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The Need for EU Harmonization in the Areas of Freedom of Establishment and Corporate Governance

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European Community Company Law

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However, certain federal acts have played an enormous role in the area of corporate law. Federal acts that have played a vital role in the US include the Securities Acts of 1933 and 1934, and the recently enacted Sarbones-Oxley Act of 2002. Moreover, the SEC was established in 1934, which was an attempt to regulate the stock market and prevent corporate scandals from occurring. The SEC is responsible for monitoring and enforcement of a number of important acts, mainly the Securities Acts of 1933 and 1934. Additionally, these acts grant the SEC the power to impose civil and criminal penalties for corporations or individuals that have manipulated corporate books or committed some other type of wrongdoing. These two acts have taken center stage throughout the last 70 years when it comes to US federal legislation in corporate and securities law.
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Abstract

This thesis addresses the connection between the right of establishment and corporate governance in the EU. A detailed discussion of both issues will occur, explaining the current situation in the EU and the need for harmonization at the EU level in the aforementioned areas. The thesis will take a comparative approach to company law analyzing the EU, specifically the UK and Germany, with the US corporate law approach.

An evaluation of the situation involving the right of establishment in the US will take place. In the US, the incorporation theory is the dominant method for establishment. The incorporation theory allows businesses, specifically corporations already formed in a jurisdiction within the US to establish within another jurisdiction without having to move their headquarters or principle place of business to the latter jurisdiction, called the real seat theory.

The right of establishment, also known as the freedom of establishment within the EU, addresses the ability for individuals to establish corporations or other types of businesses in the EU. A debate between the two dominant methods in the EU, the incorporation theory and the real seat theory will take place. Additionally, a discussion of the relevant ECJ decisions involving the right of establishment will occur.

This thesis will demonstrate that a directive implementing the incorporation theory and the internal affairs doctrine within the EU is necessary for the EU to achieve its fundamental objective of establishing a well-functioning internal market. Moreover, the thesis will also show that the incorporation theory will make it easier for businesses to have cross border functions and encourage competition within the EU. The increased competition will lead to more jobs, a better economy, and a more prosperous Europe.

Along with the freedom of establishment, a detailed discussion of corporate governance will occur. Corporate governance includes rules implemented to regulate businesses. An extremely important factor involved in corporate governance is governance codes. The majority of Member States have some form of a governance code, which are non-binding and enacted in order to help corporations and market participants perform more effectively. Many codes emphasize the need for a high level of accountability, transparency, and disclosure by corporations and market participant. A central argument in this thesis is that a European Code on Corporate Governance is necessary in order to minimize the differences in the governance rules in the various Member States.

The European Code would allow businesses to maintain the flexibility necessary to handle changes in the market and address specific problems in particular jurisdictions. The concerns include legal, political, and social
pressure exerted on those responsible for making the rules governing corporations and market participants.

An essential part of this thesis will explain the link between the right of establishment and corporate governance and the need for harmonization efforts in both areas in the form of a directive in the freedom of establishment and a European Code in the field of corporate governance.

**Keywords:** corporate law, fundamental freedoms, freedom of establishment, incorporation theory, real seat theory, internal affairs doctrine, corporate governance, and corporate governance codes.
Preface

Corporate Law has changed drastically over the last 20 years. Corporate scandals that occurred in 2002 and 2003 involving numerous major companies in the EU, the US, demonstrated a need for a comparative analysis of company law, with a focus on these two jurisdictions.

The idea to discuss issues of such great importance in the EU including the freedom of establishment and corporate governance came after numerous conversations with colleagues and my tutor Henrik Norinder of Lund University.

After numerous discussions involving these areas of EU law, it was evident that an analysis of the current state of EU law in the freedom of establishment and corporate governance was necessary. Thus, this thesis is an attempt to demonstrate the need for harmonization measures within the EU to ensure that the Community’s chief objective of obtaining a well-functioning single market occurs.

The EU must diminish the serious impediments including the use of the real seat theory, and the differences in the Member States corporate governance codes in order to achieve a well-thriving internal market. This thesis will provide examples of the problems caused by the different approaches used by the Member States across the EU in the areas of the freedom of establishment and corporate governance. Additionally, the thesis will provide insights and solutions to the lack of harmonization within the EU and ways to make the possibility of a well-thriving single market in the Europe come true.
Acknowledgement

I would like to thank my friends, colleagues, and the institutions that I have attended over the years for helping me with the completion of this thesis. Additionally, I would like to thank the many professors I have had throughout my years of education, specifically my tutor Henrik Norinder. Without his help, this thesis could not have completed. I would also like to thank my parents, to thank my sister and brother, who have given me the support I needed over years. Along with the many friends I have met here in Lund, I would like to thank my very close friends Ellen Sjöberg and Robert Bergstan who have helped me tremendously throughout my time here in Lund.

Additionally, I would like to give my thoughts to the victims, their families, and the Virginia Tech community after the tragic events that occurred in Blacksburg during the spring 2007.
## Abbreviations

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<tr>
<th>Abbreviation</th>
<th>Description</th>
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<tr>
<td>EASD</td>
<td>European Association of Securities Dealers</td>
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<td>EC</td>
<td>European Community</td>
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<td>ECGN</td>
<td>European Corporate Governance Network</td>
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<td>ECJ</td>
<td>European Court of Justice</td>
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<td>WTO</td>
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1. Introduction

The European Community has made substantial changes over the last fifty years. A substantial alteration is the fact that it has grown substantially from six Member States in its inception to 27 today. Furthermore, the Community has been able to regulate matters, which it did not have the competence to do at its inception.\(^1\) The EU has also had a tremendous impact in the globalization movement with its common currency and reduction of trade barriers within the Union.

This thesis will examine the current business climate in the EU after the major corporate scandals in 2002 and 2003, focusing on the need for the EU to find a more effective method to establish a well-functioning internal market, which has been the Community’s fundamental objective from the outset.\(^2\)

This thesis will start by explaining the need for a comparative corporate law approach. Moreover, it will address the problems associated with analyzing too many jurisdictions at the same time. Thus, the central analysis in this thesis will focus on the EU and the US. The many similarities and differences that exists in the way the EU, the individual Member States, and the US handle company law issues will also offer a great deal of insight and can create an effective manner in which the EU can achieve its goal of a well-functioning internal market.

Next, the thesis will discuss the EU harmonization process, analyzing whether increased EU regulation is necessary in the areas of freedom of establishment and corporate governance. Additionally, an analysis of the methods of harmonization that are the most appropriate will occur.

The next part of the thesis will address the freedom of establishment. Examining the right of establishment in the US, specifically the incorporation theory, the internal affairs doctrine, and the impact Delaware has had on corporate law in the US and other parts of the world.

A critique of the situation within the EU regarding the freedom of establishment will also take place. In this section, an intense investigation on the differences between the incorporation theory and the real seat theory will occur. The conclusion will be that the EU needs to implement a directive adopting the incorporation theory in order to resolve the dispute between the two theories.

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\(^1\) Competence gives EC institutions the power to initiate action at the European level. The EC treaty is the building block for the competences that EC institutions have. Competence can is often listed expressly the EC Treaty or can be implied when legislation is needed to fulfill the objective of the treaties. See, Article 308 EC Treaty.

\(^2\) Articles 2-5 EC treaty
The last major portion of the thesis will address issues relating to corporate governance within the EU and the US, specifically differences in corporate board structure, board composition, and board independence. In the corporate governance context, three jurisdictions will take center stage in the discussion. In this section, an examination of the differences between the Member States as regards to corporate governance, particularly the UK and Germany will occur. In addition, a comparison and contrast of the UK and Germany approach and the US method to corporate governance will take place as well.

The main argument in this thesis is that EU law needs to change, allowing for EU harmonization measures in company law to occur. The conclusion will be that the EU must implement a harmonization measure in the form of a directive in the area of freedom of establishment and a European Code on Corporate Governance in the field of corporate governance.

Accordingly, this thesis will address central questions, such as how the freedom to establishment and corporate governance are connected and why harmonization steps are necessary in these areas given the current state of company law within the EU. Moreover, a discussion of the best ways to harmonize the areas of freedom of establishment and corporate governance will take place.

1.1 Purpose

The purpose of the thesis is to address the question whether the EU has made the necessary changes in EC company law to address the issues that became public during the major corporate scandals in Europe and the US. Additionally, the thesis will analyze the way the EU collectively as well as the individual Member States, handle issues such as the freedom of establishment and the corporate governance with the way the US treats similar issues within its jurisdiction. Finally, the thesis will discuss the need for EU action in the aforementioned areas in order to create a well-functioning internal market.

1.2 Methods

This thesis uses a comparative legal analysis, to investigate company law, specifically the areas of the freedom of establishment and corporate governance, in different jurisdictions. Using both legal and economic rules from the EU, specifically the UK and Germany, and the US to conclude that harmonization needs to occur in the aforementioned areas.

The analysis involves a review of legal and business rules that exists in the EU and US involving company law. Additionally, a discussion of the
changes that have occurred in corporate law in the two jurisdictions, since the major corporate scandals earlier this decade will occur.

1.3 Delimitation

Although, this thesis will focus on the freedom of establishment and corporate governance in the EU and the US it will not address in detail rules involving securities regulations, accounting, auditing rules or rules on mergers or takeovers. While these areas of company law may relate to the freedom of establishment and corporate governance, it is impossible to cover them all in serious detail here. Thus, they will be reserved for another study.

Furthermore, of particular note is the fact that the thesis does not address in detail the relation between the freedom of establishment and tax issues. Tax issues are often relevant for establishment purposes because Member States frequently take measures to obtain the maximum amount of corporate tax benefits. Yet, it is not possible to go into the detail necessary to explain the numerous corporate tax issues in the thesis.

Moreover, this thesis will focus on large public corporations in the particular jurisdictions addressed. Thus, a discussion of the numerous other types of corporations will not take place.

Additionally, this thesis will focus on jurisdictions within the EU and the US, particularly Germany, the UK, and the US. Unfortunately, it will not be possible to go into deep discussions involving France or the Netherlands, Member State that have had an enormous impact on EU company law. Nor is it possible to go into depth on influential countries that are outside the EU or US, such as Japan.
2. The Comparative Company Law Approach

In the area of company law the individual Member States, as well as other jurisdictions, particularly the US, have heavily influenced the EU. Certain Member States have also adopted freedom of establishment or corporate governance rules that are similar to those that originate in countries, such as Japan, Australia, or South Africa.3

Still, the role played by the Member States in the context of European company law should not be underestimated. Not only do the individual Member States have a voice at the European level, their distinct methods of company law have dramatically influenced the way the EU and the different Member States regulate business in Europe. Although, all the Member States in the EU have played a role in EC company law some Member State have been extremely influential, such as the UK and Germany.4

The impact these Member States have had in EU company law and jurisdictions outside the EU is evident after reviewing numerous jurisdictions consisting of both Member States and countries outside the EU that have added rules originating in the UK and Germany. Examples include the influence the UK legal system has had on the US and the impact Germany has had on Japanese corporate law. Indeed, the impact of the Member State on EU corporate law is comparable to the effect that Delaware has had in the context of US corporate law and other parts of the world.5


4 France has also been extremely influential in EU law and throughout the world. This is evident when one looks at the impact of the French Civil Code. “The code Napoleon has been one of the first (on such a scale), the most important and the most pervasive processes of codification that ever took place.” See, Josselin, Jean-Michel, Marciano, Alian. (2002). The Making of the French Civil Code: An Economic Interpretation. European Journal of Law and Economics Vol. 14, Iss. 3, p. 193-203. Additionally, Dutch corporations have been involved in numerous cases involving the right of establishment. See, Kamer van Koophandel en Fabrieken voor Amsterdam v. Inspire Art Ltd, C-167/01

5 The Delaware effect acknowledges the impact of the choice of forum law in the US. “When business owners decide to incorporate in a state, courts from other jurisdictions usually respect that decision and the laws of the state of incorporation are applicable even if the corporation has little or no activity besides in the state of incorporation”. See, McCahery, Joseph A., Vermeulen, Erik P.M. (2005). Does the European Company Prevent the “Delaware Effect”? European Law Journal, Vol. 11, No. 6, Nov. p. 785-791
2.1 The Impact of Corporate Scandals in the EU and the US

In many jurisdictions, the status quo usually continues in company law until a landmark event or series of events alters the situation and the business industry, as well as political actors realize that tighter scrutiny and stricter rules are necessary. This was especially evident after the collapse of global corporations, such as Ahold and Parmalord in the EU, and Enron and Worldcom in the US. Legislators in both jurisdictions concluded that a drastic change in corporate governance needed to occur in order to maintain stability in the business community, regain the trust of shareholders, and to demonstrate to the public that the respective governments took the regulation of corporations very seriously and would take the necessary steps to cleanup the business climate.

In the US, politicians faced an enormous amount of pressure to change the business environment after the scandals became evident to the public, but only after shareholders and corporations had lost an enormous amount of money. The result was one of the most sweeping changes in US corporate law history, the Sarbanes-Oxley Act. The legislatures and the business community in the EU had similar pressure placed on them to change the business environment in their jurisdiction and the result was the creation of the Modernizing Company Law and Enhancing Corporate Governance in the European Union: A Plan to Move Forward, also known as the Action Plan.

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6 For example, after various corporate scandals in the UK in the early 1990s both market participants and legislatures understood that a change was necessary and there was a push for corporate governance codes. The Cadbury Report enacted in the UK, addressed many of these problems. Eventually codes and business recommendations created in other Member States addressed issues involving corporate governance. See “The Cadbury Report”. The Financial Aspects of Corporate Governance. (1992). The Committee on the Financial Aspects of Corporate Governance and Gee and Co. Ltd. London See also, Sheridan, Lynsey, Jones, Edward, Marston, Claire. (2006). Corporate Governance Codes and the Supply of Corporate Information in the UK. Corporate Governance Vol. 14, Iss. 5, p. 497-505r


8 The Sarbanes-Oxley Act is a federal act in the US enacted 2002 and named after the sponsors of the bill. The act passed with overwhelming support by the Democrats and the Republicans in both the House and the Senate. The act demonstrated the collective opinion in Congress that the business environment needed to change after the scandals. The act increases the scrutiny of public disclosures made by registered companies. The act also significantly increases the penalties for violating cooperation governance, auditing, or accounting rules. See, Olach, Tom. (2007). Securities Investigations Revealed. The Internal Auditor. Vol. 64, Iss. 1, p. 70-75

2.2 The Need for Comparative Law

When determining how the EU should tackle issues involving harmonization, freedom of establishment, and corporate governance it is important to compare and contrast methods used in the individual Member States and in a jurisdiction with similar economic and political circumstances to the EU. Furthermore, a comparative law approach is necessary in order for legislators, regulators, and corporations to choose the best solutions possible to deal with issues involving company law.

At times legal principles from different jurisdictions congregate to provide a general concept of company law. Yet, these legal principles are often so overly broad and simplified that they fail to address specific situations in a particular jurisdiction. Moreover, the legal principles that converge do not necessarily give an adequate explanation to the diverse approaches taken in different jurisdictions throughout the world that may be easier to comprehend by analyzing the economic, social, cultural, or political differences that exist when examining company law in too many jurisdictions.

Furthermore, although a global economy exists and basic legal, political, and ideologically ideas are often shared between various regions of the world, each jurisdiction must decide the best way to handle the unique corporate law problems present in that particular jurisdiction. Thus, the EU must determine its own corporate law rules that take into account its unique political, cultural, and legal traditions.

However, this does not mean that EU officials and market participants involved in making business rules should not look at comparable jurisdictions before they create legal rules. On the contrary, it is essential for those who implement company laws to analyze current corporate rules from various jurisdictions and then alter or create new methods in order to fit the needs of the EU. This enables those who make company laws and policy to determine the best solutions for the EU and eliminate rules that would conflict with existing company law rules within the EU.

For example, it would be incredibly difficult to compare aspects of company law in countries such as Indonesia, China, or Venezuela, with analogous issues in company law in the EU or corporate law in the US without

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11 Overly broad and simplified policies can be scene in chapter 8 that discusses the OECD principles on corporate governance, which are too basic to fit the needs of the businesses and market participants in the EU today. See, Ogus, Anthony. (1999). Competition Between National Legal Systems: A Contribution of Economic Analysis to Comparative Law. International and Comparative Law Quarterly, Vol. 48, p. 405-406
discussing in detail drastic political, social, economic, and cultural distinctions that exists within the various jurisdictions. Unfortunately, this thesis will not be able to address such differences in depth. Therefore, the comparative approach will be primarily between the EU, the individual Member States and the US.

2.3 Comparative Corporate Law: EU and US

The approach in this thesis will be to compare jurisdictions that have basic similarities in the aforementioned areas. Thus, this study will include a comparative analysis between the EU and the US. This is not to say that the two jurisdictions are identical or so closely related that they do not have meaningful variations in the way they address company law issues.

In fact, large differences exist between the EU and the US. The EU is consisting of several sovereign countries, known as Member States. On the other hand, the US is one country with many jurisdictions within the country, called states. Additionally, in the EU numerous types of law are dominant in the various Member States, including the civil and common approaches. Yet in the US common law is the overwhelmingly dominate method. Of course, this is not an exhaustive list of the differences between the jurisdictions, but it should show that wide variations exist between the EU and the US.

Still, these two jurisdictions are the central focus of this thesis for several reasons. Both jurisdictions have the same objectives of producing a thriving business environment that is capable of competing on the global market, providing better jobs for its citizenry, and maintaining economic benefits for its workers. Furthermore, the jurisdictions use numerous company law rules from one another amending business and legal principles, when they address issues involving company law within their jurisdiction. Moreover, both jurisdictions have governments that emphasize the idea of democracy, legitimacy, and transparency. In addition, business and legal decisions made in the EU and the US affect not only their own jurisdiction, but clearly have global implications. Finally, there is spirited competition between

12 This thesis will also briefly discuss jurisdictions outside the EU or the US. In this respect, Japan can be of great interest because of its strong economy and fundamentally sound legal corporate governance structure. An analysis of Japan corporate governance structure would also be of importance because Japan’s corporate law has its foundations in German law. Furthermore, American influences have been evident after the American occupation of World War II. The impact of American corporate law is evident in the development of the Japanese Commercial Code in 2003 introducing new corporate governance measures. Thus, the EU and the US corporate law systems have influenced Japanese law. Deeper analysis of the Japanese corporate structure and the recent governance changes in Japan. See, Saara, Janis. (2002). Balancing Social and Corporate Culture in the Global Economy: The Evolution of Japanese Corporate Structure and Norms. Journal Law & Policy, Vol. 24, Iss. 4, p. 299-312

13 Along with Japan, the US and the EU jurisdictions have extremely large economies and a large amount of power in the business world. Decisions they make can affect countries
the two jurisdictions that often produce clear benefits for both consumers and businesses. ¹⁴

throughout the world and their power and influence is evident after reviewing international organizations, such as the World Trade Organization and the United Nations. ¹⁴ Benefits include companies finding more efficient ways to conduct business, leading to cheaper prices and better products for consumers. See, Wieland, Josef. (2005). Corporate Governance, Values Management, and Standards: A European Perspective. Business & Society Vol. 44, Iss. 1, p.74-85
3. Company Law Harmonization

This section of the thesis will discuss different methods for company law harmonization within the EU. The section will discuss positives and potential setbacks from EU harmonization in the field of company law.

3.1 Corporation Defined

The definition of the term corporation is often quite complicated. Still, a basic definition of corporation is an artificial entity that possesses legal powers and conducts business in its own name including acquiring assets, entering into contracts, and incurring liabilities similar to a natural person. Additionally, the corporation is a separate entity from its managers and shareholders. The corporation also has legal powers, thus it can sue and of course, others have the ability to sue the corporation. Additionally, corporations are required to pay taxes similar to a real person. Another important characteristic of corporations is that a corporation has continuity of life or perpetual existence.

A central question when addressing harmonization in the areas of freedom of establishment and corporate governance is whether the EU or the national governments are best equipped to meet the objectives of the EC treaty. It is now time to address the need for EU regulation in the fields of freedom of establishment and corporate governance.

3.2 The Need for EU Regulation

Under economic theory, markets should allocate resources to the most highly valued use possible in order to have the best aggregate social welfare gains for its citizenry and businesses. Therefore, the EU should find ways to allocate resources in a manner that is the most beneficial to its corporations and citizens.

Many claim that the best way to apportion resources is to have the private sector or the individual Member States place checks on business. Put differently, that EU regulation in the economic sector should not be common, instead used as sparingly as possible because the current state of EU company law is sufficient to regulate business conduct that deviates from generally accepted business practices. Additionally, many argue that extra rules regulating corporations will lead to more bureaucratic

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16 Perpetual existence does not really mean that all corporations will continue until the end of time but rather that a corporation will continue indefinitely until the owners decide to dissolve it or merge it into another business. See, Hamilton, Robert W. (1996). Ibid
governance scheme. Essentially, the critics argue that EU regulation will guarantee negative effects, but will not generate positive outcomes. Thus, critics argue that the large variations between the Member States in the establishment and governance process are not an impediment to the formation of a single market.\(^{17}\)

According to these arguments, EU intervention is frequently unnecessary and counter-productive. For example, corporations will often have to pay large fees to lawyers, accountants, and consultants in order to meet higher standards under a stricter corporate governance scheme in the EU causing copious market complexities and preventing corporations from being as prosperous as possible.

However, when corporations are exclusively governed by private methods it cannot be assumed that market participants will provide the best aggregate situation for businesses they work for or the community as a whole. This is mainly because private actors often take into account various factors that do not coincide with the best interest of the corporation, its shareholders, or the social welfare of everyday citizens.\(^{18}\)

In addition, EU regulation can create a more efficient business environment within Europe. The EU can intervene to reduce the higher transaction costs incurred by businesses forced to obtain more outside workers to meet new corporate governance rules in the EU.

Moreover, government intervention at the EU level can promote fairness and efficiency within the EU business community.\(^{19}\) When equitable rules exist within the EU business community, it is easier for the EU to achieve its economic goals.

### 3.3 Different Company Law Methods

Although, a distinction between economic and non-economic justifications for EU intervention often exists they commonly coincide to provide sufficient reasons for EU regulation in the realm of corporate law. The discussion of whether EU harmonization in company law, specifically the freedom of establishment and corporate governance, is necessary in order

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\(^{18}\) This was evident after the numerous corporate scandals in the early 1990s and early part of this decade. There was wide acknowledgement from people in the corporate arena and politicians that more government intervention was necessary in order to clean up business environment created by the scandals. See, Thomsen, Steen. (2006). *The Hidden Meaning of Codes: Corporate Governance and Investor Rent Seeking*. European Business Organization Law Review, Vol. 7, Iss. 4. p. 845-851

for the EU to obtain a single well-functioning internal market will now occur.

Corporate law approaches are different due to historical, political, social, legal, and economic differences that exist within the Member States. It is evident that the differences among the various company law approaches in the EU are often vast; some of the main differences include “the formation and financing, internal organization, disclosure requirements, choice of company’s legal form, and limitations on groups of companies and business combinations”. 20

Today, the distinctive approaches by the various Member States in the EU demonstrate that harmonization in the area of company law has proven to be extremely difficult, time consuming, and complicated process. Frequently deep-rooted legal traditions in the Member States cause difficulties when there is an attempt to harmonize company laws within the EU. Often, it seems that little to no progress has been made in the harmonization of company laws in the areas of freedom of establishment and corporate governance.

3.3.1 The Need for Harmonization in the EU

It is extremely important that Member States continue to harmonize in the areas of freedom of establishment and corporate governance. This thesis will demonstrate that it is easier for market participants and everyday citizens to comprehend one clear, basic, and unambiguous approach to company law within the EU, rather than the alternative, learning the basic company law rules along with the constant changes that occur in the 27 Member States. 21

After examining, the status of company law in the EU and corporate law in the US the conclusion in this paper will be that harmonization measures are necessary in the EU. Thus, the Community must take the necessary steps to harmonize the freedom of establishment and corporate governance in order to reach its fundamental objective of a fully integrated internal market.

3.3.2 EU Harmonization Methods

Additionally, it is important to understand what methods the Community should use to harmonize the Member States rules in the freedom of establishment and corporate governance. The EU harmonization approach must take into account the short, medium, and long term affects of harmonization of company laws throughout the Community.

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The level of regulation is also very important. Too much regulation in the EU will be too costly and inefficient requiring corporations to complete long and difficult procedures in order to meet company law requirements. Yet, too little regulation would allow corporations, particularly management and directors to commit actions that would be harmful to the corporation, its employees, and its shareholders possibly leading to problems, such as insider trade, corporate negligence, and fraud.

3.4 Alternative Methods for EU Intervention

Now that it has been determined that some form of harmonization is necessary in the areas of freedom of establishment and corporate governance it is time to determine the best approach for harmonizing these areas in the EU. Numerous methods for EU harmonization in the aforementioned areas exist within the EU. Alternative methods for EU harmonization in these areas include a regulation, a directive, or code.

A regulation would require that Member States harmonize quickly and meet the Community standards on the freedom of establishment and corporate governance. Regulations are binding in their authority and have direct applicability. Moreover, regulations apply to Member States, individuals, and corporations.

Directives are binding on Member States but do not bind individuals until they become national law. Despite the fact that directives are binding on the Member States the method of the national legislation, implementing the directive is up to the Member States. Thus, unlike regulations, directives leave a lot of room for the Member States to determine the best way to implement EU rules.

Codes are nonbinding and voluntary action. In the context of corporate governance, harmonization measures, such as codes are common in the Member States. Codes will be addressed in depth in a later chapter.

3.5. The Best Approach to EU Harmonization

This thesis will demonstrate that the Community must implement a directive concerning the freedom of establishment requiring that Member States

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23 Ibid
24 See, Chapter 8
implement the incorporation theory in a manner that does not place unnecessarily harsh restrictions on corporations trying to incorporate in their Member State. The proper harmonization method for corporate governance would involve implementing a European Code on Corporate Governance. The reasons a directive and a European Code are necessary will be explained in detail in the following chapters.  

3.6 US Harmonization

Throughout US history, the states have generally regulated corporate law and the federal government usually has a lesser role. In the US, state statues enable individuals to create a corporation and provide rules governing that corporation.

However, certain federal acts have played an enormous role in the area of corporate law. Federal acts that have played a vital role in the US include the Securities Acts of 1933 and 1934, and the recently enacted Sarbanes-Oxley Act of 2002. Moreover, the SEC was established in 1934, which was an attempt to regulate the stock market and prevent corporate scandals from occurring. The SEC is responsible for monitoring and enforcement of a number of important acts, mainly the Securities Acts of 1933 and 1934. Additionally, these acts grant the SEC the power to impose civil and criminal penalties for corporations or individuals that have manipulated corporate books or committed some other type of wrongdoing. These two acts have taken center stage throughout the last 70 years when it comes to US federal legislation in corporate and securities law.

In addition to the Securities acts enacted during the New Deal, the recently enacted Sarbanes-Oxley Act of 2002 has had an enormous effect on corporate law in the US. The Sarbanes-Oxley act went into effect after the major corporate scandals in the US. However, many critics claim that the act goes too far when it regulates foreign companies or fiduciaries of foreign companies. Thus, many claim that the US is unjustifyably attempting to regulate corporate actions in jurisdictions outside the US. Moreover, the Sarbanes-Oxley act has led many individuals to question enforcement authority of the US regulatory agencies in jurisdictions outside the US.

\[25\text{ See, Chapters 4 and 8}\]
\[26\text{ In the EU laws governing business or corporations are called company law, while in the US the rules governing business or corporations are called corporate law.}\]
\[27\text{ The US Federal Securities Act of 1933 and 1934}\]
\[28\text{ The US Sarbanes-Oxley Act of 2002}\]
4. Freedom of Establishment

The freedom of establishment is a fundamental principle under EC law. The EC law includes four fundamental freedoms, the freedom of establishment, free movement of services, free movement of capital, and the free movement of workers. The ECJ normally treats the fundamental freedoms similarly.

4.1 Ensuring a Well-functioning Internal Market in the EU and the US

Presently, the Member States use different methods when addressing the freedom of establishment, which often conflict with one another. This is evident when one analyzes the conflict between Member States that use an incorporation theory (UK), and those that use a real seat theory (Germany).

The present circumstances in the EU involving the various approaches to the freedom of establishment often make it extremely difficult for corporations to have operations with a cross-border function or establish in Member States other than the jurisdiction where the corporation was originally established.

This thesis will illustrate that the differences among the Member States establishment rules leads to numerous problems for corporations attempting to have cross border operations in the EU. This thesis will also discuss the numerous benefits that would accrue because of legislative action in the form of a directive implementing the incorporation theory and the internal affairs doctrine at the EU level and the positive impact the directive would have on corporations, citizens, and economies within the EU.

4.1.1 Preventing Impediments to the Internal Market

The ECJ vigorously protects the fundamental freedoms in the EU, forbidding restrictions on the freedoms that do not meet objective qualifications of necessity and proportionality.

Correspondingly, the US Supreme Court has interpreted the US Commerce Clause to limit the ability of the individual States in the US to burden interstate commerce or to discriminate in favor of their residents to the
It is no surprise that the two jurisdictions often use similar antidotes to address problems presented when residents receive preferential treatment at the expense of non-residents. Both jurisdictions have a fundamental goal of ensuring a well-functioning internal market, and overriding state or corporate action that unnecessarily hinders the functioning of the internal market in their particular jurisdiction.

4.2 The Incorporation Theory and its impact on US Corporate Law

A fundamental difference exists between the way the EU and US handle the establishment of corporations within their jurisdiction. Currently, corporations legally established in a state within the US are capable of incorporating in other jurisdictions in the US. Thus, it is irrelevant where the corporation’s main headquarters is located, its principle place of business, or its main transactions takes place. The incorporation theory has allowed some jurisdictions to have an enormous impact on US corporate law and corporate law in many jurisdictions throughout the world.

4.2.1 The Race to the bottom

Nonetheless, critics of adopting the incorporation theory within the EU have argued that the incorporation theory will lead to a race to the bottom. Essentially, claiming that extremely liberal business rules in Delaware are telling examples of the problems that occur when a jurisdiction implements the incorporation theory.

The race to the bottom theory declares that states will do whatever necessary to attract businesses and compete with other jurisdictions in order to capture benefits that are associated with corporations establishing in its jurisdiction.

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32 The Interstate Commerce clause states “Congress shall have the power to regulate Commerce with foreign Nations, among, the several States, and with the Indian Tribes.” See, Article 1, Section 8, Clause 3 of the US Constitution.
34 The influence Delaware has had on other jurisdictions is known as to as the Delaware effect. Delaware is a state located in the Northeastern part of the US. Despite its small size, Delaware has played an extremely important role in corporate law. Not only affecting vital business decisions within its jurisdiction and the US, but also having an enormous affect on corporate law throughout the world. Delaware is widely considered the state in the US with the most favourable laws for business corporations. See, Troger, Tobias H. (2005). Choice of Jurisdiction in European Law-Perspective of European Corporate Governance. European Business Organization Law Review. Vol. 5, Iss. 2, p. 605-614
According to the race to the bottom theory, laws will eventually be so relaxed and favorable to businesses that the rules would have little to no practical effect on regulating corporations. Proponents of the race to the bottom argument also claim that enacting the incorporation theory in the EU would ease business rules on corporations allowing market participants the ability to manipulate business practices for personal benefit at the expense of corporation, shareholders, employees, and the public.

4.2.2 The Race to the top

The race to top is a theory that contradicts the race to the bottom. The race to top states that society will benefit because corporations are able to choose where they want to establish. Essentially, the theory states that if jurisdictions enact laws that are too favorable to corporations it would harm the interests of shareholders and shareholders would respond by failing to buy shares of corporations in that jurisdiction eventually leading to the reduction of the price shares of the corporations in that state. Thus, under the race to the top theory shareholders would be able to place a check on corporations even if they are located in states with very liberal corporate law rules.

4.3 Legislation Enabling EU Harmonization in the Field of Freedom of Establishment

Article 293 EC treaty allows Member States to recognize corporations or businesses established legally in another Member States. Yet, Member States are only required to enter into negotiations. Therefore, no obligation exists for Member States to enter into agreements recognizing corporations or businesses legally established in another Member State.

The problems presented by the nominal negations requirement, as opposed to requiring Member States enter into agreements on mutual recognition of companies or firms were evident after the failure to implement a mutual recognition of companies during the Mutual Recognition Convention on Business Recognition.

Moreover, the EC treaty under article 235 grants legislative branches in the European Community general power to implement changes in the Community, even when the EC treaty has not granted such power

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36 Benefits that are present when companies establish in a jurisdiction include increased tax revenue, more revenue from corporate registration fees, and more jobs.


38 See, Article 293 EC

39 This is a nominal requirement because Member States face no real pressure to enter in agreements and the requirement to enter into negotiations is meaningless if the Member States do not make a good faith effort to enter into agreements involving the recognition of corporations established in other Member States. See, Article 293 EC
explicitly.\textsuperscript{40} In order to use this power the Community action must be necessary to obtain one of the objectives of the Community.\textsuperscript{41}

Yet, severe limitations exist on the use of the general power in article 235 EC treaty. The action by the Community must be necessary in order to attain one of the objectives of the Treaty. Additionally, the subsidiarity principle in article 5 EC treaty explicitly restricts the Community’s ability to act in areas of joint competence with Member States.\textsuperscript{42} Furthermore, action at the European level can only happen when it is necessary and proportionate. Thus, the Member States must not be capable of addressing the issues adequately before European action occurs in areas of joint competence.\textsuperscript{43} The necessity and proportionate obligations attempt to limit European action that would place severe limitations on the Member States competences.

Thus, it is normally difficult for the EU to use article 235 EC Treaty to implement community legislation in the area of company law. In order to meet the requirements of this article the Community must demonstrate that it is necessary for legislative action at the European level to occur.

Furthermore, the Community has to demonstrate that the Member States are not doing a sufficient job regulating the freedom of establishment and corporate governance before EU harmonization can take place in these areas. Accordingly, the Community would also have to guarantee that its actions are limited and only go so far as necessary to achieve Community objectives in order to meet the proportionality requirement.

It is now time to address the freedom of establishment in the EU, specifically analyzing the incorporation theory, the internal affairs doctrine and the real seat theory.

\textbf{4.4 Freedom of Establishment in the EU}

In the EU, the incorporation theory and the real seat theory have been competing for dominance for several decades. The problems that arise because of the differences between the incorporation theory and the real seat theory cause severe impediments to the harmonization and coordination of corporate laws in the Community. The EU must reduce the differences in order for the Community to realize its quintessential objective of a well-functioning internal market.

\textsuperscript{41} See, Article 293 EC
\textsuperscript{42} See, Article 5 EC Treaty
\textsuperscript{43} Joint Competence is an area where both the European Community and the Member States have the power to act. Thus, the power they have in areas of joint competence is shared.
4.4.1 Incorporation Theory vs. Real Seat Theory

The incorporation theory allows corporations already established in the EU to establish in another Member State without regard to the establishment rules in the Member State where the corporation is attempting to establish.

Yet, some Member States continue to use the real seat theory, such as Germany and the Danish government’s business authority in Centros, despite the ECJ’s decisions in cases, such as Centros and Ubseering. The real seat theory declares that a corporation shall reside in the state in which it maintains its principle place of business.

In contrast to the incorporation theory, the real seat theory requires a corporation to change its principal place of business when it decides to establish in another Member State. Therefore, the corporation would generally have to wind up its operations in that original state of establishment and reincorporate in the Member State where it is attempting to establish. Member States that use the real seat theory often have a protectionist effect preventing nonresident companies from establishing within its jurisdiction, even if that is not the intent of the Member State. Thus, the practical aspect of the real seat theory is to favor domestic companies over companies established in other Member States.

In Member States where the real seat theory prevails, the laws of the state where the company has its headquarters or principal place of business usually govern the internal affairs of corporations. The outcome of the debate over the different theories of establishment is extremely important as it plays a vital role in the functioning of the internal market. It is also important because the type of establishment used in a Member State often determines which Member States rules will apply in a situation where the governing law is in dispute.

4.5 Secondary Establishment

It is important to ascertain the role played by governments when regulating corporations created outside the jurisdiction where the corporation was originally established. This leads to some serious questions that need to be addressed involving secondary establishment. In both the EU and the US

44 The ECJ dismissed the Danish governments’ arguments based on the real state theory, instead affirming the incorporation theory approach to establishment within the EU. See Centros Ltd v. Erhvervs-og Selskabbstrelsen, C-212/97, Ubseering BV v. Nordic Construction Company Baumangement GmbH, C-208/00 and Kamer van Koophandel en Fabrieken voor Amsterdam v. Inspire Art Ltd, C-167/01

significant issues are presented when governments attempt to regulate corporations that are located in other jurisdictions.

**4.5.1 Secondary Establishment in the EU**

Secondary establishment in the EU involves companies or firms setting up branches, subsidiaries, or agencies in jurisdictions other than that of the place of establishment. European institutions, particularly the ECJ in cases such as Centros and Ubseering have made concerted effort to assist cross border operations involving secondary establishment. Still, more needs to happen to ensure that EU citizens and corporations established within the EU obtain their rights in relation to the freedom of establishment.

Under article 43 EC treaty, restrictions on the establishment of corporations, branches, subsidiaries, or agencies already established in one of the Member States shall be prohibited. Moreover, unlike US law, article 48 of the EC Treaty declares that companies or firms that have their registered office within the Community shall receive identical treatment (shall be treated the same way) as natural persons who are nationals of a Member State. As a result, corporations and natural persons shall receive identical treatment for legal purposes.

**4.5.2 Legal Persons vs. Natural Persons in the US**

This is indeed very different from the way US courts treat the relationship, between corporations and natural persons. In the US, companies do not have the same legal standing as natural persons. As a result, courts in the US have treated natural persons differently than corporations, which give the individual states the ability to have stricter rules for corporations than natural persons.

**4.5.3 ECJ cases Involving Secondary Establishment**

EU institutions, particularly the judicial branch, have attempted to limit the ability of Member States to place unnecessary impediments to the

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46 See, Article 43 – 48 EC Treaty
47 See, Centros Ltd v. Erhvervs-og Selskabstrelsen, Case C-212/97, and Ubseering BV v. Nordic Construction Company Baumangagement GmBH, C-208/00
48 "Companies or firms formed in accordance with the law of a Member State and having their registered office, central administration or principal place of business within the Community shall, for the purposes of this chapter, be treated in the same way as natural persons who are nationals of Members States". In the US, corporations are not identical to citizens for legal purposes and face more restrictions than citizens do in certain areas. See, Centros Ltd v. Erhvervs-og Selskabstrelsen, C-212/97, and Ubseering BV v. Nordic Construction Company Baumangagement GmBH, C-208/00
49 "A corporation is not a citizen within the meaning of the privileges and immunities clause of Article IV, Sect. 2 of the United States Constitution, although it is a person within the meaning of the Fourteenth Amendment". Restatement (Second) Conflict of Laws Section 311 of the California Corporations Code
establishment process in the EC Treaty. The ECJ has been extremely involved in the establishment process by prohibiting Member States from having unnecessary restrictions on the possibility for EU corporations established in one Member State to establish in the territory of another Member State. Numerous examples exist of the ECJ addressing the freedom of establishment in the EC, examples include cases such as Daily Mail, Centros, and Ubseering.

Daily Mail is an ECJ case that involved a corporation already established in one Member State attempting to establish in another Member State. However, the Member State where the corporation originally established (the UK) attempted to impose taxes (exit taxes) before the corporation could leave the country. The ECJ held that Articles 52 and 58 of the Treaty do not grant a right for a company incorporated under the rules of a Member State and having its registered office there to transfer its headquarters to other jurisdictions.

The Centros case involves a company established in the UK attempting to establish in Denmark. The Danish government refused to allow the company to establish stating that it had to protect creditors. The ECJ stated that the Danish refusal was a restriction on the freedom of establishment and the company must have their right to establishment protected. Thus, the ECJ ruled in favor of the company attempting to establish in Denmark and against the Danish government.

Ubseering is about a company with its headquarters in the Netherlands that did not have the status of a legal person in Germany. Therefore, the Dutch company did not have the ability to sue in Germany, unless it reincorporated and moved its headquarters to Germany. The ECJ declared that the Dutch company did not have to reincorporate in Germany to have legal rights. Thus, the ECJ rules that the corporation must have the right to sue in Germany.

4.6 The Internal Affairs Doctrine

A heated topic among those in the EU business community involves where the lines of regulatory power should be drawn when dealing with a company that is incorporated in Member State A (Germany), but conducts most of its business in Member State B (UK). A parallel situation may arise in the US when a corporation incorporates in Delaware, but conducts most of its business in California. An important question focuses on which States’ law governs this process.

The US attempts to answer this question by using the internal affairs doctrine to address this type of situation. In the US, under the internal affairs

50 See, Article 43 EC Treaty
51 Regina v. HM Treasury and Commissioners of Inland Revenue ex parte Daily Mail and General Trust plc C (81/87)
doctrine individuals can determine which States’ law is applicable in the freedom of establishment process or corporate governance process. Generally, the internal affairs doctrine applies even when a corporation conducts most of its business in another jurisdiction within the US, or when the majority of its businesses are located in another jurisdiction.

4.6.1 Resistance to the Internal Affairs Doctrine

In the US, when a corporation conducts business within a particular jurisdiction they are usually required to follow the rules of that jurisdiction. For example, when a corporation conducts business within Utah they normally have to follow the Utah state laws involving morality. Thus, the corporation usually cannot rely on the laws of a less restrictive jurisdiction. As a result, a business incorporated in Delaware but conducting business in Utah could not claim that it is only required to follow Delaware’s laws involving morality and disregard the morality laws in Utah.

Interestingly, the internal affairs doctrine operates contrary to general business law rules in the US. Under the doctrine, corporations usually can incorporate in a State and follow the laws of another State. The internal affairs doctrine

“usually allows individuals to form a corporation pursuant to the statute and incorporation the State without regard to the residence of those who intend to participate in the venture and without regard to where the parties intend to conduct business”.54

Still, some states have been reluctant to accept the internal affairs doctrine, implementing legislation that declares that certain provisions of its laws will apply when a corporation conducts a significant amount of business in its jurisdiction, regardless of where the corporation is domiciled. 55 For example, big states such as California and New York find it troubling that they lose large amounts of corporate tax revenue, and oppose the notion that

52 “The internal affairs doctrine is a judge made choice of law canon mandating that disputes regarding internal affairs activities concerning the relation between the corporation, its directors, officers, and shareholders.” The doctrine states that the laws of the state of incorporation shall govern corporations. See, the Internal Affairs Doctrine: the Theoretical Justification and Tentative Explanation for its Continued Primacy”. (March 2002). Harvard Law Review, Vol. 115, No. 5, p. 1480-1501
55 See, 2115 California Corporations Code, “Section 2115 of the California Corporations Code establishes a test to see whether a corporation’s dominant relationship is with California. Specifically, the section calls for examining whether over 50 percent of a corporation’s property, sales and payroll, as well as the residence of the owners of over 50 percent of the outstanding voting stock, are in California.” When that is the case, certain sections of the California Corporations Code will be applicable. See, Gevurtz, Franklin A., (2000). Corporation Law Hornbook Series. West Group. St. Paul, Minnesota. p 37
corporations can incorporate in Delaware and follow Delaware law, while conducting most of its business in its jurisdiction.

4.6.2 Privileges and Immunities Clause in the US

Additionally, critics opposing the internal affairs doctrine argue that the US Supreme Court has stated in the privileges and immunities clause that corporations are not identical to natural persons for legal purposes in all situations. Therefore, corporations in the US are not necessarily entitled to the same protections of natural persons under the law. Thus, critics of the internal affairs doctrine claim that if states such as California or New York want to use aggressive methods to regulate nonresident corporations than it is acceptable, since corporations are not identical to natural persons for legal purposes in the US.

4.6.3 The Interstate Commerce Clause in the US

Nevertheless, supporters of the internal affairs doctrine can look to the interstate commerce clause to validate the use of the doctrine. In CTS Corp. v. Dynamics Corp. of America, the US Supreme Court stated that the internal affairs doctrine is a way to facilitate interstate commerce in the US. The court reasoned that the internal affairs doctrine is advantageous to the internal market and is a valid method to ensure that the market works as efficiently and productively as possible.

4.7 Enacting the Incorporation Theory and Internal Affairs Doctrine in the EU

Despite the criticism, the EU should adopt both the incorporation theory and the internal affairs doctrine because both doctrines reduce transaction costs and enhance the possibility of completing the EU internal market. Moreover, the doctrines coincide with each other, with the incorporation theory addressing methods of establishment, while the internal affairs doctrine focuses on choice of law rules that apply once a corporation

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57 Interstate Commerce Clause prohibits laws that will unduly restrict commerce between the individual States within the US. Article 1 Section 8 Clause 3 of the US Constitution.

establishes in a jurisdiction. Additionally, both doctrines protect the interests of EU citizens and corporations by giving them the ability to establish in another jurisdiction without moving its headquarters or principal place of business to the jurisdiction where the company is establishing itself.

In addition, the incorporation theory increases the possibility of businesses to function in a cross-border manner. Moreover, for establishment purposes the incorporation theory limits the ability for Member States to favor corporations established in its jurisdiction at the expense of corporations established in another Member State. Thus, unlike the real seat theory, the incorporation theory and the internal affairs doctrine enhance the possibility for businesses to be more competitive in other jurisdictions. The increased competition will eventually lead to a better EU economy, with more jobs, and better products at cheaper prices. 59

The ECJ has concluded that corporations registered within the EU should not be restricted from establishing in other Member States because of strict national legislation that makes it unduly burdensome for corporations to have cross border operations. 60 Although, the ECJ has denounced attempts by certain Member States to use the real state theory in cases, such as Centros and Ubseering no legislative action at the European level requiring that Member States enact the incorporation theory has taken place. 61 For these reasons, a directive implementing the incorporation theory and internal affairs doctrine is necessary in the EU.

4.8 The Connection Between Establishment and Governance in the EU

The EU needs more than a directive implementing the incorporation theory and internal affairs doctrine. Although, a directive implementing both concepts is a necessary step in the harmonization process, drastic variations between the Member States would still exist causing serious impediments to the single market if a European Code on Corporate Governance is not also implemented. 62

59 In Germany, the real seat theory is the preferred method. The ECJ essentially denounced the real seat theory in Centros and Ubseering, requiring Member States to recognize corporations established in another Member State because failure to do so routinely makes it more difficult for corporation to establish in another jurisdiction. See Centros Ltd v. Erhvervs-og Selskabstrelsen, C-212/97, and Ubseering BV v. Nordic Construction Company Baumangagement GmBH, C-208/00
60 Ibid
61 The ECJ has stated that a Member State does not have the ability to put unnecessary restriction on corporations that a incorporated in one Member State and are attempting to incorporate in its Member State. If a Member State, such as Denmark is concerned about fraud or protecting creditors than that State can place restrictions once that business is legally incorporated in that jurisdiction. See, Centros Ltd v. Erhvervs-og Selskabstrelsen, C-212/97.
62 Corporate governance can be defined as the collection of rules that regulates the conduct of those in control of a business organization. While Comparative corporate governance is the collection of mechanisms in use in selected parts of the world to regulate those in
Thus, it is important to demonstrate how the freedom of establishment coincides with corporate governance rules within the EU. The practical impact of an EU directive implementing the incorporation theory and the internal affairs doctrine on corporate governance within the EU would be immense. The incorporation theory would allow corporations already established in the EU to establish in another Member State.

4.8.1 The importance of board structure for establishment purposes

Corporate boards would be able to analyze the various corporate governance rules within the different Member States if the EC implemented a European Code on Corporate Governance. Corporations could then base establishment decisions on important factors, such as whether corporations in a particular jurisdiction can have a one-tier governing board or whether a two-tier board system is mandatory under law. 63 This can prove to be a very important question because a corporation may prefer to establish itself in a Member State where a change in the structure of the board would not be obligatory.

Corporations are often reluctant to move to a Member State where the corporation would be required to change the structure of the board. The reason for the lack of enthusiasm on the part of corporations is attributed to the cost, inefficiency, and large amounts of time it can take to restructure the board from a one-tier board to a two-tier approach or vice versa.

Specifically, the incorporation theory and the internal affairs doctrine would allow a corporation that has a two-tier board structure, like the Netherlands to establish in Germany, a Member State that also has a two-tier board structure. Instead of forcing the Dutch corporation to attempt to establish in a Member State with a one-tier governing board structure, such as the UK or Ireland.

However, the real seat theory would limit the ability for the board to take decisions involving board structure into account. For example, if a corporation in the Netherlands decided to establish itself in Germany it may have serious difficulties. Most likely, the Dutch corporation would have to wind up all its operations in the Netherlands and attempt to make Germany its principal place of business before it is capable of establishing in Germany. Despite, ECJ decisions, like Centros and Ubseering that have

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control of business organizations, with attention to the origins and attention to the differences between the countries or regions. Lawrence A. Cunningham, Comparative Corporate Governance and Pedagogy 34 Ga, K, Rev, 721 (2000) p. 722-723

63 In the EU, there are generally two distinct methods for corporate boards to operate, either using a unitary board or a two-tier board. The unitary board has one board that has the supervisory and management functions of the board combined. Yet, the two-tier board has two separate boards, the supervisory board and the management board. In chapter 6 a more detailed explanations of corporate governance occurs.
demonstrated the need for the incorporation theory within the EU, Germany continues to use the real seat theory as its primary method of establishment.

4.8.2 Board Composition and the Establishment Process

Furthermore, the variations in board composition may play an important role in the decision making process for corporations attempting to establish in another Member State. A major reason for this is the fact that some Member States require labor representation on the board.64

For instance, a corporation in the UK should consider the fact that under German law labor representation is mandatory on the board in large public corporations. Thus, establishment by a UK company within Germany would mean that the UK company would be required to have a certain percentage of the board members represent labor in large public corporations. Therefore, the type of board structure and the composition of the board in a corporation are extremely important, thus a corporation should take into account these factors before it attempts to establish in a member state.

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64 In Germany and the Netherlands, when corporations are of a certain size labor must be represented. Moreover, in some Member States like Austria, Sweden, and Denmark it is optional for corporations to have labor represented on the board. Yet, in the UK labor representation on the board is not obligatory.
5. Corporate Governance

This part of the thesis will focus on corporate rules in the EU and the US. The main part of the discussion will involve Germany, the UK, and the US, with a comparison involving the diverse methods the different jurisdictions use to regulate corporations.

5.1 Corporation Governance Defined

Numerous definitions for the term corporate governance exist, but a general definition of corporate governance is the rules implemented in order to regulate businesses. As stated in the Cadbury Report, “Corporate governance is the system by which businesses are directed and controlled.”65 In addition, definitions of the term corporate governance frequently include terms such as control, supervision, and management of the company and the internal governance of the company.

5.2 Quorum and Notice Requirements

For the most part the board of directors does not operate individually; instead, they operate together as a board. Directors usually do not have the authority to act on their own and in most cases have to act in meetings of the board or other situations where the board acts jointly. Usually, a minimum number of board members are required, called a quorum, in order for the board to take action legally. The quorum is generally set at a majority of the board.66

Moreover, a requirement that board members give adequate notice in order to guarantee that they are aware the meeting will occur exists. Both the quorum and the notice requirement are to prevent corporate action without a sufficient number of board members and to make sure that board members receive timely notice about meetings even when they are unable to attend.67

66 Yet, modern statutes often allow corporations to set the quorum above 50 percent of the board. For example, some corporations require in their articles of corporation that 75 percent of the board is present. On the other hand, some states give corporations the ability to have a smaller number of board members than a majority. See, Gevurtz, Franklin A., (2000). Corporation Law. Hornbook Series. West Group. St. Paul, Minnesota. p. 191
5.3 The Action Plan

The EC implemented the Action Plan after the notorious corporate scandals in the EU and the US, in order to enhance corporate governance disclosure, strengthen shareholder and employee’s rights, and modernize the corporate board. The Action Plan attempts to make businesses within the EU more competitive creating plans to improve business over the short-term (2003-2005), medium-term (2006-2008) and long-term (2009 onwards). In an attempt to improve these areas, the Action plan states that listed public corporations should release information about any material transactions with other parties, the need for corporations to refer to national governance codes and explain deviations if any exists, and the composition and organization of the board.

Additionally, the Commission saw several issues as extremely important when it implemented the Action Plan. These issues include listed companies submitting an annual corporate governance statement explaining key developments, the governance structure in the company, the need for corporations to find ways to increase the shareholders ability to exercise their rights, and promote the role of independent directors on the board.

Furthermore, the Action plan is an attempt by the European Commission to facilitate cross border operations through the freedom of establishment and create better corporate governance schemes in the EU. When implementing the Action Plan the EC concluded, the harmonization of a set of minimum rules governing freedom of establishment would assist companies in their quest to establish in different Member States because the regulatory framework within the EU would be similar.

The Action Plan also seeks to establish more legal certainty regarding company law in the EU. When Member States have vastly different corporate governance schemes it leaves people in charge of making corporate decisions in difficult positions, as they are not sure how corporate governance rules apply in the different Member States. Thus, the large differences in the Member States continues to impede the possibility for a well functioning internal market because corporations may be hesitant to become involved in cross-border functions when the Member States have large variations in the way they govern corporations.

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69 See, www.ecgi.org/commision/ European Corporate Governance Institute

70 Ibid

71 Ibid

72 Ibid
6. The Corporate Board

It is now time to address the variations in the approaches in the way Member States structure their corporate governance board starting with the differences in the unitary and two-tier governing body.

6.1 Two types of Governing Bodies

Generally, the formation of corporate boards is in one of two ways. Either in a unitary system, where the governing body is made up of a single board or in a two-tier system where the governing body is divided into two separate boards, a supervisory board and a management board. Examples of the unitary board approach are the UK and the US, whereas the German and Dutch corporate board structure provides examples of the two-tier governing body in large public companies mandating the two-tier structure.

The unitary board combines both the supervisory and the management functions, although certain unitary systems achieve a certain degree of separation of these functions through various mechanisms. The two-tier board institutionalizes a clear distinction between the supervisory functions on the one hand, and the managerial functions on the other.

6.2 The EU and its Wide Variations of Corporate Governance

Interestingly, in the EU, corporate boards have several different types of governing body structures. Member States that use the unitary board system only include the UK, Ireland, and Italy. Member States with a compulsory two-tier board for larger companies are Germany, the Netherlands and Austria. Yet, many Member States allow corporations to use either the unitary or the two-tier board structure. Under the scheme were corporate boards use both the unitary or two-tier board structure includes, France, Sweden, and Denmark.

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73 A good example of the separation between supervisory and management functions is the UK, where the Chairman does not have an executive role like the US. Instead, the UK allows the Chairman to act independently, not having to coordinate its decisions with management. The separation of roles can be justified because it often places a check on the amount of power an individual on the board has.


75 Ibid

76 Ibid
Currently, a large variation exist involving the type of corporate governance structures within the EU with a distinction between market-oriented Member States that focus on competition and those that place more attention on co-operation. The examples often used to explain this dichotomy between the various approaches to corporate governance in the EU are the UK where the unitary board is dominant, and Germany, which has the two-tier board in large public corporations. The UK is the more market-oriented placing larger emphasis on competition. On the other hand, in Germany the governance structure tends to value cooperation and consensus more than the UK corporate governance structure. Now an evaluation of the two distinct approaches of the German and UK governing bodies and the governing body in the US will take place.

6.3 The Unitary Board in the US

Contrary to their continental European counterparts, drastic variations in the organizational structure of the governing body of corporations are not common in the UK or the US. In both jurisdictions, corporations almost exclusively use a unitary board structure.

However, in the US in most large public listed companies the supervisory and managerial functions still remain attached in the form of the Chairman of the Board and the Chief Executive Officer. The Chairman/CEO often takes the lead role in both the supervisory and managerial functions of the corporation. This gives a board member with both responsibilities a large amount of control and power to decide the direction of the corporation, the necessary steps to oversee the corporation’s actions, and the ability to establish the procedures that will ensure good governance and best practice policies in the corporation.

The influence and power that is generally concentrated in the hands of the Chairman/CEO has caused many in the EU to be skeptical of the American unitary governing board and its ability, to place a genuine check on management and its action. The EU Commission spoke about some of the difficulties presented by having one individual serve as both the Chairman and the CEO in the US in a report issued after the financial corporate scandals of 2002. Specifically, the Commission stated that

“The commission believes that a crucial governance challenge facing American corporations involves establishing an appropriate balance between managing the company and providing the independent directors with the powers and resources they need to perform its role. In addition, the Commission recommends that each company give careful considerations,
based on its particular circumstances to separating the offices of the Chairman and the Chief Executive Officer”.77

This statement shows that many in the EU have serious concerns about the US unitary board and its ability to separate the supervisory and the management functions. Yet, it seems unlikely that many US jurisdictions or corporations will implement changes that would prevent the Chairman of the Board from also acting as the CEO in the near future.

Nonetheless, some EU officials believe that it is possible for corporations to benefit from one individual serving as the Chairman and the CEO in the US unitary system. As the business round table put it in a recent White Paper release

“Most American corporations are well served by a structure in which the CEO also serves as chairman of the board. The CEO serves as a bridge between the management and the board, ensuring that both act with a common purpose. Some corporations have found it useful to separate the roles of CEO and Chairman of the board to provide continuity of leadership in times of transition. Each corporation should make its own determination of what leadership structure works best, given its present and anticipated circumstances.”78

The debate in the EU over whether the US should alter corporate practices and separate the roles of the Chairman and the CEO demonstrates the difficulties facing US legislators, regulatory boards like the SEC, and corporations, and market participants.

Moreover, in the US, some have argued that when the Chairman of the board also serves as the CEO, the board should have an independent director take the lead role during the supervisory functions conducted by the board. This is to ensure that the Chairman/CEO observe their fiduciary duties and acts in the best interests of the corporation. When an individual serves as both the Chairman and the CEO, it is frequently much easier for them to manipulate corporate information to their benefit at the expense of others in the corporation, shareholders, or employees. Thus, independent actors in the one tier structure can serve a similar role to that of the supervisory board in the two tier system by placing a check on the Chairman/CEO and preventing them from having unlimited power.

77 The Conference Board in its report entitled Commission on Public Trust and Private Enterprise
78 The business round table in the White Paper
6.4 The Chairman and CEO Positions in the UK

In EU Member States with a unitary board, a push to separate the supervisory and managerial functions of the board has been apparent over the past decade. This is evident after evaluating the different manner in which the US and the UK grant certain responsibilities to particular individuals on the board.

As indicated earlier, in the US the same individual often holds both the CEO and the Chairman of the board position in large public corporations. However, in the UK the Chairman is usually independent from the executive team. Thus, the Chairman in the UK is often a non-executive board member, while in the US the Chairman normally operates as an executive, also holding the position of the CEO.

Nevertheless, in both countries the limited representation of shareholders allows the board to give the Chairman the ability to play a crucial role in the board of directors nominating process. In the US, this means that the Chairman usually selects independent directors that are beneficial to management, since the Chairman usually serves on the management team as the CEO. Thus, the independent director often feels indebted to the Chairman/CEO for selecting them.

Conversely, in the UK the Chairman is usually isolated from management. Therefore, the Chairman in the UK is more likely to select independent directors that are not indebted to management when selecting individuals in charge of supervising management. This is one reason why come claim that the UK Chairman is more independent than its American counterpart is. When an individual works as both the Chairman and CEO, the managerial or supervisory duties may conflict with each other.

Additional reasons for separating the Chairman and CEO positions include the continuity of leadership during times of company transition and placing checks and balances of the supervisory and management functions of the board.

Yet, no conclusive evidence proving that it is beneficial to separate the two functions exists. Furthermore, in many corporations, the Chairman will still have a significant impact on management decisions even if they do not act as the CEO. Moreover, the individuals in the two positions often have a good working relationship, working closely with each other and sharing corporate strategy. Thus, the Chairman may be able to influence the CEO both inside the workplace and at social events that company employees attend. Thus, it may not be necessary to separate the functions of the Chairman and the CEO.
6.5 The German Two-Tier Board

The German board in large publicly traded companies is substantially different from the unitary governing body previously mentioned. In Germany, unlike many other jurisdictions, a strict separation of powers from the supervisory board and the management board exists, as does a requirement of labor representation on the board. All companies publicly traded in Germany form under the Aktienesellschaft. The Aktienesellschaft is a two-tier system that divides the supervisory board (Aufsichtsrat), and the management board (Vorstand).79

In Germany, when corporations are of a certain size the two-tier systems is obligatory under law. Under the German two-tier system, the distinction between the supervisory board and the management board is a requirement followed rigorously. Generally, the two boards have different legal responsibilities the supervisory board is in charge of appointing the members of the management board and responsible for supervising the managing board.80 On the other hand, the management board is responsible for conducting the executive decisions for the corporation. Thus, both the supervisory and the management boards in Germany often play a role similar to the role played by the supervisory and management functions in the one tier board system.

Another function of the managing board that is comparable to the US corporate board’s managing function is that both have an individual that essentially has the role of CEO. In Germany, that person is the Vorsitzender, while in the US that individual is the CEO.81 Despite the fact that the two often have different responsibilities, the individuals that hold these positions are imperative from a corporate accountability perspective because in both systems someone at the highest level of the corporation is responsible for management’s actions and ensuring that the management meets its fiduciary obligations.

However, unlike in the unitary board in the UK and more specifically the US, the German supervisory board does not play a meaningful role in management decisions.82 Thus, the German management board usually

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82 Germany law prohibits the same individual from working in both the supervisory and management board in the same corporation. As a result, no direct relation exists between the German chairman of the board and the CEO. However, the distinction between the supervisory and management functions is not as palpable in the US. US boards allow an individual on the supervisory board, the Chairman of the Board, to have a position on the management team serving as the CEO in the same corporation.
makes executive decisions for the company without the assistance of the supervisory board.

Still, the supervisory board of the large publicly listed German corporation plays a role comparable to that of the independent directors in the unitary board. Both have the responsibility of checking the management’s actions, ensuring that management acts appropriately and that the corporation meets fiduciary requirements.

### 6.6 The Autonomy of the Boards in the German two-tier system

In many aspects, the independence of the management board in the German corporation has increased over the years. This is evident after determining that the important executive decisions German corporations make today are largely reserved for the management board, whereas in the past the supervisory board often played a role in executive decisions. Thus, to a large degree the supervisory board and the management board in Germany have maintained isolation from one another. These developments have come about mainly do to the conflicting interests between the supervisory and management boards in Germany.83

Still, one of the main distinctions between the German two-tier approach and its one-tier counterparts is the fact that the Aktiengesetz (German corporate statute) explicitly prohibits board members from serving on both the supervisory and the managing board.84 Additionally, the management board is in charge of management functions, and the supervisory board generally does not enter into the realm of the management board.

Furthermore, the independence of the two German boards are demonstrated when the supervisory board denies the managing board permission to act. Even in this situation, the managing board is able to receive shareholder approval to override the supervisory board’s refusal.85

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83 For instance, if the supervisory boards were small and allowed to take part in management decisions then a lot more problems could arise between the two boards. Some of the problems that could occur frequently because of the conflict of interests between the two boards include deadlock in voting situations or the possibility that company secrets would be leaked out.


85 Under the articles of incorporation (Satzung) in Germany, the supervisory board’s approval of specific management action may be required. Even in this case however, the statute underscores the independence of the management board by allowing it to sidestep the supervisory board and obtain shareholder approval where the supervisory board has denied its approval to the management board action.
6.6.2 Problems presented by Board Autonomy

Still, in certain circumstances the two-tier board system present in Germany will not prevent the management board from deceiving the supervisory board. One reason that this may occur frequently in Germany compared to other jurisdictions is that members of the management board tend to have a large amount of autonomy compared to executives in other jurisdictions.

For example, in a two-tier system, such as the one in Germany, the Vorsitzender normally has more freedom to make decisions than a CEO in a large US or UK publicly held corporation has in a similar situation.86

Yet, the fact that German law prevents the supervisory board from overriding the management boards’ decisions on corporate operations means that the two boards are able to keep their separate and independent roles.

6.6.3 The Two Boards: Distinct but Dependent

Although, the two boards are distinct from one another they are still dependent on each other in various occasions. For instance, when the supervisory board appoints members of the management board it creates a vertical relationship between the boards. Consequently, in the two-tier structure the boards have a vertical relationship, as opposed to horizontal.87

Another example of the working relation between the two boards is demonstrated when the management board is required to give certain information to the supervisory board. This requirement ensures that the latter receives the necessary information to prevent the management board from taking actions that would be contrary to the corporations’ objectives, serving as a check on the management board’s actions. In addition, in situations where the management board refuses to send the proper information in a timely and accurate manner the supervisory board has the ability to ask that the German judiciary require the management board send the relevant information to the supervisory board rapidly.

Nevertheless, critics have questioned the independence of German supervisory board members in certain situations. One of the principal reasons is that individuals, who sit on supervisory boards of publicly held companies in Germany, frequently work on management boards for banks or large insurance companies.88

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86 As a result, in certain areas members of the German management board have more independence than the management functions in the unitary board systems. See, Plessis, Jean J du. (2004). The German Two-Tier Board and the German Corporate Governance Code. European Business Law Review Vol. 15, Iss. 5, p. 1148-1155
87 The vertical two-tier structure is important because it means that the management is not elected, but appointed. Ibid
different corporations, as a supervisory board member in one board and a member of the management board in another may cause a situation where a conflict of interests may present itself, especially when the two corporations are direct competitors or conduct business within the same area. 89

For these reasons, some have argued that the problems of board independence are more prevalent in Germany than in the UK or US.90 Thus, individuals in these situations must be extremely diligent and mindful of the predicament that they may find themselves in when they work on two boards for different corporations, ensuring that their actions are transparent and objectively justified from both a legal and business perspective.

6.7 Board Composition

In many countries, a requirement that corporations have officers exists. Normally, these positions are president, vice president, secretary, and treasurer and the board of directors usually appoint the officers.91 The board usually has the ability to appoint as well as remove officers on the board. Although, the removal of officers does not occur often is an important check on the authority of officers.

Even though, basic similarities involving the board officers and the removal of board members exists major differences are evident between the EU and the US regarding board composition. The variations in board composition in the EU vary greatly. As a result, some Member States have board compositions that are very different from board composition in the US. The area where board composition varies the most between the EU and the US involves employee representation and shareholder representation on the board. The German, UK, and the US approaches to board composition are the focus of the discussion on board composition.

The different methods that Member States use in order to give employees influence in corporate matters without diminishing the capacity of shareholders to act in their best interest is very interesting. Certain Member States, such as Germany and the Netherlands, automatically give employees

89 For example, “a supervisory board member may be an executive of another company that has a commercial relationship to the company in which they serve on the supervisory board and for that reason would not be independent. Additionally, the individual’s own company has an equity interest in the company on whose board that individual sit. This is most often the case with banks, but it is also true to a more limited extend outside the banking area.” See, Backer, Larry C. (2002). Comparative Corporate Law. United States, European Union, China, and Japan. Cases and Materials. Carolina Academic Press. Durham, North Carolina. p. 1147
a voice on corporate boards when they reach a certain size. Furthermore, certain Member States also give employees a voice without diluting shareholder’s abilities involves creating benefits for employees to invest in the company’s stock. This enables employees to have a large impact on business decisions made by the corporation and a strong presence on corporate boards.

Additionally, in most two-tier jurisdictions, directors that represent shareholders are required to be independent. It is important to note, that the recent trend in many one-tier jurisdictions has been to appoint non-executive independent directors in situations where an executive may be in a conflict of interests. When appointing non-executive independent directors in the unitary board system the objective may be to create a parallel situation to the two-tier board, as the independent directors tend to play a role analogous to the supervisory board’s role in the two-tier board. Moreover, in many of the countries within continental Europe, shareholders receive representation based on the amount of shares they have in the company.

However, in the UK and US, shareholder representation is much more limited than in its continental European counterparts are because shareholders in those two jurisdictions tend to have divergent interest and the fact shareholders disperse themselves throughout the jurisdiction, which leads to relatively weak shareholders representation on the board. Moreover, in the US and the UK shareholders with a considerable amount of shares do not automatically have a seat on the board. Thus, in these jurisdictions, even shareholders with a significant amount of shares often face an extremely timely, costly, and difficult proxy process in order to have a place reserved for their specific views.

6.7.1 The Composition of the German Board

In Germany, the size of the board in larger corporations has traditionally been large compared to its UK or US counterparts. This is evident after reviewing the corporate statutes that requires large German corporations with at least 20,000 employees to have at least 20 directors on their supervisory board. In an effort for German boards to meet good governance and best policy recommendations, calls for a reduction of the size of the German board have become frequent recently. However, these requests have largely been ignored mainly do to the powerful labor representation in the German two-tier board.

92 The board sizes in Germany have also been larger than boards in other EU Member States. Although, Germany’s main corporate law statutes requires that boards have from 3 to 21 members, the large board sizes are required by Germany codetermination laws.
93 The supervisory board in Germany does not have the same board structure as those in the US. “The supervisory board might be better analogized to an amalgam of the audit, compensation, and nominating committees on a U.S. board, with the additional functions of disclosing management policy to labor and arbitrating potential labor disputes.” See, Kraakman, Reinier R., Davies, Paul, Hansmann, Henry. (2004). Anatomy of Corporate Law, A Comparative and Functional Approach. Oxford University Press. New York. p 39
The rational for labor representatives to resist the reduction in size of the German supervisory board is the belief that labor would suffer tremendously if there was a reduction in the size of German boards. According to critics, the push towards smaller boards diminishes the ability to ensure adequate labor representation on the board.

Allegedly, the reduction of the size of the board would make it easier for board members to manipulate corporate decisions for their own benefit, not taking into account the interests of labor. However, an amendment of the German codetermination laws could guarantee adequate employee representation if the size of the boards were reduced. Yet, codetermination laws could ensure that a certain percentage of the board represents labor. Thus, labor could still place a check against the interest of management or shareholders if a reduction of the size of the board occurred.

Moreover, critics of the composition of German board claim that only a very small number of individuals make up a significant percentage of the available supervisory board positions reserved for shareholder representatives at major German companies. However, these individuals are generally very well qualified for the board position in a major corporation, a large number of well qualified individuals never have the opportunity to serve on the board.

7. Board Independence

In company law, independence is “the absence of any monetary financial or commercial relation with the company that might impair the duty of loyalty to shareholders.”\(^{95}\) German supervisory boards usually have both inside directives and non-executive board members. Additionally, members of the supervisory board are generally independent from the management board that they are in charge of overseeing. The push for more non-executive board directors has prevented directors with close ties to management from dominating German supervisory boards. The rational for preventing executive directors from dominating the supervisory board is to limit the possibility of a conflict of interest.

7.1 Conflict of Interests: Rational Actors

The economic analysis of company law is extremely influential in certain jurisdictions throughout the world, particularly the EU and the US. A basic assumption in economic analysis involving company law presumes that individuals and businesses will act in a rational manner.\(^{96}\)

The assumption is that these rational actors will operate in the best interests of his or herself in personal matters, including when an individual acts as a shareholder of a corporation or an employee of a corporation with a pension plan. However, when individuals work as a fiduciary of a corporation, as a manager, director, lawyer, or accountant they must take actions that coincide with the best interest of that company.

Essentially, the rational actors must put the interests of the corporations before their own interest whenever that individual is a fiduciary of a corporation and a conflict may arise.\(^{97}\) Stated differently, when an individual has a fiduciary relationship with a corporation the expectation is that they will act in the best interests of the corporation no matter what personal benefits the individual could realize. Thus, rational actors seek to benefit by maximizing their own wealth in the individual context and the wealth of the business they work for in the corporate context.

Still, in practice individuals that make business decisions on behalf of corporations frequently analyze particular situations and conduct a cost benefit analysis to determine whether it is necessary to follow corporate


\(^{97}\) A fiduciary duty occurs when an individual or business owes an obligation to be extremely loyal to the corporation or business that they are representing.
rules. Thus, it is important to examine the type of analysis that market participants make when faced with difficult business decisions.

When managers or directors of corporations put their own interest ahead of the interests of the corporation this can lead to a serious problem. Thus, a serious quandary may arise when corporate actors are involved in a situation that presents a conflict of interest. An example of this is a situation where the corporation contemplates merging with another business many shareholders and employees may oppose the decision because of the uncertainties a merger may present for the company. For instance, whether the merger will change the price of corporate shares and whether employees will be able to keep their jobs after the merger.

However, the uncertainty of the price share of a corporation in the future does not necessarily mean that it would be an erroneous business decision for the corporation to complete the merger. The shareholders may not be entitled to all the information necessary to make a well-informed decision. Furthermore, instances where corporations want to have cross-border operations or establish in another Member State can be troubling for employees because they fear that they may lose jobs or have to relocate, but that in itself does not mean that it is the wrong business decision for the corporation.

The problems presented by a potential conflict of interests has made regulators realize that something must be done to limit the risk of conflict of interests affecting corporations, eventually leading to corporate governance codes.
8. Corporate Governance Codes

Since the 1990s, many corporate scandals have taken place, eventually leading to a reform of corporate boards in many Member States. Usually, countries have changed their corporate governance strategies to meet good governance or best practices models. The good governance and best practice models are a set of general themes often used as guidelines for corporate governance rules in many jurisdictions. The good governance and best practice models are an attempt to guarantee that corporations are acting appropriately, efficiently, and as productively as possible.

Many of the current governance codes follow the good governance and best practice models in the Member States including

“a move toward smaller boards, independent auditing and compensation committees, more board meetings, and more independent directors than inside directors. These corporate governance codes can generally be defined as a “systematically arranged set of principles, standards, best practices, or recommendations that are legally and contractually non-binding, that relate to the internal governance of corporations (covering topics such as the treatment of shareholders, the organization and practice of supervisory boards and corporate transparency), that are issued by a collective body.”

Corporate governance codes come in many variations and usually are only applicable regarding listed companies. Moreover, the codes tend to place significant emphasis on the need for a supervisory body that is distinct from management and is accountable for its decisions.

Although, the governance codes in the Member States are nonbinding, limiting what types of penalties are available to ensure corporations follow the governance codes, incentives exists for corporate actors to comply with

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98 See, O’Shea, Niall. (2005). Corporate Governance - how we have where we are and what’s next. Accountancy Ireland, Vol. 37, Iss. 6, p. 33-37
100 Ibid
102 The basic rules that govern corporations range from corporate statutes involving, company laws, securities regulations, and corporation’s articles of association Codes that originate from academia or leading business firms; these are private voluntary codes. Securities markets are another type of codes, these are committees connected with the stock exchange of listed companies. The 3rd type of code are those that are linked to public authorities. Finally, codes referred to in law or supervised by a government body or another type of code and include Spain and an US example in the US Sarbones-Oxley Act.

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the codes. Market pressure including the reputation of corporations and individuals plays a vital part in ensuring that corporations and corporate actors comply with governance codes. Additionally, economic and legal advisors, including economic consultants, lawyers, and investment bankers usually inform their clients that they should follow the applicable governance code in the jurisdiction.

Many of the applicable governance codes in the EU Member States have a comply or explain component. Under the explain portion when a company determines that it is preferable to set aside a specific provision of the code, it may do so if they adequately explain their reasons for the deviation from the applicable code. Comply or explain disclosure requirements exert a significant amount of pressure on corporations to follow corporate government rules. Moreover, frequently a strong tendency for corporations to adhere to the corporate governance rules rather than taking the time and energy to explain the deviation from the applicable rule exists.

A possible setback involving the comply or explain principle involves the tendency for some corporations to disregard rules that may have a harmful effect on the corporation as long as they explain their deviation. Yet, it is difficult for those in charge of ensuring companies adhere to the applicable governance code to know if the explanation given for the deviation from the code is actually valid. This poses the question what is to stop corporations from fabricating explanations for deviations of the applicable governance code. Furthermore, it is important to determine whether codes allow companies to give a generic explanation for a deviation, or does the explanation have to apply to a specific problem the corporation faces. Another problem with corporate governance comply or explain rules is that corporate actors often formerly comply because of the time, energy, and extra scrutiny a deviation may bring, but in practice depart from the code without appropriate justifications.

Normally, corporate governance codes address these problems by also creating disclosure requirements. In most corporate governance codes applicable in the Member States, corporate disclosure plays a vital role.

103 When nonbinding rules apply then liabilities, such as injunctions, fines, or imprisonment will usually not be applicable.
104 Market pressures also include those who intervene in the markets, such as stock agencies, rating agencies, organizations, the media and the public.
105 Importantly, judges have also been known to mention governance codes, despite the fact they are often nonbinding, in cases where an alleged deviation from the applicable code is before them.
106 The “comply” requirement obliges corporations to comply with governance rules, while the “explain” portion allows corporations to explain the deviation from the rules.
Companies are required to disclose in their annual report how the corporation is functioning, as well as key information the corporation has made during the reporting year.

Disclosure allows supervisors, shareholders, employees, and the public to evaluate, criticize, and praise corporations and their actions. In the corporate community, board members should follow good governance and best practice models in order to make corporations operate as efficiently as possible and protect the reputation of both the company and the individual. Moreover, the media exposes shortcomings of corporations and their disclosure methods, while coworkers and competitors exert a large amount of pressure on corporations and corporate actors to follow governance codes. Thus, even when corporate actors deviate from the governance codes the explanation must be valid or serious penalties may apply when board members make erroneous statements.107

8.1 Enacting a European Code on Corporate Governance

The numerous corporate governance codes developed in the Member States lead to the conclusion that Member States are eager to create rules that will create a best practice corporate governance structure within the EU. It is also evident that the corporate governance strategies that Member States use are important to domestic corporations in Member States, the economy of that Member State, and the EU economy, as they are interrelated.

Although, many critics argue that a European Code on Corporate Governance is unnecessary because they claim there is a trend for EU Member States to have more similarities than differences in their corporate governance strategies, the need for a European Code on Corporate governance is still present.

Additionally, investors analyze the quality of the corporate governance schemes used by a Member State as well as the economic performance of the company when making investment decisions. The McKinsey survey of investor perception is a good example of this declaring “investors report that they are willing to pay more for a company that is well-governed, all other things being equal”.108

Still, critics of the European Code argue that a best practice model already exists under the OECD Principles of good governance; hence, a European Code on Corporate Governance would be superfluous. The OECD

107 When individuals or corporations publish untrue, incomplete, or even misleading information, the rules on board liability for disclosure usually apply.
principles of good governance is a nonbinding international governance policy that all the Member States that were in the EU at the time of its implementation have agreed on and have signed on as signatories.

However, a drawback with the OECD principles on corporate governance applicability in the EU is the fact that it is a very broad set of principles in order to cover the many differences in national governance systems that have agreed to use the OECD principles. Additionally, many of the countries that took part in the creation of the OECD principles on governance are outside the EU and have different corporate governance schemes than the Member States in the EU.

For example, the OECD principles emphasize that they are nonbinding, yet often used by individuals or institutions that participate in the creation of governance codes as guides. Thus, individuals and organizations use OECD principles to examine and develop the legal and regulatory framework for corporate governance that reflect their own economic, legal, and circumstances in the particular Member State at issue.

However, the OECD principles do not necessarily focus on the corporate laws of the different Member States; instead, it has a much wider audience. Thus, there is often only limited adherence to the OECD principles on corporate governance in the EU.

Furthermore, the fact that an international policy is already in place does not mean that European action is not necessary. Examples of areas where the EU has acted where international rules already existed include the area of human right and environmental laws. For example, in the area of human rights, internationally recognized agreements exists that EU Member States have signed, yet the European countries still felt it was necessary to implement the European Convention of Human Rights in order to fit broader legal principles into the specific needs of the EU.

Thus, the OECD principles do not preclude EU action implementing a European Code on Corporate Governance. A European Code in Corporate Governance in the area of corporate governance is necessary for the EU to achieve its objective of a well-thriving market and would be extremely beneficial from an economic viewpoint.

A European Code on Corporate Governance would give market participants the flexibility necessary to address current corporate governance issues and problems that may arise in the future. The European Code would also be economically beneficial and allow corporate actors to adjust rules to fit the needs of particular situations.

Nonetheless, some argue that a European code would impose only negligible restraints on corporations and market participants, failing to govern corporations adequately at the expense of the public, citizens, shareholders, and the corporations themselves. Additionally, critics argue
that penalties for violators of the code would not be severe enough. Therefore, corporate actors would be able to find ways to manipulate the European Code, using the least restrictive corporate governance rules applicable to a particular situation.

The European Code on Corporate Governance would only be a minimum common denominator setting a minimal standard of rules involving corporate governance that would be applicable throughout the EU. Yet, if the Member States determined that, the European Code does not have the rules necessary to govern corporations adequately; they would be free to impose tougher corporate governance rules and regulations within their jurisdiction.

Thus, the European Code allows EU harmonization to occur without the negative impact of market participants losing the flexibility of the corporate governance codes that are applicable in most Member States today. Moreover, the European Code would provide an equal playing field for market participants without imposing severe penalties that may deter business actions. Moreover, a European Code on Corporate Governance could demonstrate the link between the interests of corporate actors, mainly the importance of shareholder representation on the board, and the representation of labor on the board.

Additionally, a European Code would ensure that Member States enact their own corporate governance code or face the consequences of not complying with EU law. The noncompliance with the European Code may eventually lead to ECJ rulings against the Member States or corporations that fail to comply with the European Code.

Moreover, a European Code could ensure tougher regulation when it is necessary to achieve objectives similar to those in OECD principles and the aims of the EC treaty. Moreover, the European Code could take advantage of the fact that the EU has a common currency, and a common set of corporate rules in the EU exists.

8.2 Principal Objectives of the European Code on Corporate Governance

The principal aim of the European Code on Corporate Governance would be to ensure that corporations and market participants are accountable for their actions; corporations are transparent, and follow disclosure requirements. A European Code on Corporate Governance ensuring that corporate actors perform appropriately would consist of requiring timely and accurate disclosure of corporate information.
Another objective of the code would ensure that public companies obtain independent directors to sit on supervisory boards. Of course, directors or auditors obtain some benefits when working for a corporation that is successful, regardless of whether they are independent or inside actors. For example, it is likely that the corporation will want to continue their relationship with independent directors or auditors when the corporation is doing well or when it seems that the independent actors are working efficiently and productivity will increase. Furthermore, the independent directors may receive additional benefits in the form of increased salary, better pension plans, or more holiday time when the corporation is successful.

Moreover, independent directors do not guarantee that board members will be free from corruption or fail to put themselves in situations that may present a conflict of interest. Still, it is significant that independent directors usually do not have direct ties to the corporation. As a result, independent actors usually do not have the same reasons as inside directors or auditors to act in a manner that is contrary to their fiduciary duty of loyalty, for example, by acting in a self-motivated manner or disclosing deceitful information so that the individual acting inappropriately can benefit. Thus, the European Code would require that a certain percentage of board members in listed companies are independent directors.

8.3 Corporate Disclosure Requirements in the European Code

A situation where there is consensus in the business and legislative arenas that state action is necessary to prevent serious glitches in the internal market from occurring involves corporate disclosure. Corporate disclosure is vital to the success of the internal market in the EU.

One of the best ways to ensure that the internal market within the Community is functioning efficiently and that the EU economy is operating at a high level is to create ways that market participants can obtain information involving corporate actions conveniently. When certain individuals within corporations have information that is not available to

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110 Market participants within the Community are individuals that are somehow connected to the internal market in the EU. These can be companies, managers, directors, shareholders, lawyers, and accounts, this list is nonexhaustive. Essentially, any one has the ability to be a market participant if they have the possibility of buying shares within the EU.
business competitors the public, these individuals may be able to gain a substantial advantage.\textsuperscript{111}

Government regulation is necessary in order to prevent these individuals from manipulating the internal market. Forcing companies to disclose company information can close the gap between those that have information and the public who seeks such information in order to make better business decisions.

In order to ensure corporate disclosure takes place corporations should have certain incentives for providing timely and accurate information to the public. The earlier corporations disclose information the more beneficial it is for the public as well as interested parties, such as shareholders and employees. This gives market participants the necessary information to predict whether their investments or potential cross border operations are rational business decisions or are likely to fail under the current business circumstances.

The importance of the accuracy of information is evident because if individuals in the public receive official information from companies that is clearly erroneous or misleading then they are likely to make business decisions that have negative outcomes. Eventually, these decisions will end up costing the public, shareholders, employees, and corporations, an enormous amount of money, having the potential to rattle investor confidence causing extremely detrimental affects on the internal market within the EU. Thus, the individuals who make mistakes on annual statements or disclosure information shall face stiff penalties and the code should make it clear that noncompliance by market participants of the fundamental objectives of the code is unacceptable.

\textbf{8.4 Corporate Governance Conclusion}

The many recent corporate scandals have renewed a rigorous debate over corporate governance in the EU. Yet, the need for common corporate governance mechanisms across the EU is evident after reviewing the extreme variations in governance schemes throughout the EU. The corporate governance plan for the future must be easy to understand, vibrant, and transparent in order to meet the needs of the corporation’s shareholders, employees, directors, and management.

The harmonization of corporate governance rules between Member States through a European Code would allow corporations to make better decisions and create more legal certainty, regarding what the basic legal governance laws on corporations will be in the various Member States. This will lead to a better European economy with more jobs, more investment, and more

\textsuperscript{111} The individuals, who run companies, managers and directors, usually have more information than the public.
efficient corporations, which would create a better possibility for the EU to achieve if fundamental objective a well functioning single market.

Additionally, harmonization of corporate governance rules will make the job of market participants, such as lawyers, consultants, accounts, and managers easier. This is important because these groups of workers are imperative to a corporation’s existence and vital to the corporation’s likelihood of success. Rules that are easier to comprehend diminish the likelihood that corporate actors will commit actions that have a negative impact on corporations, shareholders, or employees. Moreover, when harmonization of the laws of corporate governance occurs in the Member States it will be easier to spot mistakes whether they are committed negligently, purposefully, or in a fraudulent manner.
9. Conclusion

This thesis demonstrates the need for EU harmonization in the fields of right of establishment and corporate governance. The thesis discusses the link between these two crucial areas of EU company law. Moreover, the thesis explains that the lack of cohesion between Member States rules in the area of freedom of establishment and corporate governance cause serious impediments to the fundamental objective of the EC Treaty, establishing a well-functioning single market within the EU.

The thesis uses a comparative law approach in order to show the various approaches in the EU and the US regarding the freedom of establishment and corporate governance. This approach shows the difficulties presented when a clear and unambiguous approach to company law in the EU is not present. Instead, impediments to the common market including different rules on establishment and various rules governing corporations continue to exist in the EU.

This thesis explains the current situation involving the freedom of establishment in the EU, exploring in detail the two major approaches to establishment in the EU, the incorporation theory and the real seat theory. The thesis demonstrates that a directive implementing the incorporation theory, allowing corporations established in the EU to incorporate in another Member State, is necessary. A detailed description of the numerous benefits of the incorporation theory occurs, using EU Member States that use the incorporation theory as well as the US to show the advantages of the incorporation theory.

In addition, to the incorporation theory, a requirement that Member States adopt the internal affairs doctrine must also be included in the directive implementing the incorporation theory. The internal affairs doctrine is a choice of law theory that would allow corporations to benefit by using the laws of the state of incorporation. Along with the incorporation theory, the internal affairs doctrine would facilitate cross border operations, eventually leading to more competition. The increased competition would be beneficial for the EU economy and corporations established in the EU. Moreover, the incorporation theory and the internal affairs doctrine are a necessary step if the EU is to obtain a well-functioning internal market.

Furthermore, a detailed analysis of corporate governance in the EU, specifically, the UK and Germany also took place. This part of the thesis demonstrated the need for a change in the business climate after the numerous scandals that took place in the EU and the US. Discussing the corporate board and corporate governance codes made it possible to show the divergent views within the EU as regards to corporate governance.
Additionally, a comparative law approach analyzing the OECD principles on corporate governance was necessary in order to show how different jurisdictions handle the problems involving corporate governance.

The thesis demonstrates the need for the European Code on Corporate Governance showing the wide variations Member States have as regard to corporate governance and the fact that a European Code was not created in order to act as a guide for corporations and market participants.

Although, some argue that the OECD principles give Member States the basic guidelines to adhere to good governance and best practice models this statement is flawed. The fact that the OECD principles on good governance are applicable to many countries outside the EU can lead to various problems. For example, the OECD principles on corporate governance are often overly broad and do not take account of the economic or business circumstances of the various Members States.

On the other hand, the European Code on Corporate Governance will be able to take the particular circumstances in the EU and the individual Member States into account. Furthermore, the European Code could set a higher standard for businesses in the EU to help the EU establish a well-functioning internal market. Moreover, it would be easier for corporations and market participants located in the EU to comprehend a basic approach to corporate governance.

Moreover, the European Code on Corporate Governance would focus on fundamental issues involving corporate law and directly address the need for transparency, accountability, and disclosure in the corporate setting. Thus, the European code could place much higher standards than the existing OECD principles. Although, the European Code would be nonbinding, the comply or explain principle would force companies and market participants to adhere to the code or face consequences, such as a receiving a negative reputations for deviating from the code without a valid rational.

Finally, the thesis shows the connection between the right of establishment and corporate governance and the need for harmonization in both areas in order for a well-functioning internal market in the EU to occur, including the directive implementing the incorporation theory and the internal affairs doctrine as well as the need for a European Code on Corporate Governance.

**9.1 Future development in Company Law**

Unfortunately, it seems unlikely that the EU will adopt a directive implementing the incorporation theory or the internal affairs doctrine. Additionally, the EU does not seem to be in a hurry to create a European Code on Corporate Governance either. The slow push for harmonization in the EU involving the company law, specifically establishment and governance methods will limit the chance for the EU to have as an efficient government as possible. Moreover, the need for harmonization in these
fields are apparent, even more so after the corporate scandals. Hopefully, the EU and the individual Member States realize that harmonization measures at the EU level is critical if the EU attempts to achieve its goal of becoming the jurisdiction with the most competitive market in the world and obtain a well-functioning internal market.
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