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Why do businesses incorporate in other EU Member States? An empirical analysis of the role of conflict of laws rules

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ABSTRACT

Research in law, political science and economics has taken a strong interest in the way companies strategically incorporate in foreign jurisdictions. However, the empirical research about corporate mobility in the EU has so far been limited in two respects: it has focused on the analysis of foreign companies in the UK and it has mainly been concerned with differences in the costs of incorporation such as minimum capital requirements. This paper aims to fill these gaps. It is the first paper that presents data on incorporations of foreign businesses in the commercial registers of each EU Member State. It is also the first one to assess the impact of differences in the conflict of laws rules applicable to companies as they reflect the case law of the Court of Justice on the freedom of establishment. It finds that countries which have a clear-cut version of the 'incorporation theory' attract more incorporations than countries which have retained elements of the 'real seat theory'. The paper also discusses the policy implications from these findings for EU harmonisation in this field.

1. Introduction

Do companies make strategic decisions to incorporate in certain jurisdictions following a search for the most favourable legal rules? This is likely to be the case as far as this choice allows businesses to reduce their tax bill, whether directly, or by benefitting from lower levels of transparency. As far as company law is concerned, a prerequisite for meaningful choice of law is the ability of firms to freely and separately choose their place of incorporation, regardless of the physical location of their activities. It also points towards to a fundamental divide in the conflict of laws rules applicable to companies (*lex societatis*): on the one hand, countries that follow the 'incorporation theory' recognise any company properly constituted according to the law of another country, and accept that the company law of the country of incorporation applies to such companies. On the other hand, countries following the 'real-seat theory' seek to prevent free and separate choice of company law by determining the law applicable to a company by reference to the location of its headquarters; this effectively requires companies to incorporate in the jurisdiction from where it is managed.

In the European Union, an interesting situation has emerged. Despite partial harmonisation of substantive rules, companies are mostly creatures of national law and, as a starting point, the conflict of laws rules applicable to companies are similarly determined at the Member State level; here too, they may thus apply either the 'incorporation theory' or the 'real seat theory'. However, in addition, we also have to consider the case law of the Court of Justice, interpreting the freedom of establishment of Article 49 of the Treaty of the Functioning of the European Union. Although the Court generally does not phrase its arguments in the categories of conflict of laws rules, it has become clear that its case law has imposed some restrictions on the use of the real seat theory for companies from other Member States.

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This position became most obvious in the landmark case of *Centros*:[1] two Danish citizens living in Denmark established a limited liability company (ltd) in the UK. The founders' main motivation was to avoid the minimum capital requirements under Danish law. Even though it is somewhat unclear whether Denmark followed the real seat doctrine at the time, the Danish authorities refused to register a branch of Centros ltd in the commercial register because it did not plan to conduct business anywhere except in Denmark. The Court of Justice rejected this line of reasoning and held that Centros ltd was validly exercising its freedom of establishment and that the refusal to register was an obstacle to this freedom.

In another case, *Überseering*,[2] it can be seen that the consequences of a mismatch between the place of registration and the real seat can even be more severe. Überseering was established as a Dutch private company; yet, a German court held that due to its German real seat (and due to the traditional German use of the real seat theory) it should be classified as being German. Yet, as Überseering, naturally, was not incorporated under German law, it would also follow that Überseering would only be regarded as a German partnership with the result that the partners (i.e. the original shareholders) would be personally liability for any debts of the company. Here too, then, the Court of Justice held that an 'outright denial' of the Dutch company by German courts would violate the company's freedom of establishment.

In spite of this general shift towards the 'incorporation theory', the European case law has also stated that the country of the real seat is 'entitled to take measures designed to prevent certain of its nationals from attempting, under cover of the rights created by the Treaty, improperly to circumvent their national legislation or to prevent individuals from improperly or fraudulently taking advantage of [the freedoms]'.[3] Thus, the Court of Justice has left some ambiguities about the possibility of corporate mobility and it may not be clear whether it can be said that, at present, there is a meaningful market for incorporations in the EU.

It follows that this paper combines two questions. One of them is a question of comparative law, namely that it examines whether Member States have a clear-cut version of the 'incorporation theory' or whether they have retained some elements of the 'real seat' theory (for details see 4.2, below). The other is the empirical question about the impact of the resulting differences on the incorporation behaviour of firms, and more specifically an investigation in the possible reasons why at least some businesses incorporate in other EU Member States.

The corresponding structure of the paper is as follows: Section 2 provides an overview of the previous empirical research and the data collection of the present study. In particular, it explains how this paper fills gaps in the empirical literature on this topic, as it is the first one that assesses the impact of differences in the conflict of laws rules applicable to companies based on data on all incorporations of foreign businesses in the commercial registers of each Member State. Section 3 presents descriptive statistics of foreign-based private companies in all Member States today as well as times-series data on new incorporations in the UK since 1990. These new data are one of the innovations of this paper. They also provide an initial assessment of whether there is a meaningful market for incorporations in the EU. The regression analysis in Section 4 turns to the question of whether the country differences can be explained by differences in conflict of laws rules applicable to companies and/or other factors. Finally, Section 5 reflects on the wider implications of the findings for European harmonisation, as well as the possible impact of the result of the UK's 'Brexit-referendum'.

2. Previous research and data collection

2.1. Previous empirical studies

In the US, it is well established that companies make deliberate choices about their seat, with the result that many listed US companies choose Delaware as their place of incorporation (for US-EU comparisons see e.g. Ventoruzzo et al., 2015: 35–97; Mucciarelli, 2012). In Europe, current empirical research is more limited. An EU study on the application of the Cross-Border Mergers Directive explained the problems with collecting statistical data on questions of cross-border company mobility and on cross-border mergers in particular, as follows:

'Collecting this data proved extremely challenging, as the information that the national registries keep is partial, and the commercial databases were inconsistent and scarce. Indeed, previous studies on parallel topics encountered the same problems in gathering accurate and quality information' (Bech-Bruun and Lexidale 2013: 962).

The task of collecting data on the number of companies that operate in a Member State different from the one in which they have been incorporated or have their real seat is also a demanding one. To start with, it is therefore helpful to present an overview of the scope and method of the existing empirical research which has aimed to tackle this problem.

This literature, summarised in Table 1, suggests different proxies to identify the country with which companies are mostly connected, despite being incorporated in another jurisdiction. It has been observed that the registration of branches is not strictly enforced in many Member States (Becht et al., 2008: 245). Therefore, the most promising strategy is to proceed indirectly by examining the company's filings in the state of incorporation. One possibility is to use the address of the directors as an indication of the company's real seat. The proxy can be further varied by, for example, classifying a company as formally foreign if all directors live abroad, or if the majority lives abroad (as used by used by Becht et al., 2008; Braun et al., 2013). As far as the information is available, it can also be revealing to identify whether the managing director is also a shareholder (or even the sole shareholder) (as used by Teichmann and Knaier, 2015).

Alternatively, one may go further and aim to collect information about companies without any physical connection of the company to the country of incorporation. In order to identify such companies some studies have examined whether the company's registered office was shared with at least 100 other companies – i.e. it having a mere 'letterbox' in the country of incorporation. This is said to work reasonably well for the UK where registration agents use the same address for a large number of companies without any business activity in the state of incorporation (Ringe, 2013: 247), while in other countries this strategy is less reliable.

In this respect, a terminological and substantial clarification has to be made. In the literature, the term 'letterbox companies' is occasionally used for such companies that do business in one country, but are incorporated with only a 'letterbox' in another one (Sørensen, 2015). However, frequently, the term 'letterbox companies' is also equated with companies which are mere 'special purpose entities' (SPEs, also called 'conduit companies'). Those too merely have a 'letterbox' in the country of incorporation, but they only hold financial assets, they are not involved in business activ-

[1] *Centros Ltd v Erhvervs- og Selskabsstyrelsen* (1999) C-212/97.

[2] *Überseering BV v Nordic Construction Company Baumanagement GmbH* (2002) C-208/00.

[3] *Centros Ltd v Erhvervs- og Selskabsstyrelsen* (1999) C-212/97 at paras. 24-25. For the subsequent case law see *Kamer van Koophandel en Fabrieken voor Amsterdam v Inspire Art Ltd.* (2003) C-167/01; *SEVIC Sytems AG v Amtsgericht Neuwied* (2005) C-411/03; *Cartesio Oktato es Szolgaltato bt* (2008) C- 210/06; *VALE Építési kft.* (2012) C-210/06; C-106/16, *Polbud – Wykonawstwo sp. z o.o* (2017) C-106/16.