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EU Company Law and the Company Laws of Europe

Mads Andenas

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EU Company Law and the Company Laws of Europe

Mads Andenas[1]

1. EU Law, Comparative Law and the Fundamental Changes

The company laws of Europe are undergoing fundamental change. All European countries have undertaken extensive reform of their company legislation. Domestic company law reform has traditionally been driven by initiatives to remedy weaknesses that have come to light in larger corporate failures or scandals. Initiatives to make corporate governance more effective is one such feature of recent European company law reform. In parallel, company law reform has been taken in the opposite direction by the wish to simplify and lessen the burdens in particular on smaller and medium sized businesses (SMEs). The new Member States have gone through even more fundamental reform to facilitate a modern market economy and then to implement the *acquis communautaire* in company law. The prospect of regulatory competition increasing the number of domestic businesses incorporating abroad, has increased the pressure to reduce capital requirements.

European Union law has an important role in this process of change. The case law of the European Court of Justice on the right of establishment and to provide services and the free movement of capital, has in the recent years been brought to bear on national company law and corporate practice. National company law have been set aside as restricting the free movement of companies or restricting the exercise of the fundamental freedoms in other ways. As European Union law gradually opens up the choice of country of incorporation for businesses in Europe, the competition between national company laws is increasing.

The harmonisation of European company law through EU legislation (directives and regulations), has also been given a new impetus by the case law of the Court of Justice and different initiatives by the European Commission. This requires transposition in national company legislation. New EU legislation gives further effect to the free movement of companies, which again opens up for regulatory competition.

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National company legislation cannot now be applied without regard to the case law of the European Court of Justice on the fundamental freedoms in the EC Treaty on the right of establishment and to provide services and the free movement of capital. Many provisions of the national legislation require the active use of the directives they transpose. In case of conflict, EU law requires that it is the rule of the directive that is applied. More generally, the EU company law legislation in directives and regulations constitutes a system which is the basic framework for national company law, and is often the natural starting point when company law matters are to be resolved. Neither can EU company law legislation in directives and regulations be applied without regard to the fundamental freedoms in the EC Treaty and the case law of the European Court of Justice. EU company legislation itself has to be interpreted and applied so that it complies with in the EC Treaty on the right of establishment and to provide services and the free movement of capital. In case of conflict, the Treaty prevails.

Comparative law is not of any less importance in this new context. The application of the fundamental freedoms in the EC Treaty in the review of national company law, can be assisted by analysis of the company laws of other Member States. That is even more so the case for the transposition or subsequent interpretation of EU directives. Concepts and rules often originate in a national system, and even if they may change when they are imported into a directive, knowing about their original meaning may provide assistance. Also the way that directives have been transposed in other Member States, may assist when a directive is to be given effect in the application of national company legislation.

Comparative law is of great importance also when company lawyers are to apply the company laws of other Member States. This is increasingly necessary as a consequence of the Internal Market integration. Contracts with companies of other Member States, investments in their securities and cross-border mergers are just some of the many transactions which require such knowledge.

The company with business in one Member State and incorporation in another, is a further field where comparative company law is required. At the upper end of the market, it is often not enough to have company lawyers of the different jurisdictions working together. There is a growing need for company lawyers with extensive comparative law expertise. At the lower end, where one cannot afford legal advice from experts from different jurisdictions, the company lawyer just must deal with the comparative law issues that occur.

This provides a considerable challenge to scholarship and teaching of comparative European company law.

2. Harmonisation and Free Movement

Although there is no question of the total approximation or harmonisation of the company laws of the member states, a considerable body of European company law have been brought into existence.[2] This has come about mainly through the enactment of directives under Articles 44(2)(g) and 95 EC (former Articles 54(3)(g), 100a EC). The first mentioned Article is set out in Chapter 2, "Right of establishment of Title II EC, "free movement of persons, services and capital". It provides:

> The Council and the Commission shall carry out the duties devolving on them under the preceding provisions,[3] in particular
>
> (g) by coordinating to the necessary extent the safeguards which for the protection of the interests of members and others, are required by member states of companies within the meaning of Article 48(2)[4] with a view to making such safeguards equivalent throughout the community.

Article 44(2)(g) EC is basis for nearly all enacted directives in European company law. Despite its position in Chapter 2 of the Treaty, the Community institutions pursue a broad interpretation which is orientated towards the aims of the Treaty.[5] In that view also measures with the purpose to approximate the prevailing conditions of company law can be based on it as long as they have beneficial effect on cross-border transactions.[6] A broad construction of Article 44(2)(g) EC may now be justified, but there

[2] See for instance E Werlauff *EU Company Law. Common Business Law for 28 States* (2nd ed DJØF Publishing Copenhagen 2003) who argues in his introduction that ' the company law of these many states is not uniform – nor it is required to be so – but all the main company rules will, or shall, be reflected in the company law of each individual state.' He continues: 'In the "old" days European law accounts of company law necessarily had to be comparative ... the emphasis was on the differences in the company law of the states. Now the emphasis will be on the common, cross border features of company law.' He sets out a systematic treatment of EU company law with less emphasis on transposition of directives or national law concepts. See also V Edwards *EC Company Law* (OUP Oxford 1999) whose treatment generally follows the directives in their order of adoption, and M Andenas and F Wooldridge, *European Comparative Company Law* (Cambridge University Press, Cambridge 2008) whose focus is on the national company laws.

[3] These provisions are those of Article 43 EC, which prohibits restrictions on the setting up of agencies, branches or subsidiaries by nationals of any member state in the territory of another member state. This prohibition is applicable to restrictions on the setting up of agencies, branches or subsidiaries by nationals of any member state in the territory of any member state.

[4] This provision stipulates that "companies or firms" means companies or firms constituted under civil or commercial law including cooperative societies and other legal persons governed by private or public law, save for those which are not profit making.

[5] See Case C-97/96, *Daihatsu* [1997] ECR I-6843, 6864.

[6] R Houin 'Le régime juridique des sociétés dans la Communauté Economique Européenne' [1965] RTDE 11, 16; see also V Edwards EC Company Law (Clarendon Press Oxford 1999) 5-9 and M Habersack *Europäisches Gesellschaftsrecht* (Munich Beck 1999) para 20.

must be a link between the legislation adopted under this provision and the fostering of a company's right of establishment.[7] Previously there was considerable support for an interpretation according to which Article 44(2)(g) EC is restricted to rules which promote the right of establishment.[8] Article 44(2)(g) EC merely gives the competence to issue directives, not regulations.

Article 95(1) EC provides for a different procedure for the adoption of measures for the approximation of the provisions laid down by law, regulation or administrative action in the member states which have as their object the establishment and functioning of the internal market. Such measures must be adopted by means of the rather long and complex co-decision procedure set out in Article 251 EC, which gives the European parliament the ultimate power of vetoing the relevant draft legislation. In European company law Article 95(1) EC has in practice only been significant as the basis for directives on capital market law.[9] It has been regarded as *lex generalis* in relation to Article 44(2)(g) EC.[10] The Community legislator regularly uses both. Article 44(2)(g) and Article 95(1) EC as legal bases to enact these directives.[11] Article 95(1) EC also entitles the Community legislator to enact regulations.[12] Nevertheless, Community regulations in Company Law have not yet been based upon Article 95(1) EC. Both the Council Regulation 2137/85 on the European Economic Interest Grouping (EEIG)[13] as well as the Council Regulation 2157/2001 on the Statute for a European company (SE)[14] were based on

[7] See Case C-122/96, *Saldanna and MTS Securities Corporation v Hiross Holding* [1977] ECR I-5325.
[8] See for instance R Rodière 'L'harmonisation des legislations européennes dans le cadre de la C.E.E.' [1965] RTDE 336, 342-350; Y Scholten 'Company Law in Europe' [1967] 4 CMLR 377, 382; see for the discussion also: P van Ommeslaghe 'La première directive du Conceil du 9 mars 1968 en matière de sociétés' [1969] CDE 495, 502-516; P Sanders 'Review of Recent Literature on Corporation Law' [1967] 4 CMLR 113, 119 ff; E Stein, *Harmonization of European Company Laws* (1971) 174-182.
[9] S Heinze *Europäisches Kapitalmarktrecht* (Beck Munich 1999) 12; E Wymeersch 'Company Law in Europe and European Company Law' [2001] 6 Working Paper Series Universiteit Gent 3.
[10] Following the broad interpretation of Article 44(2)(g) EC.
[11] But other Articles have also been invoked, for instance Article 47(2) EC for the UCITS Directive, the former Article 54(2) EC for the Directive on Mutual Recognition of Listing Particulars.
[12] Article 249(3) EC provides that 'a directive shall be binding as to the result to be achieved, upon each member states to which it is addressed, but shall leave to the national authorities the choice of form and methods'. Article 249(2) EC provides that 'a regulation shall have general application. It shall be binding in its entirety and directly applicable in all member states.'
[13] Council Regulation 2137/85 EEC of 25 July 1985 on the European Economic Interest grouping, OJ L 199 of 31 July 1985, 1.
[14] Council Regulation (EC) No 2157/2001 of 8 October 2001 on the Statute for a European company (SE), OJ 2001 L 294/1.

Article 308 EC.[15] Article 308 EC provides that the Council may, acting unanimously on a proposal from the Commission and after consulting the European Parliament, take the necessary measures, if action by the Community should prove necessary to attain in the course of the operations of the common market one of the objectives of the Community, and the Treaty has not provided the necessary powers. The European Economic Interest Grouping is a fiscally transparent entity having some of the characteristics of a company and some of an unincorporated body. The European Company is able to operate across borders. It is subject to a rather complex legal regime, consisting partly of rules of European law. The European Company is described more fully in the succeeding chapter.

Article 293 EC is another source for Community measures in European company law. It provides that the member states shall enter into negotiations with each other with a view to securing for the benefit of their nationals: the mutual recognition of companies or firms within the meaning of the second paragraph of Article 48, the retention of legal personality in the event of transfer of their seat from one country to another, and the possibility of mergers between companies or firms governed by the laws of different countries. On this basis, in 1968 the six original Member States signed the Convention on Mutual Recognition of Companies and Legal Persons.[16] It however never came into force as it was not ratified by the Netherlands.[17] The implementation of this provision would have required an international treaty, and the unanimous consent of the member states and of their parliaments would have been necessary. Also negotiations for a Convention on cross-border mergers ailed.[18] The issue is now governed by the Tenth

[15] The Commission and the European Parliament preferred Article 95. See the draft proposal of 16.10.1989, OJ C 263/41 and OJ 1991 C 176/1 and for the discussion: HW Neye 'Kein neuer Stolperstein für die Europäische Aktiengesellschaft' [2002] Zeitschrift für Gesellschaftsrecht 377 f; Wiesner [2001] GmbH-Rundschau, R 461; GF Thoma and D Leuering 'Die Europäische Aktiengesellschaft – Societas Europaea' [2000] Neue Juristische Wochenschrift 1449; M Lutter 'Europäische Aktiengesellschaft – Rechtfigur mit Zukunft?' [2002] Betriebsberater 1, 3.

[16] See for the text: [1968] Revue trimestrielle de droit européen 400; for the english version: [1969] EC Bull Supp 2 and E Stein *Harmonization of European Company Laws* (1971) 525. A Convention under Article 293 EC is not technically a Community Act, but a Treaty between the Member States. See for more details: V Edwards *EC Company Law* (Clarendon Press Oxford 1999) 384-386; B Goldman 'The Convention between the Member States of the European Economic Community on the Mutual Recognition of Companies and Legal Persons' [1968-69] 6 CMLR 104.

[17] E Werlauff *EC Company Law* (Jurist– og Økonomforbundets Forlag, Copenhagen 1993) 15-17.

[18] See for the preliminary draft of the Convention of 1967: Comité des experts de l'article 220 alinéa 3 du Traité CEE, 'Droit des sociétés – Fusions internationales, Avant-projet de convention relatif à la fusion internationale des sociétés anonymes', Document de travail no 4, 16.082/IV/67-F. See for the draft convention of 1972 EC Bull Supp 13/73 and B Goldman 'La fusion des sociétés et le projet de convention sur la fusion internationale des sociétés anonymes' [1981] 17 CDE 4.

Directive.[19] Treaties between the member states did not develop to a useful instrument for the approximation of national company laws.

3. Free Movement and the Fundamental Freedoms: the Right of Establishment

The Treaty provisions mentioned above concern the application of the right of establishment to companies and the harmonization of the laws of the member states. The four freedoms, especially the right of establishment (Articles 43-48 EC) and the free movement of capital (Article 56-69 EC) provide the foundations of European company law. They also generate the precondition for a free and economical choice of location. For instance, the application of the right of establishment and to provide services has ended certain discriminatory taxation laws.[20]

The right of establishment can be regarded as the cornerstone of European company law. Articles 43(2) and 48(1) EC provide that companies established in the EC may create secondary establishments in other member states and thus set up agencies, branches or subsidiaries there. There is a considerable body of decisions of the ECJ in which the non-discriminatory exercise of this right of secondary establishment has been emphasised[21] and elaborated. This has contributed to the considerable body of European company law, which otherwise owes its existence to the recognition of certain general principles of law, secondary legislation, and decisions of the ECJ concerning such legislation, provisions of which have sometimes been held to be directly effective.

It is a matter of debate whether following the decisions of the ECJ in *Centros*[22] *and Überseering* line of cases,[23] it is now the case that a company

[19] The Tenth Council Directive on cross-border mergers, [2005] OJ L 310/1. See for the legislative history and background, P Farmer 'Removing legal obstacles to cross-border mergers: EEC proposal for a tenth directive' [1987] Business Law Review 35 f, 53.
[20] See case C-62/00 *Marks & Spencer* [2002] ECR I-6325.
[21] Note the account of certain of these cases in J Usher *The Law of Money and Financial Services in the European Community*, pub. Oxford EC Law Library 2000 pp. 91-6. In Joined Cases C-397/98 and C-410/98, *Metallgesellschaft Ltd and others v IRC and Another* and Hoechst AG and Another v Same, [2001] ECR I-1727; Case 19/92 *Kraus* [1993] ECR I-1689, 1697 para 32; Case 55/94, Gebhardt [1995] ECR I-4165, 4197 para 37; Case C-212/97, *Centros* [1999] ECR I-1459, 1491 para 20 ff; Case C-255/97 *Pfeiffer* [1999] ECR I-2835, 2860, para 19. First, the ECJ held that Article 43 only prohibits discriminatory restrictions. See for instance: Case 2/74 *Reyners v Belgium* [1974] ECR 631, 651 para 16/20; Case 71/76 *Thieffry* [1977] Case 765, 777 f.
[22] Case C-212/97, Centros [1999] ECR I-1459. See for more details: J P Hansen 'A new look at Centros – from a Danish point of view' [2002] 13 European Business Law Review 85.
[23] Case C-208/00, *Überseering* [2002] ECR I-9919; F Wooldridge 'Überseering: Freedom of Establishment of Companies Affirmed' [2003] 14 EBLR 227; W Roth 'From Centros to Überseering: Free Movement of Companies Private International Law and Community Law' [2003] 52 ICLQ 192; E Wymeersch 'The Transfer of the Companies Seat in European Company Law' [2003] 40 CMLR 661; M Andenas 'Free Movement of Companies' [2003] 119 LQR 221.

is given the right of primary establishment under Community law (as opposed to national law) to transfer its statutory seat from one member state to another.[24] This problem with its link to the question of mutual recognition of companies will be discussed more fully in the succeeding chapter.

The ECJ held in *Sevic*,[25] decided a few weeks after the enactment of the Tenth Directive on Cross-Border Mergers, that a Luxembourg company had the right to merge with a German company, despite contrary rules of German law. Refusal to permit a merger would be a restriction in the meaning of Articles 43 and 48 EC and could only be justified if it pursued a legitimate objective under the Treaty and justified by imperative grounds in the public interest. The ECJ regarded the treatment of the Luxembourg company as an instance of discrimination. In para 22 of the judgment it stated that:

In so far as, under national rules, recourse to such a means of company transformation is not possible where one of the companies is established in a Member State other than the Federal Republic of Germany, German law establishes a difference in treatment between companies according to the internal or cross-border nature of the merger, which is likely to deter the exercise of the freedom of establishment laid down by the Treaty.

It follows from *Centros*[26] that non-discriminatory measures which form obstacles or hindrances to access to market also requires justification on public interest grounds. One reading of this and the line of cases discussed here is that anything which makes cross-border establishment less attractive constitutes a restriction under Articles 43 and 48 EC. Such a wide restrictions concept goes much beyond the discrimination found in the present cases, and its consequences for company legislation in Member States are potentially far-reaching.

[24] It does not seem that the Court recognised such a right of primary establishment in *Centros*: see the discussion of the case in St Rammeloo *Corporations in Private International Law – a European perspective* (Oxford University Press Oxford 2001) 72-85: note especially the literature mentioned in footnote 233 on p.72. In *Überseering*, which is discussed in the chapter on the formation of companies the court has at least recognised the right to transfer the actual centre of administration from one member state to another: note in particular paragraph 64 of its judgement. See also M Andenas 'Free Movement of Companies' [2003] 119 LQR 221.

[25] Case C-411/03 *Sevic Systems AG* [2005] ECR I-10805.

[26] Case C-212/97 Centros Ltd . Erhvervs- og Selskabsstyrelsen [1999] ECR I-1459. See also Case C-55/94 Gebhard [1995] ECR I-4165, para. 37; Case C-108/96 Mac Quen [2001] ECR I-837, para. 26; Case C-442/02 CaixaBank France [2004] ECR I-8961, para. 11. In the latter case the ECJ gave 'market access' a wide scope. The ECJ extended the Gebhard formula to measures which prohibit, impede or make less attractive the freedom of establishment.

The ECJ addresses justifications in para 23 of *Sevic*:

> Such a difference in treatment constitutes a restriction within the meaning of Articles 43 EC and 48 EC, which is contrary to the right of establishment and can be permitted only if it pursues a legitimate objective compatible with the Treaty and is justified by imperative reasons in the public interest. It is further necessary, in such a case, that its application must be appropriate to ensuring the attainment of the objective thus pursued and must not go beyond what is necessary to attain it (see Case C-436/00 *X and Y* [2002] ECR I-10829, paragraph 49; Case C-9/02 *De Lasteyrie du Saillant* [2004] ECR I-2409, paragraph 49).

The intensity of the review of the proportionality of national company law constitution a restriction under the wide test now developed becomes of great importance.

One remaining question is the application of the *Centros* line of cases to companies leaving a jurisdiction. The cases have dealt with discrimination by host state authorities against a company from another Member State. The question is if the same wide restrictions concept can be applied to regulation by the country of incorporation or seat when the company wants to leave the jurisdiction. Here the case of *Daily Mail*[27] still casts its shadow over the area. The well known distinction between export and import restrictions has been used to limit the recent ECJ case law on free movement of companies. The cases can be cast as dealing with discrimination against foreign companies. But restrictions on the exit of companies from one jurisdiction, entering another, either remaining a foreign company there or as a company incorporated in the new jurisdiction, constitutes a major obstacle to free movement and the functioning of the Internal Market. It is suggested that the *Daily Mail* case has no clear *ratio*, and the approach to exit restrictions is inconsistent with that taken to such restrictions in the case law on free movement. The facts of the *Daily Mail* case did not give rise to add questions of the structure of the legal personality of the company, and the transfer of its residence to Netherlands for tax purposes was not relevant as a company law matter. Both the United Kingdom and the Netherlands accept the incorporation doctrine.

In the cases where the ECJ has had to refer to *Daily Mail*, it has done so in a manner that perhaps could leave the impression that it is still good law, supporting exit restrictions. However, the ECJ has not had any opportunity to reconsider and over-turn *Daily Mail*, and the references made to the case does not develop a new *ratio* for the case or support

[27] Case 81/87 *R v Treasury ex p Daily Mail* [1988] ECR 5483.

that the ECJ would treat entry of companies ('export restrictions') any different from exit ('import restrictions'). However, the ECJ may soon have to address the exit issues directly. A Hungarian court of Appeal has referred several questions[28] to the European Court (ECJ) in the case of *Cartesio.*[29] The Hungarian court asks the following questions on the free movement of companies:

May a Hungarian company request transfer of its registered office to another Member State of the European Union relying directly on community law (Articles 43 and 48 of the Treaty of Rome)? If the answer is affirmative, may the transfer of the registered office be made subject to any kind of condition or authorisation by the Member State of origin or the host Member State?

May Articles 43 and 48 of the Treaty of Rome be interpreted as meaning that a national rules or national practices which differentiate between commercial companies with respect to the exercise of their rights, according to the Member State in which their registered office is situated, is incompatible with Community law?

The important part of the questions to the ECJ is the reference to conditions imposed on the company leaving the jurisdiction. In its ruling on the questions in *Cartesio* the ECJ has an opportunity to overrule *Daily Mail*, or make very clear that *Daily Mail* is limited to its facts in a legal and factual context which is very different today.

4. Free Movement of Capital

The free movement of capital has in a number of cases provided the grounds for review of national company legislation and practice. The free movement of capital has become an important precondition for the establishment of companies and the European company law. The internal market can only be established if capital transactions can be made without any discriminatory or non-discriminatory restrictions.[30] Article 56(1) EC provides that all restrictions on the movement of capital between Member States and between Member States and third countries shall be prohibited.[31] The ECJ held in its *Elf Aquitaine* decision 2002[32] that any restriction on investment or on the exercise of control in European

[28] Under the Art 234 EC Treaty procedure.
[29] (Case C-210/06). OJ C 165, of 15.07.2006, p. 17.
[30] Case C-483/99 *Commission v France (Elf-Aquitaine)* [2002] ECR I-4781; Case C-302/97 *Konle* [1999] I-3099, para 44.
[31] For a closer look see N Moloney, *EC Securities Regulation*, (OUP, Oxford 2002) 45.
[32] Cases C-367/98 *Commission v Portugal* [2002] ECR I-4731; C-483/99 *Commission v France (Elf-Aquitaine)* [2002] ECR I-4781 and C-503/99 *Commission v Belgium* [2002] ECR I-4809).

companies, like 'Golden Shares',[33] is in breach of the principle of the free movement of capital The ECJ held that:

> the free movement of capital, as a fundamental principle of the Treaty, may be restricted only by national rules which are justified by reasons referred to in Article 58 of the Treaty or by overriding requirements of the general interest and which are applicable to all persons and undertakings pursuing an activity in the territory of the host Member State. Furthermore, in order to be so justified, the national legislation must be suitable for securing the objective which it pursues and must not go beyond what is necessary in order to attain it, so as to accord with the principle of proportionality.

In the *Golden Share* cases the restrictions primarily originated with Member State authorities wishing to influence the decision making process within a privatised company or its shareholder structure. There are other cases where the restriction follows primarily from a decision of the company, its management or its shareholders.

In the first round, the European Commission brought three actions for infringement of Articles 56 EC Treaty (free movement of capital) and 43 EC Treaty (freedom of establishment) against Belgium, France and Portugal.[34] The 2002 cases concerned control procedures such as the rules on prior authorisation and rights of veto in companies that had been privatised. This was a way of securing a certain level of state control after privatisation. The case against Portugal concerned limitations on participation by non-nationals and a procedure for the grant of prior authorisation by the Minister of Finance once the interest of a person acquiring shares in a privatised company exceeds a ceiling of 10%. The companies concerned were undertakings in the banking, insurance, energy and transport sectors.

[33] So-called 'Golden Shares' guarantee certain voting rights or blocking power. They could for instance confer the right to outvote other shareholders at general meetings, or to veto certain decisions of the company, such as the sale of core assets. Other rights of Golden Shares could follow from provisions in the company's articles or shareholder agreements intended to ensure that no shareholder is beneficially entitled to an interest in more than a fixed proportion of voting shares. A third variant enables the government to nominate some of the directors. In some jurisdictions, golden shares have been created under existing company legislation, in others new legislation has been required to introduce State prerogatives in privatised companies.

[34] Cases C-367/98 *Commission v Portugal* [2002] ECR I-4731; C-483/99 *Commission v France* [2002] ECR I-4781 and C-503/99 *Commission v Belgium* [2002] ECR I-4809. It did not follow the opinion of its Advocate General, but basically agreed with the Commission's complaint that 'golden shares' can, depending on the circumstances, infringe the free movement of capital and the freedom of establishment. Dismissing the complaint against Belgium, it upheld the applications against France and Portugal.

In the case against France, the Commission complained that a Decree of 1993 vested in the State a 'golden share' in Société Nationale Elf-Aquitaine. The Minister for Economic Affairs is required, first, to approve in advance any acquisition of shares or rights which exceeds established limits on the holding of capital and, second, may oppose decisions to transfer shares or use them as security.

The case against Belgium concerned two Royal Decrees from 1994 vesting in the State 'golden shares' in Société Nationale de Transport par Canalisations and in Distrigaz. The Minister for Energy could oppose any transfer of technical installations and any specific management decisions taken from time to time concerning the companies' shares which may jeopardise national supplies of natural gas.

The Court considered that the 'golden shares' held by each of these three countries were restrictions. The legislation was liable to impede the acquisition of shares in the undertakings concerned. It could dissuade investors in other Member States from investing in those undertakings. The Court focused 1) on the prohibition (in Portugal) on the acquisition by nationals of another Member State of more than a given number of shares; 2) the requirement (in France and Portugal) that prior authorisation or notification is to be given where a limit on the number of shares or voting rights held is exceeded; and 3) the right (in France and Belgium) to oppose, *ex post facto*, decisions concerning transfers of shares.

The Court then considered the grounds put forward by way of justification for the restrictions. They were based on the need to maintain a controlling interest in undertakings operating in areas involving matters of general or strategic interest. The Court first held that, concerning the objective pursued by France (to guarantee supplies of petroleum products in the event of a crisis), it fell within the ambit of a legitimate general interest. But the Court considered the measures went beyond what is necessary in order to attain the objective indicated. The provisions did not indicate the specific, objective circumstances in which prior authorisation or a right of opposition *ex post facto* will be granted or refused, and were contrary to the principle of legal certainty. The Court was unable to accept such a lack of precision and such a wide discretionary power, which constitutes a serious impairment of the fundamental principle of the free movement of capital.

The Court did however accept the justification put forward by Belgium (to maintain minimum supplies of gas in the event of a real and serious threat). Here, no prior approval is required. Intervention by the Belgian public authorities in the context of a transfer of installations and the pursuit of management policy was subject to strict time-limits, in accordance with a specific procedure involving a formal statement of reasons and subject of an effective review by the courts.

The need to safeguard the financial interests of the Portuguese Republic did not pass the test. The Court referred to the settled case law to the effect that such economic grounds, which were put forward in support of a prior authorisation procedure, can never serve as justification for restrictions on freedom of movement.

In 2003, the ECJ handed down decisions in two further actions by the European Commission against, this time against Spain and the UK.[35]

The UK case followed the privatisation of the British Airport Authority (BAA) in the late 1980s. The articles of association of this company made provision for a special share to be held by the Secretary of State allowing a veto of winding up or a disposal of one of the UK airports. In addition to that, the articles prohibited any shareholder from holding more than 15 % of the BAA shares. Concerning the veto, the judgment endorsed the broad scope of capital movement and establishment as in the 2002 cases: the EC Treaty prohibits all restrictions on the movement of capital between Member States and between Member States and third countries and direct investments in the form of participation in an undertaking by means of shareholding or the acquisition of securities on the capital market constitute capital movements. Regarding the 15 % restriction, the UK had argued in essence that the alleged 'restrictions' were in fact rules defining the company itself and applicable by mechanisms of private company law only. The Court held that the restrictions at issue do not arise as the result of the normal operation of company law. The articles of association were to be approved by the Secretary of State pursuant to the Airports Act 1986 and that was what actually occurred. In those circumstances, the Member State acted in this instance in its capacity as a public authority.

Finally, the Court also rejected the UK argument that the BAA provisions were to be considered as 'selling arrangements' under the *Keck* case law on Article 28 EC.[36] The UK argued that its case did not entail a restriction on the free movement of capital as access to the market was not affected. This could be an important ruling, closing the door for holding that a broad category of potential restrictions should go clear of the free movement of capital as long as they are not discriminatory.

[35] Case C-463/00 *Commission v Spain* [2003] ECR I-4581, and case C-98/01 *Commission v United Kingdom* [2003] ECR I-4641.

[36] Case C-267/268/91 *Keck and Mithouard* [1993] ECR I-6097. As long as they are not discriminatory, 'selling arrangements' (distinguished from 'product requirements'), are not considered to be restrictions under Article 28 EC on the free movement of goods. Keck is one outcome of the Sunday trading litigation of the early 1990s where the argument was that regulation of the opening hours of shops (such as a ban on Sunday trading) could constitute a restriction on the free movement of goods. After *Keck*, a ban on Sunday trading would typically be a 'selling restriction' and Article 28 EC would not be engaged.

The Spanish provisions that were challenged constituted a system of prior administrative approval in several privatised companies[37] introduced by the Spanish legislation extending to major decisions relating to the winding-up, demerger, merger, or change of corporate object of certain undertakings, or to the disposal of certain assets of those undertakings.[38] The ECJ[39] held this system to constitute a restriction on the free movement of capital and also addressed possible justifications for a restriction. A justification could not be excluded for reasons of public interest, but the Court quickly rejected the justification offered in the Spanish case, mainly on grounds that the concerned undertakings could not qualify as undertakings whose objective was to provide public services. 'Public security' could be relied on only if there is a genuine and sufficiently serious threat to a fundamental interest of society which was not present in this case.[40]

A further judgment from 2005 reaffirms the principles developed in the previous cases.[41] The case concerned an Italian rule providing for an automatic suspension of the voting rights attached to shareholdings exceeding 2% of the capital of companies in the electricity and gas sectors, where those holdings are acquired by public undertakings not quoted on regulated financial markets and enjoying a dominant position in their

[37] The undertakings were Repsol, Telefónica, Argentaria, Tabacalera and Endesa, dealing with a wide range of business activities. The Spanish Law 5/1995 on "the legal arrangements for disposal of public shareholdings in certain undertakings" which governs the conditions on which several Spanish public-sector undertakings were privatised introduced a system of prior administrative approval. Major decisions relating to the winding-up, demerger, merger or change of corporate object of certain undertakings or to the disposal of certain assets of, or shareholdings in, those undertakings needed to be approved.

[38] The Spanish Law 5/1995 on "the legal arrangements for disposal of public shareholdings in certain undertakings" which governs the conditions on which several Spanish public-sector undertakings were privatised.

[39] The Spanish rules had been held to be justified by Advocate General Colomer in his Opinion and the court did not follow the Advocate General.

[40] The ECJ did not accept that, in the case of *Tabacalera* (tobacco) and *Argentaria* (commercial banking group operating in the traditional banking sector), that the legislation could be justified by general interest reasons linked to strategic requirements and the need to ensure continuity in public services. Those undertakings are not undertakings whose objective is to provide public services. In the case of *Repsol* (petroleum), *Endesa* (electricity) and *Telefónica* (telecommunications), the Court acknowledged that obstacles to the free movement of capital could be justified by a public-security reason. However, the Court held that the proportionality requirements were not satisfied for the following reasons: 1) the administration had too broad discretion, exercise of which is not subject to any condition; 2) investors were not appraised of the specific, objective circumstances in which prior approval will be granted or withheld; 3) the system incorporates a requirement of prior approval; 4) the operations contemplated are decisions fundamental to the life of an undertaking; and finally, although it appears possible to bring legal proceedings, the Spanish legislation did not provide the national courts with sufficiently precise criteria to review the way in which the administrative authority exercises its discretion.

[41] Case C-174/04 *Commission v Italian Republic* [2005] ECR I-4933.

own domestic markets. The ECJ ruled that the suspension of voting rights prevents effective participation by investors in the management and control of undertakings operating in the electricity and gas markets. That the provision only affects public undertakings holding a dominant position in their domestic markets does not detract from that finding. A general strengthening of the competitive structure of the market in question did not constitute a valid justification for restricting the free movement of capital.[42]

In 2006, the ECJ again ruled on 'golden shares', this time in two Dutch telecommunications companies Koninklijke KPN NV (KPN) and TNT Post Groep NV (TPG).[43] When these companies were partly privatised in the 1990s, the statutes of KPN and TPG contained a special share held by the Netherlands State, conferring special rights to approve certain management decisions of the organs of those companies. The ECJ held that these special rights were not limited to cases where the intervention of that State was necessary for overriding reasons in the general interest recognised in the case law. The ECJ considered that the special rights in the Dutch case discouraged not only direct investors but also portfolio investors.

In 2007, Advocate General Ruiz-Jarabo Colomer delivered his opinion in the Commission action against Germany over the 1960 Volkswagen-Gesetz (VW Act).[44] This legislation is based on a 1959 agreement between the Federal Republic (Bund) and the Federal State (Land) of Lower Saxony, and reserves some special rights to the Land of Lower Saxony which has been the biggest single shareholder of the German carmaker. The special rights include that of the ten members representing shareholders in the supervisory board, four will represent of public authorities. The maximum limit on the voting rights of a single shareholder to 20 per cent coincides with shareholding of the federal and state governments at the time the law was adopted. The Advocate General argues that the law dissuades those wishing to acquire a larger shareholding, and constitutes a restriction on the free movement of capital.

The free movement of capital judgments discussed here are in cases brought by the European Commission in cases against Member States. The case law is extending an intense review of state practice relating to the exercise of rights as a shareholder, and it is clear that the state cannot operate with the same freedom as a private shareholder.

[42] Italy adopted a provision after the judgment, which amended the law in question. However, the Commission did not consider that the changes introduced fully implemented the ruling of the Court and consequently on 13 October 2005 reminded Italy of its obligation to comply.
[43] Cases C-282/04 and 283/04 *Commission v Kingdom of the Netherlands* [2006] ECR I-9141.
[44] Opinion of 13 February 2007 on case C-112/05 *Commission v Germany.*

At the same time, there is the question of the consequences of this case law on restrictions imposed in company articles and in agreements between private shareholders. The direct effect of the fundamental freedoms where both parties are private (not Member States or emanations of Member States), is much discussed. The free movement of capital is generally considered to be capable of direct effect not only where one of the parties is the state (vertical direct effect) but also where there are only private parties involved (horizontal direct effect).

National company laws and practice will be subject to a gradual review through the case law, and the ECJ's jurisprudence on the free movement of capital will give new impetus to the harmonisation effort in EU legislation. The basic foundation is now laid in the cases discussed above but the actual impact and speed of this process is another matter.

5. The Harmonising Directives on Company Law

The Company Law Directives cover a number of disparate areas of law and with the exception of the Sixth Directive[45] (which only had to be implemented in member states where divisions as defined in the Directive, were permitted) have all required implementation by Member States. The impact of the company law directives, together with that of certain other directives in the field of securities law, has been extensive in all the member states. These directives have had considerable influence on the United Kingdom Companies Acts 1980, 1981, 1989, and 2006 as well as on certain other United Kingdom primary and secondary legislation.[46]

Although Article 48 EC is applicable to all forms of companies or firms, the secondary European company law covers primarily companies limited by shares or otherwise having limited liability. According to the considerations of these directives the coordination of these provisions was especially important since the activities of such companies often extend beyond the frontiers of national territories.[47] It has also been argued that these entities in contrast to partnerships and their equivalents in other Member States share more similarities and can therefore be harmonized more easily.[48]

Amongst the companies limited by shares the law of public companies is regulated more intensively. While the First, the Fourth, the Seventh and the Eleventh directives are applicable both to public and private

[45] Sixth Council Directive of 17 December 1982 based on Article 54 (3) (g) of the Treaty, concerning the division of public limited liability companies (82/891/EEC), OJ 1982 L 378/47.

[46] For example, Council Directive (EEC) 89/592 of 13 December 1989, OJ 1989, L 334/30 on insider dealing was implemented in the UK by Part V of the Criminal Justice Act 1993.

[47] Recital 1 of the First and Second Directive.

[48] G C Schwarz, *Europäisches Gesellschaftsrecht* (Baden-Baden Nomos 2000) para 14, 293.

companies, the Second, Third, Sixth directives apply only to the public limited company.[49] In the view of the European legislator the distinction is made because their activities are predominant in the economy of the Member States.[50] This concept has often been criticised because the use of the different company forms between the Member States.[51] For that reason the distinction between companies of different size and economical importance is more significant.[52] In addition to that, some Member States who only had a single form of limited companies introduced a private company form for smaller companies, a more useful form, in the process of the implementation of the Directives.[53]

The First Directive[54] is concerned with the disclosure and publicity requirements of companies the validity of pre-incorporation and *ultra vires* transactions entered into by companies, and the nullity of companies.

The Second Directive[55] provides for minimum requirements for the formation of public companies and the maintenance, increase and reduction of their capital.[56]

Both the First and the Second Directive have been subject to proposals for revisions undergoing a process of simplification. In 1999 the Company

[49] E Wymeersch, 'Company Law in Europe and European Company Law' [2001] 6 Working Paper Series Universiteit Gent, 6.
[50] See consideration 1 of the Second Directive and consideration 3 of the Draft Fifth Directive.
[51] See also E Wymeersch, 'Company Law in Europe and European Company Law', [2001] 6 Working Paper Series Universiteit Gent 5; See for a comparative overview: GC Schwarz, *Europäisches Gesellschaftsrecht* (Nomos Baden-Baden 2000) para 15, 530 ff; E Wymeersch, 'A Status Report in Corporate Governance Rules and Practices in Some Continental European States' in K Hopt and H Kanda and M Roe and E Wymeersch and St Prigge (eds), *Comparative Corporate Governance – The State of the Art and Emerging Research* (OUP Clarendon Oxford 1998) 1045, 1049.
[52] E Wymeersch 'Company Law in Europe and European Company Law' [2001] 6 Working Paper Series Universiteit Gent, 6; K Hopt 'Europäisches Gesellschaftsrecht - Krise und neue Anläufe' [1988] Zeitschrift für Wirtschaftsrecht (ZIP) 96, 103.
[53] M Lutter 'Die Entwicklung der GmbH in Europa und in der Welt' in M Lutter (ed) *Festschrift 100 Jahre GmbH-Gesetz* (Nomos Baden-Baden 1992), 49-55 (Danmark, the Netherlands).
[54] First Council Directive of 9 March 1968 on co-ordination 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 (68/151/EEC), OJ 1968 L 65/8.
[55] Second Council Directive 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 (77/91/EEC), OJ 1977 L26/1, on which see C M Schmitthoff, *The Second Directive on Company Law* (1978) 15 CMLR 43; G Morse *The Second Directive – raising and maintenance of capital* [1977] European Law Review 126.
[56] See for the implementation in the different member states: F Wooldridge *Company Law in the United Kingdom and the European Community* (Athlone Press London 1991) 25 ff; GC Schwarz, *Europäisches Gesellschaftsrecht* (Baden-Baden Nomos 2000).

Law SLIM Working Group issued a Report on the simplification of the First and Second Company Law Directive.[57] The Commission supported these recommendations relating to the First Directive and issued a proposal for its amendment.[58] The main object of the proposal is to accelerate the filing and disclosure of company documents and particulars by the use of modern technology, and to improve the cross-border access to company information by allowing voluntary registration of company documents and particulars in additional languages. It was also decided to update the First Directive where necessary, namely with regard to the types of companies covered and the references to the Accounting Directives. In respect to the Second Directive the High Level Group of Company Experts suggested in its Report of 4 November 2002 a two step approach a short term reform of the directive and a creation of an alternative capital regime in the long run.[59] Directive 2006/68/EC of the European Parliament and of the Council of 6 September 2006 has been enacted, amending Council Directive 77/91/EEC as regards the formation of public limited liability companies and the maintenance and alteration of their capital.[60] This instrument permits the relaxation of the valuation requirement for contributors in kind in some circumstances. It also contains new provisions governing the giving of financial assistance for acquisition of shares. The relevant provisions are very detailed.

The Third[61] and Sixth Directives are respectively concerned with mergers and divisions of public companies; the former instrument has no application to take over bids, but to the type of operation known in the United Kingdom as reconstructions.

[57] See Report from the Commission to the European Parliament and the Council– Results of the fourth phase of SLIM, 04.02.2000, COM (2000) 56 final; E Wymeersch 'Company Law in the Twenty-First Century' [2000] 1 International and Comparative Corporate Law Journal 331, 332-335; E Wymeersch 'European Company Law: The Simpler Legislation for the Internal Market (SLIM) Initiative of the EU Commission' [2000] 9 Working Paper Series, Universiteit Gent.

[58] Proposal for a Directive of the European Parliament and the Council amending Council Directive 68/151/EEC, as regards disclosure requirements in respect of certain types of companies, 3.6.2002, COM(2002) 279 final. The Directive was amended by Directive 2003/58/EC of the European Parliament and Council [2003] OJ L 220/13.

[59] See Report of the High Level Group of Company Law Experts of 4 November 2002, 78-93 <http://europa.eu.int/comm/internal_market/en/company/company/index.htm>. Some of the main governance reform proposed were as follows: are (1) the minimum capital requirement should not be removed, nor increased (2) the introduction of no par value shares is widely demanded (3) the valuation requirement for contributions in kind should be relaxed in certain cases (4) the conditions under which listed companies can restrict or withdraw preemption rights when they issue new shares should be simplified (5) more flexible requirements should be established at least for unlisted companies for the acquisition of own shares (6) the prohibition of financial assistance should be relaxed (7) squeeze-out and sell-out rights should be introduced generally.

[60] Directive 2006/68/EC of the European Parliament and of the Council of 6 September 2006 amending Council Directive 77/91/EEC as regards the formation of public limited liability companies and the maintenance and alteration of their capital, [2006] OJ 264/32.

[61] Third Council Directive of 9 October 1978 based on Article 54 (3) (g) of the Treaty concerning mergers of public limited liability companies (78/855/EEC), OJ 1978 L295/36.

The Fourth Directive[62] is concerned with the accounts of public and private limited liability companies, whilst the Seventh Directive[63] is concerned with the consolidated accounts of such companies. Both these directives make provision for a number of options and are influenced by Anglo-Dutch as well as by French and German accounting principles. The Fourth and Seventh Directive were frequently amended.[64] They were modified by two Directives of 8 November 1990 which dealt respectively with exemptions for small and medium sized companies (SMEs) and the publication of accounts in ECU, and the scope of these two accounts Directives.[65] Recently, the European Council adopted a Directive of 13 May 2003 which amends the Fourth Directive in respect to the possible exemptions of small and medium-sized enterprises (SMEs) from certain accounting requirements.[66] In addition to that, the Directive of 18 June 2003 brings existing Accounting rules into line with current best practice.[67] It complements the International Accounting Standards (IAS) Regulation as the amendments allow Member States which do not apply IAS to all companies to move towards similar, high quality financial reporting. Besides, it provides for appropriate accounting for special purpose vehicles, improves the disclosure of risks and uncertainties and increases the consistency of audit reports across the EU.

The International Accounting Standards (IAS) Regulation, adopted in June 2002 requires all EU companies listed on a regulated market to

[62] Fourth Council Directive of 25 July 1978 based on Article (3) (g) of the Treaty on annual accounts of certain types of companies (78/660/EEC), OJ 1978 L221/11.

[63] Seventh Council Directive of 13 June 1983 based on Article 54 (3) (g) of the Treaty on consolidated accounts (83/349/EEC), OJ L193/1: see F Wooldridge 'The EEC Council Directive on Consolidated Accounts' [1988] 37 ICLQ 714. Amendments were made to the Fourth and Seventh Directives by Directive 2007/46 of 14 June 2006 OJ 2006 L 224/1.

[64] See for instance Directive 2001/65/EC of the European Parliament and of the Council of 27 September 2001 amending Directives 78/660/EEC, 83/349/EEC and 86/635/EEC as regards the valuation rules for the annual and consolidated accounts of certain types of companies as well as of banks and other financial institutions, OJ 2001 L 283/28 or Council Directive 91/674/EEC of 19 December 1991 on the annual accounts and consolidated accounts of insurance undertakings, OJ 1991L 374/7.

[65] Council Directive of 8 November 1990 amending Directive 78/660/EEC on annual accounts and Directive 83/349/EEC on consolidated accounts as concerns the exemptions for small and medium sized companies and the publication of accounts in ecus (90/604/EEC), OJ 1990 L 317/57 and Council Directive of 8 November 1990 amending Directive 78/660/EEC on annual accounts and Directive 83/349/EEC on consolidated accounts as regards the scope of those Directives (90/605/EEC), OJ 1990 L 317/60.

[66] Council Directive 2003/38/EC of 13 May 2003 amending Directive 78/660/EEC on the annual accounts of certain types of companies as regards amounts expressed in euro, OJ 2003 L 120/22. The Directive raises the thresholds for turnover and balance sheet total under which Member States can apply the exemptions about 17%. The Council's move follows a Commission proposal in January 2003. See the Proposal for a Council Directive amending Directive 78/660/EEC as regards amounts expressed in euro of 24.01.2003, COM(2003) 29 final.

[67] Directive 2003/51/EC of the European Parliament and of the Council of 18 June 2003 amending Directives 78/660/EEC, 83/349/EEC, 86/635/EEC and 91/674/EEC on the annual and consolidated accounts of certain types of companies, banks and other financial institutions and insurance undertakings, OJ 2003 L 178/16.

use IAS from 2005 onwards and allows Member States to extend this requirement to all companies.[68] It is the aim of the IAS Regulation to help eliminate barriers to cross-border trading in securities by ensuring that company accounts throughout the EU are more reliable and transparent and that they can be more easily compared.[69]

The Eighth Directive[70] deals with the approval of the auditors of the annual and consolidated accounts of public and private limited liability companies. Differences between accounts and auditing regimes and rules concerning the independence of auditors make it difficult to make meaningful comparisons of financial statements audited in different countries.[71] Important alterations were made to the Eight Directive by Directive 15 May 2006 on statutory audit of annual accounts and consolidated accounts amending Council, Directives 78/660 (the Fourth Company Law Directive) and Directive 83/349 (the Seventh Directive) and repealing Directive 84/253.[72]

The Eleventh Directive[73] governs the coordination of Company Law concerning disclosure requirements in respect of branches opened in a member state by specified kinds of companies governed by the law of another member state. Single member private limited liability companies are governed by the Twelfth Directive.[74]

The Tenth Directive[75] on Cross-Border Mergers of public limited companies supplements the Third Directive on national mergers of such companies. Germany feared that international mergers may be used for the purpose of circumventing codetermination laws, and this long delayed the

[68] Regulation (EC) 1606/2002 of the European Parliament and of the Council of 19 July 2002 on the application of international accounting standards, OJ 2002 L 243/1.
[69] See also the Proposal for a Regulation of the European Parliament and the Council on the application of international accounting standards, Brussels of 13.2.2001, COM(2001) 80 final.
[70] Eighth Council Directive of 10 April 1984 based on Article 54 (3) (g) of the Treaty on the approval of persons responsible for carrying out the statutory audits of accounting documents (84/253/EEC), OJ 1984 L126/20.
[71] The Eighth Directive contains no guidance on the independence of auditors, which has been the subject matter of a consultation by the Commission. See the Commissions Recommendation of 15 November 2000 on quality assurance for the statutory audit in the European Union: minimum requirements, OJ 2001 L 91/91.
[72] OJ 2006, L257/87.
[73] Eleventh Council Directive of 21 December 1989 concerning disclosure requirements in respect of branches opened in a Member State by certain types of companies governed by the law of another State (89/666/EEC), OJ 1989 L395/36.
[74] Twelfth Company Law Directive of 21 December 1989 on single-member private limitedliability companies (89/667/EEC), OJ 1989 L395/4082.
[75] Directive 2005/56/EC of the European Parliament and of the Council of 26 October 2005 on cross-border mergers of limited liability companies, OJ 2005 L310/1. This generally adopted the mechanisms of the original Proposal of 14 January 1985 for a Tenth Council Directive based on Article 54 (3) (g) of the Treaty concerning cross-border mergers of public limited companies (COM(84) 727 final), OJ 1985 C23/11.

adoption of this proposal.[76] The High Level Group of Company Experts recommended that the Commission should urgently bring forward this proposal.[77] It was argued that the Directive supplementing the Statute for a European company[78] could be a model for resolving the difficulties relating to the board structure and employee participation. The SE Statute has also had an impact as a means of effecting cross border mergers and of the ECJ ruling in *Sevic*[79] will have an impact in this field.

The Proposal for a Thirteenth Directive on the coordination of company law concerning take-over bids of 1997 was rejected by the European Parliament on 4 July 2001 (273 votes for and 273 votes against).[80] The European Parliament's decision was motivated by three main political considerations: (1) rejection of the principle whereby, in order to take defensive measures in the face of a bid, the board of the offeree company must first obtain the approval of shareholders once the bid has been made, until such time as a level playing field was created for European companies facing a takeover bid; (2) regret that the protection which the directive would afford employees of companies involved in a takeover bid was insufficient; (3) the failure of the proposal to achieve a level playing field with the United States. The Commission therefore set up a High-Level Group of Company Law Experts under the chairmanship of Professor Jaap Winter with the task of presenting suggestions for resolving the matters raised by the European Parliament.[81] Taken into account the recommendations made by the Group the Commission presented a new Proposal for a Thirteenth Directive on 2 October 2002.[82] The new proposal pursues the same objectives as its predecessor. Firstly, it sets out to strengthen the legal certainty of cross-border takeover bids in the interests of all concerned and to ensure protection for minority

[76] V Edwards, *EC Company Law* (Clarendon Press Oxford 1999) 391-393.

[77] See Report of the High Level Group of Company Law Experts of 4 November 2002 http://europa.eu.int/comm/internal_market/en/company/company/index.htm> 101.

[78] Council Directive 2001/86/EC of October 2001 supplementing the Statute of the European Company with regard to the involvement of employees, OJ 2001 L294/22.

[79] Case C-411/03 *SEVIC Systems* [2005] ECR I-10805.

[80] For the Commission's amended proposal, see COM(97) 565 final, 10 November 1997, [1997] OJC 378/10. The text rejected had - after long negotiations - previously been agreed by the delegations of the Parliament and the European Council in a Conciliation Committee meeting on 6 June 2001. See for the text the Report of the High Level Group of Company Experts on Issues related to Take Over Bids of 10 January 2002 http://europa.eu.int/comm/internal_market/en/company/company/index.htm. See for the discussion, esp for the influence of the Directive on the self-regulation of takeovers in the UK: B Pettet *Private versus Public Regulation in the fields of Takeovers: The Future under the Directive* [2000] 11 European Business Law Review 381; M Andenas *European take-over regulation and the City Code* [1996]

[81] 17 Co Law 150; M Andenas *European Takeover Directive and the City* [1997] 18 Co Law 101. Report of the High Level Group of Company Experts on Issues related to Take Over Bids of 10 January 2002 <http://europa.eu.int/comm/internal_market/en/company/company/index.htm>.

[82] Proposal for a Directive of the European Parliament and of the Council on takeover bids, 2.10.2002, COM (2002) 534 final.

shareholders in the course of such transactions. It furthermore tries to establish a framework for action by Member States by laying down certain principles and a limited number of general requirements. Nevertheless, the Commission tried to supplement it in such a way as to incorporate the amendments adopted by the European Parliament to the previous proposals and to follow the recommendations of the Winter Report as regards a common definition of "equitable price" (Article 5) and the introduction of a squeeze-out right (Article 14) and a sell-out right (Article 15) following a takeover bid.[83] In line with the recommendations of the Winter Report, the new proposal retained the principle (in Article 9) that it is for shareholders to decide on defensive measures once a bid has been made public and proposes greater transparency of the defensive structures and mechanisms in the companies affected by the proposal (Article 10). Furthermore, the Proposal stipulated that restrictions on transfers of securities and restrictions on voting rights should be rendered unenforceable against the offeror or cease to have effect once a bid has been made public (Article 11). However, Article 12 of the Take Over Directive permits Member States not to apply this break-through mechanism, or the provisions of Article 9(2) and (3) of the Directive.

Other Directives govern the information which must be published when major shareholdings in a listed company are acquired and disposed of,[84] the protection of investors by supervising investment firms,[85] and the establishment of a European Works Council.[86] The European Council has adopted a Directive on insider dealing and market abuse.[87] The amendments were necessary to ensure consistency with legislation against market manipulation. A new Directive was also needed to avoid loopholes in Community legislation which could be used for wrongful

[83] In the finalised version of the Directive, the squeeze out right was included in Article 15 and the sell out right in Article 16. Otherwise the numbering contained in the proposal remained unaltered.

[84] Council Directive 88/627/EEC of 12 December 1988 on the information to be published when a major holding in a listed company is acquired or disposed of, OJ 1988, L348/62 which has been integrated into Directive 2001/34/EC of the European Parliament and of the Council of 28 May 2001 on the admission of securities to official stock exchange listing and on information to be published on those securities, OJ 2001 L184/1.

[85] Council Directive 93/22/EEC of 10 May 1993 on investment services in the securities field, OJ 1993 L 141/27. See also the new Proposal for a Directive of the European Parliament and of the Council on Investment Services and Regulated Markets and amending Council Directives 85/611/EEC, Council Directive 93/6/EEC and European Parliament and Council Directive 2000/12/EC, COM (2002) 625.

[86] Council Directive 94/45/EC of 22 September 1994 on the establishment of a European Works Council or a procedure in Community-scale undertakings and Community-scale groups of undertakings for the purposes of informing and consulting employees, OJ 1994 L254/64.

[87] Directive 2003//6/EC of the European Parliament and the Council of 28 January 2003 on insider dealing and market manipulation (market abuse), OJ 2003 L96/16 which replaced the Council Directive 89/592/EEC of 13 November 1989 coordinating regulations on insider dealing, OJ 1989 L 334/30.

conduct and which would undermine public confidence and therefore prejudice the smooth functioning of the markets.

6. Draft Legislation

There are several company law instruments which have not been adopted yet. The proposed Fifth Directive[88] on the structure and functioning of the organs of public limited companies[89] has not yet been enacted and seems unlikely to be, at least in its present form, even though it is one of the first projects in European company law.[90] Its initial proposals on board structure and employee participation which were stigmatised as being too rigid, were subsequently made more flexible, but have still remained unacceptable, although they may have some influence on further work on corporate governance. The Report of the High Level Group of Company Experts of 4 November 2002 focuses on several issues the Fifth Directive was meant to deal with.[91] The recommendations cover in particular shareholder rights relating to the participation in general meetings, cross-border voting, board structure (choice between one-tier/two-tier) and the role of non-executive and supervisory directors. In a Communication on shareholder rights[92] the Commission set out its ideas for a Directive on shareholder rights. The principal issue appears to be the exercise of shareholders' voting rights, especially where shareholders invest in shares through shares held by intermediaries. There may well be a consensus in the Council of the proposed directive in the near future, and also on one share – one vote initiatives which remain controversial.

Finally, a proposal exists for a Fourteenth Directive on the transfer of the registered office or the *de facto* head office of companies[93] from one

[88] Amended Proposal of 20 November 1991 for a Fifth Directive based on Article 54 of the EEC Treaty concerning the structure of public limited companies and the powers and obligations of their organs, COM (91) 372 final).

[89] For a useful account of this proposal, see V Edwards, EC Company Law (Clarendon Press Oxford 1999) 387-90.

[90] See for more details A Boyle *Draft Fifth Directive - Implications for Directors' Duties, Board Structure and Employee Participation* [1992] 13 The Company Lawyer 6; T Conlon *Industrial Democracy and EEC Company Law - a Review of the Draft Fifth Directive* [1975] 24 ICLQ 348; JJ Du Plessis and J Dine *The Fate of the Draft Fifth Directive on Company Law - Accomodation Instead of Harmonisation* [1997] Journal of Business Law 23; G Keutgen *La proposition de directive européenne sur la structure des sociétés anonymes*, [1973] 72 Revue pratique des Sociétés 1; G Kolvenbach *Die Fünfte EG-Richtlinie über die Struktur der Aktiengesellschaft (Strukturrichtlinie)* [1983] Der Betrieb 2235; J Temple Lang *The Fifth EEC Directive on the Harmonization of Company Law - Some Comments from the Viewpoint of Irish and British Law on the EEC Draft for a Fifth Directive Concerning Management Structure and Worker Participation* [1975] 12 CMLR 155 and 345; J Welch *The Fifth Draft Directive - a False Dawn?* [1983] 8 ELR 83.

[91] See Report of the High Level Group of Company Law Experts of 4 November 2002 <http://europa.eu.int/comm/internal_market/en/company/company/index.htm>.

[92] Commission proposal for a directive on the exercise of shareholders' voting rights (COM(2005)685).

[93] The Directive is applicable to all companies or firms. This is in accordance with Article 43, 48 EC. See in detail S Grundmann, *Europäisches Gesellschaftsrecht* (C F Müller Heidelberg

member state to another.[94] Certain countries use the place of incorporation theory to govern the affairs of companies where a foreign element is involved, whilst others employ the real seat theory (*siège réel* doctrine) for this purpose.[95] The real seat is the place where a company's head office, or central management or control is located.[96] The transfer of the registered office (place of incorporation) from one member state which recognises the place of incorporation theory to another such state does not seem possible at present. Furthermore, the transfer of the real seat of a company from one member state which recognises the real seat doctrine to another such state may be impossible or difficult. Thus the transfer of the real seat of a company out of Germany has been held to entail the dissolution of that company in Germany, and hence its liquidation. If this view were to be upheld, it would have burdensome tax consequences,[97] but it is doubtful whether the European Court of Justice would uphold the German approach, despite its controversial decision in *Daily Mail*[98] which was distinguished in *Überseering*.[99]

The draft Fourteenth Directive attempts to circumvent these difficulties, but still awaits adoption. A revised proposal, based on the Commission's

2003) para 895; Others request the restriction of the scope of the Fourteenth Directive to companies limited by share because this would more appropriate in respect to the scope of other company law directives. See for instance G di Marco, 'Der Vorschlag der Kommission für eine 14. Richtlinie - Stand und Perspektiven' [1999] Zeitschrift für Gesellschaftsrecht 3, 7.

[94] DOCXV/6002/97-EN of 20 April 1997. See for the German text [1999] Zeitschrift für Gesellschaftsrecht 157.

[95] This, of course, is a very imprecise differentiation. See in detail: S Grundmann, *Europäisches Gesellschaftsrecht* (C F Müller Heidelberg 2003) para 295 ff; for a comparative overview, see V Edwards, *EC Company Law* (Clarendon Press Oxford 1999) 335; H Merkt 'Das Europäische Gesellschaftsrecht und die Idee des "Wettbewerbs der Gesetzgeber' [1995] 59 RabelsZ 545 (560); J Wouters 'European Company Law: Quo vadis?' [2000] 37 CMLR 257, 284 and also Lutter, 'The Cross-Border Transfer of a Company's Seat in Europe' [2000] Europarättslig Tidskrift 60; J Wouters and H Schneider (eds), *Current Issues of Cross-Border Establishment of Companies in the European Union* (Antwerpen, Apeldoorn 1995); J P Hansen 'A new look at Centros – from a Danish point of view' [2002] 13 European Business Law Review 85, 86.

[96] For the German law: Bundesgerichtshof in BGHZ 97, 269, 272; even after the *Überseering*-decision of the ECJ: Bundesgerichtshof [2002] Recht der Internationalen Wirtschaft 877; See for the different definitions of the real seat: Drury, 'Migrating Companies' [1999] ELR 354, 362.

[97] For the positon in the UK: F Wooldridge *Company Law in the United Kingdom and the European Community* (Athlone Press London 1991) 8; for Germany: J Thiel 'Die grenzüberschreitende Umstrukturierung von Kapitalgesellschaften im Ertragssteuerrecht' [1994] GmbH Rundschau 277, 278; H F Hügel 'Steuerrechtliche Hindernisse bei der internationalen Sitzverlegung' [1999] ZGR 71, 98; for France: M Menjucq *Droit européen des sociétés* (Montchrestien Paris 2001) 301 f, 309 f and for Italy: H Bruhn *Niederlassungsfreundliche Sitzverlegung und Verschmelzung über die Grenze nach italienischem Recht - eine rechtsvergleichende Untersuchung unter Berücksichtigung der europäischen Niederlassungsfreiheit* (Bonn Diss 2002) 142-197 and 197-234.

[98] Case 81/87 R v Treasury ex p Daily Mail [1988] ECR 5483.

[99] Case C-208/00 *Überseering BV v Nordic Construction Company Baumanagement GmbH* [2002] ECR I-9919.

consultation on the transfer of a company's registered office from one Member State to another may be anticipated. Further measures governing the matter of the *de facto* head office are unlikely in the immediate future. However, it is anticipated that a future such proposal would aim at facilitate the freedom of companies to forum shop within the EU Member States whose domestic legislation best suits the company. Furthermore, the freedom of establishment of companies seems to assume a right of transfer of the seat. For that reason the High Level Group of Company Experts recommended that the Commission should move forwards with this directive.[100] In *Überseering*, the ECJ held that when a company transferred its seat from the United Kingdom to Germany, the latter country could not deny it legal capacity and the capacity to bring legal proceedings. It is unclear whether the ECJ would now adopt the same approach as in the *Daily Mail* case to the situation where home state restricts the transfer of the central administration of a company incorporated under its laws to another member state. *Überseering*, which is discussed further in the following chapter leaves certain matters unsettled.[101] The differentiation made between exit and entry restrictions undertaken by some through an interpretation of this case, finds no base in the relevant law on the right of establishment and to provide services and the free movement of capital. The differentiation made between exit and entry restrictions was not mentioned in the ECJ's judgment in the *Daily Mail* case, which appears to have no adequate legal basis. However, in particular some German writers and courts have treated this decision as good law, permitting exit restrictions upon German companies.

The draft Fourteenth Directive has seemed to be of importance because the concept of a "common market for companies" would appear to involve the possibility of the alteration of a company's head office or primary establishment from one member state to another. The implementation of the proposed Directive may give rise to certain tax problems which require resolution before it is enacted.[102] It is thought that the transfer should be tax neutral, and should produce the same effect as a cross border merger. This would require amendments of Directive 9/434/EC. It may also give rise to prejudice for creditors situated in the state from which the company has migrated, who discover that the security given to

[100] See Report of the High Level Group of Company Law Experts of 4 November 2002 <http://europa.eu.int/comm/internal_market/en/company/company/index.htm> 101. For the difficulties relating to the board structure and employee participation the Directive supplementing the Statute for a European company could be a model.

[101] See also F Wooldridge Freedom of Establishment of Companies Affirmed [2003] 14 EBLR 227, 234; M Andenas Free Movement of Companies [2003] 119 LQR 221.

[102] R A Deininger, Grenzüberschreitende Verlegung des Hauptverwaltungssitzes und der Geschäftsleitung von Kapitalgesellschaften - eine Betrachtung unter europarechtlichen, gesellschaftsrechtlichen und steuerrechtlichen Gesichtspunkten (GCA Herdecke 2001); C Ebenroth and T Auer 'Die Vereinbarkeit der Sitztheorie mit europäischem Recht - Zivil- und steuerrechtliche Aspekte im deutschen Recht' [1994] GmbH Rundschau 16.

them in accordance with the proposed Directive is inadequate. It was also contended that the provisions of the proposed Coordinating Directive on employee participation are unsatisfactory. It has been proposed that employee participation rights should be governed by legislation of the host member states, but where they are more firmly enshrined in the Home Member State, they should be maintained or registered. A new legislative proposal was adopted in June 2007.

Although drafts of a proposed Ninth Directive on Groups of Undertakings have been circulated in the past,[103] no further work on this proposed instrument, which would have applied to subsidiaries taking the form of a public company (the form of the parent undertaking would have been immaterial) since 1984. The apparent abandonment of work on groups of undertakings seems regrettable. As is contended in the section which follows, the proposal was probably too much influenced by German law to prove widely acceptable. However, recent proposals on a Corporate Law Group for Europe have recently been made by a private body consisting of academics, the *Forum Europaeum Konzernrecht*.[104] These proposals were published in Stockholm by the Corporate Governance Forum. The Group of Company Law Experts set up by the Commission failed to recommend the enactment of a coherent body of law dealing with groups of companies.[105] Nevertheless, it made suggestions for a better financial disclosure of group structure in respect to the Seventh Company Law Directive and consistency with International Accounting Standards. Another recommendation is to require national authorities, responsible for the admission to trading on regulated markets, not to admit holding companies whose sole or main assets are their shareholding in another listed company, unless the economic value of such admission is clearly demonstrated.

[103] See for the proposal of 1984 Doc III/1639/84-E. The German text can be found in [1985] Zeitschrift für Gesellschaftsrecht 444, the French text in Commission Droit et Vie d' Affaires, [1986] Modes de rapprochement structurel des enterprises. See also: V Edwards, EC Company Law (Clarendon Press Oxford 1999) 390 f; U Immenga 'L'harmonisation de droit de groupes de sociétés – La proposition d'une directive de la Commission de la C.E.E.' [1986] 14 Giurisprudenza Commerciale 846 and Hommelhoff 'Zum revidierten Vorschlag für eine EG-Konzernrichtlinie' in Reinhard Goedeler (ed) Festschrift Fleck (de Gruyter Berlin 1988) 125.

[104] This was funded by a German Foundation, the Fritz Thyssen Stiftung. See the publication of their proposals in Forum Europaeum Konzernrecht Konzernrecht für Europa [1998] Zeitschrift für Gesellschaftsrecht 672; RM Manóvil Forum Europaeum sobre derecho de grupos - algunas de sus propuestas vistas desde la perspective sudamericana in: J Basedow (ed) Aufbruch nach Europa, Festschrift 75 Jahre Max-Planck-Institut für Privatrecht (Mohr Siebeck Tübingen 2001) 215; J Lübking Ein einheitliches Konzernrecht für Europa (Nomos Baden-Baden 2000); D Sugarman and G Teubner (eds) Regulating Corporate Groups in Europe (Nomos Baden-Baden 1990); C Windbichler '"Corporate Group Law for Europe" - Comments on the Forum Europaeum's Principles and Proposals for a European Corporate Group Law' [2000] 1 EBOR 265; E Wymeersch 'Harmoniser le droit des groupes de sociétés en Europe?' in O Due (ed) Festschrift Everling, (Nomos Baden-Baden 1995) 1699.

[105] See Report of the High Level Group of Company Law Experts of 4 November 2002 <http://europa.eu.int/comm/internal_market/en/company/company/index.htm> 94.

Finally, in 1987 the Commission introduced a preliminary draft for a directive on the liquidation of companies[106] which has not been developed further in the following years. The EU Bankruptcy Regulation was adopted as Regulation 1346/2000; its provisions represent a compromise between the universal and territorial principles. The main insolvency proceedings must take place in the state of domicile of the debtors while insolvency proceedings may be commenced in states which the debtor has a place of business.

7. Methodological Problems Concerning Company Law Harmonisation

It is sometimes contended that there is no need for such an extensive programme of company law harmonisation. It is thus argued that better results might be obtained by means of regulatory competition.[107] According to this idea legislators can be compared with producers of other goods and therefore regulated by the market.[108] Another aspect is that competition can be used as a discovery process which leads to more efficient solutions.[109] Many point to the fifty state legal orders available to companies in the United States.[110] However, American company law may be less concerned with the protection of investors, creditors and employees than is European company law. Investors are thus protected

[106] See for the text: draft Proposal DOC XV/43/87-EN; and for comments: E Werlauff EC Company Law (Jurist– og Økonomforbundets Forlag Copenhagen 1993) 408 ff. E Werlauff EU Company Law (2 ed Jurist– og Økonomforbundets Forlag Copenhagen 2003)

[107] Basis for this theory were the ideas of CM Tiebout 'A Pure Theory of Local Expenditures' [1956] 64 Journal of Political Economy 416 ff (Exit-Option).

[108] D C Esty and D Geradin 'Regulatory Co-operation' [2000] Journal of International Economic Law 235, 238 f; K Gatsios and P Holmes 'Regulatory Competition', in P Newman (ed), The New Palgrave of Economics and the Law, Vol 1 (Palgrave, London Vol 1 1998) 271.

[109] J A Schumpeter The Theory of Economic Development - An Inquiry into Profits, Capital, Credit, Interest and the Business Cycle (Harvard University Press, Cambridge, MA 1934); F A v. Hayek 'Competition as a Discovery Procedure' in: FA v. Hayek (ed) New Studies in Philosophy, Politics, Economics and the History of Ideas (University Press Chicago 1985) 179 ff; see also W Kerber 'Rechtseinheitlichkeit und Rechtsvielfalt aus ökonomischer Sicht' in S Grundmann (ed) Systembildung und Systemlücken in Kerngebieten des Europäischen Privatrechts, Gesellschaftsrecht, Arbeitsrecht, Schuldvertragsrecht, (Mohr Siebeck Tübingen 2000) 67, 68; V Vanberg and W Kerber 'Institutional Competition among Jurisdictions: An Evolutionary Approach' [1994] 5 Constitutional Political Economy 193, 198.

[110] See J. Wouters, 'European Company Law: Quo Vadis', 37 CmLRev 2000, pp.256, 282-9. See for the development in United States: L A Bebchuk 'Federalism and the Corporation: The Desirable Limits on State Competition in Corporate Law' [1992] 105 Harvard Law Review 1435, 1444-1448; C Alva 'Delaware and the Market for Corporate Charters – History and Agency' [1990] 15 Delaware Journal of Corporate Law 885 ff; R M Buxbaum and K Hopt, Legal Harmonization and the Business Enterprise - Corporate and Capital Market Law Harmonization Policy in Europe and the U.S.A. (de Gruyter Berlin / New York 1988) 25 ff; R Romano, The Genius of American Corporate Law (AEI, New York, 1993) 14 ff; HN Butler 'Nineteenth Century Jurisdictional Competition in the Granting of Corporate Privileges' [1985] 14 Journal of Legal Studies 129 ff; A Conard 'An Overview of the Laws of Corporations' [1973] 71 Michigan Law Review 623 ff.

through the medium of Federal securities regulations whilst creditors receive protection through the medium of federal bankruptcy legislation and the Uniform Commercial Code.

Deakin contrasts two models of regulatory competition. One based on a US pattern of 'competitive federalism', the other a European conception of reflexive harmonisation. In the European context, he contends, harmonisation of corporate and labour law, contrary to its critics, has been a force for the preservation of diversity, and of an approach to regulatory interaction based on mutual learning between nation states. It is thus paradoxical, and arguably antithetical to the goal of European integration, that this approach is in danger of being undermined by attempts, following the *Centros* case, to introduce a Delaware-type form of inter-jurisdictional competition into European company law. [111]

Further, there are several reasons why a legislative competition in the European Union cannot be as effective as in United States.[112] Traditionally, competition between the laws of Member States has not been regarded as an appropriate paradigm for the law of the European Community.[113] Further, of the 27 states which are at present members of the EU, broadly speaking, it appears that only six (the United Kingdom, Ireland, Denmark, Netherlands, Finland and Sweden) accept the incorporation theory, according to which a company is governed by the law in accordance with which it is duly established.[114] The other EC countries treat the law governing the internal affairs of a company as that of the place where it has its real seat (management and control centre). There is however, some doubt as to whether France still makes the real seat the principal connecting factor.[115] The use of the real seat theory makes it difficult for competition to occur between jurisdictions in the field of company law: according to this theory companies have to be incorporated, or reincorporated in the country in which they have their real seat. In addition to that, there are several tax barriers which may make a legislative competition more

[111] S Deakin 'Legal Diversity and Regulatory Competition: Which Model for Europe?' (2006) 12 European Law Journal 440.
[112] H Merkt ‚Das Europäische Gesellschaftsrecht und die Idee des „Wettbewerbs der Gesetzgeber' [1995] 59 RabelsZ 545, 560; Wouters ‚European Company Law: Quo vadis?' [2000] 37 CMLR 257, 284.
[113] W Kolvenbach 'EEC Company Law Harmonization and Worker Participation' [1990] 11 U.Pa.J.Int.Bus.L. 709, 711 ff; expressly C M Schmitthoff, 'The Future of the European Company Law Scene in': C M Schmitthoff (ed) The harmonization of European Company Law (UK National Committee of Comparative Law 1973) 3, 9 ("the Community cannot tolerate the establishment of a Delaware in its territory. This would lead to a distortion of the market by artificial legal technicalities").
[114] See the account of the incorporation theory in S Rammeloo Corporations in Private International Law Oxford OUP 2001 pp 116-20.
[115] Note in this sense, M Menjucq Droit international et européen des sociétés (Montchrestien, Paris 2001) 90-95.

difficult.[116] The more pluralistic orientation of many European company laws (for instance towards employee representation) does not permit a simple choice between the different national laws which would be necessary for an effective competition.[117] Finally, there is no comparable incentive for European legislators to compete since incorporation fees have not much importance for the budget of the different Member States.[118] It may of course ultimately prove possible to simplify the exercise of the right of primary establishment of companies through the enactment of the proposed Fourteenth Directive, which has been mentioned above,[119] or possibly through the decisions of the European Court of Justice.

After the decisions *Centros* and *Überseering* one might take a more positive view. They can be understood as decisions towards more freedom of choice.[120] The principle of mutual recognition as a foundation for the Free Movement in the EU might be a functional instrument.[121] Even if the Freedom of Establishment can be restricted by national law for reasons of general interest the national law of the host Member State cannot be applied if the home Member State delivers equivalent protection. This gives a certain room for competition between the different national legislators.

[116] W F Ebke 'Unternehmensrecht und Binnenmarkt – E pluribus unum?' [1998] 62 RabelsZ 195, 208; R Romano 'Explaining the American Exceptionalism in Corporate Law' in: W Bratton and J McCahery and S Picciotto and C Scott (eds), International Regulatory Competition and Coordination - Perspectives on Economic Regulation in Europe and the United States (Clarendon Press 1996) 127, 141.

[117] H Merkt 'Das Europäische Gesellschaftsrecht und die Idee des „Wettbewerbs der Gesetzgeber"' [1995] 59 RabelsZ 545 (554-560); K Gatsios and P Holmes 'Regulatory Competition' in: P Newman (ed) The New Palgrave of Economics and the Law, Vol 1 (Palgrave, London Vol 1 1998) 271 (274).

[118] R Romano, The Genius of American Corporate Law (AEI, New York, 1993) 133; D Carney 'Competition among Jurisdictions in Formulating Corporate law rules: An American Perspective on the „Race to the Bottom" in the European Communities' [1991] 32 Harvard International Law Journal 423.

(447).

[119] Furthermore, Article 65(b) EC enables measures in the field of judicial cooperation in civil matters having cross border implications to be taken insofar as necessary for the proper functioning of the internal market.

[120] S Grundmann, 'Wettbewerb der Regelgeber im Europäischen Gesellschaftsrecht – jedes Marktsegment hat seine Struktur,' [2001] Zeitschrift für Gesellschaftsrecht 783; E Wymeersch 'Company Law in the Twenty-First Century' [2000] 1 International and Comparative Corporate Law Journal 331, 339.

[121] S Grundmann, 'Das Thema Systembildung und Systemlücken', in S Grundmann (ed) Systembildung und Systemlücken in Kerngebieten des Europäischen Privatrechts, Gesellschaftsrecht, Arbeitsrecht, Schuldvertragsrecht, (Mohr Siebeck Tübingen 2000) 1, 16. See for more details: E Lomnicka 'The Home Country Control Principle in the Financial Service Directives and the Case Law' in M Andenas and W-H Roth Services and Free Movement in EU Law (Oxford UP Oxford 2002) 295, 315.

The concepts of subsidiarity and proportionality, which are contained in a Protocol annexed to the Amsterdam Treaty,[122] may have some inhibiting effect on further harmonisation of company law, although the existence of these concepts does not seem to have had an inhibiting effect in the fields of consumer and environmental law.[123] Harmonisation through the medium of model laws, as in the United States, would seem to have the disadvantage that considerable delays may occur in taking any action, and there may well be significant disparities in the extent to which particular features of the relevant model are adopted in particular states.

It will be remembered that according to Article 249(3) EC directives leave member states a choice of form and method and may be compared in this respect to model laws. However, certain of the provisions of the company law Directives contain detailed and highly specific rules: this is true, for example, of certain provisions of the Second Directive. On the other hand, certain Directives, in particular the Fourth and Seventh Directive, contain a considerable number of options and alternatives. This is necessary given differences in accountancy practice in the member states.[124]

It is sometimes suggested that legislation by Directives gives rise to the risk of petrification of the laws as directives cannot be amended very easily. The risk seems to be exaggerated: certain of the Directives provide for the establishment of Contact Committees to make recommendations for their amendment: this is true of the Fourth, Seventh and the Eighth Directives. Certain directives have been amended. Thus quite frequent amendments have been made to the Fourth Directive on Company Accounts. Articles 18-24 of the Second Directive on the formation of public companies and the maintenance and alteration of their capital, which are concerned with the subscription and acquisition by a company of its own shares was extended to transactions of this kind through the medium of controlled companies by Article 24a of the Directive which was incorporated by Council Directive (EEC) 92/10 of 23 November 1992.[125]

[122] Treaty of Amsterdam amending the Treaty on European Union, the Treaties establishing the European Communities and related Acts, OJ 1997 C 340. See also J P Gonzalez 'The Principle of Subsidiarity (a Guide for Lawyers with a Particular Community Orientation' [1995] European Law Review 355; A K Toth 'The Principle of Subsidiarity in the Maastricht Treaty' [1992] 29 CMLR 1079.
[123] Not only as a consequence of the wording in Article 44(2)(g) EC ("coordinating to the necessary extend") it has been doubted if the principle of subsidiarity can have a further restricting effect. See summarizing: K J Hopt 'Company Law in the European Union: Harmonization and/or Subsidiarity' [1999] 1 International and Comparative Corporate Law Journal, 41, 48.
[124] V Edwards, EC Company Law (Clarendon Press Oxford 1999) 117.
[125] Council Directive 92/101/EEC of 23 November 1992 amending Directive 77/91/EEC on the formation of public limited companies and the maintenance and alteration of their capital, OJ 1992 L374/64.

However, it has been contended that certain of the provisions of the Second Directive, for example those of Article 23 prohibiting (with certain exceptions) a company advancing funds, making loans or providing security with a view to acquisition of its own shares by a third party, and those of Article 29(1) concerning pre-emptive rights on an increase of capital, may well not be entirely satisfactory.[126] The Law Society's Standing Committee on Company Law criticised Article 23 on the ground that instead of the absolute prohibition now enshrined therein, financial assistance should be prohibited unless the transaction concerned had been approved by a shareholder's resolution.[127] Article 29(1) has been criticised by Rodière on the ground that it imposes only one method of protecting existing shareholders against the dilution of their holding to the exclusion of others, and may be regarded as going beyond harmonisation.[128] The High Level Group of Company Experts in its Report of 4 November 2002 took up a similar position as they suggested that acquisition of own shares should be allowed within the limits of the distributable reserves, and not of an entirely arbitrary percentage of legal capital like the 10% limit of the current Directive.[129] The Company Law Slim Working Group already in 1999 considered that current prohibitions on financial assistance in Article 23 should be reduced to a practical minimum and recommended to limit financial assistance to that part of the assets to which creditors cannot assert any claim (to the amount of distributable net assets[130] and

[126] Although Article 23 Second Directive was modelled on existing United Kingdom legislation. See V Edwards, EC Company Law (Clarendon Press Oxford 1999) 51. Article 23(1) has now been replaced by the new provisions of Article 10b(6) incorporated in the Second Directive by Directive 2006/69/EC of the European Parliament and Council, OJ 2006, L264/32.

[127] Memorandum No. 346, p.78.

[128] R Rodière, 'L'harmonisation des legislations européennes dans le cadre de la CEE' [1965] R.T.D.E. 336, 353 et seq. For recent proposals for amendment of the Directive by the Group of Company Law Experts, see 24 Co Law (2003) p.52. No such amendment has been made by Directive 2006/68/EC, OJ 2006 L264/32 which covers only a limited number of topics. Further amendments may be made in the future.

[129] The same should apply to the taking of own shares as security. It should be possible to establish flexible requirements at least for unlisted companies. See Report of the High Level Group of Company Law Experts of 4 November 2002 <http://europa.eu.int/comm/internal_market/en/company/company/index.htm> 84.

[130] This standard is also followed in certain member states with regard to financial assistance granted by private limited companies, which are not subject to the directive. The new provisions contained in Art 10b(6) of Directive 2006/68/EC stipulates inter alia that the aggregate financial assistance granted to a third party shall at no time permit the reduction of the net assets below the amounts specified in articles 15(1)(a) and (b) of the Second Directive. Thus except in the cases of reduction of subscribed capital, no redistribution to shareholders may be made when on the closing date of the last financial year, the net assets as set out in the company approved accounts are, or following such a distribution would become, lower than the amount of the subscribed capital plus those reserves which may not be distributed under the law or the statutes. The Second Directive only applies to public listed companies.

to the subscription of new shares).[131] In respect of Article 29, the High Level Group held, as the SLIM Group already had suggested, that for listed companies it would be appropriate to allow the general meeting to empower the board to restrict or withdraw pre-emption rights without having to comply with the formalities imposed by Article 29(4), but only where the issue price is at the market price of the securities immediately before the issue or where a small discount to that market price is applied.[132]

The harmonisation of company law has encountered the difficulty that certain legal concepts may be familiar in one member state, but unfamiliar and hard to understand in another. The most obvious example of this is the concept of the organs of a company, which is used in the First Directive in relation to *ultra vires* transactions. This concept is familiar in Germany and in some other member states (such as France and the Netherlands) but is not familiar in the United Kingdom or Ireland.[133] This unfamiliarity and differences between German and other concepts of corporate representation[134] help to explain the difficulties encountered by the United Kingdom in implementing Article 9 of the First Directive.[135] A third attempt at such implementation which departs to some extent from

[131] See Report from the Commission to the European Parliament and the Council– Results of the fourth phase of Slim, 04.02.2000, COM (2000) 56 final; E Wymeersch 'Company Law in the Twenty-First Century' [2000] 1 International and Comparative Corporate Law Journal 331, 332-335; E Wymeersch European Company Law: The Simpler Legislation for the Internal Market (SLIM) Initiative of the EU Commission, [2000] 9 Working Paper Series Universiteit Gent.

[132] The Commission in its Plan for Modernising Company Law considered these recommendations as a priority for the short term. See Communication from the Commission to the Council and the European Parliament – Modernising Company Law and Enhancing Corporate Governance in the European Union – A Plan to move forward, 21.5.2003, COM (2003) 284 final p. 18.

[133] See for a comparative overview: P van Ommeslaghe 'La première directive du Conseil du 9 mars 1968 en matière de sociétés' [1969] CDE 619, 619-627; see also: V Edwards, EC Company Law (Clarendon Press Oxford 1999) 34; S Grundmann, Europäisches Gesellschaftsrecht (Heidelberg C F Müller 2003) para 248.

[134] In Germany, a company is treated as acting through its organs: restrictions on their powers have no effect against third parties unless they are aware of that the representative in exceeding them are abusing their powers, or they collude with them in such abuse. The other original member states adopt the mandate or agency theory, according to which the authority of an agent may be limited by his principal. They may be ultra vires in the absence of such authority. However, the effect of the ultra vires doctrine (which was also familiar in the United Kingdom) is ameliorated by a variety of legal devices in all the relevant legal systems.

[135] D Wyatt 'The First Directive and Company Law' [1978] 94 LQR 182, 184; W Fikentscher and B Großfeld 'The proposed directive on company law' [1964] 2 CMLR 259; H C Ficker 'The EEC Directives on Company Law Harmonisation' in: C M Schmitthoff (ed) The harmonization of European Company Law (UK National Committee of Comparative Law 1973) 66, 75.

section 35A of the Companies Act 1985,[136] which itself replaced section 9 of the European Communities Act 1972, has taken place with the enactment of section 40 of the Companies Act 2006. It appears that the concept of the "true and fair view" which is used in the Fourth and Seventh Directives, is unfamiliar in most continental countries, and its implementation has given rise to difficulties in Germany.[137] The harmonisation of company law has also suffered from the fact that the Commission has limited resources, and cannot always take action against states which fail to implement it properly.

Another criticism of the harmonisation process is levelled against the failure of the Community to enact rules governing certain important matters, such as groups of companies and to make provision for a European private company, the creation of which has been proposed by J. Boucourechliev and others.[138] The "salami" process of harmonisation, which involves the harmonisation of limited topics, leaving closely related ones unaffected has also been criticised.[139] Such an approach would seem however to be inevitable given the personnel and time constraints placed on the community institutions as well as the limitations of their powers.

8. Free Movement, Harmonisation and Comparative Company Law

The process of harmonisation often involves practical exercises in comparative company law, and would seem to have stimulated interest

[136] This provision was intended to implement Article 9(2) of the First Directive, but it does not do so adequately, because it fails to apply to managing directors and chief executives and does not deal with limitations arising from board resolutions: note in this sense V Edwards, EC Company Law (Clarendon Press Oxford 1999) 42-4. It seems that s 40 of the Companies Act 2006 still suffers from the mentioned defects.

[137] M Habersack Europäisches Gesellschaftsrecht (Munich Beck 1999) para 283 seq. See for the German law: § 264(2) HGB [German Commercial Code] and Case C-234/94 Tomberger [1996] ECR I-3145, 3153 para 17 (true and fair view as overriding principle); V Edwards, EC Company Law (Clarendon Press Oxford 1999) 128-30; See generally: P Bird 'What is "A True and Fair View"?' [1984] J.Bus.L. 480; K van Hulle 'The EEC Accounting Directives in Perspective: Problems of Harmonization' [1981] 18 CMLR 121.

[138] J Boucourechliev and P Hommelhoff (eds), Vorschläge für eine Europäische Privatgesellschaft - Strukturelemente einer kapitalmarktfernen europäischen Gesellschaftsform nebst Entwurf für eine EPG-Verordnung der Europäischen Gemeinschaft (O. Schmidt Köln 1999); P Hommelhoff and D Helms (eds) Neue Wege in die Europäische Privatgesellschaft - Rechts- und Steuerfragen in der Heidelberger Diskussion (O.Schmidt Köln 2001); H-J de Kluiver and W van Gerven (eds) The European Private Company? (Maklu Antwerpen 1995).

[139] Some regard the outcomes of European company law harmonisation as a fragmentary and compromise solution. See W Schön 'Das Bild des Gesellschafters im Europäischen Gesellschaftsrecht' [2000] 64 RabelsZ 1, 7; GC Schwarz, Europäisches Gesellschaftsrecht (Baden-Baden Nomos 2000) para 3. See the present prevailing views in for instance E Werlauff EU Company Law. Common Business Law for 28 States (2nd ed DJØF Publishing Copenhagen 2003) in the 'Introduction' at p XV and S Grundmann 'The Structure of European Company Law: From Crisis to Boom' (2004) 5 European Business Organisation Law Review 601 where the title indicates the author's thesis.

in this discipline among scholars and practitioners. The use that has been made of comparative law techniques at the Community level and in processes of national legal reform, varies. As pointed out in the introduction to this article, comparative law serves several fundamental functions here. First in identifying the barriers that exist in the national laws; then, second, in the drafting of directives and other measures to overcome these barriers; third, in the transposition into and subsequent application of national law; and finally and fourth, free movement of companies will entail the use of the company law rules of different jurisdictions. There are many problems that arise in the study of this subject.

One conclusion remains certain. Harmonisation will not lessen the demand for comparative law scholarship and practical knowledge of the company laws of different EU Member States.

Regulatory Competition vs Harmonisation: Is There a Third Way?

Stelios Andreadakis[1]

The ultimate goal of the European Community is the establishment of an internal market. A common market will be achieved when all obstacles for cross-border activities of business in Europe will be eliminated and when the frontiers between the European countries will be nothing more than signboards by the road.[2] Assuming that a free internal market is becoming a reality, the next challenge is to ensure that this market is well-organized, stable and efficient. To that end, an important focus of the EU policy is to develop and implement mechanisms that enhance the efficiency and competitiveness of business across Europe. In order to do so, it will have to be able to efficiently restructure and move across borders, adapt its capital structures to changing needs and attract investors from many Member States and other countries.[3]

In the quest for the best path towards the achievement of economic and political integration, for the best mechanism for the creation of an efficient regulatory environment, regulatory competition is the issue that comes to the center of interest and magnetises everybody's attention. The main subject of this article is the interaction between regulatory competition and its main conflicting theory, Harmonisation. Do any of these seem to be the missing link in the chain of optimal Company Law regulation or is there an alternative choice? Reflexive Harmonisation will be also an essential part of the forthcoming analysis, in view of the fact that it is presented as the most promising regime, which seeks to put an end on the polarization between regulatory competition and Harmonisation.

In order to address all these themes, this article will first of all outline the characteristics of regulatory competition, as they are emphasised by both its supporters and opponents. It will then set out some theoretical considerations relating to the Harmonisation debate along with the steps that have been made towards the Harmonisation of Company Law rules in the EU. Following the creation of a theoretical background about both contrasting theories, a contrast will be made between the experience

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[2] Davis G., *European Union-Internal Market Law*, Cavendish Publishing, 2nd ed., UK, 2003, pg. 2.
[3] Report of the High Level Group of Company Law Experts on a Modern Regulatory Framework for Company Law in Europe, Brussels, 4 November 2002, Chapter II, pg. 30.

of Harmonisation and regulatory competition in the field of company law in the American and, mostly, the European context, drawing out the essential differences between them. The conflict between regulatory competition and Harmonisation has monopolised the discussion on the ideal regulatory regime and for a weird reason does not allow us to examine alternative solutions. At this point, the issue of reflexive Harmonisation will be discussed as an alternative option, because it is considered to represent the future of regulation in the European Union. The article concludes by reflecting on the future of the regulatory models in Europe and by assessing the effectiveness of reflexive Harmonisation.

1. Regulatory Competition

After a close historical analysis, it appears that regulatory competition is not a result of globalisation or a side-effect of the modern trend for no barriers in the commercial transactions. Regulatory competition came about unintentionally, in the sense that no legislator or judge had it in mind as one of the potential future developments. What can be argued is that it was underpinned by the EU's strategy of removing barriers to inter-state trade and defending against institutional pressures. In consequence, only the fact that it was not an intended and planned development rather than a methodical result of systematic planning has increased its importance.

Regulatory competition is the result of the combination of the words regulation and competition. It is useful to focus on this combination for a while. Nowadays, literately every single economic activity is subject to regulation. Regulation is about politics as it has to deal with the interaction between the players of the game. In this context, regulation is more than a legal restriction, as it always involves the art of judgement as well as the science of understanding.[4] Effective regulation is the one which finds the balance between conflicting interests and which resists the pressures from the interested parties. The need for regulation does not indicate a need for a sole regulator, who will take full responsibility for creating the ideal regulatory environment. Such person would be the protagonist, a 'monopolist regulator' as Roberta Romano characterises him[5], but there is no viable political structure to support an international regulator.[6] Since monopolistic regulation is not the answer, competition enters the discussion.

[4] Murphy D., *The structure of Regulatory Competition: Corporations and Public policies in A Global Economy*, Oxford University Press, United Kingdom, 2004, pg. 254.
[5] Romano R., 'Empowering Investors: A Market Approach to Securities Regulation' (1998), 107 Yale Law Journal 2367.
[6] Andenas, M., 'Who is Going to Supevise Europe's Financial Markets' in Andenas, M., and Avgerinos, Y., (eds) *Financial Markets in Europe: Towards a Single Regulator?*, Kluwer Law International, The Hague, 2003, xxv.

Competition between legal and social systems contributes to the evolution of society. This happens not only from a Darwinian perspective, but also because, without competition, the laws will sooner or later become less company-friendly and less efficient. As a result, the legal framework will not be the ideal one to promote wealth creation.[7] The most considerable counter-argument is that without Harmonisation, there will be a 'race to the bottom'. The country with the lowest standards will become the cheapest place to operate, so businesses will rush there. After that development, the other countries will have to lower their standards to survive.

At this point, an attempt for an initial definition can be made. Regulatory competition can be defined as a process involving the selection and de-selection of laws in a context where jurisdictions compete to attract and retain scarce economic resources.[8] A process where regulators deliberately set out to provide a more favourable regulatory environment, in order to either to promote the competitiveness of domestic industries or to attract more business activity from abroad.[9]

2. Regulatory Competition and Company Law

After exploring the origins of the term, regulatory competition will be explored in combination with Company Law in particular.

The above definition can be used as a basis for the further analysis of regulatory competition. In an attempt to extend it, the following comments are extremely useful. The regulatory approach will be constantly improved through incessant filtering and distilling, in order to meet the preferences, needs and expectations of the citizens. In this way, the result will be a set of efficient and up-to-date laws. In that sense, regulatory competition exists by definition in every country. The competing parties are the federal authorities and the State, which basically co-exist and struggle to win the battle of competition. This regulatory co-existence brings together two autonomous 'governments' operating in two different but parallel levels.

Equally, if company law is also added in this 'equation', then inevitably a more narrow approach is adopted. In this context, a comparable competing interaction takes place between governments and companies. Governments traditionally represent the national interest and are the ones who make the rules that companies have to comply with. However,

[7] Romano, note 5, pg. 141.
[8] Deakin, S., 'Is regulatory competition the future for European integration?', (2006), Swedish Economic Policy Review 13, pg. 74.
[9] Gatsios K and Holmes P., 'Regulatory Competition and International Harmonisation' (1997), *Global Economic Institutions Working Paper Series*, No. 36, London, pg. 2.

companies play an enormous role in shaping state preferences and national priorities. As a result, the field of Company Law consists of rules that are shaped by market power, negotiations, strategic alliances, coalitions and agreements.[10] These rules aim at prescribing behavioural roles; they contain activity and shape expectations.[11] Companies traditionally want more independence and more freedom; they want to have influence on the political and economic developments of modern society. That's why very often companies raise the flag of revolution against state intervention, asking for less rules or even deregulation. Governments, on the other hand, want to be the sole regulator, to have the first and the last word on anything regulation-related issue. This is where competition begins.

From the above analysis, it can be argued that an important function of regulatory competition is to remove inefficient legal rules. It is also evident that such competition needs to be carried out within a certain framework, because unregulated competition offers no guarantee that the set of legal rules, which will prevail, would be the most efficient solution. That is why deregulation seems to be an attractive option, not only because the 'laissez-faire, laissez-passer' ideology has always had passionate supporters, but also because companies nowadays strive for more autonomy and more independence. The most fanatical supporters of deregulation are the multinational companies, some of which have the power to put pressure for less strict rules or even to challenge governmental decisions in order to achieve a more lenient, if not a deregulated environment. In this respect, Chang, after a general review of the economics and politics of regulation, has concluded to the division of the last fifty years in 3 periods. The first period is between 1945 and 1970 and is characterised by regulation. The second period covered the decade between 1970 and 1980 and was a 'transition' period. Finally, the third period started in 1980 and has not finished yet. It is the 'deregulation' period.[12]

But how close to reality is this perception? In reality, we have not, and we are not experiencing an era of deregulation so much as an era of regulatory flux- an era when dramatic regulatory, deregulatory and re-regulatory shifts are occurring simultaneously. So far nobody can claim win in the regulation game.[13]

Closing that parenthesis, even if we put an asterisk next to Chang's division, this division illustrates the essence of regulatory competition. Regulatory

[10] Murphy D., see above note 4, pg. 255.
[11] Haas, P., Keohane, R and Levy M., (eds), *Institutions for the Earth: Sources of Effective International Environmental Protection*, MIT Press, Cambridge, 1993, pg. 4-5.
[12] Chang, H., 'The Economics and Politics of Regulation' (1997) 21 Cambridge Journal of Economics 724.
[13] Ayres and Braithwaite, *Responsive Regulation: Transcending the Deregulation Debate*, Oxford Socio-Legal Studies, Oxford University Press, Oxford and New York, 1992, pg. 7.

competition looks like a dilemma. Regulation or deregulation? Market forces or strict rules? Moreover, the two poles of regulatory competition can be described by two phrases that are commonly used: 'the race to the bottom', where the policy framework consists of a set of rules and 'the race to the bottom', where the market will create the right balance between the conducts of all actors within global economic. The Delaware effect represents the deregulatory dynamic and it is considered to be the winner of the race to the bottom in the field of chartering requirements for companies. A good example of race to the top is the state of California. In California, environmental regulation has been always a hot issue and the levels of protection become progressively higher and higher. The Californian market is large enough to make other states raise their own level of regulation, in order not to lose market access. This strategy involves significant risks, but large market power comes with confidence that, in the long-term, the new high standard regulations will be adopted not only throughout the United States, but in other markets around the world. This is the so-called 'Californian effect'.[14]

Accordingly, the debate is focused on whether European company law is on a race to the top or to the bottom. Although regulatory competition is a new hot topic in Europe, in the other side of the Atlantic it has a full history record. Scholars have been dealing with this issue for about 30 years in order to determine whether corporate law is indeed on a race to the top, to the bottom or to nowhere[15] in particular, as William Bratton suggested. The reason why Europe did not participate in the discussion about regulatory competition was simply because the regulatory environment in the European Union was not convenient enough until recently. It was only after 1999 and the well-known 'triangle' of ECJ landmark cases that European companies obtained the right to incorporate in any EU Member State regardless of where their business is actually run.

Despite that development Europe has still a long way to go before it becomes similar to the US. But even if our view is expanded away from EU and US only, it is a fact that all governments approach a regulatory problem in substantially different manners. Such different approaches can easily create tensions between governments and different societies, mostly because the problem involves economic activity. For example, the adoption of strict rules is the choice of a government as the most appropriate means against repression of economic power, whereas another government would choose a more laidback approach, under the concept that excessive regulation can potentially restrain economic progress.

[14] Genschel P and Plumper T.,' Regulatory Competition and International Cooperation' (1997), MPIfG Working Paper 97/4, available in the website: http://mpifg.de/pu/workpap/wp97-4/wp97-4.html, pg. 2.

[15] Bratton W., 'Corporate Law's Race to Nowhere in Particular' (1994), 44 U. TORONTO L.J. 401.

The role of a government as regulatory authority is totally different than its role as executive organ. Governments all around the world try to create a free and liberal environment for trading. At the same time, the world trends promote-or at least point to- the direction of a completely open world market, integrated, independent and as deregulated as possible. Regulatory competition theorists note that governmental intervention often creates its own burdens and inefficiencies. Nobody denies that such intervention may be welfare-enhancing, but, at the same time, there is always the question whether the cure is more harmful than the disease or not.[16] Excessive regulation or excessive strictness creates protectionism, which can early become a hard-to-overcome obstacle in a free trade orientated world. Pressure can sometimes have adverse results, i.e. instead of being welfare-enhancing it may prove welfare-reducing. Negative outcomes are always likely to emerge.

Therefore, there are some voices saying that perhaps competition is not the only pathway leading to 'the land of optimal regulation'. As Esty and Geradin conclude, 'regulatory systems should be set up with enough interjurisdictional co-operation (or Harmonisation) to ensure that transboundary externalities and other market failures are addressed, but with a sufficient degree of regulatory competition to prevent the resulting governmental structure from becoming an untamed, over-reaching, or inefficient Leviathan'[17].

As a result, there was a quest for a new theory that could promise to minimise interjurisdictional conflicts. Especially, as European company law is concerned, the desire to avoid a 'race to the bottom' was one of the original rationales for the European Company Law Harmonisation project[18]. The catchphrase which was chosen for the new theory was Harmonisation.

3. Harmonisation

Harmonisation derives from the Greek word harmony, which means synchronisation, concurrence and accord. Harmonisation, in the long term, means minimising the degree of variation and reducing the number of significant underlying differences in order to achieve similarity between systems.
The antagonists of Harmonisation compare it to monopoly, implying excessive regulation, lack of diversity, higher degree of complexity and uncertainty and, finally, no flexibility in adapting to the new

[16] Esty D. and Geradin D., Introduction XXII and XXIII in Esty D. and Geradin D., (eds), *Regulatory Competition and Economic Integration: Comparative Perspectives*, Oxford University Press, Oxford and New York, 2001.
[17] Ibid., XXV.
[18] Edwards, V. *EC Company Law*, Oxford University Press, Oxford, 1999, pg. 3.

developments. Nonetheless, they seem to forget that Harmonisation does not mean uniformity. Harmonisation recognises the existence of differences. Differences do not necessarily pose any threat to coexistence and co-operation. When different cultures, nationalities and traditions manage to co-exist and create a harmonised legal system, such system combines all the virtues and the values of them.

When the issue is harmonisation of law, harmony does not presuppose a system of similar or identical laws, as Harmonisation does not mean 100% uniformity. The goal is the creation of a framework within which laws will be put together and will operate efficiently without creating inequality and inconsistencies. Such framework can be created through the introduction of a set of basic standards, the flexibility of which must be agreed in advance, in order to avoid problems, if these standards need any kind of alteration. In other words, it can ensure stability and predictability against externalities. Externalities occur, when an activity regulated in one jurisdiction affects the well-being of people in other jurisdictions[19].

Harmonisation has also an element of centralisation. A single regulator is required, who will organize, co-ordinate and enforce Harmonisation. The minimum harmonisation requires a set of minimum standards in certain areas and gives countries the privilege and the opportunity to complete the framework by setting all the higher standards themselves. In this respect, minimum harmonisation does not rule out regulatory competition. Harmonisation aims at minimising the possibilities of future market failures and to prevent, to a reasonable extend, the race to the bottom, whereas regulatory competition aims at putting pressure on governments to perform efficiently and effectively[20]. That's why it is mistaken to treat harmonisation and regulatory competition as contradicting theories. It is better to consider them as substitutes rather than complements.[21]

The advocates of the Harmonisation theory were extensively using the example of USA. In USA, regulatory authority is located to the states more than the federal governments. The method adopted is based on a common standard, which is applied to all states and is used as a yardstick and reference point. Of course, if each country was free to adopt or develop any regulatory regime without taking into account the options of the neighboring countries, this would affect sooner or later any attempt for Harmonisation. Governments need a strong incentive in order to produce an optimal degree of Harmonisation. Once again, a ring

[19] Hauser, H. and Hosli, M., 'Harmonisation or Regulatory Competition in the EC (and the EEA)?' (1991) 46 Aussenwirthschraft 497, 501-502.
[20] Ibid., XXIII.
[21] Sun, J.M and Pelkmons J., 'Regulatory Competition in the Single Market' (1995) 33 Journal of Common Market Studies 67.

bells that reminds everybody that USA is not identical, not even similar, to EU. Romano, summarising the US experience regarding regulatory competition in company law, argues that it leads, over time, to a fairly high level of convergence between states, with the dominant model one in which mandatory rules are the exception: 'state charter competition has… produced substantial uniformity across state codes, preserving variety in it enabling approach to rules, an approach that permits firms to customise their charters'.[22] In USA, Harmonisation means that the federal government frequently takes on the character of a 'monopoly regulator', occupying the field to the exclusion of state initiative. The description of a 'monopoly regulator' which US critics use to attack federal intervention is entirely appropriate in a system which tends to react to extreme failures in the market for regulation by shutting down competition entirely.[23]

4 . Harmonisation in European Company Law

Similarly to regulatory competition, Harmonisation in the field of Company Law is still in a premature state within the European Union. There are Directives containing important rules, but a framework for the formation and governance of companies is far from being developed yet. This does not mean that EU is in favor of regulatory competition or diversity instead of uniformity and stable sets of mandatory laws. So far the critique of EC course of actions finishes with the phrase that no Harmonisation has been attained and that the impact of the Harmonisation plan has not been significant yet.

It is better, prior to any evaluation of the Harmonisation plan, to have a closer look on the current state of affairs within the European Union.

Harmonisation is a process that promises, if not guarantees, to successfully fulfill certain conditions. The achievement of uniformity is patently obvious, because a single set of rules is the first goal irrespectively of the content and the philosophy of these rules. A single set of rules replaces all local provisions that may act as impediments to the creation of a European common market and offers a common level field for all players. Apart from the evident necessity of Harmonisation for the creation of the integrated market, its legal justification is multiple. First of all, it can be found in the EC Treaty itself. Directives and Regulations refer to the Treaty and use Article 44, Article 95 or both as legal basis. Apart from that, Harmonisation is another link in the same chain with market failures. The justification for Harmonisation is in correcting market failures, which the Member States alone cannot or are unwilling to correct, by making society overall better-off than in its absence.[24]

[22] Romano, see above, note 5, 2394.
[23] Deakin, see above, note 8, pg. 13-14.
[24] Movsesyan V., 'Regulatory Competition Puzzle: The European Design', (2006) Laboratory of Economics and Management (LEM) Working Paper Series 2006/30, pg. 21.

After the first glance, advocates of regulatory competition would recommend as the best solution that EU should simply follow the US example and create a similar regulatory and institutional environment in the European Union market. The question that immediately pops up is to what extent EU has the privilege to experiment rather than innovating through introducing rules for safeguarding companies, which operate in the common market. It is also open to discussion whether EU legislators would like to create a European Delaware phenomenon as, since the 1970s, there were voices saying that the arm of EU corps is the 'virtual unification of national company laws'[25] and that protective regulators can be used as a shield against a Delaware- style effect.

Nevertheless, demanding a friendlier company law regime is different from creating a European Delaware. As Tröger indicated in 2005, 'no Member State has proper incentives and political maneuvering space to assume in the near future a similarly preponderant position like the American dominant state of incorporation'.[26] Regardless of these theoretical assumptions, the candidate Member State, which would express the ambition to win the state competition for charter offering, should be ready to face Brussels' opposition. The role of Brussels in the Harmonisation process is quite significant and such initiatives should have the approval of the EU headquarters in advance. EU will not give its blessing to any Member State, so all scenarios involving Luxemburg, Lichtenstein or even UK can only be characterised as science fiction ones.

Article 43 of EC Treaty (ex. Art. 52) protects freedom of establishment and highlights that any restriction would make establishment burdensome. Unharmonised national laws could be characterised as restrictions as well. The objective of creating a single market made Community adopt a different approach. Community intervention should be limited to the introduction of general principles rather than rigidly prescriptive rules.[27] Flexibility was promoted as a more effective means of achieving policy goals. In the field of Company Law, flexibility encourages self-governing professional organizations, industry-level associations and self- regulatory bodies, like the City Panel on Takeovers and Mergers, to participate actively in the rule-making process.[28]

[25] Schmittoff, C., 'The future of the European Company Law Scene' (1973) in Schmitthoff, C. (ed.), The Harmonisation of European Company Law, UKNCCL, London, pg. 9.
[26] Tröger, T., 'Choice of Jurisdiction in European Corporate Law-Perspectives of European Corporate Governance' (2005) European Business Organization Law Review 6:3-64, pg. 19.
[27] Deakin S.,'Regulatory Competition versus Harmonisation in European Corporate Law' (2001), in Esty D. and Geradin D(eds), *Regulatory Competition and Economic Integration: Comparative Perspectives*, Oxford University Press, Oxford and New York, 2001, pg. 194.
[28] Ibid.

The main source of diversity in the company law system in Europe is stakeholders. It is common knowledge that the conflict between insider and outsider system of corporate governance reflects the difference in corporate tradition and philosophy between countries with dissimilar systems. Both systems underline the importance of stakeholders' interests in corporate government but each one offers different ways and levels of protection. The beginning of this conflict dates back to 1973, when the first enlargement of EC took place. The fifth Directive was supposed to be the vehicle for the adoption of the insider system following the German model. The resistance was strong mostly by United Kingdom and the result is that until today there has been no agreement on that issue. The truth is that there is no 'one best' system of corporate governance. Rather the two systems have different comparative advantages. The British corporate governance system better supports companies in sectors where there is a need to move quickly into and out of new markets and in which there is need for great flexibility in the use of employers. The German system, by contrast, better supports companies in sectors that require long- term commitments and investments by employers, suppliers and other stakeholders.[29] Convergence of these two systems seems almost impossible, while the replacement of the standing corporate government system in any country seems implausible and out of the question. At this point, the United States regime is again under examination.

In the EU, divergence in fact operates at the level of law itself and entails diversity of any corporate government practices between legal systems. At the same time, in the USA regulatory competition has led to the adoption of a system in which company laws are moderately uniform in content, but highly permissive as well.[30] Harmonisation in a pan-European level should not be treated as a clone of US regulation. US federal legislation is closer to the stereotype of a single convergent regime. To be more precise, there is not a race to the top or to the bottom, but a race to converge. It is a race to converge through unregulated competition. The result was more or less predictable: the creation of a near-monopoly supplier, i.e. Delaware.[31]The European perspective, on the other hand, is based more on diversity. The real seat theory was the main obstacle to convergence of systems upon a shareholder-orientated model and it was at the same time the guarantor of diversity, which differentiated the European model from the American one.[32] Nobody can guarantee in advance that the European market can become the same with the American without any functional and operational problems. There is also no clear indication that this is the

[29] Vitolis, S., Casper, S., Soscise, D. and Woolcock, J. (1997), Corporate Governance in Large British and German Companies, Anglo-American Foundation for the Study of Industrial Society, London, pg. 35.
[30] Deakin, see note 27, pg. 209.
[31] Deakin, S., 'Legal Diversity and Regulatory Competition: Which model for Europe?', Centre for Business Research, University Of Cambridge, Working Paper No. 323, pg. 13-14.
[32] Ibid, pg. 13.

objective of EU regulators. Regulatory competition can suggest possible alternative choices or solutions.

Talking about alternative solutions, harmonisation takes again its position under the microscope. Theoretically, a uniform set of rules on company law would be an effective solution. Deakin's assessment is that 'in respect of creditor and employee protection harmonised rules may be necessary to avoid a race to the bottom'.[33] It must be noted, however, that the current form of community initiatives is not as effective as required. Setting minimum standards as a 'floor of rights'[34] can implicitly initiate a race to the top by encouraging states to set superior standards.
Teubrer borrows the term 'co-evolution' from the science of biology, in order to characterise this process. Co- evolution implies the co-existence of diverse systems in an environment where each one retains its viability.[35] In this way, harmonisation underscores the autonomy of national legal systems, limits competition and gives priority to a process of evolutionary adaptation of values of the state level.[36] As a new methodology, it combines self-regulation and external regulatory interference. Self-regulation is always the most appealing choice, but regulatory intervention should not be *a priori* rejected as long as it does not have the characteristics of inducement and provided that is does not aim at undermining the quest for a deregulated environment.

At this instant, it would be helpful to shed light on the practical side of harmonisation and, in particular, what steps the Commission has taken towards the direction of harmonisation. After that, it would be more suitable to give an unambiguous answer on the issue of harmonisation of Company Law in the European Union.

5. Steps Towards Harmonisation of EU Company Law

Commission's first step towards harmonisation, as far as Company Law is concerned, was the adoption of Directives containing appropriate rules. The first Directives were inevitably quite descriptive. For instance, the first Directive in 1968 laid down core minimum standards for public and private companies and limited partnerships relating to disclosure of basic information. After a closer look on the next Directives, it becomes apparent that the new proposed measures were gradually leaning towards a more decentralised direction. The new approach was based on Community intervention. Commission clearly opted for that approach, instead of laying down the rules and standards for a common regulatory

[33] Deakin, see note 27, pg. 210.
[34] Ibid.
[35] Teubner, G., *Law as an Autopoetic System*, Oxford Blackwell, United Kingdom, 1993, pg. 52
[36] Ibid. note 27.

environment, because it was offering more and more autonomy to the Member states (local-level actions, self-regulatory bodies). Flexibility in terms of general principles instead of firm and rigid rules does not conflict with the goal of Harmonisation. Prescriptive and fixed rules can easily become dogmatic. They end up being too authoritarian as their creators did their utmost to make them to be as nonflexible as possible.

Nevertheless, unanimity is at jeopardy as the adoption of a common line is rested upon the discretion and good will of the member States. A good illustration of tensions that are likely to happen is the so-called Vredeling draft Directive. The draft of the Fifth Company Law Directive included provisions about employee representation on the supervisory board following the German model of two-tier board structure (a minimum of one-third or a maximum of one-half of the members of the supervisory organ drawn from the employee content of the enterprise). in addition, there were provisions granting Member States with the option of having representatives with the same rights to information as those on the supervisory organ, i.e. right to information, right to consultation on all major decisions, the right to get explanations in relation to all aspects of the running of a company and, indeed, the right to demand advice and explanations if the views of the employees were turned down.

Nobody denies that these provisions were valuable additions to the existing Company Law regime and there is no uncertainty whether there should be employee participation in companies' management and decision-making process. However, the provisions of the draft Fifth Directive met the disapproval of several member States. The explanations were not convincing at all. The official reasons for the opposition were that the provisions were complicated and that they 'would disrupt voluntarist systems of industrial relations'.[37] The truth, though, was that the actual provisions had minor importance on that debate and the opposition was mostly a matter of principles and ideology rather than based on the provisions of the Directive themselves.

A second attempt towards harmonisation of company law was the scheme for the formation of a Societas Europae (SE). After almost 30 years of debate, the European Company statute was finally approved in 2001, as a promising project that would potentially work as the resultant of all the Harmonisation attempts.

Unfortunately, the first reactions were not so enthusiastic. On October 2004, only six countries had implemented the regulations at the national level. The reasons for this reaction are two: firstly, because the Regulation

[37] Docksey C., 'Information and Consultation of Employees: The United Kingdom and the Vredeling Directive', (1986), *The Modern Law Review*, Vol. 49, No. 3, pg. 281.

and the Directive on the SE provide only the basic provisions and refer frequently to the law of the Member States. Member States were in favor of a uniform legislation without reference to national company laws. It could be argued that in fact there is not a single type of SE but rather 25 different ones. It looks like a multi-layered regulation. Secondly, the impact of the SE law is relatively limited, because the Commission did not act determinedly and resolutely. It is not a hyperbole to say that the provisions on the creation and the internal governance of an SE are the product of years of negotiation and do not reflect the real intentions of its architects. SE should be the response to market forces and not the result of compromise.

Initially, SE was supposed to be the vehicle for companies that want to merge and transfer their seats across the borders of the European Union. That perception turned out to be futile. There is a significant number of problems associated with SE. Once again, it proved extremely difficult, if not impossible, for member States to reach to a reasonably accepted solution. There are issues like board structure and employee representation that still remain a thorn. It is known that the relations between certain Member States are not ideal and there are conflicts, which are so deeply rooted that they are revealed in every single occasion. The example of the Thirteenth Directive on takeovers and its collapse in 2001 uncovers the disagreements and the inconsistency that characterises some member states' views on the direction of the Directives.

Apart from this situation, there is another reason that explains Member States' reluctance to reach consensus. If we go back in time, and more specifically, in the period when EU was 'born', the European Commission was the defensive weapon against the 'Delaware effect' in the US. Member States understood competitive pressures would make their national law systems more and more vulnerable and that the best shield against these pressures was Harmonisation. A federal authority would have to carry the burden of harmonising Company Law, but only with one limitation- not to touch the core provisions. Obviously, Member States simply wanted to safeguard and preserve their lawmaking independence on the core of Company Law. When, a few years later, the European Commission tried to develop a real European company form, Member States felt that their autonomy and control was threatened. As a defense to any limitations upon their legislative omnipotence, they revoked their support to the Commission's initiatives.

Yet, the success of SE is covered by a cloud of doubt and uncertainty. For all the abovementioned reasons, the European Company's attractiveness is inexorably decreasing rather than increasing. Perhaps, the decisive shot was given by the High Level Group of Experts which noted that SE may not meet all the expectations of the business community and also referred to the development of a 'European Private Company' instead.[38] The Directive on European Works Council (EWC Directive) can be considered as one step forward regarding the issue of SE, but it does not offer answers to all of the problems nor does it bridge the already existing gap between Member States.

6 . The Future of the Harmonisation Process

Harmonisation is strongly connected with the establishment of a genuinely common market among the members of the EU. Free Competition and absence of any barriers in trade has been the primary intention of everybody involved in the creation of the single European market. The first obstacle in the way towards the development of an Internal Financial Market was the economic policies pursued by Member States.[39] The biggest problem was the different national legal systems and the divergent legal tradition of the Member States. On the subject of forum shopping and re-incorporation of companies, the main concern has always been not to encourage re-incorporations in other jurisdiction as a result not of economic reasons, but in an attempt to avoid the most unfavourable jurisdiction or to find a 'friendlier' one. Although, it is generally accepted that US and EU have more differences than similarities on this issue, the arguments concerning the creation of a European Delaware and for a race to the bottom were being used by several scholars and, surprisingly, had a great affect on the decision-making process.

It would be simple and effortless to argue that 'unregulated competition between jurisdictions could well eliminate the most significant differences between them, but without any guarantee that the system, that eventually prevailed, would be the most efficient'.[40] Deakin, who is in favour of harmonisation, came up with a conclusion that was criticised for being paradoxical. According to that conclusion, harmonisation represents the best solution within the framework of the single market as it isolates the positive characteristics of regulatory competition and combines them with evolutionary adaptation of law. Actually, Deakin puts forward 'reflexive harmonisation' as the best choice for EU and illustrates it as 'the best guarantor of diversity between national systems, and hence of experimentation in regulatory design'.[41]

7. Reflexive Harmonisation

Reflexive harmonisation aspires to be the dichotomous between strict regulation and deregulation and has its source on the theories of reflexive

[38] See above, note 3.
[39] See above, note 6, xv.
[40] Movsesyan, see above, note 24, pg. 24.
[41] Ibid., pg. 22.

law. Reflexive law aims at joining successfully self-regulation and external regulation. It involves a regulatory process which seeks to be effective and successful not by directly imposing certain measures or by stipulating certain outcomes. It seeks to intervene by showing the ends or by pointing to the right direction without any kind of inducement and persuasion. To put it simply, it has a procedural orientation.[42] This means that the law underpins and encourages autonomous processes of adjustment. It simply gives emphasis to the importance of self-regulation processes by awarding them with law-making powers.[43]

Another distinctive feature of reflexive law is that it does not seek to create a perfect market or to describe the best possible solution, even though it is doubtful whether it is possible to achieve it in practice. In fact, priority is given to the method and the process of achieving optimal results and not so much on the results themselves. In this context, harmonisation has a different rationale. It is not on target for creating a monopoly, by occupying the field as a monopoly regulation instead of state-level regulation.[44] It can be said that reflexive Harmonisation promotes, if not initiates, a 'race to the top', in which the participating Member States would not have otherwise entered into, as there was not any motivation to that direction. At the same time, reflexive Harmonisation promotes a 'race to the bottom' as well, by making Member States compete on the basis of the withdrawal of protective standards. In both cases, innovation and independent solutions are promoted, while Member States have the freedom of choice among a number of available options.
Fundamentally, reflexive harmonisation is about putting a stop to state intervention against imperfections that -are thought to- spoil the side view of the desired optimal market.These imperfections should not be cured as they are simply the differences between systems. One of the fundamental prerequisite of reflexive Harmonisation is the preservation of local-level diversity, since without diversity, the stock of knowledge and experience on which the learning process depends is necessarily limited in scope. In this sense, diversity of national systems is an objective in its own right.[45]
In a nutshell, the model of reflexive Harmonisation holds that the principal objectives of judicial intervention and legislative Harmonisation alike are two-fold: firstly, to protect the autonomy and diversity of national or local rule-making systems, while, secondly, seeking to 'steer' or channel the process of adaptation of rules at state level away from 'spontaneous' solutions which would lock in suboptimal outcomes, such as a 'race to the bottom'.[46]

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[42] Deakin, see note 27, pg. 211.
[43] Ibid.
[44] Ibid.
[45] Deakin, S., 'Legal Diversity and Regulatory Competition: Which model for Europe?' see note 31, pg. 5.
[46] Deakin, S., 'Two types of regulatory competition: competitive federalism versus reflexive Harmonisation. A law and economics perspective on *Centros*' (1999) 2 *Cambridge Yearbook of European Legal Studies* 244.

The EWC Directive can be used as an example of reflexive harmonisation process, as it has been clearly influenced by the philosophy of reflexive law. The Said Directive does not impose any specific measures, but it promotes them by giving incentives to companies to make use of its provisions even as the last available choice. In essence, the Directive seeks to achieve its ends, even by giving to companies and employees the opportunity to avoid its application. It sounds oxymoron but the underlying principle is that the Directive does not directly impose a uniform solution, but it shows the path to the Member States -and to the companies- and gives them an incentive to co-ordinate and work out a solution at a states level.

The process of reflexive harmonisation, although it still carries the label of being a controversial method, has been elevated to a higher level among other less suitable solutions. Its 'supremacy' is justified by the fact that it does not prevent solutions based on innovation nor does it go against diversity in the laws of the Member States. Thus, co-evolution is singled out as being a more efficient solution comparing to a single monopoly regime, because as it was mentioned before it combines autonomy and diversity with interdependence.

8. Conclusion

On the whole, Harmonisation did not limit nor affected negatively the diversity of national laws within the European Union; on the contrary, diversity was preserved. As a result, a new type of Harmonisation was developed. It was given the name 'Reflexive Harmonisation' and it is the European approach to regulatory competition. Such approach can be characterised as unique and idiosyncratic, because, unlike the American experience, it emphasises the importance of self-regulation and gives priority to the safeguarding of local diversity. In essence, it makes use of central regulation not in order to directly impose solutions, but to preserve a space for independent governance at lower levels of government. Reflexive Harmonisation turned out to be the missing link in the chain which was connecting the regulation of companies and business activity in general with the many different legal systems operating within the EU.

It is early to determine whether this solution will prove to be an efficient one. It looks promising due to its flexibility that derives from the evolutionary adaptation of diverse systems to the constantly changing external conditions. The jury may still be out on the long-term prospects for rival systems of corporate governance in a globalising economy. However, there is much to be said in favor of developing further the

European approach, since it would seem to combine the values of local autonomy with system wide adaptability.[47]

Recently, some policymakers have suggested that linking the European Company Statute to a European corporate governance code could provide a more efficient way to induce convergence of best practice norms within the EU.[48] This strategy may prove to be really useful and beneficial, because through linkage the member states' codes would be left untouched and thereby divergence would be respected, while, at the same time, the prospect of regulatory competition by means of the European Company would be substantially diminished.[49]

[47] Ibid., pg. 259.
[48] See High Level Group of Company Law Experts, note 3, pg. 67.
[49] McCahery, J.A. and Vermeulen, E., 'Does the European Company Prevent the 'Delaware-effect'?' (2005), TILEC Discussion Papers, DP 2005-010, pg. 22.

Some Notes on the Interpretation of Commercial Recklessness

C. G. Kilian[*]

1. Introduction

Within the context of "commercial recklessness" any particular company or directors need to consider how the bottom line (profit) and corporate culture ultimately interrelate at a business strategy level. This relationship begins immediately with the notion of 'misfortune'. The analysis of 'misfortune' in this paper deals with the apparent diminishing of directors' awareness of the significant relationship between profit and corporate culture. The latter is inadequately defined or specified in contemporary financial examples. One such deals with the declaration of dividends when in fact there is a shortfall in company profits and the impact on stakeholders or shareholders is negative. Despite this 'misfortune' a solution is provided in this paper: the inability of directors to align financial information (i.e. profit) to that of financial performance indicators (i.e. dividends) through an integrated performance business strategy.[1] Without a suitable strategy the improvements experienced in financial performance indicators may ultimately be diminished or destroyed in the future. Before we examine this relationship, it may be useful to review the following obstacle when deciding on a suitable business strategy. The directors of a company should uphold financial performance indicators by means of identifying new business perspectives that should contribute positively to company value. To establish these perspectives requires companies to critically analyze their current business strategy so as to allow for an opportunity to control financial indicators more successfully for the purposes of developing future company value.[2]

2 . The Theory of Commercial Recklessness

The commercial recklessness theory is accorded different terminologies in different jurisdictions, i.e. wrongful trading in England, reckless trading

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[1] Jones *Investments: Analysis and Management* 19883-19; Smit and Cronje *Management Principles* 1997 173; Sealy *Cases and Materials in Company Law* 2004 177; Du Plessis, McConvill, Bagaric *Principles of Contemporary Corporate Governance* 2005 258; Pretorius, Delport, Havenga, Vermaas *Hahlo's South African Company Law Through the Cases* 1999 368.

[2] *R v Bates* [1952] 2 All ER 842 at 845. The court held that "The ordinary meaning of reckless in the English language is "careless", "heedless", "inattentive duty". Literally it means "without reck". "Reck" is simply an old English word, now obsolete, meaning "heed", "concern" or "care".

in New Zealand, insolvent trading in Australia and recklessness in South Africa, but all such terms deal exclusively with the commercial world.[3] This theory is presented in much case law, and in different jurisdictions, as the classic example of insolvency. The sufferers of insolvency are ultimately the creditors of the company.[4] Nevertheless some arguments in the law do exist where companies could have increased "profitability" from insolvent trading. To illustrate the latter more clearly in terms of a financial perspective, we will make use of the following information as disclosed by *McGregors's Security Exchange Digest* May-Aug 2002 79.

Extract-income statement

	2001	**2000**	**1999**	**1998**
Top line	2193	2319	2292	1016
Operating profit	250	195	296	-56

Extract-cash flow statement

End	**2001**	574
End	**2000**	447
End	**1999**	287
End	**1998**	48

Extract-balance sheet

	2001	**2000**	**1999**	**1998**
Total Assets	710	679	552	187
Debt to Equity	.25	.29	.54	.51

[3] See in general Boros and Dunes *Corporate Law* 2007 50; Gower *Davies' Principles of Modern Company Law* 2003 219,222; De Koker *Die Roekelose en Bedrieglike Dryf van Besigheid in die Suid-Afrikaanse Maatskappye Reg* (LLD thesis UOFS 1996).

[4] In South African case law, factual insolvency is not a ground for liquidation, e.g. *Ex Parte Strydom NO: In Re Central Plumbing Works (Natal) (Pty) Ltd; Ex Parte Spendiff NO: In Re*

Continued

<u>Notes:</u>

- Share price in 1999 is R18, 00 and R3,20 in 2001.
- The highest share price in 2000 was R6,20 and the lowest R3,50

In 1999 the listed share price was nearly four times higher than the price per share in 2001 owing to impressive dividend pay-outs. Generally a high dividend pay-out increases the listed share price as a result of the price to earnings ratio (P/E ratio). Was this company reckless when declaring dividends, since the profitability of the company could not have allowed for such payments?[5] From 1998 the company employed a suitable business strategy in order to alter the capital structure of the company so as to allow for an increase in company profitability; conversely, this strategy allowed for a decrease in dividend payments. From observing the share price in 1999 and in 2001, one may enquire: which of the two strategies increased the value of the company?[6] The answer may surprise the reader, but 1999 and previous years could have constituted a business strategy as well.[7] In 1999, for example, the market capitalization (quoted share price multiplied by the total number of shares) of the company was in fact higher than in 2001. In other words, in the event of a take-over the valuation of the company based on its issued shares is considerably more expensive than in 2001, although the company in 2001 reports a better debt to equity ratio.

Nevertheless, in recent times, commercial recklessness has become a matter of increasing concern in academic circles, particularly when vague enlightenment of offences are involved. In *Moore v I Bressler Ltd* [1944] 2 All ER 515 the court dealt with the question as to whether companies are subjected to offences. In this case, an officer of the company defrauded the company. The court considered that if the officer is acting within his authority, it is irrelevant to conclude whether the company was harmed by his conduct.[8] In Australia, *R v Roffel* [1985] VR 511 the Victorian Supreme

...*Candida Footwear Manufacturers Pty (Ltd); In Re Jerseytex (Pty)Ltd* 1988 1 SA 616 (D) 623 E. The Strydom case is held to be the correct insolvency test, i.e. the ability of the company to pay its debts as they fall due and not the question of whether its liabilities exceed the assets; *Ex Parte De Villiers: In Re Carbon Developments (Pty)Ltd (in liquidation)* 1992 2 SA 95 (W) 114B.

[5] *Cohen v Segal* 1970 (3) SA 702 (W); *R v Bates* (1952) 2 All ER 845; Elana Smukler "Theft by Corporate Controllers" 1995 *SAMerc LJ* 155.

[6] *Triptomania Twee (Pty) Ltd v Connolly* 2003 1 SA 374 (C). Reckless encompasses not only foreseen circumstances but also unforeseen circumstances.

[7] Vigario *Managerial Accounting and Finance* (1998) 285 "The traditional theory, or generally believed theory of capital structure, assumes that an optimal capital structure does exist and depends on the level of gearing. The company cannot maximize shareholders' wealth unless the optimal weighted average cost of capital is achieved".

[8] The duty to act within their powers: see *S v De Jager* 1965 (2) SA 616 (A); *S v Hepker* 1973 (1) SA 472 (W); *In re George Newman & Co* [1895] 1 Ch 674; *Cohen v Segal* 1970 (3) SA 702 (W).

Court was to decide whether an officer of a closely held company could be charged with theft. The court dismissed the charge on the basis that the intentions of the officer could be attributed to the company; thus the company had consented to his misfortune. Nonetheless, the theory of commercial recklessness as an offence, the same rationale applied in the Moore and Roffel cases, is relevant in some jurisdictions when they opt to reject a charge of reckless commercial conduct.[9] Obviously, case law exists that has used clear legal definitions of an offence, either by statute or common law. In South Africa, for example, the court in *S v Parsons* 1980 2 SA 397 (KPA) considered an offence to be defined as had previously been held in the *Shawinigan v Volkins & Co Ltd* (1961) 3 All ER 396 (my emphasis):

> "In my view 'recklessly' means grossly careless. Reckless is gross carelessness – the doing of something which in fact involves a *risk*, whether the doer realizes it or not; and the risk being such, having regard to *all circumstances,* that the taking of that risk would be described as 'reckless'."

Although this paragraph may seem to be vividly clear, one may pose the following important questions; should risk be interpreted only from a selective economic point of view and should "all circumstances" be taken from a legal or economic point of view?[10] As noted earlier in our financial example, the relationship between a financial indicator and financial information could very easily be interpreted to be relevant only when the company is trading in insolvent circumstances. Although this is true and is relevant, sometimes a company may be solvent but limited cash flows cause an inability to pay the debts of the company as they become due, thus constituting insolvent trading. Moreover, one could draw the fair conclusion that performance indicators alone do not describe commercial recklessness adequately.[11] This circumstance reminds one immediately of the *Moore* and *Roffel* cases owing to the fact that a business strategy to increase the share price through the P/E ratio could be interpreted as beneficial to the company. From this it follows (1) that it is difficult to pierce the corporate veil when the company has suffered no harm and (2) that legal instruments should be wary of economic consequences. It is, however, important to stress that should the company or directors fail to take measures to reduce the risk of creditors, then the courts will do so through the authority of case law. This approach is not without its

[9] *DPP v Gomez* [1993] AC 442; *R v Rozek* [1986] 3 All ER 281.

[10] De Koker *Die Roekelose en Bedrieglike Dryf van Besigheid in die Suid-Afrikaanse Maatskappye Reg* (LLD thesis UOFS 1996) 409 – 412

[11] Luiz and Van der Linde "Trading in Insolvent Circumstances – Its Relevance to Section 311 and 424 of the Companies Act" 1993 *SA Merc LJ* 231

difficulties either. Stegmann J in *Ex Parte Lebowa Development Corporation Ltd* 1989 3 SA 71 (T) 113 concludes that insolvency occurs:

> "As soon as a company's assets are reduced so that they exceed its liabilities by less than the amount of the issued capital, capital begins to be lost. When assets are reduced to such an extent that they equal liabilities, the entire capital has been lost".

To analyse this dictum, we refer to our financial example explained earlier. From the debt to equity ratio in 1998 (0.51) plus the very high market capitalisation, we may deduce the presence of severe commercial recklessness in 1998. Ironically, the business strategy employed after 1999 to alter the financial position of the company could also be interpreted as gross carelessness even if there had been a substantial increase in profits.[12] For example, the debt to equity ratio in 2000 plus the high share price in 2000 could very easily indicate lesser assets.[13] In this regard, we assume that the "amount" of the issued capital is the issue price.

What then, are the key elements to indicate recklessness, irrespective of whether a company is trading in insolvent or solvent circumstances? We will discuss the following 3 key elements in order to consider the issue of legitimate business practices in the commercial world. The goal of this discussion is to provide insight into the economics dealing with recklessness, after which the author will focus on different jurisdictions aimed at solving reckless problems.

3. Risk in all Circumstances

In *Ozinsky NO v Lloyed and Others* 1992 3 SA 396 (C) the crucial question was not answered or asked, namely "what is the cost of constructing an average kitchen (project) and of receiving payment in full"?[14] Is it to be 15, 30 or 60 days?[15] This was critical information because it transpired to represent the time granted by the creditor of the company to receive payment in full. Failure of advance planning on this point was fatal since the individual sales (constituting the turnover) would otherwise never have been able to settle the current debts as they became due. A

[12] *Triptomania (Pty) Ltd v Connolly* 2003 1 SA 374 (C).
[13] Share statistics operate in terms of a high and low share price for any given financial year. Thus, with certain share statistics circles in a financial year, it is possible to use the high share price. In this regard, a company that is listed on the securities exchange could very easily be interpreted as being reckless owing to the issue price of its shares in the constitution of the company compared to the shares listed in relation to the availability of assets.
[14] 404 E, 411 H. The kitchens were sold on instalments. The director relied on a deceased estate in USA to provide cash; Ex Parte Lebowa Development Corporation Ltd 1989 3 SA 71 (TPD) 97 C-D.
[15] 404 B, 406 E.

suitable business strategy to overcome this obstacle of cash flow is to ask for "deposits" before the company installs a kitchen. The latter was not considered by the court, and it is in fact crucial to employ "deposits" as a strategy to avoid a charge of commercial recklessness. The court held differently, and found that Ozinsky was not liable to commercial recklessness.[16] I suggest that the Ozinsky case should not be followed by future judgments relying on the "common business practice" to ask for a deposit. It is clear that Ozinsky did not consider the risk in "all circumstances" perhaps because of the lack of internal business research.

3.1 What types of risk?

In the commercial world there are 2 kinds of risk.[17] The first is associated with business risks, and the second with financial risks. The former are related to the internal structures of the company, i.e. the operating income of the company, its cash flow or business cycle and the growth factors that contribute positively to operating income.[18] The ability of the directors to ensure continuous growth in the operating profit concerns their ability to identify non-financial indicators so as to gain a competitive advantage in the market.[19] Financial risk is risk associated with that of shareholders, because the capital structure of a company contains debt finances. Now, if a company with a low business risk makes use of greater financial risk, to such an extent that there is no surplus or profits to be declared as dividends, it is not associated with reckless business practices or considered to be in financial distress.[20] Financial distress is risk associated with that of the creditors of the company. To clarify this point, in the following paragraph we will be focusing on a case law example associated with financial distress.

4 Research to Establish all Possible Circumstances

In the *S v Goertz* 1980 1 SA 269 (CPD) the owner of a business extended the cash flow cycle as a consequence of an increase in credit sales or credit transactions, without appreciating the recommended cash flow cycle for this particular business. As result the availability of working

[16] 405 B-J, 406 C.

[17] Arnold *The Handbook of Corporate Finance, A Business Companion to Financial Markets, Decisions and Techniques* 2005 529

[18] *Re Stanford Services Ltd* [1987] B.C.L.C. 607; *Re Firedart Ltd* [1994] 2 B.C.L.C. 340; *Re New Generation Engineers Ltd* [1993] B.C.L.C. 435; *Re Bath Glass Ltd* [1988] B.C.L.C. 329.

[19] In practice it is difficult for a company to identify or to disclose non-financial indicators. In this regard please see the following http://www.globalreporting.org/Home found on the internet 5th October 2007; Black *In Search of Shareholder Value* (2001) 340. Black created a blueprint for future disclosure requirements in order to increase financial transparency.

[20] The common rule is that the declaration of dividends depends on the availability of profits.

capital to ensure the continuation of the business in the future decreased. To introduce credit facilities to clients should not be interpreted, *per se*, as being a reckless commercial practice but to extend the cash flow cycle owing to high credit sales and to sell the product far below the profitability margin is in fact a recipe for financial disaster – it has no commercial sense or value. Fagan J rightly stated that the credit sales under these circumstances were in fact a squandering of company assets and completed a charge of recklessness. Thus, the emphasis in this regard should not be solely dependent on the increase in turnover to support future continuation but rather on the research conducted to establish the risk involved (to ensure the probable future continuation of the business) when entering into credit transactions. To illustrate the latter point more clearly, we will make use of the following example to indicate a possibility of loss or no loss when a business increases its turnover by implementing credit transactions with special reference to working capital:

- In 1998 the turnover of a company was 16638
- The intention was to increase the turnover by 10% (1664) in 1999 by means of credit sales or transactions
- The working capital in 1998 was 5657
- To sustain an increase in turnover, the owner must increase the working capital to support the continuation of the firm. This could be done by means of asset or liability finance
- Working capital through liability finance decreases the working capital to 3100 <u>or</u>
- Working capital through asset finance increases the working capital to 6195.

Thus, the balance statement would indicate the differences in asset and liability finance as follows:

	1999	**1999**
Long term liability	3328	3328
Current assets	(6195) 12000	(3100) 12000
Current liability	5805	8900
Total assets	(6195-3328) 2867	(3100-3328) -228

Notes:

- The -228 (liability finance) indicates in general a shorter cash flow cycle than 2867 (asset finance)

From analyzing the above example it becomes clear that business research is crucial to identify different levels of risk, as held by Stegmann J in *Ex Parte Lebowa Development Corporation Ltd* 113:

> "At this point, reasonable men wind up their company and pay creditors in full, unless they have access to further capital and can revitalize their company with some appropriate from of capital reconstruction."

It is interesting to note that Stegman J implies that financial distress leads to liquidation of the company, unless the company alters the capital structure.[21] The opportunity to do so is discussed in the next paragraph.

5. The Big Picture – A Business Strategy that Allows for Future Business Continuation

The third element is more complex to understand owing to the fact that every contract or transaction entered into by the company contains a possibility that the company might not be able to continue. Thus, the charge of recklessness must be an objective inquiry and not a subjective inquiry. In the *Dorklerk Investment Pty (Ltd) v Bhyat* 1980 1 SA 443 (WLD) 446 the owner of an immovable property which a company had been occupying obtained a judgment to eject the company from the premises. Every time an order was granted, the company lodged an appeal to the Transvaal Provisional Division and then to the Appellate Division.[22] The court held that the appeals themselves cannot be interpreted as recklessness, because these are the rules of civil procedure and must be followed by legal counsel to achieve justice in the commercial world. While the company was awaiting the outcomes of the appeals, the company openly paid a considerable amount of money to its directors (who were members of the same family), which was disclosed in the financial statements. The court held that the paying of debts and the probable setting aside of the ejection order were lawful and were carried out without any prejudice. Needless to say, after the appeals the company was placed under liquidation. With all due respect, these circumstances are irrelevant when deciding on recklessness. The court ignored one very important question: was

[21] *Ex Parte De Villiers : In Re Carbon Developments (Pty)Ltd (in Liquidation)* 1993 1 SA 493 (AD) 503 G-H. The judgment of Stegmann J was implicitly criticized by Goldstone J.

[22] 447; Fourie "Roekelose of Bedrieglike Optrede – artikel 424 van die Maatskappywet 61 van 1973" 1980 *THRHR* 328; Fisheries Development Corporation Ltd 1989 3 SA 71 (T); Howard v Herrigel 1991 2 SA 660 (A).

the company highly geared before the judgments were contested?[23] Unequivocally, the answer is affirmative since the company would have been placed under liquidation even if the appeals had been allowed. The "big picture" is further complicated through fluctuations in turnover for a particular company during the financial year and this by itself could be employed as a ground to reject a charge of recklessness, i.e. the company in the *Dorklerk Investment* case hardly conducted any business during the period when the appeals were being contested.[24] A court's focus when deciding on a charge of recklessness should instead fall on whether continuation did exist or did not exist in reality and was consequently being ignored or not being appreciated by the company directors.[25] With all due respect, this case should not be followed in the future. Below, we focus on the legal environments in England, South Africa, New Zealand and Australia, and on whether these complement the abovementioned. But before we do so the next paragraph is important from an economic point of view.

5.1 Factors that should be managed by a business strategy to avoid financial distress

To determine the level of financial distress to which a creditor may be exposed, the following factors are important:[26]

- The ability of the company to increase its operating income or profit, i.e. is the top line highly responsive to the ups and downs in the economy of the country?
- The debt to equity ratio of the company may allow creditors to demand a high return for the increased risk.
- The liquidity of the company assets: how easily could a fixed asset be sold to alter the capital structure of the company?
- Cash flow cycle. A short cycle allows for greater debt finance, without causing financial distress, than a longer cash flow cycle. Sometimes a company may experience a negative bottom line or net profit, while being in the possession of cash.[27]

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[23] *Ex Parte Strydom NO: In Re Central Plumbing Works (Natal) Pty(Ltd); Ex Parte Spendiff No: In Re Candida Footwear Manufactures Pty(Ltd); Ex Parte Spendiff No: In Re Jerseytex Pty(Ltd)* 1998 1 SA 616 (D) 623 E

[24] *Re Produce Marketing Consortium Ltd* [1989] 1 W.L.R. 745. If a director failed an objective enquiry, then he cannot be excused from liability simply because he acted honestly.

[25] *S v Parsons* 1980 2 SA 397 (D), *S v Van As* 1976 2 SA 921 (AD); *S v Harper* 2 SA 638 (D)

[26] Arnold *The Handbook of Corporate Finance, A Business Companion to Financial Markets, Decisions and Techniques* 2005 531.

[27] Please see the *McGregors's Security Exchange Digest* example.

6. The British Legal Environment

It is interesting to note that Gower and Davies interpret recklessness directly as the result of director incompetence.[28] This is simply described as maladministration of company business matters, to the extent that the creditors of the company suffer as a result thereof. The maladministration is limited in law. Firstly, if the directors have improperly used capital to finance the business, this is not necessarily an act of recklessness. Secondly, if the directors have acted improperly towards the creditors of the business the same applies. What constitutes recklessness, then? Recklessness is closely associated with the concept of competence or negligence. Competence has its limitations in the law as well. The taking of business risks is not necessarily a foundation for the charge of recklessness, nor is this the case when the company collapses. In *Re Barings Plc (No.5)* [2000] 1 B.C.L.C 523 CA, the Court of Appeal was required to answer to the charge of recklessness when a director of the company delegated his functions to lower level management. Now, the delegation per se does not constitute incompetence but the manner of the delegation may constitute a charge of recklessness. The director in this case, used no system of monitoring the functions delegated or was unable to understand the information produced by the managers to whom the function was delegated. In this regard, we may conclude very easily that the director did not understand the risk of delegation, did not consider setting a research system in place to keep track of the lower managers and ignored the big picture.

Gower and Davies continue that the directors of any company must maintain a minimum level of knowledge and understanding of their business to identify possible incompetencies and to rectify the latter before the act gives rise to a charge of recklessness. A practical example is to be found in the case of *Re Richborough Furniture Ltd* [1996] 1 B.C.L.C. 507. In this case the director of the company possessed absolutely no relevant business knowledge of how to rectify severe capital shortages, or how to deal effectively with escalating debts or the pressures of creditors. The court disqualified the director from partaking in any business activity for 3 years. It is useful to mention here that the director in the Ozinsky case was a university graduate in commerce, and yet she did not rely on the basic business principles of requesting a deposit to ensure working capital. However, Gower and Davies continue that when a director relies on outside professional advice, even if the advice or recommendations do not "pay off" this is not necessarily a case of recklessness. Although the director in the Ozinsky case did rely on professional help, in my opinion the taking of a deposit is a well-known commercial principle which should not be breached.

[28] Gower *Davies' Principles of Modern Company Law* 2003 219.

If we compare this principle with that of the English Insolvency Act 1986, then section 214 accords a colourful meaning to wrongful trading. It states that wrongful trading is only relevant when it appears that a person who was a director of a company at some time before the company was placed under liquidation knew that there was no reasonable prospect for that company to avoid liquidation. Only a liquidator may make use of section 214 for a charge of wrongful trading against the company directors. However, section 214 contains a built-in protection clause. Firstly, it is highly unlikely for a liquidator to institute action against the directors for the simple reason of avoiding carrying high litigation costs personally as they do not constitute a right in the liquidated estate.[29] Secondly, the measurement of wrongful trading is a subjective enquiry. The "counterpart" of section 214 in South Africa is section 424 of the current South African Company Act 1973., which states the following:

> "When it appears whether it be winding-up, judicial management or otherwise that any business of the company was or is *being carried* on recklessly …on application of the master, the liquidator, the judicial manager, any creditor or member or contributory of the company…"

The advantage of this section is that it allows for an objective enquiry, although this is not always appreciated by the South African courts. It is therefore regrettable that section 424 is largely, if not exclusively, only applied during the liquidation of a company in South Africa.[30]

7 The Anticipated Legal Environment of the Companies Bill for South Africa

The anticipated Companies Bill regulates reckless commercial behavior in section 215 b, which declares that a director is guilty of an offence if he or she:

> (b) was knowingly a party to –
> (i) reckless carrying on of a business or
> (ii) an act or omission by a business calculated to defraud a creditor, employee or security holder of the

[29] Havenga "Creditors, Directors and Personal Liability under section 424 of the Companies Act" 1992 *SA Merc LJ* 63); Van der Westhuizen *Section 424 of the Companies Act 61 of 1973: Civil Liability of Directors and Others for Fraudulent or Reckless Conduct of the Business of a Company* (LLM Thesis, UNISA) 1994.

[30] Du Plessis "Corporate Governance and the Cadbury Report" 1994 *SA Merc LJ* 81; Havenga *Fiduciary Duties of Company Directors with Specific Regard to Corporate Opportunities* (LLD Thesis, UNISA) 1998; Luiz and Vander Linde "Trading in Insolvent Circumstances – Its Relevance to section 311 and 424 of the Companies Act" 1993 *SAMerc LJ* 230.

company or with another fraudulent purpose.

The first impression of this section stems from the word "knowingly". Does it imply a subjective enquiry? If so, then the Ozinsky case as noted earlier was decided correctly for reasons other than the "deposits" requirement. Also, the anticipated Act makes provision for a "compliance notice". The purpose of this notice is to inform a director of any possible misconduct or act in contravention of the Bill. The certificate may be issued by the Commission or Take Over Panel to allow the director an opportunity to cease, correct or to reverse his actions. The problem created by this statement is simply that, if the director of a business is unaware of the usefulness of a deposit, how should the commission be aware of the "breach" of this well-known or orthodox commercial principle when the director is not "knowingly" aware of it? It is true that "incompetence" cannot be a subjective test, because should such a question be posed to any person in the public sphere, most likely incompetence infringes a person's right to dignity[31] – especially in South Africa, where the illiteracy of the adult population is nearly 40%. There are constitutional tools in South Africa that could provide for an objective enquiry into recklessness, and for it to be constitutionally correct to refer to some people as incompetent.

8. The New Zealand Legal Environment

The New Zealand Companies Act 1993 regulates reckless trading in section 135. Here it is stated that a director must not:

a. Agree to the business of the company being carried on in a manner likely to create a substantial risk of serious loss to the company's creditors; or

b. Cause or allow the business of the company to be carried on in a manner likely to create a substantial risk of serious loss to the company's creditors.

If one considers (a) above, then surely the same result would be evident as the anticipated South African Bill makes use of the word "knowingly"

[31] De Waal *The Bill of Rights Handbook* 2001 230. The Constitution of South Africa 108 of 1996 merely states as follows in section 10, "Everyone has the inherent dignity and the right to have their dignity respected and protected." It is possible for the legislature to require an objective enquiry for recklessness based on incompetence by using the constitutional tool of section 36 to limit the right to dignity. Section 36 (e) provides for a less restrictive means to achieve the purpose; perhaps disqualification from partaking in any business activities would be useful. See once again the *Re Richborough Furniture Ltd* [1996] 1 B.C.L.C 507.

and yet the New Zealand court applied an objective enquiry when a director "agrees" to create a substantial risk. In *Löwer v Traveller & Another* (2005) 9NZCLC 263 the court refereed to legitimate and illegitimate risks. To decide whether the transaction is a legitimate risk requires an objective enquiry, irrespective of whether the director was aware that the transaction would be likely to create a substantial risk of serious loss. In order to understand the risk of a specific transaction, the court in *Traveller & Anor v Löwer* (2004) 9 NZCLC 263 provided guidelines regarding how to decide whether a specific risk is legitimate; personal benefits payable to a director to encourage him to continue the trade of an insolvent company; if the company trades but is insolvent the director must employ an appropriate business strategy to salvage the company; whether the director's conduct was in accordance with the orthodox commercial practices; whether creditors understood the risk to their funds which were being employed by the company; was the risk high or low; and a higher risk situation requires a higher degree of internal research.

Case law exists where the High Court did require a subjective enquiry. For example, in *Global Print Strategies (in Liquidation); Re Mason & Anor v Lewis & Anor* the court held, that for recklessness to be evident a director must make a willful or conscious decision regarding the loss posed to the creditors of the company.[32]

9. The Australian Legal Environment

In Australia, reckless trading is known as trading in insolvent circumstances, which is regulated by the Corporations Act 2001. Section 588 G applies under the following circumstances:

> (1) This section applies if:
>
> (a) a person is a director of a company at the time when the company incurs a debt; and
>
> (b) the company is insolvent at that time, or becomes insolvent by incurring that debt, or by incurring at that time debts including that debt; and
>
> (c) at that time, there are reasonable grounds for suspecting that the company is insolvent, or would so become insolvent, as the case may be; …

[32] http://fmlaw.co.nz/publications/comm_articles/directorsliabilities.htm found on the internet 5th October 2007.

The focus of section 588G applies to a large extent when the liabilities of the company exceed its assets. When may one suspect that the company is insolvent? The following addresses the question from a legal point of view.

> (2) By failing to prevent the company from incurring the debt, the person contravenes this section if:
>
> > (a) the person is aware at that time that there are such grounds for so suspecting; or
> >
> > (b) a reasonable person in a like position in a company in the company's circumstances would be so aware.

The Corporations Act requires "awareness" in order to be able to impose a charge of recklessness. The case of *ASIC v Plymin, Elliot and Harrison* (No 2) [2003] VSC 230 dealt with the question whether a director should have been aware of the insolvency of the company.[33] The Victorian Supreme Court made use of the "cash flow" test to establish the insolvency of the company. Based on evidence provided to the court, it was indisputable that the Company was unable to pay its debts as they fell due. One such indubitable example was the fact that the bank had revoked its relationship with the company and stipulated the repayable credit facility on demand. But although the court used an objective enquiry to establish the insolvent position of the company, this was irrespective of whether the director's own belief had not assisted him to such a conclusion. The court continued that the actual "awareness" could be supplemented by the reasonable person test as indicated in section 588G 2 (b). However, the court also established that there was no suitable business strategy to alter the financial position of the company favourably. This by itself should be a warning of insolvency trading to other directors or non-executive directors of the company.

7. Conclusion

Since businessmen are not financial experts it must be borne in mind that a company cannot be solely managed by a formula so as to avoid financial disasters. A director should employ the three steps mentioned to avoid a charge of recklessness: to understand the risk, to conduct research in

[33] Luiz and Vander Linde "Trading in Insolvent Circumstances – Its Relevance to section 311 and 424 of the Companies Act" 1993 *SAMerc LJ* 230; Farrar "Fraudulent Trading" 1980 *Journal of Business Law* 336.

order to investigate the risk in all circumstances and to keep the "big picture" in mind to allow for a business's continuation.[34]

The proposed Bill for South Africa calls for a subjective enquiry into the charge of recklessness, and it is the writer's sincere hope that the legislature will reconsider this. In this regard, he proposes the case law guidelines of New Zealand, although the lack of a business strategy as found in Australian law particularly could serve as a warning of recklessness. But in South Africa the reality is that 40% of the adult population are functionally illiterate, and this factor cannot be ignored by any legislature: whether the new proposed Bill is intended for existing businessmen or for the future entrepreneurs in the commercial world,[35] it seems that existing businessmen may exploit the new Bill to their own advantages as obviously in the Ozinsky case.

[34] *Fisheries Development Corporation of SA Ltd v Jorgensen and Another* 1980 4 SA 156 (W).
[35] http://www.skillshare.org/skillshare_southafrica.htm found on the internet 5th October 2007.