

## **European Private Company – A View from the New Europe**

### **Position of the “Expert Group 10+”**

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#### **A. Introduction**

Across Europe, small and medium-sized enterprises (SMEs) play a key role in job creation and innovation, incorporating the entrepreneurial spirit of the local society.

Figures clearly support this view: over 90 percent of all European businesses are considered SMEs. Statistically, the typical European enterprise is a micro-business employing 3 persons. Crafts and small businesses account for over 53 percent of Europe’s jobs and are responsible for half of Europe’s total turnover.

From country to country various organisational forms (corporate, non-corporate) might prevail in being most commonly adopted by individuals to run small and medium-sized businesses, depending on availability, accessibility (set-up costs and duration), legal tradition, network effects, and – last but not least – legal environment (predominantly tax and social security regulations).

Most of SMEs operate locally. However, there are also some that engage in cross-border transactions. Another transnational element that might be identified is foreign shareholding – SMEs are formed as wholly owned subsidiaries or joint ventures of foreign firms.

#### **B. Issues to be Considered**

In considering the value of introducing a new organisational form of European Private Company (EPC), several aspects must be addressed:

- I. the EPC and its impact on the regulatory landscape in the EU; and
- II. the importance of EPC for intra-community trade.

If, based on the above-mentioned considerations, the need to adopt a new pan-European legal form for small and medium-sized businesses is answered in the positive, a third set of problems will require a closer attention:

- III. specific problems of EPC and regulatory response thereto (designing a proper EPC-Statute).

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Prior to taking legislative action on the European level, a further issue must be clarified:

IV. Constitutional basis for EC law enactment.

That means that a proper Treaty basis for such an action will have to be substantiated, depending on the possible justification of legislative action by the Community. However, this latter question will be omitted from the following discussion, as it is not specifically related to the question raised in the Commission's consultative document.

### C. The EPC and the Regulatory Landscape of the EU

In the ongoing debate on the future shape of European company law, and in the corresponding (and actually earlier) discussion in American scholarship, two opposing paradigms have been described and evaluated: harmonization and regulatory competition. There is no need to recapitulate here the basic assumptions and alleged virtues of either of these approaches, as they are commonly known. What is important here is that, at the end of the day, they both lead to a certain degree of regulatory convergence. Quite contrary to common sense, the comparison of the degree of actually achieved convergence ("law in action" versus "law on books") does not necessarily have to fall in favour of the harmonization model (alleged triviality of company law directives /Enriques<sup>4</sup>, impact of pre-existing national legal doctrines and legal tradition /Halbhuber<sup>5</sup>).

What is important to emphasize here is that, ultimately, in either of the above-mentioned models, one set of rules (legal systems) is (likely) to prevail and supersede the others, either *de iure* (harmonisation) or *de facto* (regulatory competition). Putting it differently, harmonisation results in the replacement of the diverging legal systems by means of enactment, whereas competition entails replacing by market forces. Against this background, one might perceive the enactment of a supranational legal form (here the EPC) as an attempt to reconcile these two approaches: the EPC brings legal uniformity across Europe, simultaneously broadening regulatory choice (supply side) and leaving existing national legal forms (Ltd., GmbH, sp z o.o. etc.) untouched. In the end, inter-jurisdictional horizontal charter competition (state-state) is supplemented by the vertical competition (community-state). To some extent, this resembles the Canadian model, where there is a choice between federal and state incorporation.

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<sup>4</sup> Enriques, "EC Company Law Directives and Regulations: How Trivial are They?" ECGI – Law Working Paper No 39/2005 (May 2005).

<sup>5</sup> Halbhuber, "National Doctrinal Structures and European Company Law" (2001) 38 CMLRev. 1385 *et seq.*

The introduction of the EPC is likely to have a substantial impact on the current dynamics of European charter competition or company law reform at large. If one looks at the legislative efforts to date of the national lawmakers (member states of the European Union), one might conclude that regulatory competition has not yet been a driving force of law reform. In fact, rather than charter competition, it is a member state's own vision of "good" law that has accounted for regulatory change over time (Kamar<sup>6</sup> refers to competition for investments as the reason for regulatory change). In the accession countries, the most important driving force was the alignment of the national law with the EU-standards. It would be misleading to assume – based on the very fragmentary nature of the EC-harmonisation of the law of private companies – that the "Europeanisation" of accession countries' law did not have an impact on the regulation of private limited companies in those countries. During the Europeanisation of company law in transition economies, one of the "old" EU member states frequently played the role of "intermediary" – it was tempting for lawmakers of the new member states (importing countries) to avail themselves of the implementation experiences of older member states (exporting countries). Within this process, a transfer of legal ideas was not confined to rules of EU-origin, but included exporting country's own institutions.

The aforesaid is to demonstrate two characteristics of regulatory change: first, so far there have been forces other than regulatory competition that have driven law reform in members states; and second, in that regulatory change, the spill-over effect plays, or is likely to play, an important role. Introducing EPC is relevant for both these perspectives.

EPC is much more likely to effectively challenge national lawmakers than would a foreign corporate form (even British Ltd.). Here, again, we would like to point out one factor that is unjustifiably underestimated and not yet duly researched and explored in the legal scholarship: the role of law professors in the lawmaking process. The mainstream discussion on regulatory competition – as it appears – is overly idealistic. It assumes that, in the drafting process, the predominant interests at play are those of the stakeholders (direct and indirect addressees of the legal rules) and, possibly, the fiscal interests of the state. This might be correct for the U.S., where the Bar gets involved in preparing (model) legislation and where the competitive pressure among state jurisdictions is (at least potentially) fairly high. In the majority of European countries, there are influential law professors who are in charge of drafting codes. As their reputation is tied to their influence and the extent to which their ideas are translated into legislative and judiciary decisions, they become *sui generis* stakeholders in the production of company law.

In this context, an introduction of a genuinely pan-European legal form (EPC) that is likely to gain practical significance in the domestic market of the respective

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<sup>6</sup> Kamar, "Beyond Competition for Incorporations" NYU, Law and Economics Research Paper No 05-01 (May 2005).

member state is also capable of effectively challenging the actual decision-makers. In various member states this might be true for different reasons.

In jurisdictions with high standards of legal discussion and well developed legal scholarship, acknowledged law professors are likely to be captured in defending their previous legal writing, whereas “rising stars” of legal scholarship might make their names by attacking existing doctrines. In countries where company law scholarship is less developed, particularly in the post-socialist countries, established law professors are usually overcommitted and tend to devote themselves to many non-academic activities. This is not intended as a generalisation, but even among prolific authors, there are those who lack real understanding of modern company law and its economic foundations. Consequently, a “market for lemons” emerges, where products of critical thinking are pushed out by legal writings and scholarly contributions produced at a “lower intellectual cost.” The widespread *argumentum ad auctoritatem* approach ensures them a high impact-factor.<sup>7</sup>

Thus, the emergence of the EPC as a genuinely European and easily available legal form is likely to challenge pre-existing legal doctrines in any given member state, entailing a spill-over effect and a critical approach to domestic law. From a scholarly perspective, and taking into account the abovementioned forces that drive (or restrain) company law reform in member states, this all seems to constitute a sufficient substantive argument to go ahead with the work on the EPC Statute.

#### **D. The Importance of EPC for Intra-Community Trade**

In the introductory remarks we identified two cross-border aspects that are relevant for the discussion of the EPC:

- a) some SMEs engage in cross-border transactions; and
- b) some private limited companies are formed as wholly owned subsidiaries of foreign firms.

a) For small and medium-sized enterprises, costs arising from inter-jurisdictional differences are proportionately much more significant than they are for larger firms. The cost of legal advice is relatively high for SMEs, as many of them do not have their own in-house lawyer who would acquire firm-specific skills.

Also, the credibility of SMEs for foreign partners depends on transparency and a similarity to the foreign partners’ domestic law. The degree of this credibility is reflected in the costs associated with the transaction (trade credit costs, securities).

b) Introduction of a pan-European Private Company might also be important for a group of companies that operate internationally. Company law is just one, and not even the most important, part of the legal environment that entrepreneurs take into

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<sup>7</sup> Radwan, “25 thoughts on European Company Law in the EU of 25” (2006) 17 EBLR 1169 at 1173.

into account while making business decisions, particularly those pertaining to the establishment in a given country.

What matters is labour law, tax law, and the law of social security. These and many more areas of law still show a significant degree of divergence among member states. However, this conclusion should not restrain us from taking company law seriously. Succeeding with law reform in this area might inspire forward steps in other fields.

The importance of facilitating freedom of secondary intra-community establishment has been rightly recognized by the European legislator who long ago responded by enacting the 12<sup>th</sup> Company Law Directive. But this step, which promotes single-member companies across the EU, must be perceived as only a modest attempt at achieving the goal of easing the formation of subsidiaries in the common market. The enactment of a common EPC-statute would enable national companies to set up a European-wide group of EPCs, which offers substantial structural advantages in comparison to a grouping of different national legal forms (eg, SARL, Kft, s.r.o., etc.). This would enable smoother management, and would make running the group of affiliated companies less costly.

National private companies subject to very fragmentarily harmonization by means of EU-directives continue to differing in such fundamental areas as organizational structure, rights and obligations of shareholders, power, duties and responsibilities of management, financial constitution, etc. Here, again, costs arising from these differences are relatively higher for SMEs than for large companies.

#### **E. Specific Problems of EPC and the Regulatory Response thereto (Designing a Proper EPC-Statute)**

To be clear, the EPC is to a significant extent an idea of law professors (much like the German GmbH that was also artificially invented and has worked well in practice for more than a century). Having the EPC in addition to – not instead of – national legal structures would make Europe an interesting laboratory of business organisational forms.

We believe that the first decision to be made by the European Commission is whether to go ahead with the EPC-project. This we answer affirmatively. If, consequently, the Commission decides to take up and pursue the proposal, a more specific consultation will be needed. Therefore, we will make only a few remarks on the most contentious matters. It appears that the most controversial problems include two issues: (a) companies' capital and creditor protection; and (b) the notorious question (for EU-harmonisation) of workers' codetermination.

##### *a) Companies' Capital and Creditor Protection*

The problem of companies' capital and creditor protection should be perceived both in the context of broad political and regulatory systems, and from the point of

view of the pure merits of any of the possible systems (legal capital, solvency test, option model – ie, leaving the choice of regime up to the companies themselves). The discussion on capital and creditor protection is not confined to the EPC. The debate on the future of the Second Company Law Directive revealed major differences among scholars that do not necessarily correspond with national borders and legal systems. That discussion is likely to have an impact on the model of creditor protection adopted by the potential EPC-Statute.

In the earlier debate, doubts had been expressed as to whether, given striking differences in the significance that various jurisdictions attach to the construct of legal capital and minimum capital requirements, it is even possible to come to a consensus on a creditor protection model for the EPC. Throughout this discussion, it was presumed that if the EPC was equipped with legal capital, the UK would likely object. However, applying the paradigm of regulatory competition, a contrary conclusion seems justified. It is precisely the high amount of minimum capital that has caused a massive exodus of domestic (particularly Danish, Dutch and German) firms to the UK to seek incorporation under Companies Act, instead of forming ApS, B.V. or GmbH (to give examples of countries where use of Centros/Inspire Art doctrine is made on a large scale<sup>8</sup>). Therefore, requiring the founders of an EPC to contribute a minimum capital of 25.000 EUR<sup>9</sup> will, at the outset, put the EPC at a disadvantage vis-à-vis British Limited.

A reasonable compromise, and also a fairly efficient solution, would be to require an initial contribution of, say, 1.000–2.000 EUR. As Professor Freedman<sup>10</sup> convincingly demonstrated, the reasons for limited liability are less obvious for micro-firms. Moreover, a certain level of financial commitment in the form of cash contribution might constitute a minimum seriousness test (Teichmann<sup>11</sup>) and prevent most of the more specious start-ups, while not creating any real obstacle to a legal form granting a privilege of limited liability. This would have particular impact on many of the new member states' legal systems, in which, contrary to the European trend, access to legal forms granting limited liability has become overly costly (eg, in Poland, Hungary, and, to a lesser extent, Slovenia, Slovakia, and the Czech Republic – in contrast, in Cyprus, Malta and the Baltic Republics, access to limited liability is relatively cheap), especially when the limited capital supply and lower purchasing power of these countries are taken into account.

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<sup>8</sup> Becht, Mayer, Wagner "Where Do Firms Incorporate?", ECGI – Law Working Paper No. 70/2006, available from <[http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=906066](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=906066)>.

<sup>9</sup> In recent proposals the minimum capital requirement is set at the level of 10.000 EUR paid in cash, cf. European Parliament's resolution of February 1st 2007 with recommendations to the Commission on the European private company statute (2006/2013(INI)).

<sup>10</sup> Freedman, "Limited Liability: Large Company Theory and Small Firms" (2000) 63 MLR 317 *et seq.*

<sup>11</sup> Teichmann, "The European Private Company" ECL (4/2004) et p 162 *et seq.*

*b) Workers' Codetermination*

For decades, the controversy over workers' involvement has been the stumbling block for the European Company (SE). There are reasons to expect that it will cause fewer problems for the EPC, as rules on employees' codetermination apply usually to bigger entities only. In post-socialist countries, worker codetermination – if it exists at all – is usually confined to privatised companies. Interestingly, in Poland, the buy-out by employees of formerly state-owned enterprises proved to be one of the most successful methods of privatising small and medium sized firms.

For political reasons, it seems that an attempt to adopt a codetermination-free EPS Statute would be doomed to failure. Therefore, a compromise is needed. This compromise should be based on the following assumptions:

- Mandatory workers' codetermination shall be limited to companies employing a given number of workers, not less than 50;
- the approach adopted for the SE-Regulation could be used for the EPC as well, allowing negotiations between the company and its employees in order to achieve a tailor-made system of codetermination; and
- the default rule should prescribe that the number of workers' representatives shall not exceed one-third of the seats on the board.

**F. Feasibility of EPC and Other Issues**

Going ahead with work on the EPC Statute will require consideration of certain additional issues.

The current proposal provides that EPC shall be a genuinely European form (no state law applicable). This raises questions concerning the interpretation of open-ended clauses, inaccuracies and cases of vagueness in the Statute itself and in the companies' articles, judicial development, gap-filling, etc. It is far from certain that national courts will be able to refrain from looking at EPC from the vantage point of their own national legal doctrines and domestic law on limited liability companies (UAB, SPRL, privat AB, GesmbH, etc.). A coherent interpretation, enforcement, and judicial law development, would require a convergent judicial system. Leading cases would need to be published in all official languages. Also, commentaries written jointly by scholars from different member states and available in various language would be needed. Thinking ahead even further, resorting to a form of arbitration would also be an option to consider.

EPC gives a chance to “experiment” with European lawmaking, to make it an interesting laboratory, without the fear that failure will cause too much damage (national legal forms will continue to exist, offering a lasting alternative for entrepreneurs). It would be prudent to set up a special registrar for EPC with uniform registration forms and procedures. This registrar should be available online in different language versions.

All this would constitute a first step to creating a framework for more efficient venture financing across Europe.

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