The Case for Further Flexibility in Matters of Cross-Border Corporate Mobility

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La semplicità è l'ultima sofisticazione ('Simplicity is the ultimate sophistication'.)
Leonardo da Vinci

The right of establishment provided for by the Treaty of Rome of 1957,[1] one of the founding principles on which the European Union[2] was built, consists in the abolition of restrictions to the freedom of nationals of a Member State to create a business activity on the territory of any Member State including by establishing a company or a branch or subsidiary of a company there.[3]

Soon enough, it became apparent that a natural extension of this right was to allow existing companies established in a Member State either to merge into a company established in another Member State or to move their corporate seat to another Member State and become subject to the national corporate laws of such jurisdiction (in the latter case, without triggering a loss of legal personality of the migrating company).

1. 'IT'S COMPLICATED … '

Regrettably however, three complicating factors delayed an early integration of this corollary of the freedom of establishment under EU law.

First, the manner in which the right to establishment was worded in the EEC Treaty left sufficient room for interpretation on whether it did or did not include a right for corporate mobility and the constraints within which such a right would operate that most Member States did not feel compelled to adapt their decades-old limitations to inbound or outbound transfers of corporate seats in order to facilitate those operations. And while the EEC Treaty contained an undertaking from Member States to negotiate the terms of secondary legislation in respect of '*the maintenance of [companies'] legal personality in cases where the registered office is transferred from one country to another and the possibility for companies subject to the national laws of different Member States to form mergers*',[4] such commitment never materialized into positive law (with respect to changes of corporate seats[5]) or in a belated manner (with respect to cross-border mergers[6]).

Second, to this date Member States are still allowed by European law to use a connecting factor of their choosing with regard to the applicability of their own *lex societatis* to companies. Variations of two legal theories are used in practice: the 'incorporation theory' and the 'real seat theory'. Under the former, a company must apply the corporate law of the place where its registered seat has been established (i.e. a 'form-over-substance' approach, which has the merit of clarity and simplicity) whereas under the latter, a company is made subject to the laws of the jurisdiction where its business is in fact managed (i.e. a 'substance-over-form' approach, which has the benefit of avoiding artificial situations and 'shopping' of national corporate laws). This lack of harmonization results in practical complications when it comes to cross-border mobility of EU companies. By way of example, a UK-registered company willing to move its effective place of management to France would be bound to apply the corporate laws of both the UK (applying the incorporation theory) and of France (applying the real seat theory), which renders this operation more complicated than necessary. If the example was reversed, the French company willing to migrate to France would in pure theory become 'stateless' since neither the UK nor France would consider that their national corporate laws apply to it under the connecting factor they have chosen, thereby preventing the proposed migration.

Third, there appears to have been a growing uneasiness of some Member States about company migrations performed otherwise than for 'legitimate reasons' and deemed to prejudice the interests of

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1 Treaty Establishing the European Economic Community, 25 Mar. 1957 (the **EEC Treaty**).

2 Then European Economic Community.

3 EEC Treaty, Art. 52.

4 EEC Treaty, Art. 220.

5 With the exception of special rules relating to the cross-border transfers of seats of *Societas Europaea* and *Societas Cooperativa Europaea*.

6 Directive 2005/56/EC of the European Parliament and of the Council of 26 Oct. 2005 on cross-border mergers of limited liability companies (the **Cross-border Merger Directive**).

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stakeholders. An example would be a change of corporate seat carried out with the sole purpose of escaping the burden of unfavourable national tax or employment legislation. As a result, secondary legislation regarding matters of cross-border mobility, such as such as the European Company Regulation[7] and the Cross-border Merger Directive, took a long time to negotiate and, in their final versions, contain measures protecting creditors, minority shareholders (at the option of Member States only, however) and employees.[8] Until now, these restrictions however remained – in our eyes of practitioners – reasonable.

2. A BRIDGE TOO FAR?

The case law developed by the Court of Justice of the European Union (CJEU) helped tremendously with the first (absence of secondary legislation) and second issues (conflicting theories on corporate seat) highlighted above but unfortunately exacerbated the third (a degree of anxiety over 'artificial' transfers of seat).

A series of decisions of the CJEU indeed consecrated a right for EU companies to move their corporate seat to another EU jurisdiction without suffering substantial restrictions. These were notably the *Sevic*[9] case (company transformations are a specific application of the freedom of establishment), *Cartesio*[10] and *Vale*[11] cases (cross-border transfers of seats and conversions are protected by the freedom of establishment; restrictions to transfers must be proportionate to the objective of protecting stakeholders) and finally *Polbud*[12] case (cross-border conversions without relocation of the 'real seat' are also permissible; no further distinction between 'primary' and 'secondary' freedom of establishment).

This last judicial decision however struck a nerve among Member States. Its most common interpretation is that EU-based companies may now pick the *lex societatis* of a Member State of their choosing without moving their effective place of management there. This far-reaching result generated fears of a 'race to the bottom' between national corporate laws on the one hand and of artificial cross-border migrations made for the sole purposes of gaining a tax or other advantage detrimental to stakeholders (e.g. creditors, minority shareholders or employees) on the other hand.

Consequently, the EU Commission felt compelled to intervene in the form of a draft proposal for a directive relating to cross-border conversions, mergers and divisions[13] aiming to harmonize the rules applicable to such matters.

3. PENDULUM EFFECT

The stated objectives of the Draft Directive are twofold, i.e. to (1) facilitate cross-border conversions, mergers and divisions and (2) protect the interests of all stakeholders.[14]

While these purposes do not seem inherently incompatible between them at first sight, the degree of complexity of certain provisions of the Draft Directive and generally the very high level of protection afforded to stakeholders in such text – even where the interests of certain stakeholders are not involved – suggest that the second objective of the Draft Directive may have been favoured over the historically important first, possibly as an overreaction to *Polbud*.

This outcome is particularly problematic for practitioners since a low degree of flexibility of the proposed legislation is likely to result in more costly transfers of seats, avoidance behaviours aiming to achieve the desired purpose outside the framework of the New Directive (notably by small companies) or even, in some specific cases, a technical impossibility to relocate companies from a Member State to the other by way of cross-border merger, division or conversion. Legal certainty is also at fault on some particular matters.

In order to underline their significance, we suggest illustrating these difficulties resulting from the approach taken by the EU legislator through two case studies[15]: (1) a cross-border reorganization (including a merger and a division) involving a listed company active in a regulated business and (2) the cross-border conversion of a start-up company.

3.1. Case Study #1

3.1.1. *Facts*

We assume the following scenario for this first case study, which is not based on real facts but constitutes a 'typical' Brexit driven reorganization:

A French company, being listed on a regulated market in the European Union and active in a regulated sector (such as banking or insurance), carries out major regulated activities in EU countries through its England based regulated subsidiary (operating through branches).

In the context of Brexit, that French company takes the decision to absorb its 100% English subsidiary with a view to later on demerge the English business into a UK subsidiary again and the

7 Council Regulation (EC) No 2157/2001 of 8 Oct. 2001 on the Statute for a European company (SE).

8 With the SE Regulation being complemented by Council Directive 2001/86/EC of 8 Oct. 2001 supplementing the Statute for a European company with regard to the involvement of employees.

9 CJEU, Case C-411/03, Sevic Systems AG.

10 CJEU, Case C-210/06, Cartesio Oktató és Szolgáltató bt.

11 CJEU, Case C-378/10, Vale Építési kft.

12 CJEU, C-106/16, Polbud - Wykonawstwo sp. z o.o.

13 Proposal for a Directive of the European Parliament and of the Council amending Directive (EU) 2017/1132 as regards cross-border conversions, mergers and divisions (the **New Directive**).

14 Draft Directive, explanatory memorandum.

15 These case studies assume that the New Directive is in force in its current form and that related national implementation laws have been adopted and are also in force.

European Union business into a Luxembourg regulated entity which will continue to exercise the activities through branches in various European Union Member States.

All of these transactions are validated by the relevant financial regulators. We shall ignore for the sake of this analysis any implications of capital markets law.

We shall finally assume that it is not intended for any employees of the reorganized companies to be dismissed or in any other way negatively affected by the proposed transaction.

This is typically a cross-European Union transaction that should be facilitated by applicable EU merger legislation.

But will this the case under the New Directive?

3.1.2. *A Merger and a Demerger*

One of the challenges that will be faced in such a project is that it includes two very different transactions. There is first a cross-border merger between a French and an English company and secondly a cross-border division into a Luxembourg regulated business as well as into an English one. Both transactions would be caught by the New Directive.

3.1.3. *A Question of Language*

It comes as no surprise that the question of language to be used in the reorganization documentation is a practical and key one. Indeed one would now (prior to the New Directive) have to deal with an English speaking regime in England, a French speaking regime in France and a regime allowing English and French language uses in Luxembourg.

It is positive to see that the New Directive proposes to allow the use of a language 'customary in the sphere of international business and finance' to draw up relevant documentation. This is indeed indispensable to make such related cross-border transactions work without 'loss in translation'.

3.1.4. *Time Certainty*

A second key concern in these transactions would consist in insuring that the transaction can be carried out on a specific date with a certain legal effect. As one can imagine the merger and the demerger transaction in a regulated activity would have to ideally become effective on the same day and even in practice on a specific weekend so as to allow transition of systems like IT platforms or other.

It is important to notice that the effective date that is referenced here is not the accounting effective date but the legally effective date following which interactions.

Under the Cross-border Merger Directive rules, it is the law of the Member's State of the company resulting from the cross-border merger, here France, that applies. In case of the division it is the law of the divided company, which is again France, which determines the date of effectiveness of this transaction. In our case, one is lucky enough to have a single jurisdiction determining those effective dates but this does not mean that the effective date can be 'arranged' to be the same. This would be even worse if two different jurisdictions determine effectiveness. Harmonized criteria would be required or even better an actual option to 'set' the legal effective date (a bit like the accounting effectiveness date) so as to allow parties to achieve same date closings.

Under the proposed cross-border division rules certain verifications need to be done. Notably in our case, a check on whether the contemplated cross-border division constitutes an 'artificial arrangement' as defined by the New Directive is one of the preconditions for the demerger to be going through.

Given the process that is provided in this respect, there can be absolutely no certainty as to what is the date and timeframe for the demerger and, as a consequence, when the latter can actually become effective. In our case, certain timing is thus quite difficult despite it being key for planning certainty. It should also be noticed that in the case we have chosen, corporate steps mainly serve to implement a transaction that has already been scrutinized and of course approved by a number of European Union financial sector regulators so that the merits of following a distinct artificial arrangement procedure is not immediately apparent. One may regret that wider exemptions have not been provided in order to smoothen such complex cross-border processes which have already been approved or are being scrutinized by relevant regulators.

The argument will be made that given that financial regulators have already approved the transaction, the national authorities designated pursuant to the New Directive to access whether artificial arrangements are in place should be rather straightforward.

However, two objections can be made. First of all, we should remember that this case study is about a listed company. It is in the modern world of shareholder activism not at all excluded that for reasons of its own, objections to a transaction are being made by activist shareholders at the level of the French company leaving no choice probably in reality to the Member State authorities making an in-depth assessment and this irrespective whether financial regulator has already or not approved the transaction.

Secondly, where two authorities have to intervene, it is not at all certain that one of these authorities will necessarily defer to the judgement that has already been made by another authority on the transaction.

In short, given the added corporate requirement on an in-depth assessment it will become very difficult from a corporate law perspective to determine a certain calendar for the transaction while this is being essential for these sensitive reorganizations.

3.1.5. *Demerger Forms*

In addition, our example assumes that the demerger may actually occur into a newly incorporated Luxembourg entity.

This would probably constitute the exception in a regulated environment. Regulators by far prefer that demergers occurs into an existing already regulated entity that has all relevant permits and licences in place and, as the case may be, even has already an

appropriate regulatory track record. The New Directive will only regulate demergers into new entities as opposed to into existing entities. The reason of complexity that is involved does not seem to be a convincing one because, as our example shows, a reorganization of this nature in a financial sector will by essence be a very complex situation anyway.

The fact that the New Directive now clearly seems to exclude cross-border demergers into existing entities from its corporate raises furthermore the question of whether such transactions will actually remain feasible. Luxembourg national law has allowed such cross-border demergers. The question is whether this solution can persist in light of the new EU regime.

3.1.6. *Cross-border Cooperation*

The New Directive continues to require pre-merger respectively pre-division certificates being delivered between Members of the European Union.

Whereas the certificates are very useful, a lack of harmonization as to their content raises issues in practice. It is very frequent in 'real life' that the recipient Member State authority asks for that pre-merger or division certificate to have a certain content which might not be in compliance with or required under the laws of the issuing authority. Even more, the issuing authority may request that the receiving authority confirms accomplishment of all relevant steps in that local jurisdiction subject to one or the other clearly identified items before issuing its own certificate. Here again, the opportunity seems to have been missed to harmonize where harmonization would effectively be useful by proposing a standardized type of certificate. Also, at least, one should have, as would be the case in the financial sector, authorities that can or must coordinate amongst each other to insure that such certificate is being properly issued. No such cooperation procedure is unfortunately provided.

3.1.7. *Controlling Authority*

Another issue that arises is that of the controlling competent authority.

In Luxembourg the authority that has been chosen to be this authority is the notary. The notary is a public official being subject to strict requirements under Luxembourg law. However, he/she presents a huge advantage in that a notary remains accessible to discuss in advance how a transaction like the one under review actually would be implemented. It seems very unlikely that the Luxembourg notaries could remain in charge of being the (only) Luxembourg competent authority given all the assessments that need to be made in relation to the new cross-border conversion and division rules for which notaries are not necessarily fully equipped and/or issued with the right authority to make the relevant assessment.

This will result in the parties to a complex transaction losing the possibility potentially to liaise and pre-discuss with a competent authority to coordinate not only the timing, but as we have seen the content, the form and other merger or demerger related issues where notional authorities need to cooperate. It would have been useful to provide for a system whereby pre-consultation procedures are organized in every Member State (at a central national level) which allows to acquire the necessary certainty on a transaction in full transparency with the competent authorities. This would constitute a real asset for cross-border transactions in a European context as it would allow to provide further certainty to these transactions.

3.1.8. *What Does this all Mean?*

Where does this then leave us in a transaction as the one described above?

There is no doubt that the new framework provides certain advantages. The framework creates however a much bigger uncertainty between various actors as to the timing on which exactly such a transaction can occur given that certain rights are allocated to verify the artificial arrangement threat.

Also, generally, more and more protection rights seem to be mandatorily shifted to a time prior to the merger becoming effective. Now it is, for instance, compulsory that the creditors be protected prior to the merger becoming effective. This seems again to create an additional layer of uncertainty for purposes of implementing these transactions.

No appropriate level of exemptions has been included as in our case study it is impossible to get the consent of all the members of a company to facilitate the transaction given the listed nature of the company in France.

Nothing in the transaction does affect the rights of these French listed company shareholders as they will not be issued any additional shares and will not be diluted, only intra-group, wholly owned subsidiaries being involved. Also the assessment of artificial arrangement could have been adjusted to provide adequate exemption in the situation where transactions are already approved by other regulators hereof, the financial sector. Also public information about the transaction will probably have to occur given the listed nature of the company where again, it is important and crucial to have certainty on timing. This is not realistic anymore because the timing remains uncertain due to the many openings for challenges in the course of the procedure.

An opportunity seems also to have been missed to create further coordination and cooperation between Member State authorities in charge of verifying the accuracy of the procedures that are being implemented.

Transactions which are very similar, the merger and demerger finally seem to suffer different degrees of regulation with a demerger being more complex and in certain instances not possible where the merger transaction would be achievable. That raises a concern of consistency for purposes of complex transactions as the one described above.

3.2. Case Study #2

3.2.1. *Facts*

We assume the following second scenario which is faced by many start-ups at an early stage of their development:

A start-up is formed in a European Union Member State because the founder has received the advice from a 'friend and lawyer' that, in order to limit his liability, he/she should quickly establish a limited liability company in order to carry out his activity. This has been done without much further thought.

Once it comes however to fund raising and further developing the start-up which is ready to take on board a certain number of employees, protect its IP and get seed or Series A or B funding from investors, the situation may change. Indeed, better opportunities can potentially be provided in another Member State. This is what the European Union is about: freedom of movement.

Now comes the question of indeed moving that existing start-up company which has the original IP into another EU jurisdiction. This will, going forward, be governed by the New Directive. Prior to the New Directive these types of transactions would have been done by way of a migration, i.e. by way of simply moving the registered office into another jurisdiction.

The cross-border conversion mechanics are justified by the need to make simpler and cheaper procedures that create much more legal certainty. The procedure of conversion will however actually become a rather complex and delicate procedure.

3.2.2. *Exit Rights*

An advance brought by the New Directive will be to allow that a 'friend and family member' who is not happy anymore in the company and who does not want to hold shares in a company of another EU jurisdiction can be cashed out. This is definitely something positive.

3.2.3. *Reports: A Burden*

A number of reports need to be prepared in the context of a cross-border conversion. First, there is the management report. That management report can be waived if all the shareholders agree. Again the exemption is not necessarily realistic because in start-up scenarios you may have had an initial 'friend, family and fool member' who might not be happy with the transaction that goes on and will try to leverage his getting-out of the company. Any requests put forward to him to facilitate a transaction will come at a certain cost. It would have been appropriate to allow for this exemption to apply in case all consenting members have waived and the dissenting members have had the opportunity to cash out.

There is further a requirement for report on employees' matters. Here again the exemption for the small and medium companies is not the appropriate one, it seems to us, because the exemption relies solely on the fact that there are no employees at all. That is not the case in start-ups because very often the founding members of a start-up company are also its employees. It would have been appropriate to include a provision that also exclude SMEs from the type of requirements applying to employees.

The independent review by an auditor of the transaction items may be excluded in the case of a start-up if the latter qualifies as an SME. This is to be seen as very positive. However, an issue arises in as much as the expert has necessarily to be appointed by the competent authority designated by the various Member States. This takes away flexibility given that certain transactions require a lot of concertation and discussion to make sure that all kinds of experts that have to be involved do understand the transaction correctly. Not to allow actors to freely appoint their experts, who may have to respond and correspond to certain qualification requirements, will make the whole process a lot more cumbersome in its preparatory stages.

3.2.4. *Changes to the Draft Terms*

The draft terms of conversion need to be agreed in advance. The question then arises whether the draft terms may be changed in the final stages still. One needs to understand that a start-up company that will move its registered office to another European Union Member State will probably only do so if it is convinced that it will receive the relevant funding that it seeks to obtain. This means that it needs to be in agreement broadly speaking with its main investors. However, these processes are evolving processes and changes may occur until the very last minute. Where New Directive (and this also applies incidentally to the merger and division transactions) is not clear is how any changes to the draft terms of merger will impact and possibly delay going forward the whole merger, conversion or division process. It is not excluded that even small changes to the draft terms as announced by a shareholders meeting will result in the whole process having to be started anew. This is very costly for a start-up as such and an exemption to this extent should have been provided to allow changes to the draft terms of mergers at a very late stage to the extent that certain consents have been obtained.

The conversion process will thus need some time to occur. For a start-up company, this may be a question of death or life. Very often start-up companies do have to raise capital in emergency situations in order to finance their bare functioning. Here as part of a condition to financing there is a change of jurisdiction of registration this will become very tricky.

3.2.5. *Exit Right*

As has been indicated, it is very favourable that in the context of conversion, members that do not agree with the conversion have the right to exit.

However, in the context of a start-up company the adequate cash compensation may be a challenging criteria to fulfil given that a start-up company by definition is not necessarily easy to value. It would have been preferable to see guidance as to what should be the basis for such valuation, again so as to prevent any interpretation issues between Member States in the context of the process.

3.2.6. *Creditor Protection*

The protection of the creditors is similar to that provided for in a merger or a division. This being said, the presumption of non-prejudice stated in the New Directive is very favourable but not at all tailored to the situation of a start-up company that may not afford the independent expert report costs on confirming that it will be able to serve its debt, nor is a start-up company interested in having to fight creditor rights in multiple jurisdictions. It would have been appropriate to include an SME exemption in the case of creditor protection rights as well.

3.2.7. *Artificial Arrangements*

The artificial arrangement check becomes in the context of the start-up companies possibly a very tricky, political one.

Yes, it may be that a start-up company changes its corporate seat from one jurisdiction to another to benefit from better EU conform subsidies and grants regimes and/or tax treatment that goes with it.[16] Does this mean that in this area, where a lot of competition goes on, the artificial arrangement clause could be used to prevent circulation of start-ups within the European Union?

This will certainly be something that start-up companies that have developed certain IPs will be concerned about and will certainly not lead to a good integration of the market. It will give government an undue say in what sensitive companies it allows or not to move.

When a technology that is developed by a start-up company is sensitive and requires protection, this should be caught by legislation other than company legislation.

3.2.8. *Indemnity Rights*

Now here comes what might be seen as an absolute deterrent to any cross-border conversion for a start-up company. It is proposed that the converted company shall remain liable from any difference in national legal systems of the Member State of departure and destination where any contracting party or counterparty to the company carrying out the conversion had not been informed of the cross-border conversion by the company prior to concluding that contract.

That would mean that a start-up company, which by definition is not sophisticated, which by definition will not provide for the circumstance in its initial contracts, could have an indefinite liability if it is transferring its registered office within the European Union. No start-up company, no investor will accept this type of liability which cannot be very clearly circumscribed.

Mergers, divisions and conversions are done with a view of being able to imposing on counterparties such transactions. Yes, a certain procedure needs to be followed. Yes, there are certain checks to be performed. Yes, there are creditors' protection rights. But there must be a limit to it. One is evolving in a European Union framework, especially start-up companies and small companies that are trying to establish. To create an indefinite liability for a difference of legislation while staying in the same single market will kill the use of the conversion system.

3.2.9. *The Result?*

What will that lead into? Well, very simple: circumvention.

What will a start-up do? A start-up will not use the conversion mechanics which is supposed to provide legal protection. The start-up will simply incorporate a 100% subsidiary in the other jurisdiction and transfer all of its business to it under a contract which is much less protective, where there is much more uncertainty for the start-up on one side, but also for the counterparties on the other side. And as the case may be, there could even be an arbitrage for doing a cross-border merger at the end because, again, the cross-border merger does not contain the artificial arrangement purpose rule. This is not what this legislation is supposed to be about, namely creating legal certainty at lower cost. It will encourage circumvention which is quite of a pity.

Last but not least, and going beyond Case Study #1 and Case Study #2, is the fact that the New Directive seems incomplete. In today's world, companies are not only merging or dividing, they are not only converting into other legal forms, they do also transfer branches or businesses or assets where they want the universal transfer regime to apply. Such regimes, which are similar to a division, exist in number of jurisdictions. These are very important in the context of restructurings like the one we have seen. It is a real pity that the opportunity of this New Directive has not been used to also consecrate this type of transfer mechanics.[17]

4. AS A MATTER OF CONCLUSION

The New Directive fails to meet its main objective as it does not seem to strike the right balance between protecting certain interests on the one side and, on the other, allowing an effective freedom of movement of companies in a legally certain (be it as to timing or even feasibility) environment. There is a high probability that this imbalance is, at least in part, the product of an overreaction of the EU Commission to the CJEU's most recent case law in corporate mobility matters and recent proposed changes in the international tax environment.

This instrument does not – by far – cater enough for exemptions to certain rules, where there are legitimate reasons (e.g. a financial regulator already has vetted the transaction) or economic sense (e.g. exemptions for SMEs) would perfectly justify such. And where better coordination between competent (corporate) authorities

16 An interesting report on this is to be found under https://www.pwc.de/de/industrielle-produktion/executive-summary-digitaliiserungsindex-en.pdf.

17 Such regimes exist for a number of years in Belgium and Luxembourg for instance.

should have been the priority, it does not even start to address these very down-to-earth issues.

In our view, the New Directive will have a clear result: there will be less intra-European Union corporate mobility and an increased use of 'alternative' structures to implement the same economic purposes. This is much regrettable as a more nuanced approach, closer to the concerns of the field, would have actually resulted in great progress for ensuring the legal certainty and effectiveness of cross-border mergers, divisions and conversions.

It raises the final question: is corporate law the right sphere of law to drive political behaviour, regulate 'moral' issues and protect interests other than those of the classical corporate stakeholders?

We think not.[18]

18 An electronic search in the full text of the New Directive gives the following results: 'fraud' (seventeen occurrences), 'abuse' (twenty-three occurrences), 'artificial arrangements' (thirty-one occurrences), 'tax' (forty occurrences), 'prejudice' (or its derivatives – sixty-two occurrences), 'legal certainty' (nine occurrences), 'simplification' (five occurrences) and 'flexibility' (two occurrences). We encourage the reader to look for the odd ones on the list and draw his/her own conclusions.