with respect to insolvency law. We show that the EIR leaves some scope for it, as a switch of COMI by a corporate debtor on the brink of insolvency is not effectively prevented. We also show that, however, since in the EU it is most often creditors who file for bankruptcy, regulatory arbitrage is a weapon in their hands too. Subsequently, we argue that it is unrealistic to expect any EU Member State to supply debtor-friendly insolvency law rules in order to prosper as a bankruptcy venue (Part 4).

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[10] Horst Eidenmüller, *Free Choice in International Company Insolvency Law in Europe*, 6 EUR.

In order to pull the two issues together, we finally discuss "relabeling," or the idea that by qualifying a corporate law provision as an insolvency law one, it may apply to insolvent companies with a COMI in the relevant jurisdiction, no matter where the company is incorporated. We highlight an important implication of "relabeling" that has been overlooked in the literature so far, i.e. the fact that it may increase the regulatory surplus to be gained from insolvency forum shopping. We suggest that relabeling may not necessarily be desirable if arbitrage gains are shifted from corporate law to insolvency law (part 5). Part 6 concludes.

2. Regulatory interactions among jurisdictions

All jurisdictions impose mandatory rules aimed to protect creditors vis-à-vis their (corporate) debtors. In a multi-jurisdictional setting, however, it may be possible for private parties to avoid such rules by choosing a different jurisdiction not imposing them, whenever it is in their interest to do so. The choice will be made either jointly by debtors and their voluntary creditors or unilaterally by the former, with the latter giving tacit consent whether by accepting to enter into a relationship with the former or by not reserving ex ante the right to veto such a choice. Of course, involuntary creditors and more generally non-adjusting creditors[11] can never be said to give consent to this kind of choice: they can only bear its consequences, since they have a credit relationship with the corporate debtor that they have entered into unwillingly or whose terms they are unable or unwilling to renegotiate to react to unilateral moves by the debtor.

This part evaluates in general terms the degree to which States may defer to free choice of law in the realm of creditor/corporate debtor relationships and the various means through which they can limit such a choice. It also briefly outlines the implications of multiple jurisdictions' options with regard to private parties' choice. Our focus in this part will be mainly on corporate law, but the analysis can be easily extended to

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BUS. ORG. L. REV. 423, 428 (2005).

[11] Nonadjusting creditors are those that do not "adjust" the terms of their claims to anticipate or anyhow take into account the effects of new developments. *See generally* Lucian A. Bebchuk & Jesse M. Fried, *The Uneasy Case for the Priority of Secured Claims in Bankruptcy* 105 YALE L.J. 857, 864 (1996).

securities regulation and insolvency law.[12] For analytical purposes, we will first look at possible interactions among States in the absence of any supranational institutions restraining jurisdictions' options with regard to substantive regulation and/or conflicts of law (section 2.1), and then introduce one such institution, the E.C., into the framework (section 2.2).

2.1. Regulatory interactions in the absence of co-operation

Jurisdictions' attitudes towards choice of law range from absolute negation of free choice to absolute respect for it. In the former case, rules are imposed on companies (or transactions) having a meaningful connection to the relevant jurisdiction, no matter what private parties' choice of law is. In the latter case, there are no restrictions on free choice of law, but for the fact that normally one can opt-out of a single mandatory rule only by choosing another jurisdiction for a whole class of transactions and conducts (e.g., one can opt out of the German rule on minimum capital for limited liability companies (*Gesellschaften mit beschrankter Haftung*, hereinafter: GmbHs) only by choosing a different jurisdiction to regulate the firm as a corporation).

A. Choice-denying techniques. Jurisdictions can effectively deprive private parties of free choice of corporate law by providing that their own corporate law applies if a corporation has a sufficiently strong connection with them. Most commonly, what counts is where the "real seat" (whatever this means) is located. Whenever a corporation's real seat is within a jurisdiction's borders, any incorporators' choice of a foreign law is disregarded, leading to the non-recognition of the foreign entity (as under German law before *Überseering*).[13]

The real seat doctrine can be symmetric or asymmetric: in the former case, a jurisdiction does not accept foreign firms' choice of its own corporate law unless they es-

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[12] Needless to say, while tort law is sometimes used as a means to protect creditors (even voluntary ones) against (corporate) debtors' opportunism, tort law is of no concern here, since it does not make sense at all to talk about free choice with regard to it.

[13] *Überseering BV v Nordic Construction Company Baumanagement GmbH* (Case C-208/00) [2002] ECR 9919 (hereinafter: *Überseering*). *See e.g.* BGH 21.3.1986, V ZR 10/85, BB 1986, 2153; Bernhard Großfeld, *Internationales Gesellschaftsrecht,* comment 26, in JULIUS VON STAUDINGER, Kommentar zum BGB (13th ed., Neubearbeitung 1998); Werner F. Ebke, *The "Real Seat" Doctrine in the Conflict of Corporate Laws,* 36 INT'L. LAW. 1015, 1034-6 (2002).

tablish their real seat within its territory (this is the case, e.g., in Germany). In other words, the symmetric real seat doctrine implies a self-imposed export ban on one jurisdiction's corporate law.[14] In the latter case, no such export ban is self-imposed and foreign firms are free to choose the relevant jurisdiction's corporate law no matter where their real seat is located (as is the case in Italy).[15]

When the real seat doctrine rules, the only way to escape the reach of mandatory rules will be to locate (or relocate) the corporation's real seat in another jurisdiction, which can of course be costly to do: how costly will of course depend on how "real" the real seat has to be[16] and on how international are the operation of the relevant companies. Moving one's headquarters, as the case may be, implies that at least the human capital needed to direct the firm be moved, while the (re)location will imply that some other laws and regulations from the relocation State will apply to the firm's headquarters, such as labor and income tax laws for the corporation's top officers.

B. Choice-restricting techniques. The asymmetric real seat doctrine can hardly be distinguished from a pseudo-foreign corporation statute declaring domestic corporate law overall applicable to domestic businesses (however defined) incorporating as foreign companies. Often, however, pseudo-foreign corporation statutes over-impose a subset of domestic rules not comprising the entire corporate law body, for the rest deferring to the state of incorporation law. Of course, the more encompassing the subset of domestic rules, the more limited the private parties' free choice.

Private parties' free choice can also be restricted by making national rules applicable to foreign entities no matter where their real seat is located. Although this is uncommon in the corporate law area, it is normally what happens, with due qualifications, in securities regulation and insolvency law. Securities regulation normally applies to foreign issuers so long as they offer their securities, or their securities are widely traded,

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[14] Ebke, *supra* note 13, at 1036. For Austria, *see* Eva Micheler, in KOMMENTAR ZUM AKTIENGESETZ § 254, comment 38 (Peter Doralt, Christian Nowotny & Susanne Kalss eds. 2003) (reporting the prevailing opinion that a shareholder resolution to relocate to another country results in a dissolution of the corporation).

[15] See Article 25, Law 31 May 1995, No. 218 (Italy).

[16] For instance, while in Germany the headquarters only have to be located within its territory, in Italy, Italian corporate law also applies if the "principal place of business" is in Italy (*ibid*.), thus making

in the relevant jurisdiction.[17] In a strictly territorialist setting, insolvency law usually applies to firms having assets in the relevant jurisdiction, no matter what their nationality is or where their real seat is located, and only to assets within the jurisdiction.[18]

Finally, jurisdictions always reserve the general power to refuse the application of foreign (corporate) law under the public policy exception, that leaves judges the option to apply domestic law if the outcome deriving from application of the relevant foreign law would contrast with fundamental principles and values.

C. Deference to free choice. Jurisdictions may also decide to put no limits to private parties' free choice. In the corporate law domain this is the case whenever the choice of law rule follows the incorporation doctrine and no such techniques as those outlined above are deployed. The only element of inflexibility derives from the fact that, as already hinted, by incorporating in a given State, companies subject themselves to its whole set of corporate law rules or, in other words, may not engage in "cherry picking:" they cannot choose State A's corporate law rules on, e.g., minimum net assets and State B's corporate law rules on directors' liability.

This is less the case, however, with regard to relationships with creditors in two ways. First, since traditionally these rules are in part corporate law ones and in part insolvency law ones, so long as conflict of laws rules differ with regard to the two bodies of law, it might be possible to select one State's corporate law and another State's insolvency law.[19] Second, a corporation and one of its creditors or classes of creditors might agree that they would be better off if the applicable corporate law were a different one than that otherwise applying to the corporation. What they could do is to create a corporate vehicle in the state of their choice and make it the corporate debtor in their relationship. By doing so, they would choose their favorite corporate law without any need to change the corporate law regulating relationships among shareholders, between shareholders and managers and between shareholders and other creditors. Of course,

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companies operating mainly in Italy more captive to Italian corporate law than German ones to German law.

[17] *See e.g.* Harald Baum, *Globalizing Capital Markets and Possible Regulatory Responses*, *in* LEGAL ASPECTS OF GLOBALIZATION 77, 90-93 (JÜRGEN BASEDOW & TOSHIYUKI KONO eds., 2000).

[18] *See e.g.* Andrew T. Guzman, *International Bankruptcy: In Defense of Universalism*, 98 MICH. L. REV. 2177, 2179 (2000).

they will do so only if the advantages of their corporate law of choice more than offset the disadvantages deriving from the fact that only the vehicle will be liable for the corporate debt (unless the parent guarantees for that debt, in which case of course the corporate law of the parent would come back to the foreground). As a matter of fact, this may happen only when a viable business is assigned to the corporate vehicle, as the case may be in a conglomerate.

Jurisdictions can defer to free choice to various degrees, even leaving aside the possibility for the use of the choice-restricting techniques described in section A. First of all, a jurisdiction may opt for geographically-restricted free choice, i.e. limited to a one or more other jurisdictions (normally, this will be the outcome of some form of co-operation among States like a treaty for the reciprocal recognition of companies).[20] Second, free choice can be granted either at the incorporation stage only or mid-stream as well. In the former case, incorporators are free to choose any given jurisdiction's corporate law, but if they choose the domestic one, they cannot change their mind later on and/or, if they choose another jurisdiction, they cannot reincorporate as a domestic corporation later on. In the latter case, a choice made at the outset can be modified later on. A possibility is also that restrictions are placed on out-bound (and/or, less likely, in-bound) mid-stream reincorporations, such as laws granting existing creditors the right to veto reincorporations.

D. Implications for inter-jurisdictional interactions. Let us now briefly comment on how jurisdictions' attitudes toward free choice affect the dynamic interactions among jurisdictions, i.e. on whether and to what extent States are affected by each other's choices in regulating the relationships between creditors and corporate debtors.

If all the relevant jurisdictions adopt the real seat doctrine, States face very low constraints to their freedom to design mandatory corporate law rules, due to the (high) costs of (re)incorporating abroad. Their only concern can be that domestic businesses derive a competitive disadvantage (e.g. a higher cost of debt financing) vis-à-vis businesses from other States or, in a similar vein, that they are at a disadvantage in attracting

[19] See *infra*, part 4.

[20] This is the effective result of the ECJ case law, which allows free choice within the EEA. See *infra*, section 2.2.

foreign investment. At best, the fact that other jurisdictions better regulate companies can only prompt changes when it is felt that those rules translate into a regulatory environment more conducive to corporate investment or more generally into a more effective and business-friendly set of rules. When this happens, it means that policymakers are genuinely concerned about preserving or enhancing their country's ability to attract investment (competition for investments)[21] and/or that they care about "yardstick competition:"[22] what is in action when this is the case is some form of "regulatory emulation" among the States.[23]

To the extent that at least one jurisdiction allows for free choice, and at least one other jurisdiction adopts the asymmetric real seat doctrine, a market for rules exists. Only States adopting the symmetric real seat doctrine States are totally out of such a market. Those adopting the asymmetric real seat doctrine enter the market but only as suppliers, impeding access to it to their own "consumers." Regimes adopting choice-restricting techniques, in turn, not only enter the market as suppliers of corporate law rules, but also allow their consumer to choose. Nevertheless, their consumers' choice is constrained, because freedom of choice cannot be used to escape those rules that also apply to (pseudo-)foreign corporations.

The higher the number of jurisdictions that allow choice and/or that can be chosen, the deeper and potentially more dynamic the market. More precisely, the degree of dynamism and competition of a market for rules depends on a number of factors, that can only be mentioned here, such as how easy it is to exercise free choice, how relevant the differences among existing jurisdictions are (i.e., how big the regulatory surplus that can be obtained by moving is), whether any jurisdiction and its policymakers are willing and able to attract foreign incorporations, and so on.

When free choice is a real option in practice and no jurisdiction cares about attracting foreign corporations, some form of weak, "defensive" regulatory competition

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[21] *Cf.* Ehud Kamar, *Beyond Competition for Incorporations* 11-26, ECGI WORKING PAPER NO. 42/2005, *at* http://ssrn.com/abstract=720121.

[22] *See* Pierre Salmon, Political Yardstick Competition and Corporate Governance in the European Union, ECGI WORKING PAPER NO. 38/2005, *at* http://ssrn.com/abstract=730385.

can develop, in which States adapt their laws to the more attractive features of other jurisdictions in order to retain existing and prospective domestic companies. In the absence of a clear maximand (such as franchise tax revenue in Delaware) States will take the interests of all stakeholders into account that have some influence on the political process. Hence, any effects regulatory competition may have on the development of the law will be mitigated. Although shareholders (as the group deciding about where to incorporate) have a structural advantage over creditors in regulatory competition, legislation beneficial to the former and detrimental to (non-adjusting) creditors need not necessarily ensue if creditors have sufficient political representation and/or can gain the support of well-organized interest groups, such as trade unions and trade associations.

If one jurisdiction actively engages in attracting (re)incorporations from abroad, a situation very similar to the current situation in the US as described by Robert Daines exists: each of the market participants competes with the active jurisdiction (Delaware in the US) for (re)incorporations of its domestic companies. In other words, there is not one single market for incorporations, as instead n-1 markets, where n is the number of the jurisdictions leaving free choice to their businesses and where the suppliers are two for each market: "Delaware" and the home state.[24] Of course, such a multiple market setting can be very competitive so long as "Delaware" remains active in attracting reincorporations. In fact, Delaware will not only itself innovate, but it will also respond to any attractive market innovation by one of its competitors; Delaware's response, in turn, will prompt a response from each of the other competitors.[25]

In such a case, regulatory competition may entail interjurisdictional "externalities,"[26] if rules have an effect on constituencies located outside the State, while only groups located within the jurisdiction need to be taken into account in the political process. This may have detrimental effects on creditors if they are disproportionately located

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[23] *See generally* Stephen Woolcock, *Competition among rules in the single European market*, *in* INTERNATIONAL REGULATORY COMPETITION AND COORDINATION. PERSPECTIVES ON ECONOMIC REGULATION IN EUROPE AND THE UNITED STATES 289, 298 (William Bratton et al. eds., 1996).

[24] *See* Robert Daines, *The Incorporation Choices of IPO Firms*, 77 N.Y.U. L. Rev. 1559 (2002).

[25] *See* Roberta Romano, *The States as a Laboratory: Legal Innovation and State Competition for Corporate Charters*, YALE LAW & ECONOMICS RESEARCH PAPER, *at* http://ssrn.com/abstract=706522.

[26] *Cf.* Jan Wouters*, European Company Law: Quo Vadis?* 37 COMMON MKT. L. REV. 257, 269 at 289 & 294 (2000).

outside the state of incorporation. As already seen, defensive regulatory competition in the absence of a Delaware can raise no such worry, because States typically have to take the interests of both shareholders and creditors into account and therefore "internalize" the effects of any corporate law reform through the political process and because, even before that, the interests of relevant stakeholders would be taken into account no less than in any "isolated" corporate law reform effort.[27] However, in the presence of a Delaware, jurisdictions may have to sacrifice these interests if they want to retain their corporations by enacting legislation benefiting shareholders and managers, but possibly harming non-adjusting creditors.

Finally, one can imagine a scenario in which various jurisdictions actively compete in order to attract incorporations. Such was the case in the US at the end of the nineteenth century and at the beginning of the twentieth. For various reasons, that are not worth exploring here, the conditions under which this scenario developed in the US at that time are quite unique[28] and therefore highly unlikely to reproduce, in the US or elsewhere. Intuitively, with multiple competitors acting in the same market, the regulatory environment is most conducive to innovation and to rules that most cater to the interests of those who make the decision on where to incorporate.

2.2. Regulatory interactions among jurisdictions in the presence of cooperation: the EU case

In the previous section we analyzed a scenario of multiple jurisdictions making uncoordinated, unilateral choices with regard to free choice of corporate law. In this section we concentrate upon EU Member States and briefly describe how the EC institutions can affect regulatory interactions among jurisdictions and their policies with regard to free choice and to the substantive regulation of the relationships between credi-

[27] Luca Enriques, *EC Company Law and the Fears of a European Delaware,* 2004 EUR. BUS. L. REV. 1259, 1274; Tobias H. Tröger, *Choice of Jurisdiction in European Corporate Law – Perspectives of European Corporate Governance*, 6 EUR. BUS. ORG. L. REV. 3, 62 (2005).

[28] *See* Luca Enriques, *The Comparative Anatomy of Corporate Law*, 52 Am. J. Comp. L. 1011, 1029-30 n137 (2004) (book review).

tors and corporate debtors.[29] The EC introduces a strong form of co-operation into the framework of otherwise unilateral choices with regard to regulatory interactions. We show that co-operation at the EC level can lead to a higher or lower degree of deference toward private parties' free choice (and hence contractual freedom and regulatory competition), depending on whether the EC institutions foster companies' mobility and mutual recognition rather than (or more than) impose substantive mandatory rules on private parties.

A. Negative harmonization. Negative harmonization on the basis of the EC Treaty's freedom of establishment as implemented by the ECJ's case law imposes restraints on choice-denying techniques. The *Centros-Überseering-Inspire Art*[30] triad of cases requires Member States to recognize foreign EU (and EEA[31]) corporations' legal capacity and allows restrictive measures only under very limited circumstances.[32] Any such measures "liable to hinder or make less attractive the exercise" of the freedoms need to satisfy the *Gebhard*[33] criteria, i.e. they "must be applied in a non-discriminatory manner; they must be justified by imperative requirements in the public interest; they must be suitable for securing the attainment of the objective which they pursue, and

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[29] Of course, the EC or an EC-like institution is just one possible form of international cooperation. Other forms include bilateral agreements. For instance, treaties requiring the recognition of American companies exist e.g. between Germany and the US (Treaty of Friendship, Commerce and Navigation between the United States of America and the Federal Republic of Germany, October 29, 1954, BGBl 1956 II 487, art XXV) and between Italy and the US (Treaty of Friendship, Commerce and Navigation between the United States of America and the Italian Republic signed at Rome, February 2, 1948). On the effects of these treaties *see* BGH 29.1.2003, VIII ZR 155/02, 58 BETRIEBS-BERATER 810 (2003) (recognizing legal capacity and standing to sue in Germany); Jens C. Dammann, *Amerikanische Gesellschaften mit Sitz in Deutschland,* 68 RABELS ZEITSCHRIFT FÜR AUSLÄNDISCHES UND INTERNATIONALES PRIVATRECHT 607 (2004); Tito Ballarino, *La società per azioni nella disciplina internazionalprivatistica*, *in* 9/1 TRATTATO DELLE SOCIETÀ PER AZIONI 3, 93-94 (Giovanni E. Colombo & Giuseppe B. Portale eds., 1994). By contrast, the equivalent Austrian Treaty explicitly requires that limited liability companies maintain a central office within the territory of their incorporation (Treaty of Friendship. Commerce and Consular Rights between the Republic of Austria and the United States of America, signed in Vienna on June 19, 1928, BGBl 1931/192, art. IX).

[30] *Überseering*, *supra* note 13; *Kamer van Koophandel en Fabrieken voor Amsterdam v Inspire Art Ltd* (Case C-167/01) [2003] ECR 10155 (hereinafter: *Inspire Art*).

[31] *See e.g.* BGH September 19, 2005, II ZR 372/03, 51 RECHT DER INTERNATIONALEN WIRTSCHAFT 945 (2005) (recognizing a Liechtenstein corporation's legal capacity in Germany irrespective of its "real seat").

[32] *Inspire Art*, *supra* note 30.

[33] *Reinhard Gebhard v Consiglio dell'Ordine degli Avvocati e Procuratori di Milano* (Case C-55/94) [1995] ECR 4165.

they must not go beyond what is necessary in order to attain it."[34] Furthermore, Member States may take measures to prevent or penalize fraud or abuse.[35] Broad-sweeping statutes generally imposing national creditor protection devices on pseudo-foreign corporations are therefore impermissible. Since those imperative requirements are apparently narrowly construed, Member States are to a large degree forced to allow for free choice among EU corporate laws.

The actual extent of Member States' discretion is still unclear and possibly will remain so for a long time. What is worth highlighting here is that to the extent that private international law rules have not been harmonized, they are still an issue of national legislation. One could conclude from this that only the result of the conflict of laws analysis in each particular case needs to be measured against the requirements of primary EC law.[36] However, in *Überseering* the ECJ also held that a corporation validly incorporated in the Netherlands is entitled under art. 43 and 48 of the Treaty to exercise the freedom of establishment in Germany as a corporation incorporated in the Netherlands.[37] As a result, Member States will have to recognize not only the legal capacity of pseudo-foreign corporations, but also a certain substantive core of the corporate law of the state of incorporation, although it is not clear how far this core extends.[38] Outside of

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[34] *Id.,* recital 37; *Centros*, *supra* note 7, recital 34; *Inspire Art*, *supra* note 30, recital 133.

[35] *Centros*, *supra* note 7, recital 38; *Inspire Art*, *supra* note 30, recital 136.

[36] *See e.g.* Erich Schanze & Andreas Jüttner, *Die Entscheidung für Pluralität: Kollisionsrecht und Gesellschaftsrecht nach der EuGH-Entscheidung „Inspire Art",* 48 DIE AKTIENGESELLSCHAFT 661, 665 (2003); Peter Ulmer, *Gläubigerschutz bei Scheinauslandsgesellschaften,* 57 NEUE JURISTISCHE WOCHENSCHRIFT 1201, 1205 (2004) (both pointing out that articles 43 and 47 of the EC Treaty do not intend to harmonize private international law).

[37] *Überseering*, *supra* note 13, recital 80.

[38] The German *Bundesgerichtshof* recently held that it follows from the recognition of the legal personality of English companies that the liability of managers and shareholders to corporate creditors is determined by the law of incorporation. BGH March 14, 2005, II ZR 5/03, 60 JURISTENZEITUNG 848 (2005). *But see* Gebhard Rehm, *Völker- und europarechtliche Vorgaben für die Bestimmung des Gesellschaftsstatuts,* in AUSLÄNDISCHE KAPITALGESELLSCHAFTEN IM DEUTSCHEN RECHT § 2, comment 70 (Horst Eidenmüller ed. 2004) (explaining that it would be theoretically possible to recognize foreign corporations as such, but to apply certain German law provisions to them). Under the most radical position in German literature, this core shrinks to legal capacity, while German law still applies to all other issues, including the main creditor protection doctrines. *See* Holger Altmeppen, *Schutz vor „europäischen" Kapitalgesellschaften,* 57 NEUE JURISTISCHE WOCHENSCHRIFT 97 (2004); Holger Altmeppen & Jan Wilhelm, *Gegen die Hysterie um die Niederlassungsfreiheit der Scheinauslandsgesellschaften,* 57 DER BETRIEB 1083 (2004). *But see contra* Amtsgericht Bad Segeberg, March 24, 2005, 17 C 289/04, 95 GMBH-RUNDSCHAU 884 (2005) (rejecting a claim for damages because of late filing of insolvency (*Insolvenzverschleppung*) on the grounds that English law should apply).

it, the application of the law of the state of incorporation is not imperative, i.e. whether something is considered corporate or insolvency law is largely an issue of the national conception of these fields. Member States may even "relabel" rules as insolvency law (if it serves the purpose of being able to apply their own law under the applicable conflict of law rules), as long as the *Gebhard* criteria are not violated.

We will address the issue of conflict of laws again briefly within the context of the most important creditor protection mechanisms later (section 3.1) and reflect upon "relabeling" strategies in section 5. For now, suffice it to say that *Centros* and its progeny of cases have reshaped the EU corporate law landscape possibly more than many national reforms in the various Member States and certainly more than any EC positive harmonization effort thus far, as section 3 will show.

B. Positive harmonization. With positive harmonization the EC imposes on Member States an obligation to adopt certain rules (through directives) or directly imposes such rules on EU (and EEA) citizens and firms (through regulations). Positive harmonization can be *substantive*, whenever it defines the content of national corporate laws, or it can relate to *choice of law* itself, either by promoting or by reducing it. Of course, individual harmonization measures may contain both substantive harmonization rules and choice of law-related ones. The distinction is useful, however, in order to emphasize the kind of impact harmonization can have on free choice.

1. Substantive harmonization. Substantive harmonization measures can pre-empt States' legislative powers to a varying degree.[39] Total pre-emption occurs in the case of maximum harmonization, while minimum harmonization leaves greater scope for States' intervention in the harmonized area.[40]

When maximum harmonization measures are adopted, Member States must adopt the rules devised in the harmonizing measure and may not impose stricter or even additional rules. Here, the degree of uniformity achieved is the highest, while of course not necessarily is the regulatory outcome the most restrictive: if the harmonizing measures

[39] *See e.g.* CATHERINE BARNARD, THE SUBSTANTIVE LAW OF THE EU 508-20 (2004).

[40] The same is also true in the case of optional harmonization (*see generally Id*. at 515), which can take many forms, such as a choice between two mandatory rules, which may be given to the Member States or to the private parties or to both, or the provision of default rules or even the requirement that States introduce a regime that private parties will be free to choose through an opt-in decision.

leave some scope for contractual freedom, the EC prevents Member States from further restricting it. At the same time, the harmonized regime may turn out to be excessively lenient, whenever the compromise-prone outcome of the EC legislative process sets an excessively low level of regulation and, for whatever reason, private parties are unable to bind themselves effectively to a stricter regime by contract or are prevented by the harmonizing measure itself to enter into such kind of agreement. In any event, regulatory competition is banned, whether it would take, as is usually the case, the direction of a greater respect for contractual freedom or the opposite one.

With minimum harmonization measures the EC requires Member States to impose at least the EC-devised rules, but Member States retain the power to impose further and/or stricter rules (so-called goldplating). When minimum harmonization couples with mutual recognition, the stricter national rules can only apply to domestic firms, while in the absence of mutual recognition Member States may also impose stricter rules on foreign firms' conduct that is for whatever reason caught by national law.

As already hinted, substantive harmonization most often means imposing some mandatory rules across the EU and the EEA, or, more precisely, extending to all Member States rules that are already in place in a majority of them, and making them "more" mandatory: first, because there is no escape from them other than by incorporating in, or otherwise choosing, if at all possible, a non-EU, non-EEA jurisdiction; and second, because repeal of the relevant mandatory rule will be more difficult, due to the well-known phenomenon of petrification.[41]

With substantive harmonization, Member States may still deviate from the harmonized outcome, albeit in a disguised, undercover way. Member States may in fact fail to properly implement the harmonizing measure; or they may fail to enforce it; or, finally, their judges and enforcers may construe the harmonized measures in line with prior, more (or less) lenient national rules:[42] in other words, Member States have various ways to cheat on the EC regulatory cartel.

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[41] *See e.g.* RICHARD M. BUXBAUM & KLAUS J. HOPT, LEGAL HARMONIZATION AND THE BUSINESS ENTERPRISE 265 (1988).

[42] Luca Enriques, *EC Company Law Directives and Regulations: How Trivial Are They?* 9-15, ECGI LAW WORKING PAPER NO. 39/2005, *at* http://ssrn.com/abstract=730388.

Similarly, Member States may successfully engage in goldplating with respect to areas covered by maximum harmonization by introducing mandatory rules that seemingly cover conducts other than those harmonized, while in fact addressing the very issues maximum harmonization was meant to cover. For instance, if the content of prospectuses is defined at the EC level via maximum harmonization, as it now is,[43] Member States wishing to impose additional disclosure obligations may do so by imposing them on issuers wishing to list their securities on a stock exchange. By doing so, most public offerings will be subject to the additional disclosure obligation the Member state wished to impose.[44]

Whenever the EC measures are not purely optional and/or do not impose purely enabling rules on Member States, not only, as already hinted, do they introduce EU/EEA-wide mandatory rules that are more difficult to escape from and to repeal. They also have an impact on regulatory competition, because their presence reduces the regulatory surplus businesses can gain from (re)incorporation,[45] thereby reducing the dynamism of the market for corporate law rules.

2. Choice of law-related harmonization. Positive harmonization can also be more directly related to choice of law issues. There are, first, measures that aim to remove barriers to freedom of establishment or anyhow to increase EU companies' cross-border mobility, thereby enhancing free choice of corporate law. The most prominent example of a choice-enhancing set of rules thus far is the Cross-border Merger Directive[46] that can work as a tool for reincorporations.[47]

Second, we have measures that harmonize the procedure to be followed in order to exercise choice of law (like safeguards for employees, creditors etc.) (so-called pro-

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[43] *See* Directive 2003/71/EC of the European Parliament and of the Council of 4 November 2003 on the prospectus to be published when securities are offered to the public or admitted to trading and amending Directive 2001/34/EC, 2003 O.J. (L 345) 64.

[44] See EILÍS FERRAN, BUILDING AN EU SECURITIES MARKET 145 (2004).

[45] *See* STEFANO LOMBARDO, REGULATORY COMPETITION IN COMPANY LAW IN THE EUROPEAN COMMUNITY 193 (2002).

[46] Directive 2005/56/EC of the European Parliament and of the Council of 26 October 2005 on cross-border mergers of limited liability companies, 2005 O.J. (L 310) 1.

[47] In the US, reincorporations are typically made by merging the parent corporation into a shell subsidiary set up in the reincorporation state. *See e.g.* Ronald J. Gilson, *Globalizing Corporate Governance: Convergence of Form or Function*, 49 AM. J. COMP. L. 329, 355 (2001).

cedural harmonization).[48] Whenever such measures attach to other measures requiring Member States to introduce new tools for companies' mobility (as is usually the case), depending on the "proportionality" of the safeguards, they can be viewed either as what is needed in order to avoid opportunistic reincorporations or as the political price to pay for greater choice. If the measures attach to tools for companies' mobility that are already existing and effective in a sufficient number of Member States, then such measures may restrict rather than enhance free choice.[49]

Finally, we have measures that directly address choice of law issues by harmonizing conflict of laws rules. Depending on the connecting factor chosen for the solution of the conflict, harmonization of this kind can either promote or restrict free choice. In the former case, regulatory arbitrage is imposed from the top, which, to be sure, is almost never the case with EC harmonization. In the latter case, regulatory arbitrage is ruled out or at least restricted within the EU.

C. Prospective harmonization. The presence of an actor like the EC, with its positive harmonization powers, may have an impact on regulatory competition and free choice no matter whether these powers are indeed exercised, provided that the relevant actors (private parties and policymakers at the State level) know that the EC may step in to react to any Member State's move to attract (re)incorporations. In two recent articles, Mark Roe has argued that the threat of federal intervention has shaped the development of US corporate law much more strongly than interstate competition by creating an incentive for Delaware decisionmakers not to overstep certain boundaries, beyond which corporate law would become untenable to federal decisionmakers, who are subject to different kinds of political pressures.[50]

Of course, it is theoretically conceivable that the mere perspective of European

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[48] *Cf*. Simon Deakin, *Regulatory Competition versus Harmonization in European Company Law*, *in* REGULATORY COMPETITION AND ECONOMIC INTEGRATION 190, 211 (Daniel C. Esty & Damien Geradin eds., 2001).

[49] For instance, suppose that most Member States already allowed for cross-border mergers without requiring any involvement of employees in the process. If the EC requires Member States to involve employees, as the Cross-Border Merger Directive does (Article 14), then harmonization hinders companies' mobility.

[50] Mark J. Roe, *Delaware's Competition, supra* note 3; Id., *Delaware's Politics, supra* note 3.

harmonization influences decisionmaking at the national level.[51] In quite a different sense than envisioned by Professor Roe, bona fide legislators occasionally implement draft directives before they are adopted. But it is quite unlikely for a state to be influenced in the way Roe describes. The European legislative process is relatively slow (compared to US Congress) and rather impervious to populist pressures due to the absence of a common European public sphere.[52] The EU legislator has rarely, if ever, been able to gain support from businesses to enact meaningful corporate law.[53] Generally, Delaware's responsiveness to the threat of federal intervention is owed to its financial dependence on franchise revenue, which creates a powerful incentive against implementing legal rules that might put its unique position among states at risk. Hence, as long as regulatory competition remains defensive and no European Delaware arises, there is no jurisdiction upon which supranational "competition" can exert significant pressure. The possibility of enacting non-trivial law may even chill non-defensive regulatory competition, since one state's attempt to attract incorporations by creating significant rents by means of corporate law could just trigger a reaction by other states, which would push for harmonization in such a case.[54]

C. Summary. We have shown that in a multijurisdictional setting, how mandatory corporate law rules are depends on the degree of freedom each jurisdiction grants to private actors. States can deny their private parties' freedom of choice in corporate law, or just restrict it or, finally, defer to it, with a corresponding decrease in the mandatory character of corporate law rules, depending of course on how easy it is *de facto* to exercise free choice. In the EU, under the impulse of the ECJ, Member States can now only restrict their citizens' free choice of corporate law, and they may do so only within the somewhat strict boundaries that the ECJ itself has drawn in its freedom of establishment

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[51] *Cf.* Roe, *id.,* at 644.

[52] Martin Gelter, *The Structure of Regulatory Competition in European Corporate Law,* 5 J. CORP. L. STUD. 247, 278-79 (2005). *See also* Luca Enriques, *Bad Apples, Bad Oranges: A Comment from Old Europe on Post-Enron Corporate Governance Reforms*, 38 WK FOREST L. REV. 911, 914-15 (2003). And *compare* Marcel Kahan & Edward Rock, Our Corporate Federalism and the Shape of Corporate Law 6-12, U. PENN., INST. FOR LAW & ECON. RESEARCH PAPER 04-12; NYU, LAW AND ECONOMICS RESEARCH PAPER NO. 04-020, *at* http://ssrn.com/abstract=564685 (June 2004) (viewing populist politics at the federal level as a serious threat to Delaware).

[53] Enriques, *supra* note 42, at 44.

[54] *See* Enriques, *supra* note 27, at 1269-70.

decisions. This implies a relaxation of the mandatory character of corporate law rules both because at any given time private parties may opt out of local mandatory rules by opting into another State's corporate law and because, from a dynamic point of view, States may have to decrease the level of investor protection to retain corporations within their borders. Such developments may be less dramatic than they appear, however, due to existing or prospective positive harmonization measures at the EC level, whether with regard to substantive law or in respect of conflict of laws rules.

3. Pre-insolvency rules and regulatory competition in corporate law

We now proceed to investigate the potential for corporate law arbitrage, forum shopping and regulatory competition in European corporate law with respect to creditor protection. Although we are ready to concede that the distinction is not clear-cut, in this part we deal with pre-insolvency rules, i.e. those operating before the onset of insolvency or, to be more precise, becoming operational irrespective of whether the corporation goes bankrupt (namely, minimum asset requirements, limits to distributions, creditors' rights to safeguards in the event of specific transactions and disclosure), and discuss regulatory arbitrage and regulatory competition within the EU and their implications for creditors. Then, in section 4, we turn to post-insolvency rules, which operate only after a corporation has gone bankrupt. Before proceeding, we would like to stress that our purpose here is not to give a complete taxonomy of each and all of the creditor protection instruments currently in use across the EU, but to show what scope the current framework leaves for regulatory arbitrage and regulatory competition in Europe.

3.1. An overview of the main pre-insolvency rules from an interjurisdictional perspective

Generally, pre-insolvency rules follow the law of incorporation, which means that they factor into the calculus of choosing a particular state of incorporation, and that they have an influence on regulatory competition in corporate law. There have been substantial efforts at positive harmonization of these rules. However, these efforts have borne little fruit thus far. First, many of these measures (in particular the Second Company Law Directive)[55] apply only to public companies (such as the *Aktiengesellschaft*, the *naamloze vennootschap,* the *société anonyme* or the *società per azioni*), but not to private ones. Second, those measures have altered national corporate law less than one might expect. EC directives relating to corporate law generally leave a variety of options to member states, where lawyers have frequently understood European law within the context of their respective national legal culture. Those provisions of secondary European law that are ere mandatory are typically underenforced at the European level, allowing either Member States or corporations to circumvent them with relative ease.[56]

Conflict of laws rules on pre-insolvency rules can generally be considered well-settled, meaning that they are usually considered part of corporate law. Hence, before *Centros*, which legal regime was applicable would either depend on the real seat theory or the incorporation theory. Member states, especially the ones that were denying or restricting free choice of corporate law, often engaged in creditor protection measures that went far beyond the requirements of EC law. Starting with *Centros*, negative harmonization by the ECJ has resulted in "defensive regulatory competition:" some of the Member States have already started to remove rules that were most apparently the outcome of isolation from competition.

A. Minimum net assets. The Second Company Law Directive requires public corporations to have a legal capital of at least € 25,000,[57] which needs not be entirely covered by assets at the time of incorporation.[58] With the Second Directive not applying to

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[55] Second Council Directive 77/91/EEC of 13 December 1976 on coordination of safeguards which, for the protection of the interests of members and others, are required by Member States of companies within the meaning of the second paragraph of Article 58 of the Treaty, in respect of the formation of public limited liability companies and the maintenance and alteration of their capital, with a view to making such safeguards equivalent, as amended by Council Directive 92/101/EEC of 23 November 1992 (hereinafter, Second Directive).

[56] Enriques, *supra* note 42, at 9-11.

[57] Second Directive, Article 6.

[58] *Id*., Article 9. Additional initial capital requirements exist for credit institutions (Directive 2000/12/EC of the European Parliament and of the Council of 20 March 2000 relating to the taking up and pursuit of the business of credit institutions, Art. 5) and insurance companies (*see* STEFAN GRUNDMANN, EUROPÄISCHES GESELLSCHAFTSRECHT, comment 140 (2005)). Furthermore, credit institutions are already required by European law to meet certain solvency requirements (Directive 2000/12/EC, art. 40-50). The EU commission has submitted a proposal for a directive (Proposal for Directives of the

private limited companies, Member States have been able to freely choose the amount for this set of corporations. This resulted in a broad variety of regulations, ranging from no such requirement in the UK, Ireland and Cyprus to € 35,000 in Austria.[59] *Centros* has already induced France effectively to abolish minimum capital for private corporations[60] and even the German Ministry of Justice has proposed a reduction from €25,000 to €10,000 in early 2005.[61]

The merits of minimum capital requirements in actually protecting creditors are highly doubtful, for reasons that need not be reiterated here.[62] Even some supporters of legal capital requirements concede that its function does not lie in protecting creditors from the risk of substantial losses resulting from an unfavorable business development, but rather in signaling seriousness to the market, thus erecting a barrier against the creation of dubious corporations with an unreasonable amount of backing by shareholders.[63]

European Parliament and the Council Re-casting Directive 2000/12/EC of the European Parliament and of the Council of 20 March 2000 relating to the taking up and pursuit of the business of credit institutions and Council Directive 93/6/EEC of 15 March 1993 on the capital adequacy of investment firms and credit institutions, COM(2004) 486 final) implementing the Basel II accord (see http://www.bis.org/publ/bcbs107.htm, visited September 20, 2005), under which minimum asset requirements will depend on the risk of outstanding credit.

[59] GmbHG (Austria) § 6(1). To be sure, only € 17,500 need to be paid up in cash before the corporation is registered (or the lower total amount of cash contributions, which is permissible if there are contributions in kind, for which the consideration has to be transferred in full (§ 10(1)).

[60] Loi n° 2003-721 du 1er août 2003 pour l'initiative économique, Journal officiel n° 179 du 5. 8. 2003, 13449, Art 1. *See* Eva-Maria Kieninger, *The Legal Framework of Regulatory Competition Based on Company Mobility: EU and US Compared,* 6 GERMAN L. J. 741, 768 (2004).

[61] Entwurf eines Gesetzes zur Neuregelung des Mindestkapitals der GmbH (MindestkapG), available at http://www.bmj.de/media/archive/908.pdf, accessed May 28, 2005. The proposal was rejected by the Federal Council (*Bundesrat*) with a view to the early 2005 elections, but new plans to faciliate the formation of startup firms are currently emerging. *See* Massimo Miola, *Legal Capital and Limited Liability Companies: the European Perspective,* 2 EUR. COMP. & FIN. L. REV. 413, 445 (2005); Wolfgang Zöllner, *Konkurrenz für inländische Kapitalgesellschaften durch ausländische Rechtsträger, insbesondere durch die englische Private Limited Company,* 97 GMBH-RUNDSCHAU 1, 11 (2006).

[62] *See* John Armour, *Share Capital and Creditor Protection: Efficient Rules for Modern Company Law*, 63 MODERN L. REV. 355, 371-72 (2000); Luca Enriques & Jonathan R. Macey, *Creditors versus Capital Formation: The Case against the European Legal Capital Rules,* 86 CORNELL L. REV. 1165-1204 (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).

[63] Marcus Lutter, *Gesetzliches Garantiekapital als Instrument europäischer und deutscher Rechtspolitik,* 43 DIE AKTIENGESELLSCHAFT 375, 375 (1998); Hanno Merkt, *Das Centros-Urteil des Europäischen Gerichtshofs,* in GESELLSCHAFTSRECHT IN DER DISKUSSION 1999, 110, 138 (Gesellschaftsrechtliche Vereinigung ed. 2000); Friedrich Rüffler, *Gläubigerschutz durch Mindestkapital und Kapitalerhaltung in der GmbH – überholtes oder sinnvolles Konzept?* 2 GESELLSCHAFTS- UND STEUERRECHT AKTUELL 140, 146 (2005); Rüdiger Wilhelmi, *Das Mindestkapital als Mindestschutz – eine Apologie im Hinblick auf die Diskussion um eine Reform der GmbH angesichts der englischen Limited,*

However, if there are any benefits to this argument, they need to be weighed against the disadvantage of preventing the formation of potentially thriving companies backed by a sound business idea but little or no assets.

The *Centros-Inspire Art* line of decisions has made it impossible for national legislators to impose minimum asset requirements on pseudo-foreign corporations. Thus, the possibilities for corporate law arbitrage in this field are nearly unrestricted.[64] In fact, minimum capital has become the most important factor driving for the incorporation of continental businesses in the UK. As already seen, this has already prompted some "defensive regulatory competition" across the EU. It is fairly easy to predict that the final outcome of this process will be the practical elimination of minimum capital requirements.

B. Restrictions on distributions. In the EU, legal rules limiting managers' discretion over the declaration of dividends or any other way of conveying corporate assets to shareholders are intertwined with the regulation of legal capital.[65] Under Article 15(1) of the Second Directive, no distributions to shareholders may be made when net assets are lower or would become lower than subscribed capital plus certain reserves which may not be distributed, except in the case of a reduction of subscribed capital. Even if this does not protect creditors against regular business risk, a public corporation will in principle be unable to convey funds to shareholders if net assets fall below the subscribed capital, unless shareholders vote to go through a capital reduction procedure which includes certain safeguards for creditors (Articles 30-39); a reduction below the minimum capital is of course ruled out entirely (Article 34). As a remedy, Article 16 of the Directive requires that distributions received must be returned if the corporation

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97 GMBH-RUNDSCHAU 13, 13-14 (2006) ; *see also* Wolfgang Schön, *The Future of Legal Capital,* 5 EUR. BUS. ORG. L. REV. 429, 436-9 (2004); GRUNDMANN, *supra* note 58, comment 328.

[64] See Stefan Grundmann, *Regulatory Competition in European Company Law – Some Different Genius?*, in CAPITAL MARKETS IN THE AGE OF THE EURO 561, 583-84 (Guido Ferrarini, Klaus J. Hopt & Eddy Wymeersch eds., 2002); Ulrich Forsthoff & Martin Schulz, *Gläubigerschutz bei EU-Auslandsgesellschaften,* in GRENZÜBERSCHREITENDE GESELLSCHAFTEN § 15, comment 27 (Heribert Hirte & Thomas Bücker eds. 2005).

[65] Of course, this does not necessarily have to be the case, since restrictions on distributions may also be related to balance sheets in the absence of legal capital rules or not be related at all with balance sheet data, as when a solvency test is required. *See e.g.* REVISED MODEL BUS. CORP. ACT § 6.40(c) (1984). Even the prohibition of concealed distributions (described below in the text accompanying notes 70-77) could conceivably apply in the absence of minimum capital.

proves that these shareholders knew of the irregularity, "or could not in view of the circumstances have been unaware of it."

However, two important caveats need to be made: first, the actual computation of net assets within the meaning of the directive is basically a balance sheet test on the basis of the last financial year's annual accounts. Thus, the extent of "capital maintenance" depends on the applicable accounting rules. In spite of the Fourth Directive[66], which, on its face, harmonizes accounting law in great detail, a considerable amount of elective provisions has allowed EU Member States to uphold their national accounting cultures,[67] while the recent IAS regulation[68] gives Member States the choice between an accounting system based on the fourth directive and one on IAS/IFRS for individual accounts (art. 5(a)).[69]

Second, as a practical matter, it is not entirely clear what kind of transactions the prohibition applies to. While the Second Directive explicitly speaks only of "distributions," German commentators generally agree that so-called concealed distributions (*verdeckte Ausschüttungen* or *verdeckte Einlagenrückgewähr*)[70] are also prohibited by

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[66] Fourth Council Directive 78/660/EEC of 25 July 1978 Based on Article 54(3)(g) of the Treaty on the Annual Accounts of Certain Types of Companies, 1978 O.J. (L 222) 11 (hereinafter: Fourth Directive).

[67] E.g., Werner F. Ebke, *Accounting, Auditing and Global Capital Markets*, in CORPORATIONS, CAPITAL MARKETS AND THE BUSINESS IN THE LAW: LIBER AMICORUM RICHARD M. BUXBAUM 113, 119 (Theodor Baums et al. eds., 2000); Martin Gelter & Mathias M. Siems, *Judicial Federalism in the ECJ's* Berlusconi *Case: Toward More Credible Corporate Governance and Financial Reporting?* 46 HARV. INT'L. L.J. 487, 505 (2005). See also Axel Haller, *International Accounting Harmonization, American Hegemony or Mutual Recognition with Benchmarks? Comments and Additional Notes from a German Perspective*, 4 EUR. ACCT. REV. 235, 237 (1995) ("The new accounting rules were interpreted in the light of the existing German accounting model […]").

[68] Regulation 1606/2002/EC of the European Parliament and of the Council of 19 July 2002.

[69] Member States are also allowed to delegate this choice to firms. *See also* Eilis Ferran, *The Place for Creditor Protection on the Agenda for Modernisation of Company Law in the European Union,* ECGI WORKING PAPER 51/2005, 21-24 (discussing the question of compatibility between the 2nd directive and IFRS accounting); Wolfgang Schön, *Gesellschafter-, Gläubiger- und Anlegerschutz im Europäischen Bilanzrecht*, 29 ZEITSCHRIFT FÜR UNTERNEHMENS- UND GESELLSCHAFTSRECHT 706, 720-721 (2000) (arguing that a "dynamic interpretation" of European accounting directives to comform to IAS would neglect the necessary regard to creditor protection); Wolfgang Schön, *Internationalisierung der Rechnungslegung und Gläubigerschutz,* 54 DIE WIRTSCHAFTSPRÜFUNG, Special Issue 74, 76 (2001) (arguing that IAS accounting shifts risk from shareholders to creditors); Martin Gelter, *Kapitalerhaltung und internationale Rechnungslegung,* 33 DER GESELLSCHAFTER 177 (2004) (showing the incompatibility between specific fundamental principles of IFRS accounting and of the Second Directive as interpreted in German-speaking countries).

[70] *See* Walter Bayer, *§ 57*, in MÜNCHENER KOMMENTAR ZUM AKTIENGESETZ, VOL. 2 (Bruno Kropff & Johannes Semler eds., 2nd ed. 2003); UWE HÜFFER, AKTIENGESETZ § 57 (6th ed. 2004).

the directive.[71] This term refers to transactions by which corporate funds are conveyed to shareholders indirectly, typically through contracts entered into on unfair terms, such as loans to shareholders with unusually low (or no) interest rates or purchases from shareholders at excessive prices. One argument that is sometimes brought in favor of such a doctrine is Article 42 of the Directive, which requires equal treatment of shareholders under equal conditions.[72] More importantly, if the prohibition is to be effective, it cannot matter whether a distribution is made through the official declaration of dividends or in any other way.[73] Naturally, the German understanding of the directive is shaped by the extensive German case law on concealed distributions to shareholders,[74] which also covers issues such as guarantees for a shareholders' personal debt by the corporation.[75] However, since the Second Directive only applies to public corporations, German law totally prohibits concealed distributions only in *Aktiengesellschaften*,[76] while in *Gesellschaften mit beschränkter Haftung* they are permitted as long as they do not reduce net assets below statutory capital.[77]

By contrast, under English law, a distribution is normally defined as a transfer of assets without consideration.[78] Still, in a vein similar to the German doctrine, English

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[71] Peter O. Mülbert, *Kapitalschutz und Gesellschaftszweck bei der Aktiengesellschaft,* in FESTSCHRIFT FÜR MARCUS LUTTER 535, 545-47 (Uwe H. Schneider, Peter Hommelhoff, Karsten Schmidt, Wolfram Timm, Barbara Grunewald & Tim Drygala eds. 2000); GÜNTHER CHRISTIAN SCHWARZ, EUROPÄISCHES GESELLSCHAFTSRECHT, comment 596 (2000); MATHIAS HABERSACK, EUROPÄISCHES GESELLSCHAFTSRECHT, comment 167 (2nd ed. 2003); GRUNDMANN, *supra* note 58, comment 343.

[72] GRUNDMANN, *supra* note 58, comment 343.

[73] *See* Wolfgang Schön, *Deutsches Konzernprivileg und europäischer Kapitalschutz – ein Widerspruch?* in AKTIEN- UND BILANZRECHT. FESTSCHRIFT FÜR BRUNO KROPFF 285, 294 (Karl-Heinz Forster et al. eds., 1997); Mülbert, *supra* note 71, at 546-7 (both arguing that the purpose of Articles 15 and 16 implies a general prohibition of concealed distributions).

[74] *See generally supra* note 70.

[75] BGH November 23, 2003, II ZR 171/01, BGHZ 157, 72.

[76] German commentators typically argue that, since Art. 15(1)(c) of the Second Directive limits distributions to profits, distributions other than through dividends are prohibited. *See e.g.* SCHWARZ, *supra* note 71, comment 596; HABERSACK, *supra* note 71, comment 164.

[77] § 57 AktG (Germany); § 30 GmbHG (Germany). *Cf.* MARCUS LUTTER & PETER HOMMEHOFF, GMBH-GESETZ, § 30, comment 3 (16th ed. 2004). By contrast, under Austrian corporate law, which usually strongly resembles German law, concealed distributions are generally illegal in both types of corporations. *See* § 52 AktG (Austria), § 82 GmbHG (Austria).

[78] *Clydebank Football Club Ltd. v. Steedman*, [2002] S.L.T. 109; PALMER'S COMPANY LAW, para. 9.705; John Armour, *Avoidance of Transactions as a 'Fraud on Creditors' at Common Law,* in VULNERABLE TRANSACTIONS IN CORPORATE INSOLVENCY, 281, para. 7.38 (John Armour & Howard Bennett eds. 2003).

courts have held excessive remuneration of directors,[79] the transfer at undervalue of real property to another corporation owned by the same parent[80] and a guarantee for another firm within the same group[81] to be unauthorized returns of capital.[82] However, transactions that are not a complete sham will not be considered a "distribution" at all,[83] meaning that, other than under German law, a subjective element is required to void a transaction.[84] The recent Company Law Reform Bill will allow distributions in kind as long as there are sufficient profits available for distribution to cover the difference between the asset's book value and the consideration received,[85] which would not be acceptable under German law. Given that the English case law on this subject is sparse, and, even more importantly, commentators appear not to see a connection with the Second Directive,[86] it is obvious that the understanding of constraints on distributions imposed by EC law differs considerably. On top of that, concealed distributions do not appear to be much of an issue in some other countries as well.[87]

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[79] *In Re Halt Garage* [1982] 3 All E.R. 1016.

[80] *Aveling Barford Ltd. v. Perion Ltd.* [1989] B.C.L.C. 626, 5 B.C.C. 677; *see* M. J. Burke, *Shareholder ratification of directors' actions,* 140 NEW L.J. 240 (1990).

[81] *Barcley Bank v. British and Commonwealth Holdings Plc.* [1996] 1 B.C.L.C. 1.

[82] *Cf.* PAUL L. DAVIES, GOWER AND DAVIES' PRINCIPLES OF MODERN COMPANY LAW 279-80 (7th ed. 2003); MICHAEL FORDE, COMPANY LAW, note 7-31 (3rd ed 1999); Eva Micheler, *Gläubigerschutz im englischen Gesellschaftsrecht,* 33 ZEITSCHRIFT FÜR UNTERNEHMENS- UND GESELLSCHAFTSRECHT 324, 328-29 (2004).

[83] Armour, *supra* note 78, para 7.38.

[84] For a detailed comparison *see* THOMAS BACHNER, CREDITOR PROTECTION IN PRIVATE COMPANIES – ANGLO-GERMAN PERSPECTIVES AFTER CENTROS, ch. on "Capital maintanance and Unlawful Distributions" (Ph.D. dissertation, University of Cambridge Faculty of Law, 2006).

[85] COMPANY LAW REFORM BILL, HL BILL 34 (NOVEMBER 2005), proposed section § 275A.

[86] For example, Vanessa Edwards discusses neither the English nor German cases in her treatise. *See* VANESSA EDWARDS, EC COMPANY LAW 69 (1999). The Rickford report discusses the issue only briefly within the context of German law. *See* Jonathan Rickford, *Reforming Capital. Report on the Interdisciplinary Group on Capital Maintenance,* 2004 EUR. BUS. L. REV. 919, 1008.

[87] For France, *see* MICHEL GERMAIN, 1/2 TRAITÉ DE DROIT COMMERCIAL G. RIPERT/R. ROBLOT 607-09 (18th ed. 2002) (discussing the issue of "dividends fictifs" under French Law and ignoring the issue of concealed distributions). For Spain *see* José Massaguer Fuentes, *Spagna*, *in* 2 ARMONIE E DISARMONIE NEL DIRITTO COMUNITARIO DELLE SOCIETÀ DI CAPITALI 1115, 1129-32 (Gian Franco Campobasso ed., 2003) (same for Spanish law). For Italy a distinction has to be made between concealed distributions and concealed restitutions of contributions. The former does not appear to be an issue (*see e.g.* Giovanni E. Colombo, *Il bilancio d'esercizio*, *in* 7/1 TRATTATO DELLE SOCIETÀ PER AZIONI 23, 535-44 (Giovanni E. Colombo & Giuseppe B. Portale eds., 1994) (providing a thorough analysis of the Italian provision – Article 2433, par. 4, C.C. – corresponding to Article 16 of the Second Directive and the relationships between the two, but totally ignoring the problem of concealed distributions). To be sure, until 2002, it was a crime to distribute "in any form" fictitious profits (Article 2621, No. 2), C.C.) and the relevant provision was construed as including the case of concealed distributions. After the 2002 reform, however, the criminal provision was reformulated without the "in any form" clause and, in the absence of

Since restrictions on distributions, including concealed distributions, may result in significant cost[88] (e.g. when planning intra-group transactions to avoid violations of such rules) and in considerable risk to shareholders if the corporation goes bankrupt, differences in the law may affect corporate arbitrage decisions to some degree. Following *Centros* and *Inspire Art,* there appears to be widespread agreement that capital maintenance rules of the state of incorporation apply[89] and choice of law with respect to distributions will therefore be possible.

C. Creditors' right to safeguards in the event of significant transactions. Jurisdictions sometimes protect creditors by granting them a right to obtain some form of safeguard in the event the corporate debtor executes a transaction supposedly capable of increasing the risk faced by the creditor. This tool has also been used by EC corporate law with regard to a few transactions, reflecting the fact that some Member States already provided for similar safeguards prior to harmonization.[90]

First of all, the Second Directive provides that in the event of a reduction of capital, "at least the creditors whose claims antedate the publication of the decision to make the reduction shall be entitled at least to have the right to obtain security for claims which have not fallen due by the date of that publication. The laws of a Member State shall lay down the conditions for the exercise of this right." Further, such laws "may not set aside such right unless the creditor has adequate safeguards, or unless the latter are not necessary in view of the assets of the company" (Article 32).

Second, "an adequate system of protection of the interests of creditors" has to be devised by Member States in the case of mergers and divisions falling under the Third

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case law so far, it is widely construed as not including concealed distributions any more. *See e.g.* Valerio Napoleoni, *Le disposizioni penali in materia di società e di consorzi*, *in* CODICE COMMENTATO DELLE NUOVE SOCIETÀ 1690, 1773 (Guido Bonfante et al. eds., 2004)). There is, however, some scholarly debate and a couple of court decisions can be found with regard to concealed restitutions of contributions, a phenomenon partially overlapping with concealed distributions (*see e.g.* the in-depth discussion in Marco S. Spolidoro, *I conferimenti in danaro*, *in* 1/2 TRATTATO DELLE SOCIETÀ PER AZIONI 247, 349-361 (Giovanni E. Colombo & Giuseppe B. Portale eds., 2004) (where no reference is ever made, however, to EC law)).

[88] *Cf.* Mülbert & Birke, *supra* note 62, at 720-1 (conceding that creditors may look favorably at rules against concealed distributions, which however come at a significant cost).

[89] *E.g.* Forsthoff & Schulz, *supra* note 64, comment 32; *contra* Altmeppen, *supra* note 38, at 97, 102.

[90] For instance, in Italy provisions similar to those described below on reduction of capital were already present in the 1942 version of the Civil Code (Articles 2445 & 2503 C.C., relating to reductions of capital and mergers respectively). For Germany, *see* §§ 225 & 347 of the 1965 Aktiengesetz.

and the Sixth Directives.[91] Such provisions also apply to the formation of a European Company by merger (Article 24, Regulation 2157/2001) and to cross-border mergers (Article 2, par. 2, Cross-border Merger Directive). In many Member States, the system of protection is very similar to the one designed in Article 32 of the Second Directive for reductions of capital.[92]

In general, the relevance of such provisions for creditor protection purposes can hardly be underestimated. To begin with, as one of us has argued elsewhere, all such provisions are either timidly market-mimicking or unimportant: they are timidly market-mimicking "with regard to sophisticated creditors, who normally reserve the far more effective right to veto such transactions (usually in broader and more detailed terms) or insert an acceleration clause applying if these transactions are entered into."[93] And they are unimportant with regard to other (voluntary) creditors,[94] either because these are weak creditors, and hence lack the negotiating power to exercise their right vis-à-vis the corporation, or because they have such power, in which case they do not need a right to obtain safeguards.[95]

Further, with specific regard to the EC measures, the Third and the Sixth Directives altogether are arguably trivial, so long as at least one Member State, namely the UK, has been able to let its companies execute mergers and divisions under different

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[91] Articles 13 and 12 respectively.

[92] See § 22, UmwG (Germany); Article 2503, C.C. (Italy) and Article L236-14 C.COMM. (France); Articles 107-08 Código das Sociedades Comerciais (Decreto-Lei nº 262/86 de 2 de Setembro 1986) (Portugal); Article 243, Ley de Sociedades Anónimas (Real Decreto Legislativo 1564/1989, de 22 de diciembre 1989) (Spain).

[93] Enriques, *supra* note 42, at 25.

[94] They may matter to involuntary creditors, provided that a number of conditions apply. First, involuntary creditors should have no other meaningful relationship with the corporation. Second, legal systems should provide for effective ways for them to become informed about the relevant transaction so as to be able to exercise their right in a timely fashion. Finally, the exercise of such a right must be cheap compared with the expected loss stemming from the increased risk of default following the transaction. In countries where creditors need to act in court in order to obtain the relevant safeguard (as is the case in Italy: *see e.g.* Carlo Santagata, *Le Fusioni*, *in* 7/2/1 TRATTATO DELLE SOCIETÀ PER AZIONI 3, 527 (Giovanni E. Colombo & Giuseppe B. Portale eds., 2004) and where no means exists to coordinate the efforts of the numerous creditors that e.g. are the victims of a mass tort, the cost of exercising the right is likely to be too high most of the times.

[95] *Id*. at 27-28 (see also fn 132, where it is noted that "such provisions do not provide that the company must obtain creditors' consent to execute certain transactions. They require creditors to activate in order to obtain protection, thus making it less plausible that a bargaining problem connected with an endowment effect will arise").

sets of rules.[96]

D. Mandatory disclosure. One of the most important elements, or possibly the dominant element of EC corporate law, is its extensive regime of disclosure.[97] The First Directive provides for the disclosure of a variety of corporate data, but most of all about the corporation's annual accounts and consolidated accounts.[98] The preambles to both the Fourth Directive and the Seventh Directive[99] refer to the interests of third parties (obviously including creditors) to justify mandatory disclosure of accounting information. Mandatory disclosure is of particular significance for small creditors who lack the bargaining power to force the voluntary provision of information (they may even be non-adjusting creditors who are not in the position to alter contract terms depending on risk of default).

However, there are good reasons to doubt whether the enforcement mechanisms of EC law for mandatory disclosure provisions are effective. In 1997 and 1998, the ECJ ruled that Germany had failed to adequately enforce disclosure for small companies[100], which sparked a reform act imposing a new regime of sanctions.[101] Nevertheless, recent empirical evidence shows that more than 90% of German firms still fail to comply.[102]

A related issue recently tackled by the ECJ in the *Berlusconi* case is accounting fraud. Even though there are no explicit provisions addressing the issue in the directives, advocate general Juliane Kokott sweepingly suggested that community law re-

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[96] *See e.g. Id*. at 33.

[97] *Cf.* Stefan Grundmann, *The Structure of European Company Law: From Crises to Boom,* 5 EUR. BUS. ORG. L. REV. 601, 617 (2004) ("Information rules dominate European company law").

[98] First Council Directive 68/151/EEC of 9 March 1968 on Coordination of Safeguards which, for the protection of the interests of members and others,are required by Member States of companies within the meaning of the second paragraph of Article 58 of the Treaty, with a view to making such safeguards equivalent throughout the Community, art. 2, 1968 O.J. SPEC. ED. 41.

[99] Seventh Council Directive 83/349/EEC of 13 June 1983 Based on the Article 54(3)(g) of the Treaty on Consolidated Accounts, 1983 O.J. (L 193) 1 (hereinafter: Seventh Directive).

[100] *Verband deutscher Daihatsu-Händler eV v. Daihatsu Deutschland GmbH*, Case C-97/96, 1997 E.C.R. I-6843; *Commission v. Germany,* Case C-191/95, 1998 E.C.R. I-5449.

[101] Kapitalgesellschaften- und Co-Richtlinie-Gesetz (KapCoRiLiG), February 24, 2000, BGBl I, 154 (among other things, introducing penalities which are not only imposed upon request by a shareholder, creditor or the works council).

[102] Franz Jürgen Marx & Holger Dallmann, *Jahresabschlusspublizität mittelständischer Unternehmen,* 59 BETRIEBS-BERATER 929 (2004).

quires Member States to impose effective, proportionate and dissuasive penalties,[103] arguing that false disclosure is at least as harmful as non-disclosure (which is covered by the directives).[104] The ECJ agreed with this assessment in principle,[105] but decided in favor of the defendants on the basis of a rather formalistic understanding of the *nulla poena sine lege* principle, which forms an integral part of community law.[106] Still, European law could in theory have an impact on the interests of creditors in general in that it ensures the accuracy of financial statements.

However, the actual usefulness of disclosure to creditors is compromised by various factors. Beside the issue of differences in applicable accounting standards[107] the lack of enforcement of disclosure in some Member States, it is important to note the directives' failure to provide a specific period after the end of the fiscal year within which disclosure must be effected. Member States sometimes prescribe relatively generous filing periods, e.g. ten months in the UK for private limited companies [108], twelve months in Germany,[109] nine months in Austria,[110] and seven months in Italy and Spain.[111] At that point, accounting information is of course already rather stale.

Thus, at least for small corporations, the European regime of mandatory disclosure may bring fewer benefits than it appears at first glance. Most of the justifications for mandatory disclosure commonly brought in the literature – which relate to the character of information as a public good and its underproduction and mispricing in an unregulated market[112] – are understandable only within the context of publicly traded

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[103] Opinion of Advocate General Kokott, Joined Cases C-387/02, C-391/02, & C-403/02, Berlusconi (Oct. 14, 2004). For an analysis of that opinion, *see* Gelter & Siems, *supra* note 67.

[104] Kokott, *id.*, recitals 67-81.

[105] Joint cases *Silvio Berlusconi, Sergio Adelchi, Marcello Dell'Utri and Others,* Joint cases C-387/02, C-391/02 and C-403/02, May 3, 2005, recital 63.

[106] *Id.,* at recitals 66-69.

[107] See *supra* footnotes 66-69 and accompanying text.

[108] Companies Act, 1985, c. 6, § 244(1)(a).

[109] HGB § 325(1).

[110] HGB § 277(1).

[111] For Italy see Article 2435 C.C., in connection with Article2365(2) C.C. For Spain see Articles 95, 171 & 218 of the Ley de Sociedades Anónimas (Law on Public Corporations) (Real Decreto Legislativo 1564/1989, de 22 de diciembre, por el que se aprueba el texto refundido de la Ley de Sociedades Anónimas).

[112] For a succinct overview, *see* Gerard Hertig, Reinier Kraakman & Edward Rock, *Issuers and Investor Protection,* in THE ANATOMY OF CORPORATE LAW 194, 204-07 (Reinier Kraakman et al. eds., 2004).

firms. For important creditors such as banks, information provided by mandatory disclosure under the regime of the directives is of little significance, since they are usually able to gain access directly through the firm's managers.[113] Trade creditors will often not have the bargaining power to make similar requests and therefore resort to others ways of obtaining information about the firm, or they will take out bad debts insurance, while mandatory disclosure is of little (if any) relevance to them.[114] The mandatory disclosure regime imposed by the directives may, in effect, be doing as little as ensuring the implementation of unitary accounting systems and standards within the respective country.

Still, accounting and disclosure provisions are a factor potentially influencing regulatory competition. From the perspective of conflict of laws rules, most authors seem to agree that accounting duties follow corporate law, i.e. an English private limited company should follow UK accounting rules.[115] Quite obviously, the ECJ would hardly tolerate if a Member State applied its own accounting law to foreign companies, given extensive European harmonization.[116] This view is confirmed by the new audit directive, which implements the principle of home country regulation, i.e. it identifies as the applicable law the one of the member state in which the auditor is approved and in which the audited entity has its registered office.[117]

However, accounting is probably one of the few areas (the only one?) where the founders of a corporation will usually not want to opt out of their home state's corporate law regime, because drawing up financial statements under a familiar system is easier

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[113] *E.g.* ULRICH NOACK, UNTERNEHMENSPUBLIZITÄT, comment 104 (2002).

[114] *But see* NOACK, *id,.* (unreferenced claim that in the UK, disclosed accounts are frequently inspected before entering into large business transactions).

[115] Bodo Riegger, *Centros – Überseering – Inspire Art: Folgen für die Praxis,* 33 ZEITSCHRIFT FÜR UNTERNEHMENS- UND GESELLSCHAFTSRECHT 510, 515-7 (2004); Martin Gelter, *Rechnungslegungspflicht der englischen* limited *mit Sitz in Österreich,* 23 ÖSTERREICHISCHES RECHT DER WIRTSCHAFT 134, 134-5 (2005); André O. Westhoff, *Rechnungslegung bei ausländischen Kapitalgesellschaften mit Sitz im Inland,* in GRENZÜBERSCHREITENDE GESELLSCHAFTEN § 17, comments 31, 32-4 (Heribert Hirte & Thomas Bücker eds. 2005).

[116] Markus Rehberg, *Zivil-, Handels- und Gesellschaftsrecht,* in AUSLÄNDISCHE KAPITALGESELLSCHAFTEN IM DEUTSCHEN RECHT § 5, comment 114 (Horst Eidenmüller ed., 2004); Gelter, *id.* at 135.

[117] Audit directive, ###, art. 33(1). On damages claims against the auditor *see* Werner F. Ebke, *in* 4 MÜNCHENER KOMMENTAR ZUM HANDELSGESETZBUCH, § 323, comments 148-168 (Karsten Schmidt ed. 2000).

and less costly, and because the home system will be harmonized with the applicable tax law. Apparently, since the Companies House does not investigate the substantive content of financial statements, it has become common practice for English PLCs with their seat of administration in Germany to submit accounts set up under the accounting provisions of the German commercial code.[118]

For large listed firms, IFRS/IAS have become the accounting system of choice with the EC "IAS Regulation".[119] However, the debate on accounting provisions for small firms is far from over. Accounting standards may therefore be one of the factors affecting a corporate law arbitrage decision.

3.2. *Corporate law arbitrage and regulatory competition*

We have seen that the ECJ has largely opened the field to corporate law arbitrage. While there have been efforts at positive harmonization, mostly concerning public corporations, they have remained largely ineffective and therefore do not significantly curb regulatory arbitrage.[120] As described above, pre-insolvency rules are mostly the domain of corporate law, much more so than in the US, where creditor protection is not really an issue for corporate legislators, except for restrictions on dividends that can be put down as mostly meaningless and prone to circumvention.[121] By contrast, in Europe, creditor protection has long been a concern of corporate law. Hence, it comes as no big

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[118] Westhoff, *supra* note 115, comment 111.

[119] See also *supra* note 69.

[120] However, the risk that the EC harmonizes a given corporate law issue making the law of a Member State particularly attractive may hinder regulatory arbitrage, if companies perceive that there is a high chance that a sufficient number of (re)incorporations in that Member State will prompt harmonization, thereby making the choice of that corporate law unattractive ex post. *See supra* note 54 and accompanying text.

[121] *See* ROBERT C. CLARK, CORPORATE LAW 618 (1986) (describing the possibility of increasing surplus by revaluating assets or changing accounting policies); BAYLESS MANNING & JAMES J. HANKS, LEGAL CAPITAL 93 (3rd ed. 1990) ("Whether one views it as a blessing or a deficiency of the existing statutory systems, it is at least a fact that the corporation acts do not pursue the implementation of their own scheme with any real seriousness"). The elimination or vestigialization of legal capital rules has arguably been the outcome of regulatory competition. *See also* Richard A. Booth, *Capital Requirements in United States Corporation Law* 4, U. MD. SCHOOL OF LAW LEGAL STUDIES RESEARCH PAPER NO. 2005-64, *at* http://ssrn.com/abstract=864685 (2005) (reporting that "many observers have suggested that the dilution of substantive rules such as those relating to legal capital may be attributable to destructive competition [among the states]" and suggesting that, to the contrary, "it may also be the case that such rules proved to be inefficient and that other more efficient rules have evolved").

surprise that the American discussion on regulatory competition has little to offer concerning creditor protection.[122]

We now proceed to assess how intense regulatory competition is today within the EU and how it is to be interpreted, and then analyze how ex ante and ex post choice of law decisions affect creditors. By ex ante and ex post decisions we mean the decision to incorporate or to reincorporate before or after credit has been extended to the firm respectively.

A. Corporate law arbitrage and regulatory competition so far. We have seen that some regulatory arbitrage with respect to pre-insolvency rules is already happening, driven mostly by minimum capital requirements, which possibly can, at least partly, be credited for a trend toward the abolition of minimum capital requirements in some countries.[123] Still, it would probably be premature to infer any long-term trends from this. Of course, legal capital requirements are usually seen as an instrument of creditor protection. However, if minimum capital requirements do not actually help creditors and rational creditors should not care about them, then the changes in the law induced by corporate law arbitrage so far are not really an issue of creditor protection, but only a removal of administrative slack that affected the interests of the founders of new companies only. If it is true that only one interest group is affected, and in a positive way, it seems hard to doubt that the effect of regulatory competition is beneficial as well. Given the minor relevance of this issue in the perspective of creditors, however, this recent development should not be construed as evidence for either a "race to the top" or "race to the bottom" with respect to creditor protection.

B. Ex-ante choice of law. Even in light of the doubts on whether each of the current creditor protection mechanisms implemented by the Member States actually serves the interests of creditors, it is hard to rule out entirely that some of them do. Conceivably, Member States could also devise new ones that do. Hence, we ask whether regulatory competition is likely to lead to the retention and development of mechanisms creditors actually care about, i.e. whether corporate law arbitrage will be beneficial.

Corporate debtors, especially when the corporation approaches insolvency, have

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[122] The only exception seems to be Bebchuk, *supra* note 1, at 1489-90 (1992).

powerful incentives to act in ways that are detrimental to creditors, because shareholders capture most of the potential gains of increased risk, whereas creditors, whose entire benefits are limited to the amount of principal plus interest stipulated ex ante, have to bear most of the risk of failure.[124] However, to counter this danger, creditors frequently request contractual clauses limiting the opportunism of debtors,[125] or they will charge a risk-adjusted interest rate.[126]

Hence, in line with the standard corporate law and economics literature, which considers corporate law to be a standard-form contract,[127] the applicable regime of corporate law also needs to be seen as part of the contract of lending. At least some corporate law creditor protection tools will affect the creditor's assessment of shareholder and manager opportunism; to the extent that corporate law reduces this risk, the creditor will charge a lower interest rate or find it not necessary to add protective covenants to the lending agreement. For example, a rational creditor will take the possibility of veil piercing or equitable subordination into account and adjust the interest rate accordingly, considering the reduced risk, if only marginally. Similarly, creditors should make some adjustment depending on whether managers and/or shareholders have or do not have the opportunity to remove assets from the corporation, thus increasing the likelihood of insolvency and reducing the chances of recovery (asset diversion). It follows that rules impeding such transactions, including "concealed distributions" doctrines or mandatory disclosure rules, should also affect their decision on the margin. Thus, assuming the ability to accurately assess risk of default and to adjust prices and conditions accordingly, creditors should precisely be getting what they bargained for in terms of ex ante expectations. A creditor may want a corporate debtor to observe a specific Member State's creditor protection regime. A powerful institutional lender could theoretically even have the bargaining power to induce a firm to submit itself to a particular re-

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[123] *See* Miola, *supra* note 61, at 441-447.

[124] *See* Stewart C. Myers, *Determinants of Corporate Borrowing,* 5 J. FIN. ECON. 147 (1977).

[125] Clifford W. Smith & Jerold B. Warner, *On Financial Contracting,* 7 J. FIN. ECON. 117 (1979).

[126] *See generally* LOMBARDO *supra* note 45, at 166 (discussing rational behavior by creditors who would reward incorporation in a Member State with good law).

[127] Frank H. Easterbrook & Daniel R. Fischel, *The Corporate Contract*, 89 COLUM. L. REV. 1416 1444-45 (1989).

gime.[128] From this discussion follows that, considering firms' ex ante incorporation choice, both debtors and lenders should have an incentive to lobby states to implement creditor protection rules which are beneficial to lenders (and borrowers).

However, the analysis so far ignores non-adjusting and only partially adjusting creditors. Most of all, tort claimants will not be able to adjust their claims. Small, less sophisticated creditors (e.g. suppliers) will be unable to exactly determine the risk involved and will find it too costly to draft an agreement exactly reflecting the risk of the borrower.[129] It is for these creditors that a "boilerplate contract" corporate law will be insufficient. Hence, in the presence of non-adjusting creditors a "race to the bottom" is theoretically possible, as those creditors will not adequately react to the choice of a suboptimal corporate law.[130]

An obvious objection is that non-adjusting creditors may free-ride on the bargaining power of large lenders. Within certain limits, this is absolutely likely to happen, namely in those cases where the law of a specific jurisdiction is beneficial to creditors as a group. However, free-riding will not work where the choice of law involves a conflict of interests between different groups of lenders, e.g. where bank loans are collateralized, while trade creditors do not possess such protection. Choice of law opportunities may therefore be detrimental to non-adjusting creditors (in particular tort creditors) vis-à-vis adjusting creditors.[131]

C. Ex-post reincorporation. So far, only newly founded companies have taken advantage of corporate law arbitrage within the EU. Once a specific regime has been chosen, firms are locked into a particular system of creditor protection. This is due mostly to costs of moving: firms have needed to resort to complicated constructions in order to

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[128] As described above (see part 2.D), an adjusting lender could select a given corporate law by asking the borrower to set up a subsidiary in the desired legal system to which the loan is given, and which enters into a non-reincorporation covenant, while the parent guarantees for the loan. However, this will work only if the subsidiary is endowed with a sufficient amount of assets to make sure that it will be able to repay; otherwise, the lender will have to call upon the guarantee, in which case corporate law governing the parent corporation will be of primary importance again.

[129] *See generally* Lucian Arye Bebchuk & Jesse M. Fried, *The Uneasy Case for the Priority of Secured Claims in Bankruptcy,* 105 YALE L. J. 857, 864-65 (1996); Horst Eidenmüller*, Beschränkungen der Niederlassungsfreiheit und ihre Rechtfertigung,* in AUSLÄNDISCHE KAPITALGESELLSCHAFTEN IM DEUTSCHEN RECHT § 3, comments 39-40 (Horst Eidenmüller ed. 2004).

[130] Bebchuk, *supra* note 122, at 1489-1490.

[131] Gelter, *supra* note 52, at 276.

switch to a new regime,[132] and they faced severe obstacles resulting from taxation. The first problem has been alleviated at least to some degree by the recently enacted Directive on Cross-Border Mergers and the ECJ's recent opinion in *SEVIC Systems AG,* where it found that that the German law on mergers' failure to allow for cross-border mergers violates Articles 43 and 48 of the EC Treaty.[133] The second issue should have been partly resolved by the Directive on the Taxation of Mergers, which prohibits the taxation of hidden reserves in cross-border mergers subject to certain conditions.[134] However, presently it remains unclear whether other types of reincorporation will be possible without resulting in deterrent tax consequences. Where reincorporation entails a change in the firm's tax residence (which will not necessarily be the case if no assets are relocated), such a move will often trigger "exit taxation" of unrealized gains. In the *Lasteyrie du Saillant* case the ECJ found that this was not permissible under the freedom of establishment where a natural person moved to another Member State.[135] There are good reasons to believe that this reasoning also applies where a corporation reincorporates or moves to another Member State, although it remains to be seen where exactly the ECJ will draw the line.[136]

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[132] Consider e.g. the Daimler-Chrysler merger (which, however, involved a German and an American corporation. *See* Theodor Baums, *Corporate contracting around defective regulations: The Daimler-Chrysler case*, 115 J. INSTITUTIONAL & THEORETICAL ECON. 119 (1999).

[133] *SEVIC Systems AG v. Amtsgericht Neuwied* (Case C-411/03) [2005] E.C.R. ### (hereinafter: *SEVIC*).

[134] Council Directive 90/434/EEC of 23 July 1990 on the common system of taxation applicable to mergers, divisions, transfers of assets and exchanges of shares concerning companies of different Member States [1990] OJ L225/1, 20, art 4(1). *But see* International Bureau of Fiscal Documentation, *Survey on the Societas Europeaea* 78 (Sept. 2003) (reporting on the basis of a questionnaire conducted in the then fifteen Member States that Directive 90/434 EEC "still needs (partial) implementation in several Member States"); Edward B. Rock, Taxes and Charter Competition 19-21 (2005) (unpublished manuscript, on file with the authors) (describing the limited scope of tax exemptions under the Directive on the Taxation of Mergers). In the US, reincorporation into another state is normally considered a "reorganization" (IRC § 368(a) (2004)) not giving rise to taxation. *Cf.* Guhan Subramanian, *The Influence of Antitakeover Statutes on Incorporation Choice: Evidence on the „Race Debate" and Antitakeover Overreaching,* 150 U. PA. L. REV. 1795, 1802 (2002). On tax impediments in Europe *see also* Tröger, *supra* note 27, at 16-18.

[135] *Hughes de Lasteyrie du Saillant v Ministère de l'Economie (Case C-09/02),* 2004 E.C.R. 2409.

[136] *See e.g.* Jens Kleinert & Peter Probst, *Endgültiges Aus für steuerliche Wegzugsbeschränkungen bei natürlichen und juristischen Personen*, 47 DER BETRIEB 673, 674 (2004); Tröger *supra* note 27, at 17; *but see* Gilbert Parleani, *Relocation and Taxation: the European Court of Justice Disallows the French Rule of Direct Taxation of Unrealised Gains* 1 EUR. COMP. & FIN. L. REV. 379, 381 (2004) (waiting for a legislative solution); but *compare* Wolfgang Schön, *Playing Different Games? Regulatory Competition in Tax and Company Law Compared* 42 COMMON MKT. L. REV. 331, 359-60 (2005) (highlighting how broad-sweeping the implications of a holding like the one in *Lasteyrie du Saillant*, *supra* note 135, for

"Midstream" or "ex post" corporate law arbitrage – i.e. during the later life of the corporation – adds another dimension to the analysis. Once firms are no longer locked into a particular legal regime, it may be in the interest of both parties to commit ex ante to stay in a particular legal system creditors have adjusted to. In this case, contractual creditors need to deal only with the law of one jurisdiction and should be able to adjust and penalize bad law with relative ease (assuming there are no information asymmetries about the content of the particular law). The possibility of implicitly altering the terms of the lending agreement by reincorporating compares to the US debate on mandatory rules in corporate law, which focuses on the relation between shareholders and managers. The usual justification given for making some rules mandatory in the midstream stage is managerial opportunism. Even if the charter terms were fair when the corporation first went public, the argument goes, management can push through charter amendments which are not necessarily in shareholders' interest because shareholders are rationally ignorant and subject to collective action problems, and because charter amendments need to be proposed by the board of directors in the US. This precludes charter amendments that will be to the benefit of shareholders, but to the detriment of management.[137] It may therefore be beneficial if companies' managers or promoters were able to tie their hands with respect to charter amendments.[138]

Similarly, it may be beneficial if a firm is committed to the terms of a lending agreement, as implied by the corporate law regime of its state of incorporation. However, if the debtor is not committed to a particular system (or if such a commitment is

corporations would be); Rock, *supra* note 134, at 21-25 (similarly doubting that unless corporate income tax is federalized, Member States can accept that corporations reincorporate without paying taxes on hidden reserves). In particular, in the case of mere reincorporation without a relocation of assets it seems hard to conceive how a taxation of reserves could be justified in light of the EC case law, as the ability to tax those reserves later will not be lost. *Cf.* Franz Wassermeyer, *Steuerliche Konsequenzen aus dem EuGH-Urteil "Hughes de Lasteyrie du Saillant,* 95 GMBH-RUNDSCHAU 613, 615-616 (2004); Andreas Engert, *Steuerrecht,* in AUSLÄNDISCHE KAPITALGESELLSCHAFTEN IM DEUTSCHEN RECHT § 8, comments 111 (Horst Eidenmüller ed. 2004) (both arguing that German exit taxation should not apply in such cases in light of European law). Also *compare Marks & Spencer plc v. David Halsey (Her Majesty's Inspector of Taxes)* (Case C-446/03), 2006 E.C.R. ### (applying a test of proportionality to the question of whether a Member State may permit the offsetting of profits made by a subsidiary in the same State while prohibiting the offsetting with profits made elsewhere).

[137] Lucian A. Bebchuk, *Limiting Contractual Freedom in Corporate Law: The Desirable Constraints on Charter Amendments,* 102 HARV. L. REV. 1820, 1835-1847 (1989).

impossible or prohibitively costly), the opportunity to move to a less creditor-friendly jurisdiction creates a new moral hazard problem vis-à-vis creditors.[139] Under the (default) regime created by the recent ECJ case law, shareholders may unilaterally decide to change the firm's charter or to reincorporate in another jurisdiction without creditors' approval.[140] This moral hazard opportunity raises information costs for creditors who need to deal with the laws of the multiple states in which a corporation might reincorporate.

With time, sophisticated creditors would probably learn how to deal with this and, at the very least, adjust interest rates accordingly. Conceivably, a lending contract or a bond covenant could require the debtor to stay within one particular legal system. In most cases, creditors will be (theoretically) in the position to protect themselves against this particular type of moral hazard. Even today, loan agreements with banks often stipulate the acceleration of the loan in the case of significant transactions such as mergers. Similarly, contracts might penalize reincorporations by raising interest rates in such a case. Such clauses may be sufficiently deterrent in many cases, at least as long as bankruptcy is not immediately impending.

Even when a "commitment" clause is in place, it is shareholders who need to initiate a reincorporation, even though creditors need to approve. The ensuing distribution of powers between shareholders and creditors is analogue to the one between managers and shareholders in the US.[141] One could argue that, in the (theoretical) case where a

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[138] Jeffrey N. Gordon, *The Mandatory Structure of Corporate Law,* 89 COLUM. L. REV. 1549, 1573-85 (1989).

[139] *See also* LOMBARDO, *supra* note 45, at 181-2.

[140] To be sure, the ECJ's *Daily Mail* opinion (*The Queen v Treasury and Commissioners of Inland Revenue, ex parte Daily Mail and General Trust (Case 81/87)* [1988] ECR 5483), which allows Member States to impose an "export ban" on the firms incorporated under their respective law, is frequently still considered good law. S*ee e.g.* Bayerisches Oberstes Landgericht, February 11, 2004, 3 Z 175/03, 95 GMBH-RUNDSCHAU 490 (2004); Frank Woolridge, "Überseering: Freedom of Establishment of Companies Affirmed" 14 EUR. BUS. L. REV. 227, 231-2 (2003); Eva Micheler, *Case note,* 52 INT'L. & COMP. L.Q. 521, 524 (2003). *Cf.* Wulf-Henning Roth, *From Centros to Ueberseering, Free Movement of Companies, Private International Law and Community Law,* 52 INT'L. & COMP. L.Q. 177, 197 (2003) (stating that Member States will have to reconsider their position on "moving out" as well); Wolf-Georg Ringe, *Anmerkung,* 58 DER BETRIEB 2806, 2807 (2005) (arguing that Daily Mail is still good law in light of the ECJ's SEVIC judgment which dealt with an inbound case). However, following the *Lasteyrie du Saillant* opinion (*supra* note 135) there are good reasons to believe that this is no longer the case.

[141] *Cf.* Bebchuk, *supra* note 122, at 1470 (explaining that, with managerial veto power over reincorporations, moves enhancing shareholder value will not ensue if they hurt managers).

move will increase the total value of the firm by improving the position of creditors, but take away some value from shareholders, a reincorporation will not be implemented.[142]

As before, the crucial question is how well creditors are able to deal with the issue on their own, in particular by contracting for a "commitment clause" ex ante. Tort creditors are of course unable to adjust, although a reincorporation to escape tort claims will not be possible, given that the private international law of torts typically follows the *lex commissi delicti*.[143] With respect to claims against the corporation, tort creditors will in most cases be primarily interested in post-insolvency rules. However, reincorporation may sometimes be a way to escape veil piercing.[144]

Furthermore, typically "commitment clauses" or "acceleration clauses" will be stipulated only to the benefit of large adjusting creditors. Again, sophisticated creditors may cooperate with shareholders and managers to the detriment of less sophisticated ones, namely by agreeing to a reincorporation in a jurisdiction where e.g. tort creditors are treated badly, but creditors whose claims are collateralized are treated well.

Of course, Member States or the EC itself may provide for creditor protection tools in the event of a reincorporation (provided, in the former case, that they satisfy the

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[142] Of course, if lending is concentrated and negotiations can take place between creditors and managers or controlling shareholders, leaving aside the possibility of bargaining breakdowns, such a reincorporation may take place. Typically, sophisticated, adjusting creditors (such as the firm's main bank) will be able to stimulate the other groups to initiate one. However, the benefits of Coasian bargaining are limited, as it will probably be used only to the benefit of adjusting creditors. On the other side of the bargaining table, it seems also likely that only large shareholders and managers, but not the minority will be primary beneficiaries of the negotiations.

[143] A theoretical case where corporate law could become relevant would be the implementation of unlimited shareholder liability for corporate torts in at least one country, as famously proposed by Henry Hansmann & Reinier Kraakman, *Toward Unlimited Liability for Corporate Torts,* 100 YALE L. J. 1879 (1991). Shareholders would have an incentive to reincorporate if the firm is facing a mass tort claim.

[144] *Cf.* Gerald Spindler & Olaf Berner, *Gläubigerschutz im Gesellschaftsrecht nach Inspire Art,* 50 RECHT DER INTERNATIONALEN WIRTSCHAFT 7, 11 (2004); Horst Eidenmüller, *Gesellschaftsrecht*, in AUSLÄNDISCHE KAPITALGESELLSCHAFTEN IM DEUTSCHEN RECHT § 4, comments 21-26 (Horst Eidenmüller ed. 2004) (both arguing that the German doctrine of *Existenzvernichtungshaftung* [liability to creditors for endangering the corporation's existence] follows corporate law); Schall, *supra* note 8, at 1552 (suggesting that veil piercing is to be considered corporate law): Stefan Leible, *Rechts- und Geschäftsfähigkeit. Kaufmannseigenschaft,* in GRENZÜBERSCHREITENDE GESELLSCHAFTEN § 10, comment 25 (Heribert Hirte & Thomas Bücker eds. 2005) (stating that veil piercing claims for undercapitalization or commingling of assets are qualified as corporate law by German courts and authors); Amtsgericht Bad Segeberg, March 24, 2005, 17 C 289/04, 95 GMBH-RUNDSCHAU 884 (2005) (rejecting veil piercing claim for undercapitalization against an English private limited company for the reason that English law does not require private companies to have any capital); *see also* Bundesgerichtshof, March

Gebhard criteria).[145] Since a reincorporation is now possible (or soon will be) either through a cross-border merger or through the creation of a European Company, in both cases by merging the operating corporation into a wholly-owned shell corporation created in the reincorporation State,[146] it is in fact the case that national rules providing "an adequate system of protection of the interests of creditors" pursuant to Third Directive[147] apply to such transactions.[148] Hence, one may argue that all creditors are protected against the risk of opportunistic reincorporations. However, as argued above,[149] while sophisticated creditors do not need such system of protection, other creditors will normally be unable to take advantage of it, with the only possible exception of tort creditors.[150]

E. Conclusion. As we have seen, EC corporate law offers considerable leeway for regulatory arbitrage vis-à-vis creditors. On the positive side, regulatory competition is likely to remove mere slack such as minimum capital, from which creditors derive no actual benefit. However, the outcome with respect to rules creditors actually may have an interest in depends on whether creditors are able to adjust to differences in the creditor protection mechanisms of corporate law. For adjusting creditors, reincorporation and other types of moral hazard may be solved by covenants, but not necessarily for others, and certainly not for tort creditors. The position of large, sophisticated creditors who are able to adjust may actually be enhanced by regulatory arbitrage, to the detriment of non-adjusting groups of creditors.

Of course, the analysis of potential results of regulatory competition depends to a considerable degree on whether Member States actually have incentives to change their laws to *attract*, as Delaware does, (re)incorporations. About this, we remain skepti-

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13, 2005, II ZR 5/03, 60 JURISTENZEITUNG 848 (2005) (rejecting a claim against shareholders of an English company in analogy to the German rules about companies prior to registration).

145 See *supra* note 33 and corresponding text. *Cf.* Schall, *supra* note 8, at 1553 (suggesting that even German creditor protection mechanisms which are part of insolvency law cannot apply to UK companies in view of the freedom of establishment).

146 *See* Luca Enriques, *Silence Is Golden: The European Company As a Catalyst for Company Law Arbitrage*, 4 J. CORP. L. STUD. 77, 79-80 (2004).

147 See *supra* note 91 and corresponding text.

148 See Article 2, par. 2, Cross-Border Merger Directive; Article 24, Council Regulation (EC) No. 2157/2001 on the Statute for a European Company (SE), 2001 O.J. (L 294) 1.

149 See *supra* note 93-95 and corresponding text.

150 But see *supra* note 94.

cal.[151] Admittedly, the fact that the UK Companies House accepts financial statements drawn up under non-UK law for purposes of the legal filing requirement[152] may be taken as evidence that it is actively engaging in regulatory competition. However, other actors such as legislators and courts have a more important role in shaping future law, and it remains to be seen whether they will actively seek to attract foreign incorporations.

4. Post-insolvency rules and bankruptcy forum shopping

The increasing scope for regulatory arbitrage in corporate law that follows or will follow EC negative and positive harmonization initiatives raises the issue of how corporate law and insolvency law interact in situations where the two bodies of law to be applied are from different Member States. There are in fact strong complementarities between the two:[153] if companies were free to choose the applicable corporate law and insolvency law, rules "could be selected that best fit the needs of shareholders and managers but not necessarily those of creditors ('cherry picking')."[154] This is also true, albeit to a lower degree, if free choice is possible with regard to corporate law only: in this case, corporate decision-makers may choose the corporate law that in the event of insolvency provides the best combination with the relevant insolvency law from the point of view of managers and shareholders. If reincorporation is an available option, the prospect of a more favorable treatment in bankruptcy, irrelevant as it might have been at the incorporation stage, will become the main driver of reincorporation decisions for companies on the brink of insolvency.

This section enquires into the interactions between corporate and insolvency law within the EU, providing an introduction to the most relevant conflict of laws rules. We subsequently reflect upon the implications of bankruptcy forum shopping in Europe.

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[151] See Enriques, *supra* note 27, at 1266-73, and Gelter, *supra* note 52, at 259-64 (both providing arguments for the implausibility of a Delaware-like scenario within the EU).

[152] *Supra* note 118.

[153] *See* Wolfgang Schön, *supra* note 136, at 353-54.

[154] Eidenmüller, *supra* note 10, at 435.

4.1. Post-insolvency rules

In order to analyze the interactions between corporate law and bankruptcy law in the post-*Centros* world, we first sketch out the private international law framework for insolvencies within the EU. The central piece of legislation in this area is now the EIR, but attention will be given more specifically to two legal tools for creditor protection, that are particularly relevant for our analysis: fraudulent conveyance laws and equitable subordination. The former can act as a substitute to the legal capital doctrine where, like in the US, such doctrine has been vestigialized. Hence, to the extent that legal capital becomes less central in the EU as well, this tool may come to the foreground. The latter provides a good example of a corporate law doctrine that Member States may relatively easily relabel as an insolvency law tool.

A. Harmonization of conflict of laws rules in insolvency law: the European Insolvency Regulation in a nutshell. In sharp contrast with the US experience, where bankruptcy law is federal, insolvency law is still a matter of national law within the EU: no relevant substantive harmonization of EU insolvency rules has ever been adopted (nor attempted) at the EC level.[155] However, in 2000 the EIR was passed in order to enhance co-operation among jurisdictions in insolvency proceedings by harmonizing conflict of laws issues relating to insolvencies.

The EIR identifies the Member State(s) having jurisdiction to open insolvency proceedings, by introducing a distinction between main proceedings, that have a universal effect (at least within the EU), and secondary proceedings, that can be opened where the debtor has an establishment[156] and only extend their effects to assets situated in the territory of the establishment's Member State (Article 3); it identifies the law applicable to insolvency proceedings as the law of the State of the court opening the proceedings (Article 4) with a number of exceptions (Articles 5-15); it introduces the principle of mutual recognition of insolvency proceedings (Articles 16-26) and provides rules for

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[155] For an account of the few substantive harmonization measures in the insolvency law field *see* MIGUEL VIRGÓS & FRANCISCO GARCIMARTÍN, THE EUROPEAN INSOLVENCY REGULATION: LAW AND PRACTICE 9 (2004).

the co-ordination of main and secondary proceedings (Articles 27-38); it finally contains rules on information for creditors and on lodgment of their claims (Articles 39-42). What is of relevance here are rules determining the competent court(s) and, hence, the applicable insolvency law(s) and their scope.

In general, it can be said that, at least in the drafters' intention, the EIR displays a strong disfavor for regulatory competition in insolvency law. As recital (4) puts it, "it is necessary for the proper functioning of the internal market to avoid incentives for the parties to transfer assets or judicial proceedings from one Member State to another, seeking to obtain a more favorable legal position (forum shopping)." As we shall see, the regulatory framework is only partly consistent with such an objective. However, it is apparent that in case of doubt in the interpretation of the EIR, Recital (4) provides an important guideline against any interpretation favoring parties' free choice of the insolvency regime.

The core provisions in the EIR are Articles 3 and 4, on international jurisdiction and applicable law respectively. According to Article 3, jurisdiction for main proceedings is identified according to the "centre of a debtor's main interests" (COMI) criterion (par. 1), while secondary proceedings can be opened where the debtor has an establishment (par. 2). Under Article 4 "the law applicable to insolvency proceedings and their effects shall be that of the Member State within the territory of which such proceedings are opened" (*lex fori concursus*). Article 4, par. 2, provides a non-exhaustive list of matters included in the *lex fori concursus*, ranging from the conditions for the opening of the proceedings to the rules relating to the "voidness, voidability or unenforceability of legal acts detrimental to all the creditors."[157] Articles 5 to 15 contain a number of exceptions to the *lex fori concursus*, such as those concerning third parties' rights in rem and contracts of employment, including an important qualification with regard to detrimental acts.[158]

Despite COMI's key role in determining jurisdiction and in solving conflict of

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[156] Article 2(h) defines an establishment as "any place of operations where the debtor carries out a non-transitory economic activity with human means and goods." On this notion *see e.g.* VIRGÓS & GARCIMARTÍN, *supra* note 155, at 158-62.
[157] On the latter see *infra* section B.
[158] See *infra* section B.

laws issues in insolvency, there is surprisingly no definition of COMI in the text of the Regulation. What we do have is a rebuttable presumption that for companies and legal persons "the place of the registered office shall be presumed to be the centre of its main interests in the absence of proof to the contrary." The rationale for this presumption is that a corporation's head office is usually situated where the corporation has its registered office.[159] It is by no means evidence of the lawmakers' willingness to favor debtor's choice in insolvency matters.[160]

A definition of COMI can however be found in the preamble to the Regulation, where it is stated that "[t]he 'centre of main interests' should correspond to the place where the debtor conducts the administration of his interests on a regular basis and is therefore ascertainable by third parties" (Recital (13)),[161] whereby legal scholars and courts across the EU agree that what counts is where the "head office functions are carried out" on a regular basis rather than where the head office is located.[162]

A thorough investigation into the meaning of COMI is unnecessary here. Suffice it to say that, despite the emphasis in the Preamble and in commentaries to the EIR on the fact that "transparency and objective ascertainability are dominant factors" in determining COMI,[163] it is out of question that COMI is a highly ambiguous and manipulative concept, which requires subjective and fact-intensive evaluations by judges.[164] As

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[159] *See e.g.* Miguel Virgós & Etienne Schmit, *Report on the Convention on Insolvency Proceedings*, para. 75 (reprinted in THE EC REGULATION ON INSOLVENCY PROCEEDINGS: A COMMENTARY AND ANNOTATED GUIDE (GABRIEL MOSS, IAN F. FLETCHER & STUART ISAACS EDS.) 263 (2002) (hereinafter: COMMENTARY); VIRGÓS & GARCIMARTÍN, *supra* note 155, at 44.

[160] *But see* Armour, *supra* note 8, 407-08 (arguing that the presumption created by Article 3(1) should be "a strong one").

[161] According to VIRGÓS & GARCIMARTÍN, *supra* note 155, at 39-40, for various reasons this definition has "the same value as the definitions contained in Article 2."

[162] *See* COMMENTARY, *supra* note 159, at 169. *See also Daisytek I.S.A. Ltd.* [2003] BCC 562; *MG Rover Ireland Ltd. et al.* [2005] BWHC 874 (CHAN); Tribunale di Roma, 26 November 2003 (*Cirio Holding Luxembourg S.A.*), 2004 RIVISTA DI DIRITTO INTERNAZIONALE PRIVATO E PROCESSUALE 691; Opinion of Advocate General Jacobs on 27 September 2005, Case C-341/094, *Eurofood IFSC Ltd*, recital 111-12.

[163] COMMENTARY, *supra* note 159, at 39; *cf.* Amtsgericht München, May 4, 2004, 1501 IE 1276/04, 25 ZEITSCHRIFT FÜR WIRTSCHAFTSRECHT UND INSOLVENZPRAXIS 962 (2004).

[164] *See e.g.* Sefa M. Franken, *Three Principles of Transnational Corporate Bankruptcy Law: A Review,* 11 EUR. L. J. 232, 249-53 (2005) (COMI is "a highly manipulative concept, especially by debtors," that leaves "ample discretion for creative judicial interpretation"); Eidenmüller, *supra* note 10, at 428 (highlighting "the fuzziness of the COMI standard"); Bob Wessels, *The European Union Insolvency Regulation: An Overview With Trans-Atlantic Elaborations*, 2003 NORTON ANN. SURV. BANKR. L. 481, (highlighting that decisions on COMI are "fact intensive"); *MG Rover Ireland Ltd. et al.*, *supra* note 162

a consequence, not only insolvent companies with international operations, but also their creditors are able, to some degree, to select the forum (and hence the law) of their choice. This is especially true with regard to subsidiaries within a group of companies: as a number of precedents already show, it is easy both for the court of the place where the subsidiary has its administration (and registered seat) and for the court of the place where the parent has its COMI to claim jurisdiction over the subsidiary's insolvency.[165]

Since it is with regard to the filing time that COMI has to be determined,[166] debtors may shop for a friendlier insolvency law also by switching COMI in the proximity of insolvency. Of course, the switch of COMI immediately prior to the filing will not pass the test of continuity that is implied in the term "on a regular basis."[167] However, for switches taking place with some anticipation, it might be difficult not to recognize the new COMI, provided that the longer the time lag between the switch and the filing, the more difficult to resort to general abuse or fraud exceptions[168] to disregard it.

Incentives for forum shopping also derive from EIR's solution to the problem of conflicting decisions on the opening of main proceedings: based on the idea of mutual trust between EU courts, the criterion is purely temporal. Once a main proceeding has

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(citing an unreported opinion by Judge Langan, Q.C. where the decision on COMI is called "a fact sensitive" one); Federico Maria Mucciarelli, *The Transfer of the Registered Office and Forum Shopping in International Insolvency Cases: an Important Decision from Italy,* 2 EUR. COMP. & FIN. L. REV. 512, 525 (2005); Marc-Phillipe Weller, *Gläubigerinteressen bei internationalen Konzerninsolvenzen,* 169 ZEITSCHRIFT FÜR HANDELS- UND WIRTSCHAFTSRECHT 570, 578-583 (2005) (both giving an overview of the variety of locations courts have considered the COMI of an insolvent corporation).

[165] For a survey of the relevant cases *see e.g.* Bob Wessels, International Jurisdiction to Open Insolvency Proceedings in Europe, in Particular Against (Groups of) Companies 8 & 16-23 (*at* http://www.iiiglobal.org/country/european_union/InternJurisdictionCompanies.pdf). *See also* Franken, *supra* note 164, at 250-53.

[166] Incidentally, this creates an internal inconsistency in the EIR. If it is true that the perspective from which to determine where the COMI is located should be the one of *potential* creditors (*see* VIRGÓS & GARCIMARTÍN, *supra* note 155, at 42), then by identifying COMI with respect to potential creditors' hypothetical determinations at the time of filing, in the case of a switch of COMI, the court will necessarily have to disregard any prior determination about COMI by creditors predating the switch. Of course, one may reason that existing creditors who failed to contract for a covenant preventing switches of COMI did accept the risk of such a switch and hence can be disregarded in determining COMI. This sounds like a fairly groundless assumption with regard to unsophisticated creditors, however.

[167] *See* VIRGÓS & GARCIMARTÍN, *supra* note 155, at 41 & 50. *See also* Susanne Staubitz-Schreiber, (Case C-1/04) [2006] E.C.R. ### (finding that the Member State where a request to open insolvency proceedings is filed retains jurisdiction even if the debtor moves COMI to another Member State subsequently).

been opened by a court, other courts have to defer to that decision,[169] with the only limit of the public policy exception (Article 26).[170] Since courts have a tendency to recognize their own jurisdiction on insolvency proceedings, if only to protect local creditors' interests,[171] this temporal criterion implies that debtors and creditors may engage in a race to file in order to place the case before a given (and supposedly friendlier) court and hence to obtain the most convenient applicable law.[172]

To the extent that the EIR leaves some scope for regulatory arbitrage in insolvency law, it is worth dealing briefly with the scope of the *lex fori concursus* as a useful introduction to the discussion in section 4.2 on whether "relabeling" corporate law rules as insolvency law rules can be a viable strategy for Member States. Without going into the details of the matters mentioned in Article 4 and of the carve-outs in Articles 5 to 15, it is again in the Preamble that we find a general criterion to determine what issues are covered by the *lex fori concursus*. Recital (6) provides that "[i]n accordance with the principle of proportionality this Regulation should be confined to provisions governing jurisdiction for opening insolvency proceedings and *judgments which are delivered directly on the basis of the insolvency proceedings and are closely connected with such proceedings*."[173] This criterion (judgments directly based on insolvency proceedings and closely connected to them) is clearly reminiscent of the ECJ case law regarding the

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[168] *Cf.*Id., at 51; Massimo V. Benedettelli, *"Centro degli interessi principali" del debitore e forum shopping nella disciplina comunitaria delle procedure di insolvenza transfrontaliera*, 2004 RIVISTA DI DIRITTO INTERNAZIONALE PRIVATO E PROCESSUALE 498, 529.

[169] *See e.g.* Bob Wessels, *supra* note 164, at 503 n.39.

[170] *See Re Eurofood IFSC Ltd.*, Irish Supreme Court, [2004] IESC 45 (27 July 2004) (deferring to the ECJ, among others, the question of whether Irish courts may refuse recognition to a Parma Court's decision taken after failure to grant the temporary administrator of an Irish company the right of fair hearing before it).

[171] *See e.g.* Frederick Tung, *Is International Bankruptcy Possible?*, 23 MICH. J. INT'L L. 31, 82-83 (2001); Weller, *supra* note 164, at 581 (referring to the Member State courts' conduct so faras "mutual 'insolvency imperialism'" ["wechselseitiger 'Insolvenzimperialismus'"]). *See also* Lynn M. LoPucki, *Universalism Unravels*, 79 AM. BANKR. L.J. 143, 148 & 150 (2005) (in the EU courts tend to claim to have jurisdiction even when they clearly do not). See however Tribunale di Rimini, 6 April 2004 (*In Re Giacomelli Sport Groups s.p.a. in amministrazione straordinaria and Giacomelli Sport España S.A.*), 2005 GIURISPRUDENZA ITALIANA 1199 (denying to have jurisdiction over a Spanish subsidiary of a failed Italian corporation).

[172] Even more so, if the ECJ follows Advocate General Jacobs' Opinion in the *Eurofood* case. According to AG Jacobs, a proceeding may be held to be opened, if the relevant national legislation so provides, at the date of filing (see Opinion of Advocate General Jacobs (*Eurofood IFSC Ltd*), *supra* note 162, recitals 89-94).

[173] Emphasis added.

Brussels Convention (now Regulation) on civil jurisdiction[174] and more precisely on the scope of its Article 1(2)(b), that declares the Convention (and now the Regulation) not applicable to bankruptcy. The case law on the Convention had in fact clarified that such provision extends to all actions deriving directly from the bankruptcy proceeding (i.e., whose outcome depends upon insolvency law)[175] *and* closely connected to it (from a procedural point of view).[176] In *Gourdain v Nadler*,[177] the ECJ concluded that the French *action en comblement du passif* is part of bankruptcy law[178] after conducting an autonomous characterization of the relevant French provisions and giving of course no weight to the "label" of the relevant provisions, i.e. whether they were located in French insolvency statutes or elsewhere.[179] The Court gave weight instead to the following facts: (1) the only competent court was the insolvency court; (2) only the liquidator could bring suit; (3) the rules on the burden of proof derogated from the general ones under the law of liability; (4) the statute of limitation was linked to a certain stage of the insolvency proceeding; (5) if the action succeeded, it would be the general body of creditors that would benefit; (6) managers could be declared insolvent in case they did not discharge their liabilities toward the creditors without inquiring into whether the relevant requisites for their declaration of insolvency existed.[180]

B. Fraudulent conveyance. All EU jurisdictions have rules against fraudulent conveyance (or fraudulent transfers) and "preferences" of certain creditors permitting recovery of funds from the recipients of such conveyances.[181]

Similarly, all US states enacted either the older Uniform Fraudulent Conveyances Act or the newer Uniform Fraudulent Transfers Act, and the federal Bankruptcy Code includes an equivalent statute on transfers[182] and another one on preferences.[183] Those statutes cover transactions in which the debtor did not receive "reasonably equivalent

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[174] Council Regulation 2001/44/EC of 22 December 2000, on jurisdiction and the recognition and enforcement of judgements in civil and commercial matters, 2001 O.J. (L 11) 50.

[175] *See* VIRGÓS & GARCIMARTÍN, *supra* note 155, at 61.

[176] *See Id*.

[177] The legal basis for this type of lawsuit is C. COM. art. L 624-3.

[178] *See Gourdain v Nadler*, Case 133/78, [1979] ECR 733.

[179] *Id*., recital 3. *Cf.* VIRGÓS & GARCIMARTÍN, *supra* note 155, at 61.

[180] See *Gourdain v Nadler*, *supra* note 178, recital 5.

[181] VIRGÓS & GARCIMARTÍN, *supra* note 155, at 134.

[182] 11 U.S.C. § 548.

value of exchange" and "for which the remaining assets of the debtor were unreasonably small in relation to the business or transaction."[184] The provision is interpreted widely to include also dividends and share repurchases.[185] Since the applicable fraudulent transfer law does not depend on the corporation's state of incorporation,[186] they are not subject to regulatory competition (between different corporate law regimes) in the US.[187] In theory, fraudulent transfers would be in the position to take the function of provisions on legal capital limiting dividends in Europe[188] and of the "concealed distributions" doctrines used in some countries.

EIR does not apply to statutes on conveyances and preferences outside bankruptcy. In that context, the only restraint on Member States is primary EC law.[189] However, any rule of this kind is superseded by the EIR once the corporation enters into bankruptcy, meaning that any conflict of laws rules applied by Member States outside bankruptcy will be of very limited significance. Under the EIR, as a general rule the law of the state opening insolvency proceedings determines "the rules relating to the void-

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[183] 11 U.S.C. § 547.

[184] Uniform Fraudulent Transfer Act, s 4(a)(2)(i).

[185] CLARK, *supra* note 121, at 88–90 (discussing dividends); Marcel Kahan, *Legal Capital Rules and the Structure of Corporate Law: Some Observations on the Differences Between European and U.S. Approaches,* in CAPITAL MARKETS AND COMPANY LAW 145, 146 (Klaus J. Hopt & Eddy Wymmeersch eds. 2003) (discussing both dividends and share repurchases). *See e.g. Wells Fargo Bank v Desert View Building Supplies*, 475 F. SUPP. 693 (D Nev 1978); *United States v. Gleneagles Inv. Co.*,565 F. SUPP. 556 (M.D. Pa. 1983); *In re Jenkins Landscaping and Excavating, Inc*, 93 B.R. 84 (W.D. Va. 1988); *In Re Dondi Financial Corp*, 119 B.R. 106 (Bkrtcy., N.D. Tex. 1990).

[186] Kahan, *supra* note 185, at 148.

[187] *Id.*; Gelter, *supra* note 52, at 281.

[188] *See e.g. LBO Mellon Bank v. Metro Communications, Inc.*, 945 F.2d 635 (3d Cir. 1991) (discussing the "reasonable equivalent value" requirement in the context of an LBO).

[189] For example, the respective German statute, § 19 AnfG states that a legal act will be evaluated under the law applying to its effects (*Wirkungsstatut* or *lex causae*). Apparently, the majority opinion in Germany interprets this as the law governing the contract, or, in the more important case where a creditor seeks to rescind a transfer of title, the *lex rei sitae,* i.e. the location of the property in question. Ulrich Huber, *Das für die anfechtbare Rechtshandlung maßgebende Recht,* in FESTSCHRIFT FÜR ANDREAS HELDRICH 695, 701 (Stephan Lorenzet al eds., 2005) (summarizing and criticizing the prevailing opinion). Similarly, Austrian courts have subjected conveyances to Austrian law if the property in question was located in Austria. OGH 23.5.1984, 3 Ob 507/84, 27 ZEITSCHRIFT FÜR RECHTSVERGLEICHUNG 290 (1986) (Austria); For Italy *cf.* Cass. 7 May 2003, No. 6899, 2004 RIVISTA DI DIRITTO INTERNAZIONALE PRIVATO E PROCESSUALE 635, 640-644 (Italy)) (finding that Italian judges have jurisdiction on a fraudulent conveyance action on the basis of the *lex contractus*). For France *see* YVON LOUSSOUARN, PIERRE BOUREL & PASCAL DE VAREILLES-SOMMIÈRES, DROIT INTERNATIONAL PRIVÉ 514 (8th ed., 2004) (concurring in the scholarly opinion that *lex contractus* applies to *actio pauliana*).

ness, voidability or unenforceability of legal acts detrimental to all the creditors."[190] The EIR, however, also provides for an important exception to this rule, which may even allow for some "separate" forum shopping concerning preferences. The general rule does not in fact apply when the person benefiting from the act proves that (a) the "act is subject to the law of a Member State other than that of the state opening proceedings," and (b) "that law does not allow any means of challenging that act in the relevant case.[191] As a result, the more lenient of the two provisions always applies if the beneficiary satisfies the burden of proof.[192] The crucial question is, of course, which country's law applies to the relevant act. The literature generally seems to imply that the law applicable to the transaction under the conventional rules of private international law of contract applies.[193] This may allow the parties entering into a contract to choose a relatively lenient fraudulent transfers regime independently from where insolvency proceedings are carried out, most obviously by a choice of law clause.[194]

In light of this, conveyances will take part in "general" forum shopping and regulatory competition for insolvency law, if there is any. Article 13, to conclude, leaves open some limited scope for forum shopping independent from bankruptcy.

C. Subordination. Several European jurisdictions have statutes or doctrines, under which loans given by shareholders to the corporation under certain circumstances are subordinated to other debt in bankruptcy. The economic rationale for such doctrines is that risk enhancement resulting from the continued operation of the firm is detrimental to third-party creditors, since the proceeds available in liquidation will typically be

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[190] Art. 4(2)(m), EIR. The German and French versions of the text lend themselves to the conclusion that it need not be shown that each individual creditor was harmed, but that the language actually means the general body of creditors. Gabriel Moss & Tom Smith, *Commentary on Council Regulation 1346/2000 on Insolvency Proceedings, in* COMMENTARY, *supra* note 159, at 155, comment 8.80.

[191] *See also* InsO (Germany) § 339.

[192] Sebastian Zeeck, *Die Anknüpfung der Insolvenzanfechtung,* 2005 ZEITSCHRIFT FÜR DAS GESAMTE INSOLVENZRECHT 281, 287.

[193] *See e.g.* Stuart Isaacs, Felicity Toube, Nick Segal & Jennifer Marshal, *The Effect of the Regulation of Cross-Border Security and Quasi-security*, *in* COMMENTARY, *supra* note 159, at 91, comment 6.132; Henriette-Christine Duursma-Kepplinger, *Artikel 13*, *in* EUROPÄISCHE INSOLVENZVERORDNUNG, comment 16 (Henriette-Christine Duursma-Kepplinger, Dieter Duursma & Ernst Chalupsky eds., 2002); Zeeck, *supra* note 192, at 286.

[194] Michael Bogdan, *in* COMMENTARY, *supra* note 159, at 91, comment 8.127. To be sure, at least in some cases, courts might consider this kind of transaction planning fraudulent or abusive. *See* Duursma-Kepplinger, *supra* note 193, comment 16; Huber, *supra* note 189, at 711.

lower if the firm continues to operate because of the loan. On the other side, shareholders will capture most of the benefits of continued operations, since a successful turnaround of the business will result in increased shareholder wealth, while the gains creditors can make are typically only minute.[195]

The best known example is the German *Kapitalersatzrecht*, which covers not only loans given in times of crisis (i.e. not necessarily insolvency, but under circumstances where only shareholders would have extended a loan), but also loans not withdrawn at the onset of a crisis.[196] Similar doctrines exist in Austria[197], Italy[198], Slovenia[199] and other countries.[200] Similarly, US courts developed the doctrine of *equitable subordination*,[201] which found statutory recognition in § 510(c) of the Bankruptcy Code of

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[195] *See generally* Andreas Engert, *Die ökonomische Begründung der Grundsätze ordnungsgemäßer Unternehmensfinanzierung,* 33 ZEITSCHRIFT FÜR UNTERNEHMENS- UND GESELLSCHAFTSRECHT 813 (2004); Martin Gelter, *The Subordination of Shareholder Loans in Bankruptcy,* HARVARD OLIN FELLOWS' DISCUSSION PAPER NO. 4 (2005), *at* http://ssrn.com/abstract=654222 (formally showing differences between the efficiency objective and the incentive effects of subordination).

[196] *Kapitalersatzrecht* was originally developed by the courts. *See* RG 16.11.1937, JW 1938, 862; RG 3.12.1938, JW 1939, 355; RG 22.10.1938, RGZ 158, 302; RG 13.1.1941, RGZ 166, 51. BGH 14.12.1959, II ZR 187/57, BGHZ 31, 258. The doctrine was codified in 1980 (§§ 32a, 32b GmbHG), but the courts continued to apply the principles they had developed in parallel with the statutory rules (BGH 26.3.1984, II ZR 14/84, BGHZ 90, 370). For a historical overview, *see* Hans-Georg Koppensteiner, *Kritik des „Eigenkapitalersatzrechts"*, 43 DIE AKTIENGESELLSCHAFT 308, 308-09 (1998); GERHARD SCHUMMER, DAS EIGENKAPITALERSATZRECHT. NOTWENDIGES RECHTSINSTITUT ODER IRRWEG? 7-81 (1998).

[197] Bundesgesetz über Eigenkapital ersetzende Gesellschafterleistungen (Eigenkapitalersatz-Gesetz – EKEG), Art. I Gesellschafts- und Insolvenzrechtsänderungsgesetz 2003 – GIRÄG 2003, BGBl I 2003/92.

[198] *See* Cass. civ., 3 Dec. 1980, n. 6315, 8 GIURISPRUDENZA COMMERCIALE II/895 (1981); Trib. Milano, 5 Dec. 1988, 88 RIVISTA DI DIRITTO COMMERCIALE II/75 (1990); Trib. Milano, 25 Mar..1993, 1993 SOCIETÀ 534; Trib. Treviso, 18 Dec. 2001, 55 BANCA, BORSA, TITOLI DI CREDITO II/723 (2002); Trib. Milano, 28 giugno 2001, 55 BANCA, BORSA, TITOLI DI CREDITO 723 (2002); *Cf. also* Cass. civ. 19 Mar. 1996, n. 2314, 1996 SOCIETÀ 1267; *See now* C.C. Articles 2467 and 2497-*quinquies*, as introduced by Legislative Decree No. 6 of January 17, 2003, GAZZ. UFF. No. 17, Supplemento Ordinario. For an overview, *see* Giovanni Tantini, *I versamenti dei soci alla società*, *in* 1/3 TRATTATO DELLE SOCIETÀ PER AZIONI 743, 795-800 (Giovanni E. Colombo & Giuseppe B. Portale eds. 2004).

[199] Zakon o gospodarskih družbah, §§ 433, 434. *See* Markus Bruckmüller, *Eigenkapitalersatz in Slowenien,* in EIGENKAPITALERSATZ IM ÖSTERREICHISCHEN, ITALIENISCHEN UND SLOWENISCHEN RECHT 69 (Susanne Kalss & Friedrich Rüffler eds. 2004).

[200] *Cf.* Pietro Abbadessa, *Il problema dei prestiti dei soci nelle società di capitali: una proposta di soluzione,* 15 GIURISPRUDENZA COMMERCIALE I/497, I/503 (1988) (discussing Belgian and Portuguese law).

[201] Taylor v. Standard Gas and Electric Co. (Deep Rock), 306 U.S. 307 (1939); Pepper v. Litton, 308 U.S. 295 (1939).

1978,[202] and the more recent *recharacterization* doctrine.[203] Other than the German doctrine, which prohibits repayments while the corporation remains not "creditworthy", the American doctrines applies only in bankruptcy. However, the crucial point for issues of regulatory competition is that the doctrine, as part of the bankruptcy code, does not share in regulatory competition for corporate law.

4.2. Forum shopping for insolvency law

It is sometimes suggested that EU bankruptcy law, as it implements a uniform system of conflict of laws rules not quite unlike the real seat theory. The EIR, at first glance, seems to imply that a specific COMI can be determined for each individual firm. However, the practical experience with the Regulation during its first years lends itself to a partly different conclusion. For firms active in one country only, COMI is unambiguous, leaving no option for forum shopping as far as different insolvency law regimes are concerned. By contrast, firms with operations in different countries, and above all international groups, have leeway to engineer insolvency proceedings in one of the countries in question. Since, unlike in the US, the substantive rules of bankruptcy are not a matter of federal law in Europe, one might even speculate whether the result will not be mere "forum shopping", but actual regulatory competition, which implies states adapting their law to attract insolvency filings.

There is little doubt that forum shopping has potential benefits. In the US, while bankruptcy law is federal law, courts have some discretion in the application of procedural and substantive rules. Proponents argue that forum shopping has enabled bankrupt firms to choose venues where judges are predictable, fast, and competent in handling the reorganization of large firms. In other words, incumbent managers may have been able to choose the forum maximizing the total value of the reorganized firm (typically the New York and Delaware courts).[204] Ex post value maximization may in some cases harm creditors to the benefit of other interest groups (such as shareholders and employ-

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[202] 11 U.S.C. § 510(c).

[203] *E.g.* In re Cold Harbor, 204 B.R. 904 (Bankr. E.D. Va. 1997); In re Fett Roofing & Sheet Metal Co., Inc., 438 F.Supp. 726 (E.D.Va.1997); In re Autostyle Plastics, Inc., 269 F.3d 726 (6th Cir. 2001). *See* David A. Skeel, Jr., *Recharacterization and the Nonhindrance of Creditors* (IN THIS ISSUE).

ees benefiting from continued operations), which is efficient if the benefits to those groups exceed the harm to creditors. Potential harm to creditors – because of the evasion of creditor protection mechanisms – therefore needs to be weighed against the benefits of ex post maximization.

Likewise, gains from regulatory arbitrage can be made by shopping between different European bankruptcy regimes. The possibility of secondary insolvency proceedings concerning the debtor's assets in another state mitigates these gains, but does not eliminate them. In some cases, secondary procedures will not be an option. First, the debtor needs to have an establishment in the country where secondary proceedings are to take place [EIR article 3(2)]. Second, proceedings will typically not be opened where the very limited assets in the relevant State are unlikely to cover costs.[205] Third, secondary proceedings will always result in the liquidation of assets, meaning that it will matter a lot to creditors in which country a reorganization procedure is initiated.[206] Furthermore, the law of the Member State will typically apply to certain procedures relating to insolvency, such as the claims against directors.[207] The particular powers of the liquidator of the main proceedings and the obligation to transfer any remaining assets to him may also make a difference.[208] Finally, as a practical matter, the "race to file" is a reality, as illustrated the Eurofood case illustrates.[209]

In the subsequent analysis, we look exclusively at the possibility of harm to creditors resulting from forum shopping. We first describe the commitment problem resulting from COMI and point out some important differences from forum shopping for bankruptcy law in the US (section A). We analyze who may act as "case placers", and what consequences this may entail (B). Finally we speculate whether States will have any incentive to attract insolvencies (C).

A. Basic structure. There are of course a number of notable differences between

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[204] *See* Cole, *supra* note 5*,* at 1859-76; Ayotte & Skeel, *supra* note 5.

[205] *E.g.* § 26 (German) Insolvenzordnung.

[206] EIR Article 27, referring to annex B.

[207] Marc-Phillipe Weller, *Forum Shopping im Internationalen Insolvenzrecht,* 24 PRAXIS DES INTERNATIONALEN PRIVAT- UND VERFAHRENSRECHTS 412, 415 (2004);. *See* below notes 232-236 and accompanying text.

[208] *See* EIR Articles 29, 33, 35.

[209] *Infra* note 216

insolvency and corporate law arbitrage. To begin with, the decision about the applicable legal regime is not taken at the stage of incorporation, but when insolvency proceedings are to be initiated. This compares to the situation described in section 3.2, with the crucial difference that the borrower is unable to commit to a particular legal system. In fact, other than by avoiding transnational activity that may result in an "unexpected" COMI altogether, firms cannot commit to insolvency proceedings in a particular jurisdiction to their creditors. The possibility of ex post forum shopping obviously reduces ex ante predictability for creditors and therefore increases the agency cost of debt.[210] However, only a limited number of jurisdictions will be within the set of available options; even though an outsider may not be able to determine COMI ex ante and managers have some opportunity to manipulate it,[211] sophisticated creditors may be able to narrow down the available options. To be sure, predictability may not be perfect, as the approach taken by English courts to COMI highlights: their decisions on COMI have been criticized as being hard to predict by outsiders.[212]

Second, the choice of law decision is not necessarily taken by the insolvent corporation. A striking difference from the US, where involuntary bankruptcies are rare,[213] lies in the persons who petition for bankruptcy proceedings (the "case placers"). Bankruptcy systems can be characterized as either" "manager-driven" or "manager-displacing." The US is the paradigmatic example of a manager-driven system, with executives having powerful incentives to file for chapter 11, which allows them to attempt a turnaround of the corporation while staying in charge. By contrast, European bankruptcy proceedings, including the British ones, are manager-displacing, as the corpora-

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[210] Franken, *supra* note 164, at 236.

[211] Horst Eidenmüller, *supra* note 10, at 427-428.

[212] *See e.g.* Franken, *supra* note 164, at 248-254. This lack of predictability is the reason why several authors have suggested that *ex ante* free choice should be adopted, which would both allow firms to choose the regime most appropriate to their governance structure and to commit to a particular regime that can be ascertained by creditors (Robert K. Rasmussen, *A New Approach to Transnational Insolvencies,* 19 MICH. J. INT'L L. 1 (1997); Robert K. Rasmussen & Randall S. Thomas, *Timing Matters: Promoting Forum Shopping by Insolvent Corporations,* 94 NW. U. L. REV. 1357 (2000); Franken, *id.* at 242-246) or that the bankruptcy forum should be "bundled" with corporate law (Eidenmüller, *supra* note 10, at 438-440; Armour, *supra* note 8, at 407-08).

[213] *See* Gerard Hertig & Hideki Kanda, Creditor Protection, in in THE ANATOMY OF CORPORATE LAW, *supra* note 112, 71, 74 n16.

tion is typically liquidated or sold piecemeal by an administrator.[214] Directors are not rewarded with the "carrot" of prolonged control over the corporation, but threatened with the "stick" of liability in the case of a late filing. However, it appears that this stick does not work effectively, as the case placers are usually creditors.[215]

B. Conflicts of interest on the demand side. Let us consider what happens when a corporation approaching insolvency could make a case for COMI in jurisdictions A and B. Assume both systems are manager-displacing. Managers will fear displacement and usually delay bankruptcy filings as long as possible. If creditors are a homogeneous group, they will submit a petition for bankruptcy in the jurisdiction maximizing the expected value accruing to creditors, which is not necessarily the jurisdiction maximizing total value (which might be a Member State offering a particularly effective reorganization proceeding).

If creditors are heterogeneous, and the law of jurisdiction A is favorable to group 1 (e.g. secured lenders), while jurisdiction B is favorable to group 2 (e.g. unsecured lenders, or employees),[216] a race to file between creditors may develop.[217] Its outcome may depend on pure chance, but also on different prerequisites for bankruptcy in different jurisdictions[218] or even on the procedural rules and safeguards for the debtor's right

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[214] *See* John Armour, Brian R. Cheffins & David A. Skeel, *Corporate Ownership Structure and the Evolution of Bankruptcy Law: Lessons from the United Kingdom,* 55 VAND. L. REV. 1699, 1723-1730 (2002).

[215] The reason may be that managers overestimate their chances to accomplish a turnaround and avoid bankruptcy, or that they fear a "hindsight bias" on the part of courts, who will find them liable to creditors even if they filed for bankruptcy when they were legally obliged to.

[216] *In Re MG Rover Espana S.A. et al.,* High Court of Birmingham, May 11, 2005, recital 8 (noting that "in striking the balance between the interests of employees on the one hand and the interests of finance and trade creditors on the other, English insolvency law treats the claims of employees less favourably than the law of other Member States"). Similarly, in the *Eurofood* case (*supra* note 170) currently pending before the ECJ, Bank of America tried to place the case in Ireland, apparently to avoid ending up in Parma under an insolvency law that is clearly much more favourable to unsecured creditors than to secured ones, due to the broader scope of the Italian law on preferences, and that might harm Bank of America's interests in light of the possibility of consolidating the procedures relating to the various group entities into one.

[217] The difference between the two groups may stem from securitization, but also from a preference for a specific location, as involvement in insolvency proceedings in a faraway country may be costly.

[218] In some jurisdictions, bankruptcy can only be declared after finding that the corporation is unable to pay debts as they become due. *See* Code de Commerce Art. L. 621-1 C (France); Article 5, par. 2, Royal Decree 16 March 1942, No. 267 (Italy); Fallissementswet Art. 1 (Netherlands); KRR Art. 21(1) (Poland); Ley 22/2003 de 9 julio, Concursal, Art. 2 (Spain); Konkurslag § 2 (Sweden). By contrast, the insolvency laws of other countries include overindebtedness as an additional, alternative criterion for lim-

to a fair hearing.[219] If one jurisdiction allows a petition for (involuntary) bankruptcy earlier than the other, the group of creditors favored by this jurisdiction will prevail.

The prospect of forum shopping by creditors may create an incentive for managers to file for bankruptcy. If jurisdiction A favors creditors and jurisdiction B favors managers and shareholders (e.g. because rules on directors' liability and veil piercing are lenient), the latter may have an incentive to file in B before creditors file in A, using their information advantage. Again, the group favored by the jurisdiction allowing the earlier onset of bankruptcy proceedings will win. Note that the costs of managers will be not only monetary, but also include the stigma of having run the corporation into bankruptcy. This may mean that managers will sometimes still delay bankruptcy, even though the bankruptcy proceedings of jurisdiction B favor them in purely financial terms. Also, creditors will often prefer bankruptcy proceedings in the state of their own residence or closer to it and consider bankruptcy proceedings abroad more costly.[220] However, in many cases, it will be possible to solve this problem by opening secondary insolvency proceedings.[221]

Generally, there are still good reasons to believe that managers/shareholders will usually beat creditors in the race to file. As insiders, they possess a considerable information advantage allowing them to assess whether the corporation is eligible for bankruptcy and possibly to win the race for filing because creditors do not know yet that illiquidity is impending. Furthermore, they will know better than creditors in which countries a good case for COMI can be made, and what options are available. Rational man-

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ited liability associations only. In its most basic form, it is fulfilled when total debt exceeds total assets. *See* Konkursordnung § 67 KO (Austria); Insolvenzordnung § 19 (Germany); Law No 7/2005 § 3 (Slovakia); Zakon o finančnem poslovanju podjetij, Nr. 54/1999 §§ 12, 13 (Slovenia). Needless to say, the interpretation of the criterion varies among jurisdictions.

[219] This is also an area where Member States can be creative in anticipating the date of an insolvency proceeding's opening. See *supra* note 172.

[220] This was probably the issue in a recent case of a conflict of competence between Czech and a German courts, where Czech creditors submitted a petition for bankruptcy in Prague, while the debtor, an unincorporated German entrepreneur, filed for bankruptcy in Hamburg. City Court of Prague, April 26, 2005, 78 K 6/05-127, 26 ZEITSCHRIFT FÜR WIRTSCHAFTSRECHT UND INSOLVENZPRAXIS 1431 (2005); Landgericht Hamburg, August 18, 2005, 326 T 34/05, 26 ZEITSCHRIFT FÜR WIRTSCHAFTSRECHT UND INSOLVENZPRAXIS 1697 (2005).

[221] *Cf.* Franken, *supra* note 164, at 255 ("if creditors of an establishment located in another Member Sates have statutory priority rights that do not have equivalents under the home-country law, they can protect their priority position by filing for a secondary bankruptcy proceeding").

agers with sophisticated counsel should be able to use forum shopping opportunities to their advantage. However, to some extent it probably depends on who the particular creditors are whether insiders will prevail in the way described. If the corporation is tightly supervised by a financial institution, the advantage may be close to non-existent. There are also reasons to believe that certain groups of creditors will typically win over other groups in a "race." In many cases, sophisticated, secured creditors will be better informed both about the financial situation of the debtor and about forum shopping opportunities. They may even enter coalitions with managers to the detriment of non-adjusting creditors.

Most likely, forum shopping will be to the detriment of tort creditors, who are unable to adjust their claims. A firm might reincorporate, with the assent of large lenders protected by an acceleration clause, to a jurisdiction where the position of tort creditors is particularly bad, and establish a COMI there on the basis of the presumption in Article 3 of EIR.

Note that a slight slant in favor of management may not necessarily be detrimental in principle. Besides management, there may be other stakeholders with an interest in keeping the corporation going, such as employees whose human capital is to some degree tied up in the firm and not protected by complete contracting. To be sure, Lynn LoPucki, the leading academic critic of bankruptcy forum shopping in the US, argues that forum shopping has hurt the bankruptcy system by allowing bad management to stay in office and letting many pre-packaged bankruptcies go through where the insolvent needs to refile within a few years.[222] This may indicate that forum shopping has allowed the US system to tilt too strongly in favor of reorganization.[223]

C. Supply side. On the "supply side" in the market for bankruptcy law, Member States could theoretically offer post-insolvency rules catering to the interests of any group. Among the strategies available, it may be most promising to cater to managerial interest, given the managerial head start in information. Since EU Members States have

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[222] LoPucki & Kalin, *supra* note 6; LOPUCKI, *supra* note 6, at 97.

[223] For a more positive assessment of bankruptcy venue choice in the US *see* however Skeel, *Bankruptcy Judges and Bankruptcy Venue, supra* note 5; Rasmussen & Thomas, *supra* note 5; Skeel, jr., *What's So Bad About Delaware, supra* note 5; Cole, *supra* note 5, at 1859-1876 (2002); Ayotte & Skeel, *supra* note 5.

different substantive bankruptcy laws, a Member State might even implement "manager-driven" bankruptcy proceedings in order to attract filings.

It seems interesting to consider what strategies Member States engaging in regulatory competition could take, or, to put it differently, what kind of law would attract case placers. The most obvious example is a law providing strong managerial control in bankruptcy, along US lines. If managers (and controlling shareholders with them) stay in control of the firm during bankruptcy by filing in a particular country, it would give them a considerable ex post advantage over creditors. Furthermore, states allowing early filings or petitions for bankruptcy would also be attractive, at least to the group favored by bankruptcy proceedings in that particular state.[224] The respective group, be it managers or a particular segment among creditors, could seize the opportunity to initiate filings. The supply of a bankruptcy law favorable to any particular group should thus be made more attractive by allowing that group to file early before interest group launches a petition in another state.

As in regulatory competition for corporate law, any influence on the development of the law as such hinges on whether its suppliers have an incentive to cater to the interests of decisionmakers. Only if there is such an incentive, the development of the law itself will be influenced, turning mere forum shopping into actual regulatory competition. The biggest problems for regulatory competition are incentives on the supply side, which are often idiosyncratic and hard to predict. According to Lynn LoPucki, judges are motivated by glamour of handling "celebrity" bankruptcies and their increased standing in the community resulting from it.[225] While this may have been the original incentive for the individual judges who started attracting cases to New York and Delaware, pressure from the local bankruptcy bar, which wanted to avoid losing business to Delaware, seems to have become an important factor later.[226] Still, even this has not be-

[224] For example, under § 123(1)(a) of the UK Insolvency Act default on an undisputed debt over £ 750 is sufficient to prove insolvency, whereas in Germany, the creditor needs to show that the debtor is unable and not merely unwilling to pay. *See* Schall, *supra* note 8, at 1538. The leading English case is *Cornhill Insurance plc v Improvement Services Ltd* [1986] 1 W.L.R. 114.

[225] LOPUCKI, *supra* note 6, at 19-20.

[226] *Id.* at 124-128.

come a universal incentive for courts to adapt their procedures everywhere.[227]

Although there is little doubt that the potential rents to be gained from forum shopping are bigger if at issue are not just minor differences in the interpretation of a single bankruptcy code (as in the US), but a variety of bankruptcy laws,[228] it is too early to conclude that legislators will enter regulatory competition under the EIR regime. First, the gains to be made are probably limited to a considerable degree by secondary insolvency proceedings. Second, the number of firms where gains are possible is relatively small. To be sure, this may be true also in the US, where forum shopping for chapter 11 "prepacks" seems to be an option mainly for large borrowers. Similarly, the COMI standard grants forum shopping opportunities only to firms with a considerable international scope of activities, and, by means of the presumption of COMI in the state of incorporation, to pseudo-foreign companies. However, COMI allows case placers to choose within a limited selection of venues, while in the US, "large public companies" are "free to file their bankruptcies pretty much everywhere they [choose]."[229]

These two factors combined make it rather unlikely that local bankruptcy lawyers in Europe will have to fear for large portions of their business. It is hard to see why Member States should allow themselves to be pressurized to change their bankruptcy laws in ways that give rent-seeking opportunities to managers or other groups. Given that Member States themselves can hardly gain financially from handling bankruptcy proceedings, the crucial issue probably is to what extent particular groups, bankruptcy lawyers in particular, will be able to (and have an incentive to) influence legislators, or possibly judges, to change the law or its interpretation to generate revenue for the bar.

D. Conclusion. The EIR offers ex post forum shopping opportunities European bankruptcy systems will have to deal with. Although an ex ante commitment to a particular bankruptcy system would likely be beneficial, COMI and its ambiguities for multinational groups and companies are here to stay. Consequently, at least some creditors are likely to be hurt by forum shopping. That said, we can reasonably predict that states will not actively compete to attract bankruptcies.

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[227] *Id.*at 21-24 (discussing Boston judges' refusal to enter competition).
[228] *Id.*at 207.
[229] *Id.*at 15.

5. The "relabeling" of corporate law rules as insolvency law rules: limits and implications

Shortly after the *Centros* case opened the door to regulatory arbitrage in the corporate law field, the European Council adopted a regulation which seemingly ruled out forum shopping and regulatory arbitrage in the bankruptcy law field. While we have seen that such objective was far from attained by the EIR, it is also true that whatever is the State that succeeds in opening the insolvency proceedings, with due exceptions and qualifications, this State will be able to apply its own insolvency law rules even to foreign entities. Hence, States (and legal scholars before them) may be tempted to re-qualify corporate law rules as insolvency law rules so as to apply their domestic law to foreign entities, as though *Centros* did not exist. With respect to post-insolvency corporate law rules, i.e. those that de facto becoming operational only if a corporation becomes insolvent, the outcome of such a relabeling would be practically the same as prior to *Centros*.

As a matter of fact, various commentators do consider insolvency law (and tort law) to be a sort of safe haven protecting domestic provisions from review by the ECJ.[230] However, two caveats need to be made. First, *secondary* EC law (like the EIR) can hardly mend a violation of *primary* law by a Member State. Second, it is not evident why the ECJ should take a formalistic perspective and bother to consider into which field of national law a creditor protection mechanism falls if its effects are identical.[231] In fact, as we have seen in section 4.1, the ECJ's criteria for the qualification of rules as

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[230] *See e.g.* Ulmer, *supra* note 36, at 1207; *cf. also* Christian Kersting & Clemens Philipp Schindler, *The ECJ's* Inspire Art *Decision of 30 September 2003 and its Effects on Practice,* 4 GERMAN L. J. 1277, 1290 (2003) ("*Existenzvernichtungshaftung* … or liability for undercapitalization can only be applied to foreign companies if they are understood as institutes of the law of torts or of insolvency law."); Hanno Merkt, *Creditor Protection and Capital Maintanance from a German Perspective,* 2004 EUR. BUS. L. REV. 1045, 1057 ("a tort law based solution would, as a general legal principle, be immune to findings that it violates the principle of freedom of establishment").

[231] *See e.g.* Karsten Schmidt, *Verlust der Mitte durch „Inspire Art"? – Verwerfungen im Unternehmensrecht durch Schreckreaktionen der Literatur –,* 168 ZEITSCHRIFT FÜR DAS GESAMTE HANDELSRECHT UND WIRTSCHAFTSRECHT 493, 499 (2004); Kieninger, *supra* note 60*,* at 753; Eidenmüller, *supra* note 129, at § 3, comment 9; Karsten Schmidt, *Publizität von "Schein-Auslandsgesellschaften" durch Firmenrecht und durch Angaben auf Geschäftsbriefen,* in EUROPÄISCHE AUSLANDSGESELLSCHAFTEN IN DEUTSCHLAND 15, 25 (Marcus Lutter ed. 2005); Armour, *supra* note 8, at 405-06.

insolvency law ones are autonomous from national laws and are strictly related to substantive and procedural features of bankruptcy law.

In light of *Gourdain v Nadler*,[232] for instance, commentators tend to exclude that claims that can be brought irrespective of whether a corporation goes bankrupt, like claims against directors for breaches of their on-going duties, are among those covered by the *lex fori concursus*.[233] Of course, actions based on the English provisions on wrongful trading would certainly be included among those covered by the English *lex concursus*, should a proceeding be opened in England.[234] Similarly, claims against directors arising from breach of the duty to file for insolvency are also held to be covered by the *lex fori concursus*.[235] However, this view is not uniformly held; some authors and recently one lower court have in fact argued that issues of liability for late filing should be decided according to the law of incorporation.[236]

Hence, the relabeling of corporate law provisions as insolvency law may only work provided that these provisions are properly "insolvencified," i.e. so long as a (sufficient) number of features linking them to the insolvency proceeding and its objectives are introduced. As a consequence, in most cases, "insolvencification" cannot be the product of scholarly or judicial interpretation. Instead, an intervention by national lawmakers and a profound revision of existing legal doctrines will be needed for relabeling to be successful.

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[232] See *supra* note 178 and accompanying text.

[233] *See* COMMENTARY, *supra* note 159, at 172.

[234] *See also* Schall, *supra* note 8, at 1549.

[235] *See* VIRGÓS & GARCIMARTÍN, *supra* note 155, at 82; Horst Eidenmüller, *Insolvenzrecht,* in AUSLÄNDISCHE KAPITALGESELLSCHAFTEN IM DEUTSCHEM RECHT § 9, comments 25-33 (Horst Eidenmüller ed. 2004) *see also* Gerd Leutner & Olaf Langner, *Durchgriffshaftung bei Scheinauslandsgesellschaften,* 2005 ZEITSCHRIFT FÜR DAS GESAMTE INSOLVENZRECHT 575, 577; Philipp Ungan, *Gläubigerschutz nach dem EuGH-Urteil "Inspire Art" – Möglichkeit einer Sonderanknüpfung für die Durchgriffshaftung in der Insolvenz?* 104 ZEITSCHRIFT FÜR VERGLEICHENDE RECHTSWISSENSCHAFT 355, 368 (2005); Rouven Redeker, *Die Fortführung insolvenzreifer Gesellschaften nach "Inspire Art",* 2005 ZEITSCHRIFT FÜR DAS GESAMTE INSOLVENZRECHT 1035, 137 (all suggesting that German *Insolvenzverschleppungshaftung* should apply when an insolvency proceeding is opened in Germany and citing *Gourdain v Nadler* as an important argument, *supra* note 178); Friedrich Rüffler, *Die Behandlung von Scheinauslandsgesellschaften,* 2 GESELLSCHAFTS- UND STEUERRECHT AKTUELL 411, 416-417 (2005).

[236] *See e.g.* Spindler & Berner, *supra* note 144, at 12; Sebastian Mock & Charlotte Schildt, *Insolvenz ausländischer Gesellschaften mit Sitz in Deutschland,* in GRENZÜBERSCHREITENDE GESELLSCHAFTEN § 16, comments 43-48 (Heribert Hirte & Thomas Bücker eds. 2005). *See also* Amtsgericht Bad Segeberg, March 24, 2005, 17 C 289/04, 95 GMBH-RUNDSCHAU 884 (2005) (rejecting a

Further, "insolvencification" may prove to be useless to extend the scope of domestic laws to entities incorporated in other Member States: Whenever insolvency law rules may be held to have a more than indirect and uncertain impact upon the exercise of freedom of establishment, they also must be consistent with the the *Gebhard* criteria.[237] Admittedly, insolvency law or tort law rules will typically apply without regard to the particular legal form, meaning that one of the *Gebhard* criteria (application in a non-discriminatory manner) will be met more or less automatically,[238] in stark contrast with pseudo-foreign corporation statutes. But no automatism will work with regard to the other criteria.

As previously hinted in section 4.1, at least in theory fraudulent conveyance could be one of the areas where "insolvencification", i.e. the introduction of rules that are functionally equivalent or similar to rules previously found in corporate law, may work out within the EU: fraudulent conveyance rules can in fact tackle opportunistic behavior in the form of asset diversion similarly to corporate law's limits to distributions. The problem is that EIR's Article 13 opens the door to regulatory arbitrage with regard to this kind of rules. Since of course insolvencification could not take place on a discriminatory basis, it would mean opening the door for regulatory arbitrage to domestic as well as foreign companies. If companies started to engage in concealed distributions through contracts for which parties chose the law of a Member State not allowing for any means of challenging them, the relabeling of rules on limits to distributions as fraudulent transfer might hinder the effectiveness of rules aimed to prevent asset diversion in jurisdictions where concealed distributions are now covered by corporate law.

Finally, we have seen that at least in some countries, like Germany, the qualification of the equitable subordination doctrine is disputed.[239] In the light of the discussion

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claim for damages on the grounds that English law applies, on which German law cannot be superimposed in light of ECJ case law).

[237] *See* Armour, *supra* note 8, at 405.

[238] Schanze & Jüttner, *supra* note 36, at 668 (pointing out that general laws of commercial traffic [„allgemeines Verkehrsrecht"] will usually not violate primary law); Schmidt, *id.,* at 25-26 (pointing out that provisions regulating commercial conduct are less likely to violate primary EU law than rules erecting entry barriers).

[239] *See* Horst Eidenmüller, *supra* note 235, § 9, comments 42-43 (qualifying the rules as corporate law); Forsthoff & Schulz, *supra* note 64, comments 40, 41-47. *But see* Weller, *supra* note 207 at 414; Peter Ulmer, *supra* note 36, at 1207; Ulrich Huber, *Gesellschafterdarlehen in der Inlandsinsolvenz von*

of ECJ case law on bankruptcy above, which is construed narrowly to refer only to "judgments directly based on insolvency proceedings and closely connected to them", it seems clear that a subordination doctrine such as the German one, which becomes applicable before insolvency and can result in a duty of shareholders not to recall the loan even if the corporation does not go bankrupt, does not necessarily fall under the scope of EIR. The question of whether a Member State can apply such a provision to foreign corporations would have to be decided under the *Gebhardt* criteria. In any case, it seems safe to say that certain rules could be recast so as to fall under the reach of EIR directly by establishing a reasonable connection to insolvency proceedings, while the main thrust of the rule remains the same.

But where effective relabeling is feasible, is it truly desirable from the perspective of a Member State intending to implement its own policies for creditor protection? The above discussion of forum shopping in European bankruptcy law casts serious doubts on this proposition. The better relabeling works and the larger the field covered by bankruptcy law, the smaller opportunistic gains that can be made by regulatory arbitrage in corporate law become. However, on the flipside of the coin, the reduced significance of corporate law shopping increases the incentive to engage in ex post forum shopping in bankruptcy, since shareholders and managers "placing the case" will have more to gain later on. In some situations, this may even be worse from the creditors' point of view: Opportunistic bankruptcy forum shopping under the EIR may be more difficult to predict than corporate law shopping and cannot be prevented by contract.[240] If such can be the outcome of relabeling, then, one may question whether it is at all wise for poli-

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Auslandsgesellschaften, in EUROPÄISCHE AUSLANDSGESELLSCHAFTEN IN DEUTSCHLAND 131-221 (Marcus Lutter ed. 2005); Zöllner, *supra* note 61, at 6 (all arguing that only the statutory rules ("Novellen-Regeln"), but not the independent case law ("BGH-Regeln") should apply to foreign corporations. For Austria *see* Sabine Dommes et al, *Die englische Private Limited Company in Österreich – Gesellschaftsrechtliche Fragen,* 15 STEUER UND WIRTSCHAFT INTERNATIONAL 477, 484 (2005).

[240] Creditors may sometimes be able to contractually reserve the right to replace the board if certain specified events occur and then eventually take full control of the corporation, or they may practically have that power without a legally enforceable stipulation to this effect (*see* Douglas G. Baird & Robert K. Rasmussen, *Private Debt and the Missing Lever of Corporate Governance,* VANDERBILT LAW AND ECONOMICS RESEARCH PAPER NO. 05-08; U. CHICAGO LAW & ECONOMICS, OLIN WORKING PAPER NO. 247, *at* http://ssrn.com/abstract=692023 (2005)), which will prevent forum shopping ex ante. Needless to say, most creditors will be quite reluctant first to reserve and then to exercise this form of protection. Furthermore, where such a protection is exercised, this will benefit large financial creditors, whose interests may not coincide with other creditor groups.

cymakers to engage in it: it may even be detrimental to the position of creditors and thus raise the capital costs of firms. At the very least, advantages and disadvantages of ex post choice of law decisions in the two fields will need to be weighed against each other with respect to particular issues.

6. Conclusion

Following *Centros*, all Member States now have essentially to defer to private parties' choices with regard to corporate law. This has already prompted regulatory arbitrage at the incorporation stage and, following positive harmonization efforts by the EC, may soon make it possible for existing companies as well. At the same time, the EIR has deeply affected regulatory interactions in the realm of insolvency law by increasing the opportunities for forum shopping. These two developments together have significantly reshaped the regulatory environment for the relationships between corporate debtors and their creditors.

This article has provided a picture of such a post-*Centros*, post-EIR environment. We have shown that despite the positive harmonization efforts by the EC, creditor protection regimes still differ across the EU, so that the regulatory surplus to be gained from (re)incorporations is still large enough. Regulatory arbitrage at the incorporation stage in order to escape from minimum capital rules cannot yet be taken as evidence for a race to the bottom, since such rules are outdated and provide no meaningful protection for creditors. We cannot rule out the possibility that companies engage in midstream reincorporations in order to exploit unsophisticated and nonadjusting creditors. However, in the absence of a European Delaware, the odds are against a US-style, intense regulatory competition in this area of law.

While the incorporation doctrine has been de facto imposed upon Member States with respect to corporate law, the EIR has harmonized conflict of laws rules in the insolvency domain by picking something close to the real seat doctrine, i.e. the fuzzy COMI standard. When a corporation incorporated abroad to take advantage of more attracting corporate law rules goes bankrupt, the COMI's insolvency law will have to apply together with the incorporation State's corporate law. EIR, with its emphasis on pure temporal priority for the opening of the main proceedings provides incentives for a race to file between the corporate debtor and its creditors. This, in turn, might prompt some Member States to reform their insolvency laws so as to make them more favorable to managers and shareholders in order to attract insolvency business. In light of the relevant interest groups in action, we doubt, however, that any Member State may have sufficient incentives to engage in broad-scope regulatory competition.

Still, the policy goal of protecting creditors prevalent in many Member States may tempt legislators to relabel corporate law rules so as to make them applicable to pseudo-foreign entities. However, relabeling requires "insolvencification" of the relevant doctrines, meaning that they will have to apply only within the insolvency context and in close connection with the proceeding. Member States will then have to decide whether the benefits of having those doctrines (possibly duly tamed in order to pass the *Gebhard* test) applied to bankrupt foreign entities outweigh the costs (if any) of not being able to apply them to non-bankrupt domestic entities. Finally, so long as the EIR does allow for forum shopping and hence insolvency law arbitrage, relabeling may increase the regulatory surplus a corporation can derive from forum shopping through an opportunistic switch of COMI. This may even increase the exposure of creditors to opportunistic conduct by shareholders and managers, and thus increase the cost of debt for all companies with international operations It is therefore doubtful whether relabeling is actually desirable from the Member States' perspective.

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