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A Battle against Regulatory
Arbitrage in the Delusive Fringes
of Article 49? – The Current
State of Law in Terms of Abuse
of Right to Establishment for
Legal Persons

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Summary

Through its decision in *Centros*, ECJ opened up for a wide use of the freedom of establishment for legal persons. In substance the ruling concluded that there are situations where the freedom of establishment can be relied upon in order to circumvent national legislation.

Such circumventive transactions can be denominated as regulatory arbitrage. It is to be understood as the actions by which economic actors seek to take advantage of regulatory differences between jurisdictions in order to reduce costs or to gain advantages. It involves artificial conformity to the letter of the law. Traditionally the Member States have combated such abuse in different ways – some through generic anti-avoidance legislations, other through specific provisions aiming at certain conducts. Through case law, ECJ has also established an abuse of right doctrine, aiming at the improper use of rights.

The concepts of regulatory arbitrage and abuse of law is situated on opposing ends. By establishing a preference for regulatory arbitrage in *Centros*, ECJ seemingly ignored involvement of its evolved abuse of law doctrine to situations involving the right to establishment.

In *Cadbury* the abuse of rights doctrine was for the first time explicitly applied on a case regarding freedom of establishment. This effectively introduced a delimitation on the possible use of regulatory arbitrage, when it consisted of 'wholly artificial arrangement'.

To assess whether the transaction comprised 'wholly artificial arrangement', ECJ elaborated on a two-pronged test previously introduced in case law. It comprises a objective element and a subjective element. The objective element consists of a teleological interpretation of the purpose behind the regulation – in order to assess if the transaction, despite formal adherence, complies with the purpose. The subjective element consists of an assessment of the intention behind the transaction. Eventually, this methodology ends in assessment of whether the transaction is the result of genuine economic activity.

Despite a surprisingly and seeming coherence *Cadbury* might, when contrasted with *Centros*, be considered as delimiting the reliance on freedom of establishment. The explicit introduction of the subjective element is dubious and, in combination with the teleological assessment, risks to be arbitrary.

This thesis concludes that perhaps *Cadbury* – and subsequent case law - is to be read so that ECJ indicates a preference for a generic anti-abuse regime.

Sammanfattning

Genom sitt beslut i målet *Centros*, öppnade EU-domstolen för en bred användning av etableringsfriheten för juridiska personer. I huvudsak konstaterar domen att det finns situationer där etableringsfriheten kan åberopas för att kringgå nationell lagstiftning.

Sådana kringgående transaktioner kan betecknas som regelarbitrage. Det ska förstås som åtgärder varigenom ekonomiska aktörer försöker dra nytta av olikheter i regleringar mellan jurisdiktioner för att minska kostnader eller för att vinna fördelar. Det genom en konstgjord överensstämmelse med lagens bokstavliga villkor. Traditionellt har medlemsstaterna bekämpat sådant missbruk på olika sätt - vissa genom generiska doktriner mot missbruk av rättigheter, andra genom specifika bestämmelser med sikte på särskilt beteende varigenom rättigheter missbrukas. Genom rättspraxis har EU-domstolen inrättat en doktrin mot missbruk av rättigheter missbruk av rätten doktrin.

Begreppen regelarbitrage och missbruk av rättigheter står i motsats till varandra. Genom att etablera en preferens för regelarbitrage i *Centros*, ignorerade EU-domstolen till synes sin utvecklade doktrin mot missbruk av rättigheter i samband med situationer där etableringsfriheten behandlades.

I *Cadbury* tillämpades doktrinen mot missbruk av rättigheter för första gången uttryckligen i ett fall gällande etableringsfrihet. Detta införde i praktiken en avgränsning för möjlig användning av regelarbitrage, då denna bestod av "rent konstlade upplägg".

För att bedöma om transaktionen utgjorde ett rent konstlat upplägg, användes ett tvådelat test som tidigare utarbetats av EU-domstolen. Det består av ett objektiva och ett subjektiva element. Det objektiva elementet består av en teleologisk tolkning av syftet bakom själva regleringen - i syfte att bedöma om transaktionen, trots formell överensstämmelse, uppfyller ändamålet. Den subjektiva element består av en bedömning av avsikten med transaktionen. I slutändan hamnar denna metodik i bedömningen av om transaktionen är ett resultat av verklig ekonomisk verksamhet.

I jämförelse med *Centros* så kan *Cadbury* betraktas som en avgränsning av etableringsfriheten – däremot överraskar domen samtidigt som den är tillsynes konsekvent. Det uttryckliga införandet av subjektiva rekvisit är tvivelaktigt och, i kombination med den teleologiska bedömningen, riskerar bedömningen att bli godtyckligt.

Denna avhandling avslutas med slutsatsen att *Cadbury* - och senare rättspraxis – kanske skall förstås så att vad EU-domstolen i själva verket gör är att man anger sin preferens för en generisk doktrin mot missbruk av rättigheter.

Preface

An opportunity to show gratitude should never be left undone.

This work is dedicated to my mother Birgitta and my father Peter, for their unconditional support and commitment to fairness. I am especially grateful for their stockpiling of books and other sources of knowledge – such an upbringing have fostered my curiosity and a thirst for knowledge.

Furthermore I thank my sister – Elisabeth – and brothers - Andreas, Mikael and Erik. Apart from being beacons for advise and life wisdom, they have all been indispensable in a intellectual competition and taught me that it is not enough to know your facts, but equally important to understand and present them in a cohesive way.

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Gabriel Zsiga

Abbreviations

AG	Advocate General
CFC	Controlled Foreign Company
ECJ	European Court of Justice
SA	<i>Societas Europaea</i> , European Company
TFEU	Treaty of the Functioning of the European Union
VAT	Value-Added Tax

1 Introduction

1.1 Background

Apart from its high-standing as being one of the worlds leading contemporary magazines, *The New Yorker* has also gained reputation for its stringent and accurate gag cartoons. In March 2009 it carried such a cartoon showing two businessmen in posh law office. The punchline was:

‘These new regulations will fundamentally change the way we get around them.’

By bluntly generalizing, ‘Big business cherrypicking the rules to be governed under, thereby zigzagging their way to the most favourable conditions in the European Union’, could probably be considered a conception deeply embedded in our post-industrial culture. Without overachieving and making this thesis a philosophical one, but rather continuing the simplified generalization, the conception as such could be put in an intellectual framework and be considered a popular – and somewhat populist – version of Lyotard’s *grand narrative*¹.

Distinguishing for such *grand narratives* is that they capture simplified descriptions of reality. Companies examining how to achieve the most favourable conditions possible, is undeniably a part of the legal reality. But that companies draw advantage of EU, is not by definition wrong. On the contrary – the competitive process that this foster could be considered as a part of Robert Schuman and other *Founding Fathers*’ vision for Europe. Furthermore, whether it is wrong to exercise a legal right can be disputed. It is a discussion that can be traced far back. ‘Nullus videtur dolo facere qui suo jure utitur’ (transl. *‘there is no harm when someone exercises his right’*), is stipulated already in the classical Justinian *Corpus Iuris Civilis*².

Meanwhile this is all to be assessed bearing in mind for example recent years efforts to combat tax havens. Efforts which several European states – with Germany as cardinal – have shared with the United States. Legal evasion and circumvention is certainly on the radar, not only of the public opinion, but also of political and legislative institutions.

¹ The French philosopher Jean-François Lyotard presented his theories on ‘meta-narratives’ in the 1970s. Lyotard described ‘meta-narratives’ as being a basic element for the power structure in the pre-post-modern society. Contrariwise post modernity is characterised by ‘micro narratives’, thus the common conception of post modernity as the state of fragmentation. For the Socialist Lyotard ‘grand narratives’ were central to describe and establish the emergence of the Capitalist society. Thus, Lyotard would most likely object to describing the popular notion of companies exploiting the most favourable legal conditions, as being a ‘grand narrative’. This subsection in its completeness should thus be considered as being freely inspired by Lyotard’s groundbreaking theories, rather than based on a strict application of his findings.

² Digesta 50.17.55

This highlights the almost schizophrenic objective behind not only this thesis, but also the legal challenges put before the ECJ. Given that clever legal constructions is used to circumvent onerous legislation, there is a rationale to allow Member States to impede the opportunities for such transactions, when performed in an abusive manner. Not least because, to do the opposite – and allow companies to cherry-pick legislation purely based on their subjective preference – would seriously fertilize mistrust against the EU and the Internal Market amongst citizens. If these saw their national laws being unrestrictedly undermined and circumvented, it is fair to assume that the support behind the European integration project would be hampered.

On the other hand, to leave it entirely to the discretion of the Member States to combat such (ab)-use, would instead undermine EU law. Not only uniformity would be exposed to Member State arbitrariness, but also the very substance of the law. It is fair to assume that the right of establishment for legal persons would be threatened. Hence, the need for a stringent EU doctrine on this area.

It is such an doctrine, that this thesis sets out to explore. The remarkable characteristic of the fundamental freedom of EU law is their direct application. They are not yet another bilateral paper tiger, but confer distinct rights upon the Union citizens. As such, these rights are used more or less extensively. This give rise to a classic dilemma for the enforcing – and rightful, in the sense law-abiding - legislator – what constitutes use of the rights and what constitutes abuse?

When reading juridical literature you often lack the broader societal context for the problem at question: How does this *really* matter in practice? The legal situation that this thesis set to examine should thus be seen in a common notion of companies' ability to cherry-pick applicable legal rules according to their preference.

1.2 Statement of purpose

The intention of this thesis is to investigate the limit for regulatory arbitrage for legal persons based on the right of establishment.

This involves a clarification and an analysis of central concepts, involving relevant case law, regarding freedom of establishment, regulatory competition and abuse of law. The presentation of these concepts will be used to analyse the *Cadbury* ruling and its after effects.

Altogether this will make it possible to review the current situation for regulatory arbitrage for legal persons based on the right of establishment.

For that purpose, the questions examined in this thesis will be:

- Has the concept of 'wholly artificial arrangement' changed the application of the principles stemming from the *Centros* judgment, saying that establishment in a Member State for the purpose of benefiting from more favourable legislation did not in itself suffice to constitute abuse of freedom of establishment?

- Could the reasoning on 'wholly artificial arrangements' be applied in a wider manner as to also cover matters outside the field of taxation? Which could those fields be? And if so, does the doctrine of 'wholly artificial arrangements' create new discretion for Member States in terms of restricting the freedom of establishment?

1.3 Method

As the thesis sets out to explore the current state of law within a particular aspect of EU law, I will be using the traditional legal dogmatic method. This will involve an interpretation of relevant Treaty provisions. Moreover, it will involve interpretation of case law from the ECJ. This material will be objectively processed in order to establish the intention as enounced by the Court.

Doctrine will be used to establish and analyse the applicable case law. In order to be up to date on the subject, particular attention will be shown to journals and periodicals.

To the extent that there are no references, and the matter cannot be regarded as conventional wisdom, it is to be perceived as personal reflections.

1.4 Disposition

Following this introduction this thesis will consist of five parts.

The first part will contain a brief presentation of relevant Treaty provisions, and concepts necessary to understand how rights conferred on companies are handled. It will also introduce case law, relevant to the right of establishment for companies.

This will be followed by the second part introducing the contravening concepts of regulatory competition and abuse of law. These are the central concepts at stake through those regulatory transactions that the right of establishment give rise to. The logic behind regulatory competition is presented, with particular focus on regulatory arbitrage. The relevance of the *Centros* case for the presence of regulatory arbitrage is particularly highlighted. The emerging doctrine of abuse of rights is presented through a definition of the concept and an outline of case law on the subject. The relation between the two concepts are examined. This part constitute the

theoretical background for the examination of the legal impact of *Cadbury* – and subsequent – cases.

The third part presents the *Cadbury* case, where the ECJ attempted to reconcile the concepts presented in previous parts. The ruling is examined in depth, with particular focus kept on notions presented in previous parts. The concept of 'wholly artificial arrangement' is conceptually and practically analysed. This part will also involve a presentation of remarks and commentaries on *Cadbury* in the doctrine – with particular focus on deficiencies and unclarity.

The fourth part will conclude previous parts and present the current state of law for regulatory arbitrage based on the right of establishment. It will describe the limits to such conduct, and present issues where the state of the law remain to be clarified. This part will also present potential areas where the conclusions drawn in the thesis can be of relevance.

The fifth and final part will provide some concluding remarks on the subject. This section will strive to provide a deeper understanding of the processes leading to *Cadbury* and its outcome. In this part, I will also present a schematic overview of legal persons possibility to rely on right of establishment for regulatory arbitrage.

1.5 Material

Inevitably when assessing EU law, the Treaties will be used. For the purpose of this thesis it is the Treaty of the Functioning of the European Union (TFEU), that is of relevance. Since it is a right stemming from Treaty provisions that is scrutinized, secondary legislation will not be considered, unless specifically stated. Since the whole purpose of the thesis is to ascertain how these provisions functions in reality, case law on the subject from ECJ will be closely scrutinized.

The vast majority of information in this thesis will consist of illuminating and/or groundbreaking rulings from the ECJ. Along with the cases as such, the opinions by the Advocate Generals have been used when analyzing the cases. Despite their non-binding character, they are considered to be indicative of the legal situation and as such highly relevant.

Juridical literature will be another important source of information. To a large extent books will be used in order to define overall concepts of EU law of interest for the thesis. In terms of the more specific concepts of interest for this thesis, these are scantily covered by books. Instead the main doctrinal source regarding the specific areas of interest covered will be legal journals, periodicals and – to some extent – conference papers.

It should be noted that the legal area assessed in this thesis is evolving. Such is also the case with the concepts presented, which may be liable to make

the doctrine on this area inaccurate. In terms of doctrine, such sources will therefore be selected on a restrictive basis, limited to acknowledged and respected publishers.

1.6 Delimitation

Article 49 TFEU attributes the freedom of establishment both to physical persons and companies. The focus of this thesis lies on the rights for companies, and persons are therefore not covered – except to the extent that case law regarding persons are of relevance also for companies.

The focus of interest of this thesis is what actually constitutes abuse of the right of establishment for companies, and especially whether regulatory arbitrage of the right to establishment is considered abusive.

Further, the examination is delimited to the *fundamental* content of the right to establishment, as opposed to the *material* intent behind the legal aspiration.

The thesis will therefore not deal with the *material* benefits – or consequences – of the freedom of establishment. I.e., the thesis will introduce the concept of *regulatory arbitrage* as a driving factor behind the usage of Article 49 TFEU, but the substantial gains achieved by such activity falls outside of the scope of this work. It is these *substantial* gains that I refer to as *material*, in the sense of being the rationale behind the reliance on the Treaty provisions.

Of relevance for the purpose of this thesis is the maneuverial space as such, for regulatory arbitrage based on Article 49 TFEU. It follows that the fiscal dimension of such regulatory arbitrage is not covered in this thesis. It is non-disputed that one of the main forces behind regulatory arbitrage based on Article 49 TFEU, is beneficial tax regimes. Article 49 TFEU is thus often considered in relation to the taxation of companies operating across various Member States³. Alas to include tax issues in the thesis would radically increase the scope of the thesis, and dilute the core issue of the fundamental limit for regulatory arbitrage based on Articles 49 and 54 TFEU.

For the same reason – to concentrate on the hardcore substance in the Treaty provision – further harmonisation on the area will not be touched upon. It is relevant to notice, that what it being investigated here is the still *exposed* parts of regulatory arbitrage based on Article 49 TFEU, ie., to the extent that there has been harmonization through secondary legislation within an area, there is theoretically no room for regulatory arbitrage. This deserves clarification as to one important part, the *Societas Europaea*.

³ P. Kent, *Law of the European Union*, 4th edn. (Harlo, Pearson Education Ltd 2008) p. 233

An ambition since the 1970s, the European Public Companies – *Societas Europaea (SA)* – became a reality in 2004, establishing the first supranational form of company in the EU⁴. Being The situation in regard of potential regulatory arbitrage based on the usage of SA, is not the purpose of this study. Nonetheless it deserves to be observed that studies show a rather widespread use of regulatory arbitrage through usage of the SA, for circumvention of co-determination rules, board structure and tax rules⁵.

This implies that there is room for regulatory arbitrage under harmonized areas as well. Nonetheless, it is not within the comprehension of this thesis to identify and assess such situations.

1.7 Contribution

The purpose of this thesis is to contribute to bring clarity to the relation between ingenious usage of the right of establishment for legal persons and the concept of abuse of law.

Much has been written about the first passage – especially in relation to the *Centros*, *Inspire Art* and *Daily Mail/Cartesio*, as described bellow. If not yet as immersed, there is also still a substantive litterature on the abuse of rights doctrine.

This thesis aims at reconciling these concepts, as to study the limits of the freedom of establishment for legal persons as set by the abuse of rights doctrine.

⁴ Council Regulation (EC) No 2157/2001 on the Statute for a European Company (SA)

⁵ H. Eidenmüller, A. Engert and L. Hornuf, 'Incorporating under European Law: The Societas Europaea as a Vehicle for Legal Arbitrage', 10 *European Business Organization Law Review* (2009) p. 1

2 A Brief History of Freedom of Establishment⁶

This chapter provides a basic introduction to the freedom of establishment for legal persons, as to its foundation and application relevant for the purpose of this thesis.

2.1 The Treaty Provisions

The *freedom of establishment* is one of the four basic freedoms on movement conferred to Union Citizens by the TFEU. These freedoms are instrumental for the purpose of the Internal Market, and the umbrella provision is to be found in Article 26 TFEU. The specific bearing of this for legal persons in term of establishment is then further elaborated in Article 49 and 54 TFEU – as well as in case law.

2.1.1 Article 49 TFEU

Article 49 TFEU is the pivotal legal basis for the whole concept of freedom of establishment. There is the central provision governing this right:

Within the framework of the provisions set out below, restrictions on the freedom of establishment of nationals of a Member State in the territory of another Member State shall be prohibited. Such prohibition shall also apply to restrictions on the setting-up of agencies, branches or subsidiaries by nationals of any Member State established in the territory of any Member State.

Freedom of establishment shall include the right to take up and pursue activities as self-employed persons and to set up and manage undertakings, in particular companies or firms within the meaning of the second paragraph of Article 54, under the conditions laid down for its own nationals by the law of the country where such establishment is effected, subject to the provisions of the Chapter relating to capital.

⁶ In 1988 the world-famous physicist and cosmologist Stephen Hawking made an ambitious, as well as appreciated, attempt to share his theories with a broader public through a less-than twohundred-pages book. The pop-scientific publication was released under the descriptive title 'A Brief History of Time'. It goes without saying that such a brief introduction on the great theories of the cosmos is schematic and simplistic. Hence, the paraphrasing of Hawking's acclaimed masterpiece in the title for this chapter. The four freedoms bestowed by the EU are usually characterized as *fundamental* – an attribution leaving out the vastness and complexity of these very freedoms.

The direct applicability of Article 49 TFEU have been pointed out by the ECJ on various occasions.⁷

The right of establishment could be expounded as covering two aspects: the right to *take up* economic activities and the right to *pursue* these activities. While the former concerns the access to the market of another Member State, the latter concerns restrictions on exercise of economic activity once in the host Member State.⁸

2.1.2 Article 54 TFEU

It is due to the provision in Article 54 TFEU that not merely natural but also legal persons is granted the freedom of establishment. Article 54 stipulates:

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 Member States.

'Companies or firms' means companies or firms constituted under civil or commercial law, including cooperative societies, and other legal persons governed by public or private law, save for those which are non-profit-making.

For the application of Article 54 TFEU – and more specifically, whether the association as such falls within the scope of the article – is to be determined by national law; a company have to be formed and registered in one of the Member States to have the right of establishment.⁹ But a company, or firm, formed an having their registered office, central administration or principal place of business within the EU shall be treated in the same way as natural persons for the purpose of establishment¹⁰.

The *dual* effect of Article 54 TFEU, is long established. Meaning that, even though, according to their wording, the Treaty provisions concerning freedom to establishment are directed to ensuring that foreign companies are treated in the host Member State in the same way as companies of that State, they also prohibit the home Member State from hindering the establishment

⁷ It has been directly effective from the end of the transitional period (December 1961), as confirmed in ECJ, Case 2/74 *Reyners v Belgian State* [1974] ECR 00631. This has been repeated eg. in ECJ, Case 81/87 *The Queen v H.M. Treasury and Commissioners of Inland Revenue, ex parte Daily Mail and General Trust plc.* [1988] ECR 5483, para 15

⁸ D. Chalmers, G. Davies & G. Monti, *European Union Law*, 2nd edn. (Cambridge, Cambridge University Press, 2010) p. 838

⁹ *Ibid* p. 861

¹⁰ P. Kent, *op. cit.* p. 232

in any other Member State of a company incorporated under its own legislation.¹¹

2.1.3 Restrictions and Justifications

The reported treaty provisions constitutes the foundation for the freedom of establishment. This freedom can be restricted under the rather narrow stipulation presented in Article 52 TFEU – balancing the freedom with overriding policies. The freedom can also be restricted under circumstances strictly examined by the ECJ – established in case law. The Court have thus refined and supplemented the limits for freedom of establishment and invented a four-pronged test – as established in *Gebhard*¹² and presented below in *Inspire Art*. The fundamental denominator for such derogations to the freedom of establishment is that a valid justification for the restriction is presented.

2.1.4 Nationality of companies

A principle of importance underlying the whole concept of freedom of movement, is that it is up to the home Member State to determine who is covered by their 'nationality'. In the same way as a Member State may choose the conditions on which it grants nationality to individuals, it decides the connecting factors for a company¹³. Meaning the conditions which the company must satisfy to be recognised by the law of the Member State as a company established under the laws of that Member State.¹⁴ In *Daily Mail* this was famously encapsulated in the description of companies as 'creatures of national law',¹⁵

There are two main doctrines governing the formation of companies. One posits that a company is established where it has its main administration (*siège réel*) and one that posits that the determining factor is where the company has its formal – ie., *registered* - head office (*siège statutaire* or *incorporation regime*).¹⁶

For the purpose of this thesis it is relevant to give a brief backdrop of the European history of incorporation rules. In the 1840s French companies reincorporated in the United Kingdom, and eventually Belgium, – in search of more favourable rules. In response France adopted the *siège réel* doctrine

¹¹ Eg., ECJ, Case 81/87 *The Queen v H.M. Treasury and Commissioners of Inland Revenue, ex parte Daily Mail and General Trust plc*. [1988] ECR 5483, para. 16; or more recently, ECJ, Case C446/03 *Marks & Spencer plc v David Helsey* [2005] ECR I-10837, para. 31

¹² Case, ECJ C-55/94 *Reinhard Gebhard v Consiglio dell'Ordine degli Avvocati e Procuratori di Milano* [1995] ECR I-04165, para. 37

¹³ Case, ECJ C-210/06 *Cartesio Oktató és Szolgáltató bt* [2008] ECR I-09641, para. 109

¹⁴ J. Steiner & L.Woods, *EU Law*, 10th edn. (Oxford, Oxford University Press 2009) p. 461

¹⁵ ECJ, Case 81/87 *The Queen v H.M. Treasury and Commissioners of Inland Revenue, ex parte Daily Mail and General Trust plc*. [1988] ECR 5483 para. 19

¹⁶ J. Steiner & L.Woods, op. cit. p. 461

– stating that the rule of law governing the corporation is that of its actual seat of business, not simply that of a state in which it has registered.¹⁷

The difference of the end result of the two doctrines becomes apparent in practicality. Member States confessing to the *siège statutaire* recognise the corporation as created and governed by the laws of the Member State of its incorporation, even if the corporation operates primarily or exclusively in different Member State. Meanwhile under the system of *siège réel* the laws of the host Member State is applied if the actual center of the company's activities is performed in the host Member State, ie., the law of the place of management governs, thus demanding a secondary establishment to be created in accordance with the laws of the host Member State.¹⁸

Clearly the different doctrines have an impact on the company law applicable for a certain company, hence affecting the procedures and regulations which a company will need to comply with when running its business.¹⁹ This in turn have a direct impact on companies ability to utilize the freedom of establishment. It is of relevance for the purpose of this thesis, since the whole rationale behind regulatory arbitrage is to benefit somehow from a cross-border activity. The *siège réel* doctrine, applied in a strict manner, provides a potential defense against circumvention (*regulatory arbitrage*, see below), as the national courts will view the reality of the situation rather than the legal form²⁰. Apart from the issue of the rules relating to 'nationalities' of companies – *siège réel* or *siège statutaire* -, there are significant differences in the Member States' individual approaches to company formation and regulation.

It can hence be more desirable for someone who wishes to act in a Member State to establish a company in another Member State and rely on the right to secondary establishment contained in Article 49 TFEU to set up business in the original, target Member State. It is then the actions by the targeted Member State – who want to *protect* itself from the establishment of the company – that can be questioned, with reference to the right of establishment. The host Member State is then a mere tool for circumvention, and the targeted Member State is in fact the home Member State. The company might then rely on Article 49 TFEU against measures taken by the home Member State in order to actually *contain* the company in the home Member State.

¹⁷ D. Charny, 'Competition among Jurisdictions in Formulating Corporate Law Rules: An American Perspective on the 'Race to the Bottom' in the European Communities', 32 *Harvard International Law Journal* (1991) p. 423, at. p. 428

¹⁸ *Ibid* pp. 428-29

¹⁹ J. Steiner & L. Woods, *op. cit.* p. 521

²⁰ C. Barnard, *The Substantive Law of the EU*, 3rd edn. (Oxford, Oxford University Press, 2010), p. 331

Such legal manoeuvre is referred to as a 'U-turn transaction' – i.e. establishment of residence in another Member State by a national of a Member State whose activity is directed toward that Member State.²¹

2.2 The Case law

The vague stipulations found in the Treaty, has been further evaluated and interpreted by the ECJ. The practical manner in how to apply the Treaty provisions, is thus to be found in ECJ's elaboration on the scope of freedom of establishment.

2.2.1.1 *Daily Mail: Restrictive interpretation of right of establishment*

The *Daily Mail* case as such is not about abuse or misuse of the right of establishment, rather about defining the right to move a company within the Union. The accepted principal aim of the transaction was to avoid paying United Kingdoms capital gains tax.²²

The issue of gravity in the case was whether the transfer of management and control of a company constituted 'establishment' within the meaning of the Treaty, i.e., if such a transfer was within the scope of, and as such guaranteed by, the right of establishment. *Daily Mail* considered the location in a Member State of the central management and control of the company as sufficient to permit the existence of a 'real and continuous link' with the economy of that Member State. The company therefore claimed that the obligation to request an authorization of transfer of residence, was an illegitimate restrictive measure.²³

The wording of Article 49 TFEU – and its precedents – states that Member States are prohibited from discriminating companies (subsidiaries) incorporated in other Member States. In *Daily Mail* the Court clarified that this also establish that states of origin are prohibited from hindering companies to establish in other Member States.²⁴

Despite this, the ECJ concluded that 'the Treaty could not be interpreted as conferring on companies incorporated under the law of a Member State a right to transfer their central management and control and their central administration to another Member State while retaining their status as companies incorporated under the legislation of the first Member State'²⁵.

²¹ L. Cerioni, 'The "Abuse of Rights" in EU Company Law and EU Tax Law: A Re-reading of the ECJ Case Law and the Quest for a Unitary Notion', 21 *European Business Law Review* (2010) p. 783, at p. 785

²² R. de la Feria, 'Prohibition of Abuse of (Community) Law: The Creation of a New General Principle of EC Law Through Tax Law' 45 *CMLR* (2008) p. 395, at p. 403

²³ ECJ, Case 81/87 *The Queen v H.M. Treasury and Commissioners of Inland Revenue, ex parte Daily Mail and General Trust plc.* [1988] ECR 5483

²⁴ *Ibid* para. 16

²⁵ *Ibid* para. 24

In his opinion on the case, AG Darmon concluded that the concept of establishment is in itself essentially an economic one, which always implies an economic link.²⁶

Rather interestingly AG Darmon predicted a technical development – expressed by him in terms of 'telephone, telex and telecopier' – which will make it possible for the management of a company to meet 'in a place chosen arbitrarily, and with no real relation to the decision centre of the company. Hence, concluding that the place in which the board of directors meet therefore cannot constitute the sole criterion to designate the place in which the central management is located.'²⁷

On the more material evaluation of what constitutes an establishment within the Treaty, AG Darmon identified two factors: *psysichal location* and the *exercise of economic activity*, both, on a permanent, or durable, basis.²⁸

In 2008 *Daily Mail* was reconfirmed in *Cartesio*. The company there argued that *Daily Mail* was no longer applicable, but it was rejected by the Court.²⁹

2.2.1.2 Segers: A Company can conduct all its business in a Member State other than that of incorporation

In the *Segers* case the scope of freedom of establishment for the company, was relevant for the inclusion of the companies executive in a national social security scheme³⁰. This illustrates that the ulterior motive for why a company relies on the Treaty provision on establishment, is dispersed and not streamlined to company or tax law reasons.

The company did not carry out any activity in the United Kingdom, where it was registered, and all business activity was carried out by the Dutch subsidiary.

The Dutch authorities rejected the owner's application of a sickness insurance scheme, by Dutch law reserved for directors of companies established in the Netherlands only.

The Court observed that a company formed in accordance with the law of a Member State, and which conduct business through a secondary

²⁶ Advocat General Darmons Opinion, 7 June 1988, Case 81/87 *The Queen v H.M. Treasury and Commissioners of Inland Revenue, ex parte Daily Mail and General Trust plc*. [1988] ECR 5483, para. 5

²⁷ *Ibid* para. 7

²⁸ *Ibid* para. 3

²⁹ Case, ECJ C-210/06 *Cartesio Oktató és Szolgáltató bt* [2008] ECR I-09641

³⁰ Case, ECJ 79/85, *D. H. M. Segers v Bestuur van de Bedrijfsvereniging voor Bank- en Verzekeringswezen, Groothandel en Vrije Beroepen* [1986] ECR 02375

establishment cannot be subject to a different treatment solely by reason of the fact that its registered office is situated in another Member State.³¹

It was further concluded that for the application of the provisions on right of establishment, it is only required that the company is formed in accordance with the law of a Member State and have its registered office, central administration or principal place of business within the Union. Provided that those two requirements are fulfilled, it is immaterial that the company conducts its business solely in another Member State through a secondary establishment.³²

2.2.1.3 Centros: Secondary establishment may enable a company to take advantage of more liberal regimes

A few months before the millennium ECJ addressed the vastness of the right to secondary establishment. Centros Ltd. was a company registered by two Danish nationals in the United Kingdom, which sought to register a branch in Denmark. By being registered in United Kingdom, Centros Ltd. fell under British rules on minimum share capital (no requirement as for the provision for and paying-up of such capital³³). For limited liability companies registered in Denmark the minimum share capital was fixed at DKK 200 000³⁴. Centros Ltd. was refused permission to register a branch in Denmark – and it was Centros challenge to that decision under Article 49 TFEU, that gave rise to the case. Hence, under scrutiny in the case before the ECJ was a measure that prevented the right of establishment – i.e., the refusal to permit the registration of the branch. The Board responsible for the registration argued that the incorporation in United Kingdom was in fact an attempt to circumvent the Danish rules on minimum share capital; the secondary establishment that Centros Ltd. sought to get registered in Denmark was in fact the company's primary establishment and not a branch.

Since the registration process was a requirement for doing business in Denmark, and registration was refused by the Danish authorities, market access was restricted. The registration process demanded by Danish authorities was hence an obstacle to the freedom of establishment. It prevented market access and, thus, hampered market integration.³⁵

The conclusion was that even though all activities of a business are conducted in the Member State where the branch is situated, rather than in the Member State of incorporation, no abuse of Article 49 TFEU will arise, and the Member State in which the branch is located may be in no position

³¹ *Ibid* para. 14

³² *Ibid* para. 16

³³ ECJ, Case C-212/97 *Centros Ltd. v Erhvervs- og Selskabsstyrelsen* [1999] ECR I-1459, para. 4

³⁴ *Ibid* para. 7

³⁵ P. Schammo, 'Arbitrage and Abuse of Rights in the EC Legal System', 14 *European Law Review* (2008) p. 351, at p. 360

to impede the establishment of a business which has utilised the vehicle of a foreign company.³⁶

ECJ famously concluded:

*'That being so, the fact that a national of a Member State who wishes to set up a company chooses to form it in the Member State whose rules of company law seem to him the least restrictive and to set up branches in other Member States cannot, in itself, constitute an abuse of the right of establishment. The right to form a company in accordance with the law of a Member State and to set up branches in other Member States is inherent in the exercise, in a single market, of the freedom of establishment guaranteed by the Treaty.'*³⁷

In *Centros* the ECJ thus concluded that regulatory arbitrage in terms of company law, is naturally inherited from the right of establishment.

As cleverly observed in the doctrine, the Court implicitly acknowledge the existence of such legitimate regulatory arbitrage when addressing a Member States entitlement to 'take measures designed to prevent some of their nationals from attempting, under cover of the rights created by the Treaty, *improperly* to circumvent their national legislation or to prevent individuals from *improperly* or fraudulently taking advantage of provisions of Community law' (emphasis added). The use of the word *improperly* suggests that in addition to cases of improper circumvention of national rules, there might be cases of *proper* circumvention of national rules through reliance on the fundamental freedoms.³⁸

AG Pergola formulated the question at stake to be whether: 'a company [is] lawfully exercising the right to set up a secondary establishment when it intends to carry on its own business *exclusively* in the country in which the branch is registered and when it is clear that the original decision to incorporate the company in a Member State other than the State in which it is intended to do business was motivated *solely* by a desire to avoid the stricter legal requirements in respect of minimum company capital imposed by the law of the Member State in which the secondary establishment was to be set up?' (emphasis added)³⁹

Pergola continued to observe that in the case, the Danish government claimed a two-pronged defense, namely that the refusal to register did not represent a restriction within the scope of Article 49 TFEU, and, in

³⁶ K.E. Sørensen, 'Prospects for European Company Law after the Judgment of the European Court of Justice in *Centros LTD*', 2 *Cambridge Yearbook of European Legal Studies* (1999), p. 203, at p. 209

³⁷ ECJ, Case C-212/97 *Centros Ltd. v Erhvervs- og Selskabsstyrelsen* [1999] ECR I-1459, para. 27

³⁸ L. Cerioni, *op. cit.* p. 790

³⁹ Advocate General Pergolas Opinion, 16 July 1998, Case C-212/97 *Centros Ltd. v Erhvervs- og Selskabsstyrelsen* [1999] ECR I-1459 para 11

alternative, that the restriction is covered by the provisions on justified restrictions.

2.2.1.4 *Überseering: Siege reel not protecting Member States*

The company *Überseering* had its administration in Germany, but was incorporated in the Netherlands. In proceedings regarding damages with a German incorporated company, a German law stating that a company's legal capacity is governed by the law of the territory in which its central place of administration is based, was challenged by *Überseering*. In effect, this meant that German law would only recognise the existence of a company whose administration and incorporation were in the same state. Due to that German law, *Überseering* had no legal standing in the damages case, because in the eyes of the German authorities it did not exist.⁴⁰

The ECJ found the German law to be a violation of Article 49 TFEU. It held that where a company is validly incorporated in one state according to the laws of that state, other states are required to recognise that incorporation⁴¹. The alternative would be that *Überseering* would have to re-incorporate itself in Germany, which would 'tantamount to outright negation of freedom of establishment'⁴².

2.2.1.5 *Inspire Art: Company is to be respected and not adjusted by host state legislation*

Under scrutiny in *Inspire Art* was a Dutch attempt to mitigate the effects of *Centros* that was scrutinised. Without preventing the right of establishment, the Dutch rules established registration as 'foreign companies' and requirements to meet certain elements in the Dutch company law.⁴³

The ECJ - importantly for the methodology – resumed the four conditions, set up through its case law, to be met by national measures liable to hinder, or impede, the exercise of fundamental freedoms guaranteed by the Treaty. Such national measures has to be:

- applied in a non-discriminatory manner;
- justified by imperative requirements in the public interests;
- suitable for securing the attainment of the objective which they pursue; and,
- not going beyond what is necessary in order to attain it.⁴⁴

Going on to reiterate from *Segers* and *Centros*, ECJ held that the fact that the company was formed in a particular Member State for the sole purpose

⁴⁰ ECJ, Case C-208/00 *Überseering v NCC* [2002] ECR I-9919

⁴¹ *Ibid* para. 95

⁴² *Ibid* para. 80

⁴³ ECJ, Case C-167/01 *Kamer van Koophandel en Fabrieken voor Amsterdam v Inspire Art* [2003] ECR I-10195 para. 100

⁴⁴ *Ibid* para. 133

of enjoying the benefit of more favourable legislation does not constitute abuse even if that company conducts its activities entirely or mainly in the second state, save where abuse is established.⁴⁵

With regard to abuse of law, ECJ concluded that it is for the national authorities and courts to establish in every case whether the conditions on which such a restriction might be justified have been satisfied.⁴⁶

Importantly, it was also concluded by the ECJ that when assessing an alleged abuse of right of establishment, the assessment must be made on a case-by-case basis.⁴⁷

After *Inspire Art*, the doctrine conclusion was that the ECJ had ruled out the limiting effect of a *siège réel* to the extent that any national regulation making the recognition of a foreign business entity's legal personality contingent on broad compliance with domestic standards conflicts with Articles 49 and 54 TFEU. Reaching the conclusion that the EU had reached a state where incorporators could select a domicile for their company independent of the of the firms physical assets and place of business.⁴⁸

⁴⁵ *Ibid* para. 105

⁴⁶ *Ibid* para. 120

⁴⁷ *Ibid* para. 143

⁴⁸ T.H. Tröger, 'Choice of jurisdiction in European Corporate Law – Perspectives on European Corporate Governance', 6 *European Business Organization Review* (2005) p. 3, at pp. 6-7

3 The Road to *Cadbury Schweppes*: Regulatory competition and abuse of rights

The previous chapter set out the basic provisions of the freedom of establishment for legal persons, and highlighted the case law within this area. That case law concludes that the liberties for legal companies to establish itself and be formed in a country did not limit the opportunities to carry out activities in another Member State. Rather it was concluded in *Centros* that companies were allowed to use the establishment provision to take advantage of more favourable legal regimes.

This chapter will introduce the concept of *regulatory arbitrage*, a legal planning technique to draw advantage of irregularities in different legal regimes governing the same activities. Regulatory arbitrage will be introduced under the umbrella of *regulatory competition*. This chapter will also introduce the *abuse of law* doctrine in EU law. Finally, the chapter will conclude the relation between these concepts.

3.1 Regulatory competition

Essentially the concept of regulatory competition is established on the idea of the existence and functioning of a 'law market', on which States compete to attract subjects. Due to the principles of the qualitative advantages fostered by competition, this process is considered to eventually lead to better laws.⁴⁹

It has been held that the effect of the EU rules on free movement is to place the different national systems into competition with each other. The underlying rationale is that those individuals or companies not satisfied with the political, legal or social environment in which they find themselves are free to move to another Member State which have a regime that suits them better. This freedom has the effect of forcing national systems to compete to produce the best rules to attract (or retain) valuable assets (capital and labour). This is known as *regulatory competition* or *competitive federalism*. The concept as such is concerned with a process of competition among public goods, more precisely regulations.⁵⁰

⁴⁹ L.E. Ribstein & E.A. O'Hara, *The Law Market* (Oxford, Oxford University Press, 2009)

⁵⁰The rationale for the theory is derived to C.M. Tiebout and his 'pure theory of fiscal federalism (often referred to as the *Tiebout model*, *Tiebout sorting* or *Tiebout migration*) as laid out in C.M. Tiebout, 'A pure theory of local expenditure' 64 *Journal of Political Economy* (1956) p. 416 as presented in C. Barnard, *op. cit.* p. 25

For such regulatory competition to function there are two pre-conditions:

- 1) The *federal* (central) authorities must lay down and enforce the rules giving freedom to exit one Member State and enter another.
- 2) The *state* (decentralized authorities) must remain free to regulate the production and the qualification of people, according to their own standards so as to enable regulators to respond to the competition.

While the first segment constitute free movement, the second segment constitute mutual recognition. It is a market consisting of these segments that create the regulatory competition.⁵¹

The outcome of this process of regulatory competition should – according to the underlying rationale - be to produce optimal, efficient, and innovative legislation (commonly rallied under the slogan *a race to the top*) because state officials vie with one another to create increasingly attractive economic circumstances for their citizens, knowing that their re-election depends upon their success. Meanwhile regulatory competition also promotes diversity and experimentation in the search for effective legal solutions by providing for comparative data to assist in regulatory reform. This reduces the risk of widespread adoption of flawed laws. This constitutes the 'laboratory of democracy' theory, which recognizes that competition is a dynamic process where trial and error is the best means of finding the optimal solution to complex problems.⁵²

It should be clarified that regulatory competition can be direct or indirect. In terms of goods and services, the regulatory competition is only *indirect* - the legal competition is diluted by consumers preferences in the specific case. When economic actors are granted to choose the legislation to be regulated under, the competition between the regulative systems are *direct* – the decision is directly influensive. Competition is presumed to result in better products. In this case the product will be law, and the consumer is the mobile economic actor. Consequently, this economic setting is presumed to lead to dynamic and creative legislation amongst Member States.⁵³

3.1.1 Regulatory arbitrage

The concept of *regulatory arbitrage* is functionally closely – and descendingly - related to the concept of regulatory competition. The rationale is articulated as follows.

⁵¹ D. Chalmers, G. Davies & G. Monti, op. cit. p. 706

⁵² C. Barnard, op. cit. pp. 25-27

⁵³ D. Chalmers, G. Davies & G. Monti, op. cit. p. 707

The starting point for the concept of regulatory competition is the paradigm that, if guaranteed the possibility to do so, mobile economic actors (e.g., citizens) will move to the government offering public goods (e.g., legislation) best matching their preferences⁵⁴. Market integration is at the very heart of the EU Treaties, and one mean to promote such integration is by providing the four fundamental movement freedoms. By removing legal obstacles to mobility and facilitate market *access* and *exit*, the free movement provisions facilitate regulatory arbitrage.⁵⁵

In legal terms, this could be understood as a process were such actors, by 'exiting', arbitrate amongst local legislations, in order to meet their own preferences. Regulatory arbitrage is, thus, to be understood as the action by which mobile economic actors seek to take advantage of regulatory differences between jurisdictions in order to reduce costs or to gain advantages⁵⁶. It is especially likely to occur when companies can choose to incorporate in different jurisdictions without having to relocate their business activities to the same jurisdiction⁵⁷. Regulatory arbitrage is in effect the underpinning force behind, and as such the demand-side precondition for, the concept of regulatory competition: if companies not react to differences in law, there is no need for jurisdictions to compete for incorporation⁵⁸.

Furthermore, the juridical development in the European Union, constitutes breeding ground for regulatory arbitrage within the scope of the Internal Market. That is due to state of affairs within the Union. As presented above, a market based on mutual recognition and free movement forms the basis for regulatory competition. The counter-measure to this is either harmonisation or to impede the driving factors (*mutual recognition* and *free movement*). The lack of such harmonisation and impeding measures, thus, constitutes the very breeding ground for regulatory arbitrage. In other words, the combination of regulatory diversity and extensive mobility, consequently leaves room for regulatory arbitrage. (*Nota bene*, it is the extent and vastness of such impeding measures that this thesis is set out to examine.)

The concept of regulatory competition is highly relevant to explain the underlying motives behind stretching the scope of the right of establishment. The explanation is that by using the EU right to establish itself in a host Member State the company in question circumvent some onerous legislation in the home Member State – or as in *Centros*, the host Member State. In political terms the consequence is that the targeted Member State is being subject to a pressure to adapt its own regulation, in

⁵⁴ The rationale set out in the *Tiebout model*,

⁵⁵ P. Schammo, op. cit. p. 360

⁵⁶ F. Partnoy, 'Financial Derivates and the Cost of Regulatory Arbitrage', *22 Journal of Corporation Law* (1999) p. 211, at p. 227

⁵⁷ H. Eidenmüller, A. Engert and L. Hornuf, op. cit. p. 4

⁵⁸ *Ibid* p. 4

order to keep the company/-ies in question. In practical terms, the company in question can take advantage of the legal differences within the Union.

3.1.2 Criticism to regulatory competition

Critics of the doctrine of regulatory competition consequently complain that it eventually ends in a situation where the arbitrary actors can extort their preferred type-of-behaviour from the legal regime.

Related to company law and regulatory competition, the American experience is much studied and referred to. It is apropos since, like the EU, the United States can be viewed as a federation in which the individual countries retain considerable sovereignty, while at the same time allocating important prerogatives on a supranational legislature⁵⁹. In the United States companies are primarily regulated by state law, but enjoys free mobility. The incorporation principle is applied, so no regard is showed to where business operations are conducted.⁶⁰

It has been claimed that the state competition for corporate charters constitutes a *race to the bottom*⁶¹. The rationale behind this is that stakeholders are harmed, when states adopts lax regulations in order to attract incorporation – which in turn, brings tax revenues. Especially, the lax regulations is used by active management, acting not only against the interest of stakeholders in general, but also shareholders. The race to the bottom, is thus, not only a legal issue but also a matter of corporate governance.⁶² Meanwhile the primal opposition from a legal policy perspective is that the phenomena forces states to take account of only those mobile economic actors affected by the regulation; that the broader stakeholder voice is lost and that the 'voice' listened to belongs to those who are equipped with the opportunity to 'exit'⁶³.

It should be noted that the race to the bottom-doctrine is countered by theories of a *race to the top*-doctrine, claiming that the market powers will actually discourage incorporation under the most liberal legal regime. Interestingly, there are also suggestions of a third result of the regulatory competition – a *race for predictability and stability*. Its rationale renounces from the assumption under the *bottom*- and *top*-theories, that it is the substantive content of the legal rules that determine the outcome of the competition. Instead the theory claims that success in the outcome depends

⁵⁹ J. MacCahery & E. Vermeulen, 'Does the European Company prevent the "Delaware Effect"?', 11 *European Law Journal* (2005) p.785, at p. 787

⁶⁰ L. Bebchuck, 'Federalism and the Coporation: The Desirable Limits on State Competition Corporate Law' (1992) 105 *Harvard Law Review* p. 1435, at p. 1442

⁶¹ This theory can be traced back to William L. Cary, professor in law at Columbia University. W.L. Cary, 'Federalism and Corporate Law: Reflections upon Delaware', 83 *The Yale Law Journal* (1974) p. 633

⁶² L. Bebchuck, op. cit. p. 1444

⁶³ D. Chalmers, G. Davies & G. Monti, op. cit. p. 707

on the ability to offer corporations a credible commitment to predictability and stability.⁶⁴

Appropriately enough, due to the divorced views on the impact of regulatory competition, the impact has also been summarized as 'a race to nowhere in particular', benefitting some stakeholders but not others.⁶⁵

3.2 Abuse of rights

The legal attitude towards what has come to be established under Union case law as abuse of rights is not easily defined. Significantly, it is a concept that is unfamiliar to some of the national legal systems while, were its is conceptually recognised, the extent of it differs.⁶⁶

Nonetheless the concept of abuse of rights linked to EU law have been summarized as having arisen in three contexts in the ECJ case law:

- (i) situations in which it has been asserted that reliance upon EC law amounts to, or results in, an abuse of rights in relation to domestic law (situations calling for the application of a domestic concept of abuse of rights);
- (ii) situations in which directly applicable provisions of EC law have been said to be the subject of abuse for the purpose of extracting a benefit (essentially financial) from the Community; and,
- (iii) situations in which an abuse of rights is said to have arisen in an area that has been harmonised by EC legislation that does not contain, explicitly, an anti-abuse rule (the second and third situations calling either for the application of a domestic concept of abuse of rights or an EC law concept).⁶⁷

Meanwhile there are two EU-levels of such abusive behaviour. First, the *internal* abuses of law, where the individual attempt to change their legal position under EU law for a more favourable one. Second, the *cross-border* abuses of law, where the individuals tries to circumvent a national legal order and elect a more favourable one, thereby obtaining a regulatory advantage.⁶⁸

⁶⁴ L. Bebchuck, op. cit. p. 1446

⁶⁵ W.W. Bratton, 'Corporate Law's Race to Nowhere in Particular', 44 University of Toronto Law Journal (1994) p. 401

⁶⁶ R. de la Feria, op. cit. p. 395

⁶⁷ Paul Lasok QC, *Abuse of Rights in EC Law – Origins and History*, (June 2006) Monckton Chambers, see website available at <http://www.monckton.com/docs/library/AbuseRightsJune06PL.pdf> (accessed 23 May 2011)

⁶⁸ A. Saydé, *Abuses of European Law, Regulatory Mobility and the Law of the Internal Market* (Cambridge, CELS Paper, 2011) p. 3

Abuse of rights could thus be described as the tension between the exercise of a certain right and the exercise of regulatory arbitrage.⁶⁹ It is for the ECJ to define and re-define the legal relationship between these two extremes.

Examination of the European doctrine on abuse of rights, is important not only to assess the conduct of legal persons, but also when assessing a national restriction of the free movement provisions. The ECJ may turn to abuse when it examines the existence of an obstacle to the free movement and/or when it examines whether a national measure which was found to obstruct the free movement can be justified.⁷⁰

3.2.1 Definition

Strictly defined, *abuse of rights/law* doctrines are a judicial means against the improper use of legal rights⁷¹. Such situations where persons try to circumvent what they consider to be inconvenient rules is a well established legal challenge. The doctrine of abuse of right is not a generic concept throughout the different Member States' legal systems – and as a general concept it is more established in Continental Europe, while the Common law and Nordic countries handle such abuse not through a doctrine, but rather through specific law measures.⁷²

For the purpose of delivering an illustrative definition of the concept, the French situation will be examined – due to France's influential *codificative* role it is particularly suitable. It recognises both the concept of *abus de droit* – referring to the excessive exercise of one's rights, thereby causing harm to others – and *fraude à la loi*. For the purpose of this chapter the latter is most relevant.

Fraude à la loi conduct conforms to the letter of the law. But it is viewed as doing so 'artificially', and therefore pre-supposes intention to evade the law⁷³.

For the purpose of understanding the concept of *fraude à la loi* – and abuse of rights in general – it might prove useful to recap⁷⁴ the *raison d'être* behind the French *siège réel* doctrine. Up until the introduction of that doctrine, French companies circumvented deterrent legislation by incorporation in either the UK or Belgium instead. Thus, the introduction of

⁶⁹ P. Schammo, op. cit. p. 369

⁷⁰ *Ibid* p. 363

⁷¹ *Ibid* p. 362

⁷² N. Brown, 'Is There a General Principle of Abuse of Rights in European Community Law?', in D. Curtin & T. Heukels, ed., *Institutional Dynamics of European Integration II*, vol. II (London, Martinus Nijhoff Publishers, 1994) pp. 513-15

⁷³ P. Schammo, op. cit. p. 355

⁷⁴ See 2.2.4.

the *siège réel* doctrine, can be considered as an emanation of the fraude à la loi doctrine⁷⁵.

The French Government maintained this position in the leading *Centros* case. In its submission to the case, the French position was that any business conducted in the country of incorporation is relevant for the purpose of freedom of establishment, only if 'there appear to be legitimate reasons for setting up a secondary establishment and there is no abusive or devious intent'⁷⁶.

In the *Paletta II* case, regarding social rights connected to abuse of freedom of movement for workers, the ECJ established the procedural principle that when deciding on the claimed abuse the measure should be asserted in the light of the objectives of the freedom as such⁷⁷. In line with the overall aspiration to produce a unitary methodology for the four freedoms, ECJ further confirmed the applicability of this principle to establishment cases in *Centros*⁷⁸. This raises the relevance of the aspirational objective behind the right to establishment as such.

This reliance on the aspirational objective behind the provision in question has – as will be showed in the following⁷⁹ – been the dominant tool to establish abuse of law. The statutory interpretation method of teleology is, thus, established as a cornerstone in relation to any potential abuse of rights.

As a result of this, and in relation to the definition of abuse of rights, it is necessary to dissect the nature of the legal regime at stake. It is so just because the abuse doctrine aims at hindering situations where rules are circumvented by *artificial arrangements*, motivated solely by regulatory considerations. In that context a legal regime can be either *neutral* or *disruptive*⁸⁰.

Under a *neutral* regulation, decisions taken by individuals should be identical to those taken in the absence of regulation, and so artificial regulatory arrangements should be prohibited. Under a *disruptive* regulation, by contrast, decisions pre- and after-regulation should differ, and artificial regulatory movements be allowed. Some legislations – such as criminal law – actually favours or demand artificial regulatory arrangements. And being explicitly *disruptive* those legal regimes, do not

⁷⁵ P. Schammo, *op. cit.* p. 356

⁷⁶ Advocate General Pergolas Opinion, 16 July 1998, Case C-212/97 *Centros Ltd. v Erhvervs- og Selskabsstyrelsen* [1999] ECR I-1459 para 8

⁷⁷ ECJ, Case C-206/94, *Brennet AG v. Vittorio Paletta* [1996] ECR I-02357

⁷⁸ ECJ, Case C-212/97 *Centros Ltd. v Erhvervs- og Selskabsstyrelsen* [1999] ECR I-1459, at para. 25. Consistent with the aspiration to create uniformity, the principle was applied on movement of capital in ECJ, Case C-436/00 *X and Y v. Riksskatteverket* [2002] ECR I-10829 at para. 42

⁷⁹ See the *Emsland*, *Halifax* and *Cadbury*-cases, and the centre position held there by an objective assessment.

⁸⁰ A. Saydé, *op. cit.* p.6

entail the prohibition of abuse of law, but rather grant a free choice of law for the Union citizen.⁸¹

Consequently, it is under *neutral* legal regimes – not intended to alter the ordinary course of actions – that artificial regulatory arrangements are to be impeded, for being abuses of law. Such arrangements respond essentially to regulatory considerations, which is contrary to the legislative intention: to not distort the ordinary conduct of business.⁸²

It has thus been proposed that abuse of EU law should be defined as 'a *gain-seeking and artificial regulatory movement affecting a neutral legal regime*'⁸³. This is a definition consisting of three cumulative elements as established through the case law. The first element consisting of the movement of private interests from one regime to another, for the purpose of the interest, more favourable⁸⁴. The second two elements – *artificiality* and *neutrality* – respectively corresponds to the two-pronged abuse test as enounced by the ECJ in *Emsland* and *Halifax*. The definitive content of these two elements will be presented in connection to the cases below, but for the purpose of this part it is sufficient to grasp that artificiality corresponds to the subjective intent behind the transaction, while neutrality corresponds to the objective purpose – *disruptive* or *neutral* -behind the legal provision. Further, it is relevant to observe that the definition of abuse of rights concerns both the *nature of the strategy* chosen by the private interests – the former two elements – and the *nature of the legislation* – the latter element⁸⁵.

In cases relating to tax issues, and regarding national measures with the purpose of preventing tax avoidance, the Court have held that such measures must be specifically designed to exclude 'wholly artificial arrangements', and not generally aimed at any situation⁸⁶. It has also been held that when choosing between two situations, the taxable person is not required to choose the most onerous of the two. On the contrary, it has been pointed that taxpayers might choose to structure their business so as to limit their liabilities.⁸⁷

3.2.2 General principles of law

It is relevant to briefly describe the general principles of law, as practised in Union legislative processes. This is important due to an ongoing debate in

⁸¹ *Ibid* p.6

⁸² *Ibid* p.6

⁸³ *Ibid* p.2

⁸⁴ *Ibid* p.3

⁸⁵ *Ibid* p.5

⁸⁶ ECJ, Case C-436/00 *X and Y v. Riksskatteverket* [2002] ECR I-10829 at para. 61

⁸⁷ ECJ, Case C-255/02 *Halifax plc, Leeds Permanent Development Services Ltd, County Wide Property Investments Ltd, v. Commissioners of Customs & Excise* [2006] ECR I-1609, paras. 73

the doctrine on whether the abuse of law doctrine, as established in case law described below, constitutes a new general principle of Union law⁸⁸.

The general principles of EU law have been introduced into the corpus of EU law, through the case law of the ECJ. These principles are important, as they may be invoked both as an aid to interpretation, but also as an judicial retreat in itself⁸⁹. Importantly, these principles – once established - stands on their own merits and does not rely on any national provisions⁹⁰. The creation of these principles has been characterised as stemming from the dialectical interaction between national laws and EU law, in which the Court fertilises EU law with principles found in national legal orders⁹¹.

Amongst these principles, and of relevance for the purpose of this thesis, are especially:

- *proportionality* – the means used to achieve a given end must be no more than what is appropriate and necessary to achieve that end⁹²; and,
- *the principle of legitimate expectations* – in the absence of an overriding matter of public interest, measures must not violate the legitimate expectations of the parties concerned⁹³. An expectation is not legitimate unless it is reasonable, and it is further more not considered as legitimate if the person concerned was not acting in the normal course of business but was trying to take advantage of a weakness in the European Union system to make a speculative profit.⁹⁴

The latter principle is important for the purpose of this thesis. Companies have a right to know what measures can be taken under the freedom of establishment. This was emphasized by the Court in *Halifax*, where it stated that 'Community legislation must be certain and in application foreseeable by those subject to it', continuing, 'That requirement of legal certainty must be observed all the more strictly in the case of rules liable to entail financial consequences, in order that those concerned may know precisely the extent of the obligation which they impose on them'.⁹⁵

⁸⁸ See eg., L. Cerioni, op. cit. p. 804; R. de la Feria, op. cit. p. 436

⁸⁹ J. Steiner & L. Woods, op. cit. p. 133

⁹⁰ L. Cerioni, op. cit. p. 806

⁹¹ R. De la Feria, *Reverberation of Legal Principles: Further Thoughts on the Development of an EU Principle of Prohibition of Abuse of Law* (Oxford, Oxford University Centre for Business Taxation Working Paper 1021, 2010)

⁹² J. Steiner & L. Woods, op. cit. p. 147

⁹³ *Ibid* p. 149

⁹⁴ TC. Hartley, *The Foundations of European Union Law*, 7th edn. (Oxford, Oxford University Press, 2010) pp. 162-163

⁹⁵ ECJ, Case C-255/02 *Halifax plc, Leeds Permanent Development Services Ltd, County Wide Property Investments Ltd, v. Commissioners of Customs & Excise* [2006] ECR I-1609, paras. 72

3.2.3 Case law on abuse of rights

Below follows a brief account of the most relevant and groundbreaking cases, establishing ECJ's doctrine on abuse of law.

3.2.3.1 The Van Binsbergen case: Establishing an Informal Abuse of Law Doctrine

An early example of the concept of abuse in the ECJ case law, is *Van Binsbergen*, in which the Court held that a Member State could take measures to prevent the exercise of the freedom to provide services, by a service provider whose activities were entirely or principally targeted at its territory for the purposes of avoiding professional rules of conduct otherwise applicable to him in this Member State.⁹⁶

Van Binsbergen were an early case establishing abuse of rights as a concept in EU law – despite doing this without actually using the word 'abuse'⁹⁷. It has been proposed that *Van Binsbergen* can thus be read along with *Centros*, to identify a distinction when evaluating whether circumvention manoeuvre constitutes abuse of the right. First, the ECJ look at the type of national measures that were being circumvented. Second, the ultimate outcome of the circumvention is assessed, ie., the generated effect for third parties interests.⁹⁸

3.2.3.2 Kefalas, et al.: Not detract from full effect and uniform application of EU law

In a series of cases⁹⁹ the ECJ had to reconcile its position with the intent of Greek national courts to apply national anti-abuse provisions against Union rights. Hence, seemingly jeopardizing the primacy of EU law over national law. The ECJ concluded to accept the right of national courts to apply national anti-abuse provisions, even on rights granted by Union law. But it did so while strictly specifying in which manner.

In *Kefalas*, shareholders sought annulment of a ministerial decision increasing the capital requirements for a public limited company, on the ground that the decision were in conflict with a Union directive. The Greek state invoked a national abuse-doctrine – and the national Court, agreeing in substance with the Greek state, asked ECJ as to who was to decide that a

⁹⁶ ECJ, Case 33/74, *Van Binsbergen v Bedrijfsvereniging Metaalnijverheid* [1974] ECR 1299, para. 13

⁹⁷ L. Cerioni, op. cit. p. 785

⁹⁸ *Ibid* p. 791

⁹⁹ ECJ, Case C-441/93 *Panagis Pafitis and others v Trapeza Kentrikis Ellados A.E. and others* [1996] ECR I-01347; ECJ, Case C-367/96 *Alexandros Kefalas and Others v Elliniko Dimosio (Greek State) and Organismos Oikonomikis Anasygkrotisis Epicheiriseon AE (OAE)* [2000] ECR I-011705; and, ECJ, Case C-373/97 *Dionysios Diamantis v Elliniko Dimosio (Greek State) and Organismos Ikonomikis Anasygkrotisis Epicheiriseon AE (OAE)* [2000] ECR I-01705

Union right had been used abusively. Thus, it raised the question on whether – in a national legal context – the exercise of a right granted by Union law can be regarded as abusive.¹⁰⁰

Based on the finding that Union law cannot be relied upon for abusive ends, the ECJ concluded that a national provision assessing the exercise of a EU right as abusive cannot be regarded as being contrary to the Union legal order.

Kefalas was one of three cases on abuse brought by Greek courts. Eventually the three cases provided specific conditions for national anti-abuse rules. ECJ made it evident that such national anti-abuse regimes must not detract from the full and uniform application of EU law, they must not alter the scope of the EU law provisions under consideration and they must not compromise the objective pursued by EU law provisions.¹⁰¹

In *Kefalas* the ECJ also listed its cases on abusive practices, ie., confirming how the concept had spread to all the fundamental freedoms – along with other areas of Union law.¹⁰²

3.2.3.3 Imperial Chemical Industries: Introducing the concept of 'wholly artificial arrangements'

The *Imperial Chemical Industries* – commonly abbreviated as *ICI* – a case regarding tax legislation. The ECJ had to consider the impact on the freedom of establishment of a national tax law measure from the United Kingdom. The Court held that national legislation, restricting exercise of the freedom of establishment, can only be justified where it had 'the specific purpose of preventing *wholly artificial arrangements*' (emphasis added)¹⁰³.

Despite introducing the legal concept of wholly artificial arrangement, the Court did not involve in defining this concept.

3.2.3.4 Emsland: Establishing a Formal Abuse of Law Doctrine

Emsland is perhaps *the* determining case on abuse of rights, establishing a whole new methodology for the assessment of concerned situations.

¹⁰⁰ ECJ, Case C-367/96 *Alexandros Kefalas and Others v Elliniko Dimosio (Greek State) and Organismos Oikonomikis Anasygkrotisis Epicheiriseon AE (OAE)* [2000] ECR I-011705

¹⁰¹ ECJ, Case C-373/97 *Dionysios Diamantis v Elliniko Dimosio (Greek State) and Organismos Ikonomikis Anasygkrotisis Epicheiriseon AE (OAE)* [2000] ECR I-01705, para. 34

¹⁰² ECJ, Case C-367/96 *Alexandros Kefalas and Others v Elliniko Dimosio (Greek State) and Organismos Oikonomikis Anasygkrotisis Epicheiriseon AE (OAE)* [2000] ECR I-011705 para. 20

¹⁰³ ECJ, Case C-264/96 *Imperial Chemical Industries plc (ICI) v Colmer (HMIT)* [1998] ECR I-4711 para. 26

Thereby, while in *Van Binsbergen* an informal EU doctrine of abuse was applied, in *Emsland* the ECJ established an explicit abuse doctrine.

The company tried to substitute their legal position under European law to a more favourable one, implying an export subsidy for agricultural goods that were exported to Switzerland and the re-imported to the EU. The German authorities which had granted the subsidy, asked for repayment. The conditions for the subsidy were laid down in a Union regulation.

The ECJ established a two-pronged test to determine what constitutes abuse of rights, under Union law. First, the test consists of a *objective* element – ie., a teleological interpretation of the relevant Community provisions. Secondly, the test consists of a subjective element – ie., the intention to attain an advantage from the Union rules by creating artificially the conditions laid down for obtaining it.¹⁰⁴

Noteable, is that the ECJ – although faltering - introduced the concept of artificiality in connection with abusive practices. This legal concept was eventually to blossom in *Cadbury*, but in *Emsland* artificiality was identified as a defining part of the subjective behaviour¹⁰⁵.

The ruling stressed the importance of the link between the subjective element and the objective result. It showed that such a link dissociates the *form* of a certain behaviour – fulfilling the conditions for obtaining a benefit – and the *substance* of the behaviour – a substance that does not meet the intention of the EU provision granting the benefit.¹⁰⁶

3.2.3.5 Halifax: Elaborating the Abuse of Law Doctrine

The *Halifax* case ultimately concerned the regard to be shown to the aim of the parties. A company tried to substitute its legal position under EU law to a more favourable one, enabling a higher VAT deduction, thus raising the question of abuse.

AG Poiares Maduro identified two types of cases which generally involve abuse of rights claims before the ECJ. The first type relates to attempts by individuals to rely on Union provisions in order to avoid or evade Member State legislation. The second type involves cases in which Union provisions are ‘abusively’ relied upon in order ‘to gain advantages in a manner that conflicts with the purposes and aims of those same provisions’. This led AG Maduro to conclude that a general principle of EU law on abuse of rights

¹⁰⁴ Case, ECJ C-110/99, *Emsland-Stärke v Hauptzollamt Hamburg-Jonas* [2000] ECR I-11569 paras. 52-53

¹⁰⁵ *Ibid* paras. 53 & 58

¹⁰⁶ L. Cerioni, op. cit. p. 788

could be derived from ECJ's case law, but that that principle in itself was not yet developed to a useful doctrine.¹⁰⁷

The ECJ confirmed AG Maduro's opinion and established, for the first time explicitly, the prohibition of abusive practices as a Union legal principle¹⁰⁸. The Court concluded this principle, by referring back to the *Kefalas* case, and presented following definition:

*'The application of Community legislation cannot be extended to cover abusive practices by economic operators, that is to say transactions carried out not in the context of normal commercial operations, but solely for the purpose of wrongfully obtaining advantages provided for by Community law.'*¹⁰⁹

Building on the principles established in *Emsland AG Maduro*, elaborated on a two-pronged test to determine the existence of abuse of Union law. A test consisting of a subjective element ascertaining the purpose of the activities in questions – not to be confused with the subjective intention of the participants in such activities. Under *Halifax*, this subjective element is to be objectively determined on the basis of the absence of any other economic justification for the activity, than that of creating a legal advantage. Maduro argued that when applying this element, the national authorities must determine whether the activity at issue has some autonomous basis, apart from the advantage, capable of endowing it with some economic justification. The second element constituting the test, corresponds to the objective test established in *Emsland* – that is a teleological element whereby the purpose and objectives of the Union rules are compared with the purpose and results achieved by the activity at issue. Maduro stresses that this second prong, actually serves as a safeguard to those instances where the sole intention actually is to seek an advantage, but that is also the intended objective by the EU legislature.¹¹⁰

To conclude the objective element, the ECJ submitted itself to a reasoning regarding the logic of *neutral* regulations¹¹¹ - which are not intended to alter the ordinary course of actions:

'To allow taxable persons to deduct all input VAT even though, in the context of their normal commercial operations, no

¹⁰⁷ Advocat General Maduros Opinion, 7 April 2005, Case C-255/02 *Halifax plc, Leeds Permanent Development Services Ltd, County Wide Property Investments Ltd, v. Commissioners of Customs & Excise* [2006] ECR I-1609, para. 63

¹⁰⁸ R. De la Feria, op. cit. *supra* 91

¹⁰⁹ Case C-255/02 *Halifax plc, Leeds Permanent Development Services Ltd, County Wide Property Investments Ltd, v. Commissioners of Customs & Excise* [2006] ECR I-1609, paras. 69

¹¹⁰ Advocat General Maduros Opinion, 7 April 2005, Case C-255/02 *Halifax plc, Leeds Permanent Development Services Ltd, County Wide Property Investments Ltd, v. Commissioners of Customs & Excise* [2006] ECR I-1609, paras. 87-88

¹¹¹ As described, in 3.2.1., the division of regulations in *neutral* or *disruptive* could prove helpful for the teleological interpretation.

*transactions conforming with the deduction rules of the Sixth Directive or of the national legislation transposing it would have enabled them to deduct such VAT, or would have allowed them to deduct only a part, would be contrary to the principle of fiscal neutrality and, therefore, contrary to the purpose of those rules.*¹¹²

Based on that background, the ECJ stated two conditions in order to conclude abusive practice - here within the sphere of VAT:

- 1) The transactions concerned must result in a tax advantage which is, notwithstanding formal adherence, *contrary* to the relevant Community regime on the area.
- 2) It must also be apparent from a number of objective factors that the *essential aim* of the transactions is to obtain a tax advantage.¹¹³

The ECJ further confirmed AG Maduro's opinion, that the prohibition of abuse is not relevant where the economic activity carried out may have some other explanation than the mere attainment of tax advantages.¹¹⁴

The ECJ concluded that to establish abuse, it must be apparent from a number of objective factors that the essential aim of the transactions in question is to obtain an advantage. The Court pointed out that it is the responsibility of the national court to determine the real substance of the transactions concerned. And in doing so, the Court clarified, it may take account of the purely artificial nature of those transactions and the link of a legal, economic and/or personal nature between the operators involved in the scheme.¹¹⁵

The two conditions established by the ECJ clearly, although in a different wording, brings on the objective and subjective element, established in *Emsland*, for the purpose of assessing whether the arrangement constitutes an abuse of right under EU law.

In the *Halifax* case, the Court also comprehended the case law regarding what constitutes economic activity. In his opinion in *Daily Mail*, AG Darmon established economic activity as one of two material factors in an establishment under the Treaty. In *Halifax* it was concluded that the scope of the term is very wide, and that it is objective in character, meaning that the activity is considered *per se* without regard to its purpose or results.¹¹⁶

¹¹² Case C-255/02 *Halifax plc, Leeds Permanent Development Services Ltd, County Wide Property Investments Ltd, v. Commissioners of Customs & Excise* [2006] ECR I-1609, para. 80

¹¹³ *Ibid* paras. 74-75

¹¹⁴ *Ibid* paras. 74-75

¹¹⁵ *Ibid* para. 81

¹¹⁶ *Ibid* para. 55

It was held by AG Maduro that there is no obligation to run a business in such a way as to maximise tax revenue for the State. On the contrary, he pointed out, the basic principle is that of the freedom to opt for the least taxed route to conduct business in order to minimise costs.¹¹⁷ The Court reiterated this, concluding that 'taxpayers may choose to structure their business so as to limit their tax liability'¹¹⁸. Thereby, seemingly influenced by *Centros*, affirming that not all legal circumvention is abusive, hence the need of an assessment systematic.

Neither *Elmsland* nor *Halifax* concerned the right of establishment for legal persons, but introduced findings of abuse of rights to be applied more widely, especially in the *Cadbury* case. It is in this aspect, as identifying core elements of a Union concept of abuse of law to be used across different areas of Union law, that *Emsland* and *Halifax* is to be appreciated.

3.2.4 Relation between regulatory arbitrage and abuse of rights

It has been observed by commentators that there is a tension between market integration and regulatory arbitrage on the one hand and between legal integration and national doctrines on abuse of rights on the other.¹¹⁹

It has been claimed that since avoidance legislation is defined in accordance to the fundamental freedoms, these, more often than not, entail that an arrangement carried out in the exercise of such freedoms shall not be considered avoidance. The freedoms is thus alleged to often constitute a sort of 'saving clause' with regard to suggested avoidance – or abuse.¹²⁰

Centros proves an interesting example of this tension, through its inherent polarisation of arguments – either in favour of regulatory arbitrage or abuse of the right of establishment. On the one hand it was argued that the registration process demanded by Danish authorities, violated the freedom of establishment and right to regulatory arbitrage – derived from the regulatory competition rationale behind the Treaty provision. On the other hand it was argued, by the Danish authorities and its instigators, that the sole purpose with the incorporation under British law and registration of a branch was to circumvent Danish law, thus, constituting an abuse of the

¹¹⁷ Advocate General Maduro's Opinion, 7 April 2005, Case C-255/02 *Halifax plc*, *Leeds Permanent Development Services Ltd*, *County Wide Property Investments Ltd*, v. *Commissioners of Customs & Excise* [2006] ECR I-1609, para. 85

¹¹⁸ Case C-255/02 *Halifax plc*, *Leeds Permanent Development Services Ltd*, *County Wide Property Investments Ltd*, v. *Commissioners of Customs & Excise* [2006] ECR I-1609, paras. 73

¹¹⁹ P. Schammo, op. cit. p. 360

¹²⁰ V. Ruiz Almendral, 'Tax Avoidance and the European Court of Justice: What is at Stake for European General Anti-Avoidance Rules?' 33 *Intertax* (2005) p. 562, at pp. 576-77

right. ECJ hereby decided on preference for market integration over establishing an abuse of rights doctrine.¹²¹

Regulatory arbitrage and abuse of rights can be described as being situated on opposite ends, explaining the legal tension and challenge to reconcile these doctrines in a coherent way. To understand the magnitude of the challenge it is worth derive the two doctrines from their ideological domicile. While regulatory arbitrage is associated with theories of regulatory – and tax – competition, thus have affinities with liberal *laissez faire* views, the latter is a legal doctrine especially common in Continental Europe, by tradition opposed to *laissez faire*.¹²²

Those national differences are worthwhile to note in this sense. It is traditionally accepted that each legal system may draw the boundary between legitimate and illegitimate forms of regulatory arbitrage according to its own criterias. Accordingly, in terms of doing so – and stifle, what is considered to be, abuse of rights – legal systems have choosed different methods. Some legal systems have developed fully-fledged and generic doctrines on abuse of rights, while other legal systems have solved this with specific anti-avoidance provisions targeting certain conducts.¹²³

All in all, this creates the delicate situation for the ECJ to carve out a coherent and unitary method of defining the relationship between regulatory arbitrage and abuse of rights, in terms of EU law. Of particular interest for the purpose of this thesis, is this clarification in relation to the right of establishment for legal persons as established by Article 49 TFEU.

This fundamental question have elegantly been formulated as, 'whether, and if so, in which cases, there can be "circumvention" without "abuse of rights" in the exercise of fundamental freedoms involving U-[turn] transactions'.¹²⁴

The transaction behind the catchphrase 'U-turn transactions' is familiar by now. Generally, it is situations where a legal person (or eg., goods, for the purpose of the other fundamental freedoms) move from one Member State to another, although the final destination of the transaction is the original Member State. Its *modus operandi* is the exercise of a right conferred by Union law, the right of free movement, to circumvent the national law of a Member State.¹²⁵

¹²¹ P. Schammo, op. cit. p. 360

¹²² *Ibid* p. 352

¹²³ *Ibid* p. 352

¹²⁴ L. Cerioni, op. cit. p. 789

¹²⁵ R. de la Feria, op. cit. *supra* 32 p. 399

4 *Cadbury* and its aftermath

The *Cadbury* case is of high-relevance since it judicially reconcile the concepts introduced in previous chapter. Through the case the ECJ introduces its *abuse of right* doctrine, as established in *Emsland* and *Halifax*, – denoted as ‘wholly artificial arrangement’ – to a situation of freedom of establishment for legal persons. The Court clearly does this in the ambition of still being coherent with the *Centros* and *Inspire Art* rulings.

4.1 The *Cadbury* judgment

The *Cadbury* case can be described as concerning tax arbitrage, and as such it has gained a lot of attention from tax lawyers. But underlying the tax dimensions of the case, the Court also examines the right of establishment of legal persons in terms of regulatory arbitrage. Despite essentially being a case regarding *tax arbitrage*, it was decided on the basis of the right of establishment for legal persons. And its valuable contribution to *de lege lata* is ECJ’s specification on the purpose behind the right to establishment, and how to juxtaposition that to the conditions in the specific case, in regards to claimed abuse of rights.

4.1.1 Background

The UK company Cadbury Schweppes had set up two subsidiaries in the International Financial Services Center in Dublin, Ireland. The business of the subsidiaries was to raise and provide finance to companies within the Cadbury Schweppes Group. The subsidiaries profit were taxed at the Irish corporate tax rate, which was substantially lower than the applicable UK rate. The UK tax authorities applied the national CFC legislation to the Irish subsidiaries, claiming over £8.5 million in corporation tax. This decision was appealed by the subsidiaries and referred to the ECJ.¹²⁶

The ECJ was, *inter alia*, asked whether the right of establishment precluded the application of CFC legislation. Ie., the question was whether such legislation was a restriction, and if so, whether it was justified. The ECJ examined this question by drawing on its findings in *Centros* and *Inspire Art* and its more developed abuse of rights doctrine found in *Emsland* and *Halifax*.

¹²⁶ ECJ, Case C-196/04, *Cadbury Schweppes plc, Cadbury Schweppes Overseas Ltd v Commission of Inland Revenue* [2006] ECR I-7995

4.1.2 Assessment of Advocate General

In his opinion AG Léger presented – and substantively embraced - three criteria, put forward by the United Kingdom and the Commission, for the assessment of whether there are a 'wholly artificial arrangement', intended to circumvent national tax legislation. Thus, establishing criterias for determining when there is an 'wholly artificial arrangement' aiming to circumvent home Member State taxation.

First, the degree of physical presence of the subsidiary in the host Member State. Second, the genuine nature of the activity provided by the subsidiary. And finally, the economic value of that activity with regard to the parent company and the entire group.¹²⁷

The first criteria relates to whether the subsidiary is genuinely established in the host Member State. It means assessing whether the subsidiary has the premises, staff and equipment necessary to carry out the services provided to the parent company.

The second criteria relates to the genuine nature provided by the subsidiary. It is a question about looking at the competence of the subsidiary's staff in relations to the services provided and the level of decision-making in carrying out those services.

The third criterion, relates to the value added by the subsidiary's activity. This criteria most clearly relates to the tax dimension of the case, since it aims at transfers of profits from the parent company to the subsidiary in order to evade taxes. The relevance of the criteria is that it makes it possible to take account of an objective situation in which the services provided by the subsidiary have no economic substance in the light of the parent company's activity.

AG Léger continued to clearly state that the motives for establishing a subsidiary and for the choice of country in which to establish it cannot constitute a relevant criterion leading to a 'wholly artificial arrangement'. In other words – recognising the position taken in *Centros* – a parent company's purpose of attaining a reduction of its taxation in its state of origin, cannot infer the existence of a 'wholly artificial arrangement'. The subjective reasons for which an economic operator has exercised the rights conferred on him by the Treaty cannot call in question the protection it derives from those rights once the objective pursued by them is fulfilled.¹²⁸

¹²⁷ Advocate General Léger Opinion, 2 May 2006, Case C-196/04, *Cadbury Schweppes plc, Cadbury Schweppes Overseas Ltd v Commission of Inland Revenue* [2006] ECR I-7995 paras. 111-114

¹²⁸ *Ibid* paras. 115-116

4.1.3 Method

In its decision ECJ sets out the parameters along which the assessment should be conducted by the national courts of whether the national restriction, or regime, infringes the freedom of establishment.

According to the judgment, if the CFC rules are too general in its application they are violating the freedom of establishment. Hence, they must be aimed specifically against 'wholly artificial arrangements' aimed at circumventing national tax normally payable. Therefore it is of importance to clarify the difference between use and abuse of establishment.¹²⁹

What distinguishes the *Cadbury Schweppes* case from others, where 'wholly artificial arrangements' are deemed to fall outside of the freedom of establishment, is that the Court in that case, to a further extent delivers a criteria to define it from.

Cadbury resembles *Centros* et al in that it concerns right of establishment. Despite this, it followed *Emsland* and *Halifax*, in the ambitious and structured setting out of a fuller test on abuse of rights.

Thus, in its exploration of the (potential) limit of the right of establishment for legal persons under Article 54 TFEU, the ECJ confided to the two-pronged test established in *Emsland* and elaborated in *Halifax*.¹³⁰ But this was done in a rather fragmented way, and not by straight-forward presenting the methodology.

The ECJ begins with an exposition on the general applicability of the freedom of establishment – the ECJ concludes that *Cadbury* was established in Ireland for the purpose of benefitting from more favourable legislation does not in itself suffice to constitute abuse of that freedom.¹³¹ The inherent strength of the Treaty right was thus confirmed by ECJ; it is not the Company's right to reliance on the Treaty provision that is to be assessed but instead the Member State's right to restrict that right.

ECJ continued to assess whether the national restriction was compatible with the Treaty provisions, providing freedom of establishment¹³². This evaluation goes in line with previous case law, establishing that 'a national measure restricting freedom of establishment may be justified where it specifically relates to *wholly artificial arrangements* aimed at circumventing the application of the legislation of the Member State concerned' (emphasis added)¹³³.

¹²⁹ ECJ, Case C-196/04, *Cadbury Schweppes plc, Cadbury Schweppes Overseas Ltd v Commission of Inland Revenue* [2006] ECR I-7995 para. 47

¹³⁰ *Ibid* para. 64

¹³¹ *Ibid* para. 37

¹³² *Ibid* para. 39

¹³³ *Ibid* para. 51

The introduction of the concept of 'wholly artificial arrangement' into the assessment, proves the challenging part. Here the ECJ created the innovative vein of the *Cadbury* case; the assessment of the 'wholly artificial arrangement'.

It is appropriate to clarify, that the formula 'wholly artificial arrangement' is a linguistic reproduction of that of the abuse of rights doctrine¹³⁴. It is simply a formulation used for the abuse of rights doctrine in tax cases. The result for the purpose of the *Cadbury* case – and subsequent case law - was that if the regulatory arbitrage involved the setting up of a 'wholly artificial arrangement', a carefully circumscribed national measure could be justified on the grounds of abuse prevention¹³⁵.

4.1.3.1 Objective approach

In accordance with *Emsland* and *Halifax* the objective element consists of a teleologic interpretation of the provision at hand. The rationale is to examine whether there are circumstances showing that, despite formal observance of the conditions laid down in Union law, the objective pursued by freedom of establishment has not been achieved.¹³⁶

In order to find out whether there were a wholly artificial arrangement, the ECJ returned to its teleological deconstruction of the right of establishment. It first concluded:

*'That objective is to allow a national of a Member State to set up a secondary establishment in another Member State to carry on his activities there and thus assist economic and social interpenetration within the Community in the sphere of activities as self-employed persons. To that end, freedom of establishment is intended to allow a Community national to participate, on a stable and continuing basis, in the economic life of a Member State other than his State of origin and to profit therefrom.'*¹³⁷

Hence, the first segment revived the definition famously set down in the *Reyners* case¹³⁸ and in the second segment the same was done with the definition set down in the *Gebhard* case¹³⁹. Based on this the ECJ further concluded:

'Having regard to that objective of integration in the host Member State, the concept of establishment within the meaning of the Treaty

¹³⁴ Advocate General Legér's Opinion, 2 May 2006, Case C-196/04, *Cadbury Schweppes plc, Cadbury Schweppes Overseas Ltd v Commission of Inland Revenue* [2006] ECR I-7995 para. 88

¹³⁵ P. Schammo, op. cit. p. 365

¹³⁶ ECJ, Case C-196/04, *Cadbury Schweppes plc, Cadbury Schweppes Overseas Ltd v Commission of Inland Revenue* [2006] ECR I-7995 para. 64

¹³⁷ *Ibid* para. 53

¹³⁸ Case, ECJ 2/74 *Reyners v Belgian State* [1974] ECR 631, para. 21

¹³⁹ ECJ, Case C-55/94, *Gebhard* [1995] ECR I-4165, para. 25

provisions on freedom of establishment involves the actual pursuit of an economic activity through a fixed establishment in that State for an indefinite period. Consequently, it presupposes actual establishment of the company concerned in the host Member State and the pursuit of genuine economic activity there.

*It follows that, in order for a restriction on the freedom of establishment to be justified on the ground of prevention of abusive practices, the specific objective of such a restriction must be to prevent conduct involving the creation of wholly artificial arrangements which do not reflect economic reality, with a view to escaping the tax normally due on the profits generated by activities carried out on national territory.*¹⁴⁰

Thus, in order to examine the actual existence of a 'wholly artificial arrangement', it concluded – reviving the systematic established in the *Emsland-Stärke*¹⁴¹ and *Halifax*¹⁴² cases:

*'In order to find that there is such an arrangement there must be, in addition to a subjective element consisting in the intention to obtain a tax advantage, objective circumstances showing that, despite formal observance of the conditions laid down by Community law, the objective pursued by freedom of establishment, as set out in paragraphs 54 and 55 of this judgment, has not been achieved.'*¹⁴³

In its teleological dissection of the Treaty objectives, the Court further elaborated on the pursued purpose behind the provisions, stating that Articles 49 and 54 TFEU is to assist economic and social interpenetration within the Union.¹⁴⁴

These objectives were investigated in the teleological assessment, as being integration in the host Member State involving 'the actual pursuit of an economic activity through a fixed establishment in that State for an indefinite period', presupposing:

- (i) actual establishment of the company concerned; and,
- (ii) pursuit of genuine economic activity there.¹⁴⁵

¹⁴⁰ ECJ, Case C-196/04, *Cadbury Schweppes plc, Cadbury Schweppes Overseas Ltd v Commission of Inland Revenue* [2006] ECR I-7995 paras. 54-55

¹⁴¹ ECJ, Case C-110/99 *Emsland-Stärke v Hauptzollamt Hamburg-Jonas* [2000] ECR I-11569, paras. 52-53

¹⁴² ECJ, Case C-255/02 *Halifax plc, Leeds Permanent Development Services Ltd, County Wide Property Investments Ltd, v. Commissioners of Customs & Excise* [2006] ECR I-1609, paras. 74-75

¹⁴³ ECJ, Case C-196/04, *Cadbury Schweppes plc, Cadbury Schweppes Overseas Ltd v Commission of Inland Revenue* [2006] ECR I-7995 para. 64

¹⁴⁴ *Ibid* para. 53

¹⁴⁵ *Ibid* para. 54

ECJ went on to conclude that were the objectives behind the provision is met – ie., were the incorporation of a CLC reflects economic reality – home Member State national law must be excluded from application.¹⁴⁶

The finding of such economic reality must be based on objective factors which are ascertainable by third parties. ECJ in particular drew attention to the extent of the physical existence of the second establishment – in terms of premises, staff and equipment.¹⁴⁷

This led the Court to promptly and specifically rule out 'letterbox' or 'front' subsidiaries, which thus, do not carry out any economic activity in the host Member State.¹⁴⁸

Remarkably the ECJ made a reference to the presentation of evidence, stressing that the company concerned must be given the opportunity to present evidence that the establishment is real and the activity in the host Member State is genuine. This leastwise suggests that the company is not without burden of evidence.¹⁴⁹

4.1.3.2 Subjective assessment

Despite its importance for the two-pronged test and in contrast with the objective element, the subjective element was rather summarily processed by the ECJ.

It was defined as 'consisting in the intention to obtain a tax advantage'¹⁵⁰.

The Court continued to establish that there must be an intention to carry on genuine economic activities in the host Member State¹⁵¹. This constitutes guidance when assessing the subjective element, since it establishes a reasonably objective criteria to build a methodology upon.

4.1.4 Context of the case

Even though it is clearly stated in the delimitation of this thesis that the purpose is not to evaluate the *material* consequences of impeded or accepted regulatory arbitrage based on the right of establishment, it is highly relevant to analyse the very context of the *Cadbury* case. As described the case furthered ECJ's intervention in taxation, generally regarded as extremely sensitive area for the Member States.¹⁵²

¹⁴⁶ *Ibid* paras. 65

¹⁴⁷ *Ibid* paras. 65-66

¹⁴⁸ *Ibid* para. 68

¹⁴⁹ *Ibid* para. 70

¹⁵⁰ *Ibid* para. 64

¹⁵¹ *Ibid* para. 66

¹⁵² R. de la Feria, op. cit. *supra* 32 p. 397

The case examined the British CFC legislation. CFC legislation stands for *Controlled Foreign Company*, and such legislation aims at a company's accumulation of profits and incomes abroad. Broadly speaking, such legislation is an anti-abuse measure aimed at preventing the diversion of capital to low-tax jurisdictions.¹⁵³

The Court concluded that such legislation result in a disadvantage for resident companies having a subsidiary in another Member State, thus hindering the freedom of establishment by such companies. Such a restriction is permissible only if it is justified by overriding reasons of public interest, and is proportionate.¹⁵⁴ This was further elaborated by the Court as meaning that it must be 'determined whether the restriction on freedom of establishment arising from the legislation on CFCs may be *justified on the ground of prevention of wholly artificial arrangements* and, if so, whether it is proportionate in relation to that objective' (emphasis added)¹⁵⁵.

A simple comparison with the *Centros* case give at hand, that while in *Centros* the intention was to circumvent the Danish *company* law, in *Cadbury* the intention was to circumvent the British *tax* law.

This proves a highly relevant difference in the teleological interpretation of the ECJ. In the *Centros* case the teleological reasoning led ECJ to conclude that the (non-disputed) regulatory arbitrage was a mere consequence of the right of establishment. The ECJ decided to not impede the reliance on right of establishment, even though the British limited company *Centros* was set up as a mere vehicle for the sole purpose of regulatory arbitrage against the Danish company law. Danish attempts to address this regulatory arbitrage was dismissed.

The teleological deduction in *Cadbury* on the other hand, led the ECJ to conclude that regulatory arbitrage – perhaps more stringently denominated here as *tax* arbitrage – lacking exercise of genuine economic activity in the host Member State, could legitimately be addressed and hampered through home Member State legislation.

Importantly, the ECJ did not conclude in its verdict whether Cadbury Schweppes' Ireland-based entities lacked such exercise of genuine economic criteria. Rather it set down the criteria for how to assess this, and left it for the discretion of the national court to decide.

¹⁵³ *Ibid* p. 425

¹⁵⁴ ECJ, Case C-196/04, *Cadbury Schweppes plc, Cadbury Schweppes Overseas Ltd v Commission of Inland Revenue* [2006] ECR I-7995 paras. 46-47

¹⁵⁵ *Ibid* para. 57

4.2 The Epilogue: Reception of *Cadbury* in the Doctrine

It has been claimed that the most striking feature in the treatment of regulatory mobility resides in inconstancy: in some cases, regulatory mobility is impeded (*Cadbury, Van Binsbergen, Halifax, Emsland*), in others it is facilitated (*Centros, Inspire Art, Cartesio*).¹⁵⁶

The seemingly conceptual confusion that ECJ's opinion – as presented so far in this thesis – may give rise to, is perhaps somewhat curated if taking into consideration an explanation introduced in the legal doctrine of the concept of 'wholly artificial arrangement'. The explanation claims that the formulation is nothing else than an attempt to give flesh to the abuse of rights doctrine in tax cases.¹⁵⁷

The teleological approach, that is fundamental for the ECJ's conclusions, can also be criticized for its intrinsic properties. It could be claimed that such an approach means ignoring the letter of the law – being an extreme form of jurisdictional discretion. The method involves both an element of evaluation, but also an element of construction. This discretion, intended to satisfy the preference of the legislature, quickly grows and risks depart from the prospective objectives.¹⁵⁸

Cadbury shows that a 'U-turn transaction' involving the setting up of a subsidiary, by a national of the home Member State, in the host Member State but mainly directed towards the home Member State is not abusive circumvention if it is not 'wholly artificial', i.e., if the subsidiary does not carry out some genuine economic activity in the host Member State.¹⁵⁹

4.2.1 Dubious nature of the subjective element

The methodology used by the ECJ in *Cadbury* explicitly relies on the systematic used by ECJ in *Emsland* and subsequently *Halifax*¹⁶⁰. It is claimed though, in the doctrine that those cases approached abuse in a different manner, meaning that the method in *Cadbury* is faulty and dubious in terms of the subjective element.¹⁶¹

The reasoning behind this is largely based on changes in linguistic, which is apparent in a comparison of the three cases:

¹⁵⁶ A. Saydé, op. cit. p.17

¹⁵⁷ P. Schammo, op. cit. p. 366

¹⁵⁸ *Ibid* pp. 372-73

¹⁵⁹ L. Cerioni, op. cit. p. 795

¹⁶⁰ ECJ, Case C-196/04, *Cadbury Schweppes plc, Cadbury Schweppes Overseas Ltd v Commission of Inland Revenue* [2006] ECR I-7995 para. 64

¹⁶¹ P. Schammo, op. cit. p. 366

- (i) In *Emsland* the subjective element was defined as consisting of 'the *intention* to obtain an advantage by creating *artificially* the conditions laid down to obtain it' (emphasis added)¹⁶².
- (ii) In *Halifax* – after AG Maduro's mentioned uneasiness with the subjective element, as it was laid down in *Emsland*, the subjective element was defined as whether 'the essential *aim* of the transactions concerned is to [apparent from a number of objective factors] obtain a tax advantage' (emphasis added)¹⁶³.
- (iii) In *Cadbury* the subjective element was defined as 'consisting in the *intention* to obtain a tax advantage' (emphasis added)¹⁶⁴.

Even though there is a conceptual stringence, there are subtleties that potentially dilute the content of the stipulations. While *Emsland* and *Cadbury* speaks of *intention* to obtain an advantage, *Halifax* is concerned with the [objectively defined] *aim* of the transaction. Already after its introduction in *Emsland* the subjective element received criticism, seemingly causing the adjustments made to it in *Halifax* – but then again reversed in *Cadbury*¹⁶⁵.

The intention behind the potentially abusive situation, were – at least up until *Cadbury* – a disputed element of a functioning abuse doctrine. One of the supporting arguments for those criticizing the element as such, was that it can only be proved with reference to the rest of the objective elements anyway¹⁶⁶. Hence, a position resembling the formulation in *Halifax*. Under this system, the second element in the assessment of abuse, often referred to as the *subjective* element, is in fact an objective estimation of the result of the conduct. This element is then purely instrumental to the objectives established through the first element.

There are claims that there is a substantial difference in *intention to obtain something* and the *aim of the transaction*. Intention is then understood as the purpose or aim of a person, thus being really subjective considerations. *Aim of a transaction* on the other hand, is understood as objective considerations.¹⁶⁷

Nota bene, this criticism resembles that of AG Legér¹⁶⁸, reasoning that the subjective reasons for which an economic operator has exercised the rights

¹⁶² ECJ, Case C-110/99 *Emsland-Stärke v Hauptzollamt Hamburg-Jonas* [2000] ECR I-11569, para. 53

¹⁶³ ECJ, Case C-255/02 *Halifax plc, Leeds Permanent Development Services Ltd, County Wide Property Investments Ltd, v. Commissioners of Customs & Excise* [2006] ECR I-1609, para. 75

¹⁶⁴ ECJ, Case C-196/04, *Cadbury Schweppes plc, Cadbury Schweppes Overseas Ltd v Commission of Inland Revenue* [2006] ECR I-7995 para. 64

¹⁶⁵ R. de la Feria, op. cit. *supra* 32 p. 410

¹⁶⁶ V. Ruiz Almendral, op. cit. p. 567

¹⁶⁷ P. Schammo, op. cit. p. 368

¹⁶⁸ See 4.1.2.

conferred by the Treaties cannot call into question the protection of these very rights.

4.2.2 General principle of EU law or principle of interpretation?

This way of reasoning have led commentators to conclude that, when the exercise of fundamental freedoms is at stake, it might actually not be a general principle of abuse of law that are applied, but simply a consequence – the lack of protection under EU law for wholly artificial arrangements/abuse of law. Based on this rather radical logic, there is instead an application of the 'rule of reason test', as present in the EU case law since the landmark *Cassis de Dijon*¹⁶⁹ ruling. Accordingly, while there is a *general principle of EU law* of abuse of law – as established in *Emsland* – for access to secondary benefits provided by EU law, in the case of resort to the fundamental freedoms the prohibition on abuse would only be a *principle of interpretation*.¹⁷⁰

This distinction between general principle of EU law and principle of interpretation, is relevant, since the distinguishing features of the general principles of EU law lies in their ability to act as overriding rules of law, reflecting underlying overriding concerns. This feature, in addition to their gapfilling and interpretative role, means that general principles of EU law as such stands on its own merits and is not dependent of a national provision.¹⁷¹

Whether the abuse of right doctrine is such a general principle of law or principle of interpretation, is to a large extent a theoretical question, as general principles of Union law also acts as interpretative for the purpose of Union legal matters¹⁷². Still, the importance has been claimed by those focusing on the lack of *abuse* doctrines in certain Member State – for example Sweden -, in such situations a general principle would provide those Member States with authority to combat abuse despite the lack of national measures¹⁷³.

But in *Cadbury* it was the other feature of a general principle of EU law, that was prominent. The principles of prohibition on abuse of law, was used to strike down a national legal provision on the basis that it did not comply with the Union abuse of law concept. This has been considered in the doctrine as a confirmation that the abuse of law doctrine is to be regarded as a instrumental general principle of EU law, generally applicable through EU

¹⁶⁹ ECJ, Case 120/78 *Rewe-Central AG v Bundesmonopolverwaltung für Branntwein* [1979] ECR 00649

¹⁷⁰ L. Cerioni, op. cit. pp. 802-03

¹⁷¹ *Ibid* p. 806

¹⁷² See 3.2.2.

¹⁷³ K.E. Sørensen, 'Abuse of Rights in Community Law: A Principle of Substance or Merely Rhetoric?' 43 *CMLR* (2006) p. 423, at p. 440

law. Thus, one of the substantial legal contributions from *Cadbury* is that all national measures falling within the scope of EU law, must conform with the abuse of law doctrine.¹⁷⁴

4.3 Subsequent case law

This thesis focuses on capturing the legal essence presented by the *Cadbury* case. Elaboration, re-interpretation and adaptation is constantly changing EU case law. The legal positions laid down in *Cadbury* - and presequent case law - is surely not escaping this. In theory, a changed doctrine on the subject can therefore not be precluded. Nonetheless, the ECJ have worked to elaborate on the approach presented in *Cadbury*.

4.3.1.1 *Thin Cap Group Litigation: Opportunity to repeal finding of wholly artificial arrangement*

This case concerned the compatibility, with the right of establishment, of UK anti-tax avoidance legislation aimed at the concept of thin capitalization. Thin capitalization is basically a way of financing a company by means of loans in preference to equity. The loan repayment is then deductible from taxable profits, whereas distribution of profits are subject to corporation tax. Thin capitalization is therefore a way of evading tax.¹⁷⁵

The ECJ reiterated its ruling in *Cadbury*, concluding that a national measure restricting freedom of establishment might be justified where it specifically targets wholly artificial arrangements.¹⁷⁶

But the Court went on to conclude that for such a legislation to be justified it must provide opportunities for the company to verify the commercial reasons behind the transaction, repealing the finding of a wholly artificial arrangement:

*'... [such restrictive legislation must provide] for a consideration of objective and verifiable elements which make it possible to identify the existence of a purely artificial arrangement, entered into for tax reasons alone, and allows taxpayers to produce, if appropriate and without being subject to undue administrative constraints, evidence as to the commercial justification for the transaction in question ...'*¹⁷⁷

This implies that for national measures restricting the fundamental freedoms, with reference to abuse of rights, to be justified, such measures

¹⁷⁴ R. de la Feria, op. cit. *supra* 32 p. 438

¹⁷⁵ ECJ, Case C- 524/04 *Thin Cap Group Litigation v Commissioners of Inland Revenue* [2007] ECR I-2107 para. 76

¹⁷⁶ *Ibid* para. 72

¹⁷⁷ *Ibid* para. 92

must allow for the subject, to show that there are actually commercial reasons behind the transaction, and thereby repeal the finding of a wholly artificial arrangement.

4.3.1.2 Lammer & Van Cleeffs: No general assumption of abuse

In *Lammer & Van Cleeffs* the ECJ further elaborated on the economic aspects of 'wholly artificial arrangements'. Belgian tax authorities applied a national anti-abuse provision, reclassifying interest paid by a Belgian subsidiary on funds lent by the parent company, established in another Member State, as taxable dividends. This introduced a different treatment between resident subsidiaries depending on whether their parent company was established in Belgium or not. ECJ regarded this differential treatment as a restriction on the right of establishment. The question was thus whether the financial arrangement by the company, constituted 'wholly artificial arrangement', making the restriction justifiable.¹⁷⁸

In the case the ECJ made clear that a national legislation restricting the freedom of establishment, cannot operate 'a general presumption of abusive practices and justify a measure that which compromises the exercise of a fundamental freedom'¹⁷⁹.

4.3.1.3 ING. AUER: Reconciling rights and abuse

As presented throughout this thesis, there is an intrinsic conflict between the abuse of right doctrine and the right to effectuate regulatory arbitrage, ie., adapt ones conduct. E.g., despite tax legislation being a *neutral* regime – not intended to alter the ordinary course of conducts – persons have the right to minimize their tax liability. The ECJ have therefore repeatedly confirmed that the ambition to benefit from a more favourable legislation does not in itself suffice to abuse¹⁸⁰.

In *ING. AUER* the ECJ merged this position, with the subjective and objective element of the abuse doctrine:

'The protection afforded by Community law does not therefore apply to situations in which a natural or legal person intends to rely abusively or fraudulently on Community provisions with the sole aim of putting itself out of reach of the legislation of a Member State.

The fact that a company has been created in a particular Member State in order to benefit from more favourable legislation is not, of itself, sufficient to support the finding that a misuse of Community legislation has occurred.

¹⁷⁸ ECJ, Case C-105/07 *Lammer & Van Cleeffs NV v Belgische Staat* [2008] ECR I-173

¹⁷⁹ *Ibid* para. 27

¹⁸⁰ ECJ, Case C-196/04, *Cadbury Schweppes plc, Cadbury Schweppes Overseas Ltd v Commission of Inland Revenue* [2006] ECR I-7995 para. 36-38

*Nevertheless, the formation of a company in a Member State under wholly artificial arrangements which do not reflect economic reality, with the aim of avoiding the tax normally payable, goes beyond the protection which Directive 69/335 must afford to the companies to which it applies*¹⁸¹

4.4 The Concept of 'Wholly Artificial Arrangements' in practice

It has been suggested that what *Cadbury* actually introduces is the notion of a limit to regulatory arbitrage, or at least *tax* arbitrage, with the intention of circumventing the financial interest of a Member State - an interpretation amplified by the subsequent *Lammer* case. Here the abusive practices coincide with the 'wholly artificial arrangement', and if the outcome is prejudicing the financial interests of a Member State, without a corresponding economic activity, the arrangement is to be deemed abusive and illegitimate.¹⁸²

Under the same logic the rulings in *Centros* and *Inspire Art* is reconciled with *Cadbury*. The reasoning is that what ECJ does in the former is simply to define in *positive* terms what regulatory arbitrage that is allowed, consequently specifying that it is allowed as long as it does not cause a prejudice to third parties protection.

On the other hand, *Cadbury* defined in *negative* terms indicating when the regulatory arbitrage is not allowed – defining the 'wholly artificial arrangement' as the absence of genuine economic activity in the host Member State. Further, concluding for tax cases, that the arbitrage is not allowed when the only outcome is a prejudice to the financial interests of the home Member State.¹⁸³

This specification of a *negative* delimitation of the legitimate regulatory arbitrage, undoubtly narrow down the broad *positive* scope set out in *Centros* and *Inspire Art*, while at the same time linking together more stringently the concept of wholly artificial arrangement and abuse of law. In *Centros* and *Inspire Art* the artificiality was not comprised when assessing the existence of abuse. In *Cadbury* the rather well-defined concept of artificiality is considered as closely related to abuse.¹⁸⁴

¹⁸¹ ECJ, Case C-251/06 *Firma ING. AUER – Die Bausoftware GMBh v Finanzamt Freistadt Rohrbach Urfaehr* [2007] ECR I-9689 paras. 42-44

¹⁸² L. Cerioni, op. cit. p. 796

¹⁸³ *Ibid* p. 796

¹⁸⁴ R. de la Feria, op. cit. *supra* 32 p. 428

4.4.1 Assessment of a 'wholly artificial arrangement'

It has been concluded by the Court that the assessment of whether there is a wholly artificial arrangement must entail a case-by-case examination¹⁸⁵.

The assessment of the wholly artificial arrangement, is done through examination of whether the arrangement 'reflect economic reality'¹⁸⁶. It goes without saying that such an assessment becomes a matter of circular reasoning. For when examining a potential artificial arrangement, it must be analysed whether there were other reasons for its adoption - ie., whether it reflects economic reality or is entirely fictitious.¹⁸⁷

ECJ concludes that were an incorporation reflects economic reality, restricting legislation must be excluded, despite existence of other circumventing motives¹⁸⁸. This must be construed as a factor widely limiting the importance, and existence, of wholly artificial arrangements. Economic reality exterminate *wholly* out of 'wholly artificial arrangement' - thereby depriving it of a fundamental criteria.

Another way of describing this – from the other perspective – is that, as the purpose of the right of establishment is to make possible a genuine economic interpenetration of the internal market, a wholly artificial arrangement that does not lead to this integration cannot benefit from the right of establishment.¹⁸⁹

4.5 Implications due to the combination of objective and subjective element

In the pre-'wholly artificial arrangement' case law, the ECJ submitted itself to focus on an objective evaluation on the use of rights. That is, it did a teleological interpretation of the right to establishment, which was the foundation for the generous application in cases like *Centros* and *Inspire Art*.

With its reasoning in *Cadbury Schweppes* the ECJ stringently follows through on its logic established on abuse of rights in *Emsland* and *Halifax*. In practice this opens up for a more subjective evaluation of the use of right

¹⁸⁵ ECJ, Case C-196/04, *Cadbury Schweppes plc, Cadbury Schweppes Overseas Ltd v Commission of Inland Revenue* [2006] ECR I-7995 para. 110

¹⁸⁶ *Ibid* para. 65

¹⁸⁷ V. Ruiz Almendral, op. cit. p. 566

¹⁸⁸ ECJ, Case C-196/04, *Cadbury Schweppes plc, Cadbury Schweppes Overseas Ltd v Commission of Inland Revenue* [2006] ECR I-7995 para. 65

¹⁸⁹ L. Cerioni, op. cit. p. 802

of establishment. As described above, it is unclear whether the actual content of the subjective element is coherent, throughout the case law¹⁹⁰.

It has been claimed – as previously described - that the second – *subjective* - element must be instrumental to the first element. Meaning that the second element must only aim at determining whether the objectives of EU law, which the ECJ will seek to discover through the teleological examination, have been satisfied or not.¹⁹¹

Instead the ECJ, with its formulation in *Cadbury* seems to have established the second element, as a purely subjective element, assessing the *intention* behind the regulatory arbitrage. That is, *not* an objective assessment of whether there are other economic explanations behind the transaction. To have two such separate standing elements – together combining a teleological assessment and a subjective-intentional assessment – have been criticized¹⁹².

By leaving the safe harbour of the hardcore application of the right stemming from Article 49 TFEU – on the expense of single Member States' incorporation authority – the CJEU (unintentionally) opens up for a more *ad hoc* application. The objective - *teleological* - stand was instrumental and consistent. The introduction of a more subjective evaluation could lead to contradictions and threaten the principle of unitary application.

It should also be observed that even the objective element as such, have been described as the most abstruse element of the abuse doctrine. Thus implying that both the elements of the two-pronged test to assess abuse of a right are controversial within the legal scholarship.¹⁹³

¹⁹⁰ See 4.2.1.

¹⁹¹ P. Schammo, op. cit. p. 369

¹⁹² *Ibid* p. 369

¹⁹³ A. Saydé, op. cit. p.5

5 Current state of law: Abuse of right of establishment for legal persons

A comprehension of the current situation for abuse of right of establishment for legal persons, must begin in the modest finding, that the ECJ's approach to abuse of rights shows an evolving approach, progressively developing a doctrine, while emphasizing the importance of case-by-case analysis.¹⁹⁴

Centros could fairly be considered as the landmark case on regulatory arbitrage based on right of establishment for legal persons. What prompted the ECJ to renew its approach in this case – thus altering both the attitude towards the fundamental freedom as such, but also to the evolved abuse of rights doctrine – has been a matter of debate. It has been noted that the simple explanation might simply be a better and more fully fledged understanding of the abuse phenomena, making the driving rationale behind the shift a purely legal nature. Yet another explanation have been raised, namely that of a policy-driven judicial activism. The rationale is that the shift is to be seen as a revitalization of the Court's interventionist approach as regards internal market issues – a further push towards European economic integration.¹⁹⁵

In any case, *Cadbury* marks an ambitious attempt to reconcile its prevailing rulings on freedom of establishment, with the evolving doctrine on abuse of law that *Centros* seemingly had deflected from. As shown in depth in the previous chapter, the controversial aspect of this was mainly to be found in the definition of a subjective assessment.

5.1 Context, Magnitude and Vastness

In the *Centros* and *Inspire Art* cases, regulatory arbitrage with regard to company law was accepted, without practical limitations, by the ECJ. The fact that the entities set up in the home Member State were mere vehicles for arbitrage, pursuing no business activity, did not obstruct the recognition of the arrangements as legitimate.

Importantly, in *Cadbury* tax arbitrage was given a green light by the ECJ, as long as it could be established that the arbitrage involved economic activity in the host Member State. Thus, that the Irish subsidiaries were set up for arbitrage purposes were not abusive or illegitimate, as long as it could be established that they were essentially more than (artificial) vehicles. This

¹⁹⁴ R. de la Feria, op. cit. *supra* 32 pp. 398-99

¹⁹⁵ *Ibid* p. 407

results in a legal equation giving that – in itself legitimate – regulatory arbitrage *plus* a wholly artificial arrangement equal abusive behaviour, justifying restrictions on the right of establishment.

One illustrative method of grasping the context of the abuse doctrine is to imagine the internal market through the idea of positive and negative regulatory magnets¹⁹⁶. While a positive magnet is liable to attract private interest a negative magnet is liable to repulse it. Under this structure, the classical free movement case law seeks to remove negative impacts – by addressing obstacles to free movement. The abuse of right doctrine, on the other hand, strives to restrain the potential impact of positive magnets – by prohibiting artificial regulatory movement, ie., illegitimate regulatory arbitrage.

This legal metaphor, inspired by physical magnetism, can also illustrate the logic behind the objective element, as enounced in *Emsland* and further elaborated in subsequent case law. In terms of regulatory arbitrage and potential abuse, it is the positive magnets that are to be assessed. The objective assessment will thus result in one of two solutions, either to *unleash* or to *restrain* the attraction exerted by such positive magnet.

Reconnecting¹⁹⁷ to the concept of *disruptive* and *neutral* legal regimes, it must be reminded that disruptive regimes aims at altering conduct pre- and post-regulation while neutral regimes should not alter conduct. This indicates the *objective* behind such legislations, and is therefore of relevance for that element in the abuse test.

Under this logic, the provisions – Article 49 TFEU, in relations to company law - in *Centros* were found to be disruptive, thus under the objective assessment considered to function as to unleash the positive legal magnet. In *Cadbury* on the other hand it was found that Article 49 TFEU in relations to tax provisions, fulfilling the *Gebhard criterias*, were neutral, thus considered to function as to restrain the positive legal magnet. The ECJ have thus found national company laws to be disruptive, while national tax law has been found to be neutral.

This logic makes it possible to carefully assess the scope of the abuse doctrine as applied to regulatory arbitrage based on freedom of establishment for legal persons. The ECJ case law aims at impeding artificial regulatory movements – *not* reflecting economic reality – to the extent that these affects neutral legal regimes, eg., if the transaction is devoid of any economic rationale regulatory arbitrage circumventing neutral legal regimes may be impeded. This means that the conduct may be influenced by regulatory considerations, but not to the extent that these are

¹⁹⁶ This concept is inspired by A. Saydé, op. cit.; Saydé in his turn have derived the concept from, *inter alia*, the ECJ case law, see Case, ECJ C-347/00 *Ángel Barreira Pérez v Instituto Nacional de la Seguridad Social (INSS) and Tesorería General de la Seguridad Social (TGSS)* [2002] ECR I-08191, para. 33

¹⁹⁷ See 3.2.1.

in solitude and there is no genuine economic rationale – that is, genuine course of business - behind the secondary establishment.

Such logic also reconciles the *Cadbury* outcome with the reasoning in *Centros* and *Inspire Art*.

5.1.1 Methodology

In the *Centros* case, ECJ began constructing a methodology for evaluating abuse of rights in connection to right of establishment for legal persons. ECJ hence established that national Courts can, on a case-by-case basis, by taking account of 'objective evidence of abuse or fraudulent conduct' deny persons the benefit of the provisions of Union law on which they seek to rely. The conduct must be assessed in the light of the objectives pursued by the provision.¹⁹⁸

It is worth pointing out that *Centros* is consistent with the newer findings in *Cadbury*, in the sense that the *Centros* subsidiary would *not* have qualified as 'wholly artificial arrangement', due to the genuine economic activity of the subsidiary.¹⁹⁹

The substantive part of the case-by-case assessment – consistent from *Centros* to *Cadbury* – is the objective evaluation of the underlying purpose of the provision.

5.1.1.1 Teleological interpretation

As has been identified several times already, the complicated intersection in the assessment of usage of rights based on Article 49 TFEU, is between regulatory arbitrage and abuse of rights. And the role of defining the legal relationship between these two extremes is on the ECJ.

ECJ has thus established a methodic way of assessing the legal situation through a teleological interpretation of the legal sources (e.g., TFEU). Of high relevance is, thus, the intention behind the freedom established through Article 49 TFEU.

It deserves to be pointed out that a teleological reasoning is only one of several methods of interpretation at hand for the ECJ. At the same time, there is an immersed suitability for the teleological approach, which relates to the type of conduct that is examined. By definition, the type of behaviour examined is not illegal. Under a literal interpretation regime the abuse problem would be ignored, since it would not capture the arbitrage situation in the first place.²⁰⁰

¹⁹⁸ ECJ, Case C-212/97 *Centros Ltd. v Erhvervs- og Selskabsstyrelsen* [1999] ECR I-1459, para. 25

¹⁹⁹ L. Cerioni, op. cit. p. 795

²⁰⁰ P. Schammo, op. cit. p. 370

The teleologic interpretation method is in itself highly relevant for the definition of the legal relationship between regulatory arbitrage and abuse of rights. It is so, because of its essential capability to strike a middleground. A teleological reading neither prejudice the legitimacy in regulatory arbitrage, nor adheres to an overly formalistic – *literal* - provision reading²⁰¹.

It has been claimed the object behind these provisions - *the four fundamental freedoms* - is to stimulate market integration, and that regulatory arbitrage is incidentally facilitated. At the same time, the situation in this case is far from clear-cut. Increasingly, the global competitiveness is raised as one of the aims with the Internal Market. This could plead in favour of interpreting the fundamental freedoms in a way that maximises access for market actors to the most favourable legal regime – stimulating a fierce competition amongst legislations. Hence, conceptualising the internal market as a mean for a regulatory competition in order to foster the most competitable regulatory regime.²⁰²

It follows that the integrational aspects behind the free movement provisions, (incidentally) facilitates regulatory arbitrage. The role for ECJ can, thus, be epitomized as to be to fine-tune the contrast between arbitrage and abuse of rights, when looking at the objective of integration: to which extent does the the arbitrage constitute integration?²⁰³

The integrational aspiration of the four freedoms, is embedded with them being ultimately economic rights. For that purpose were they created, and that is their objective.

The teleologic *modus operandi* of ECJ, was apparent in the *Centros* case. After introducing the objective element of assessment²⁰⁴, the conditions of the case were clearly examined in light of the objectives behind the Treaty provisions relied upon:

*'In the present case, the provisions of national law, application of which the parties concerned have sought to avoid, are rules governing the formation of companies and not rules concerning the carrying on of certain trades, professions or businesses. The provisions of the Treaty on freedom of establishment are intended specifically to enable companies 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 to pursue activities in other Member States through an agency, branch or subsidiary.'*²⁰⁵

²⁰¹ *Ibid* p. 371

²⁰² *Ibid* p. 361

²⁰³ *Ibid* p. 363

²⁰⁴ See 5.1.1.

²⁰⁵ ECJ, Case C-212/97 *Centros Ltd. v Erhvervs- og Selskabsstyrelsen* [1999] ECR I-1459, para. 26

ECJ's interpretation of the *raison d'être* behind the freedom of movement is that it is for the home Member State to determine the status of the first establishment. As long as the company is formed in accordance with the law of a Member State (the *home* Member State), the freedom is intended to be theirs to establish an agency, branch or subsidiary in another Member State (the *host* Member State), without the discretion of the host Member State to restrict the secondary establishment, by questioning the authenticity, or legitimacy, of the primal establishment. But the ECJ, to a certain extent, deflects from its previous case law, when ignoring the pursuit of economic activity as inherent in the exercise of right of primary establishment²⁰⁶.

In *Cadbury* the teleological interpretation of the reasoning behind the right to establishment, seemingly differed. It was concluded that the *home* Member State could restrict the right of secondary establishment, if it was concluded that there was no pursuit of a genuine economic activity in the *host* Member State. The ECJ thus relied on the right of establishment – along with the other three freedoms – as being economic in character. That the right of establishment is economic, and can be made subject to the requirement of the actual pursuit of economic activity, has been previously established in the *Factortame* case²⁰⁷.

Despite reaching different conclusions, both *Centros* and *Cadbury* treat the right of establishment as economic in nature. The different legal results therefore deserves being examined through the different angles used in the cases: in *Centros* it was the host Member State attempting to restrict the right of establishment, while in *Cadbury* it was the home Member State.

A striking feature with the approach taken in *Centros*, is that it adheres to the doctrine of companies as creatures of national law (see 2.2.4). This suggests that the ECJ considers that it is under the discretion of the home Member State to decide over the primal establishment. It is not for the host Member State to deem the establishment in the home Member State as not pursuing genuine economic activity. In other words, ECJ concludes that a parent establishment can be presumed to adhere to the economic objectives of the Treaty provisions, and thus is not under the discretion of the host Member State. This led the ECJ to conclude that the regulatory arbitrage was legitimate, since it was – under a teleological interpretation – the objective behind the right of establishment.

In *Cadbury* this position was not reciprocated, with regards to secondary establishments in host Member State. Here the conclusion was that it was possible for the home Member State to evaluate the tax arbitrage and assess whether there was any pursuit for genuine economic activity in the secondary establishment. Economic activity is not set out as an criteria in

²⁰⁶ ECJ, Case C-221/89 *The Queen v Secretary for Transport, ex parte Factortame Ltd and others* [1991] ECR I-03905 para. 20

²⁰⁷ *Ibid* para. 20

the Treaty provision, but owes its existence to the teleological interpretation of the ECJ.

5.1.1.2 Effect on Third Parties

Based on the ECJ's reasoning, any attempt of setting out a generic methodology for the assessment of regulatory arbitrage based on the right of establishment for legal persons, would be lacking without involvement of third party impact. In line with the general principles of justifications for restrictions on the fundamental freedom, such third party impact proves highly relevant to take into consideration. Such interest can in the case law of the ECJ be traced to be either Member States' financial interests, general public interests or specific – *private* – interests²⁰⁸.

The outcome of the exercise of regulatory arbitrage – in terms of existence or non-existence of a prejudice of the interests of third parties – is decisive for any restriction of the right of establishment. The role of such prejudice were recognised already in *Centros* and elaborated in *Inspire Art*: prejudice for third parties protection is a necessary factor for the justification of restrictions of the fundamental freedoms.²⁰⁹

The consequence is that circumvention of national rules via the freedom of establishment does not in itself amount to abuse when the protection of third parties interests are not at stake. *Inspire Art* also showed that it is only if Member States show that this protection is being compromised, that they can take measures preventing the regulatory arbitrage through restrictions of the right of establishment.²¹⁰

Importantly, this assessment must be made on a case-by-case basis (as established in *Inspire Art*²¹¹) and the general conditions for a national restriction of a fundamental freedom must be respected (eg., suitability and proportionality).

Under this reasoning, the the ultimate inference is that the elaboration of the prohibition of abuse of rights in the EU legal order lies in the need to strike the balance between the prejudice to the public interest (eg., tax revenue, as in *Cadbury*) or to specific interests (eg., creditors, as in *Centros*) on one hand and the integration goals of the Treaty on the other hand. Under this logic the *abuse* and *prejudice* coincides, so that if the sole purpose behind the regulatory movement (*circumvention*) is the prejudic of third party interests, then it may be justified to prevent it.²¹²

²⁰⁸ L. Cerioni, op. cit. p. 810

²⁰⁹ ECJ, Case C-212/97 *Centros Ltd. v Erhvervs- og Selskabsstyrelsen* [1999] ECR I-1459, para. 38; ECJ, Case C-167/01 *Kamer van Koophandel en Fabrieken voor Amsterdam v Inspire Art* [2003] ECR I-10195 para. 140 *e contrario*

²¹⁰ L. Cerioni, op. cit. p. 789

²¹¹ ECJ, Case C-167/01 *Kamer van Koophandel en Fabrieken voor Amsterdam v Inspire Art* [2003] ECR I-10195 para. 143

²¹² L. Cerioni, op. cit. p. 806

Notably, the ECJ have in its case law, exemplified which third party interests that can, under certain conditions, justify restriction on freedom of establishment. One such example gave: 'the protection of the interests of creditors, minority shareholders, employees and even the taxation authorities'²¹³.

5.2 Other situations potentially affected

As exemplified already in the introduction, business' legal creativity in terms of circumventing onerous regulations is inexhaustible. Generally, it can be claimed that were there is an arbitrage opportunity, commercial interests will find it. This is distinctly exemplified by the concept of *thin capitalisation*, where different commercial concepts were cleverly combined in order to delimit tax payments. Meanwhile, as evidenced by the extensive case law highlighted in this thesis, the Member State are increasingly aware of the phenomena of regulatory arbitrage²¹⁴.

In this last investigatory part of the thesis, schematic examples will be provided on areas where regulatory arbitrage based on right of establishment, might be desirable. As explained, the commercial creativity in this area is vast and 'a step ahead', so it is likely that the most profitable examples are missed in this exposition. It is the *Achilles heel* of business law doctrine, that the most clever solutions are not known publically but rather safely kept within the doors of the highest charging legal firms, thus making it challenging to list *potential* and *profitable* regulatory arbitrage opportunities.

5.2.1 New Businesses

The most obvious situation where regulatory arbitrage can be practiced is in the setting up of a new company. As practiced in *Centros*, opting out of strict minimum capital requirements may act as a motivator. There is nothing under the methodology as established in *Cadbury* that impedes this.

A well known concept stemming from regulatory arbitrage, is the business of *off-the-shelf* companies. Firms provide such companies for a fee, offering an address for the company's registered office and even a nominal director to be registered as director, in case the real owner wants to hide his identity²¹⁵.

Disqualification regimes for directors – and management – may be another instigating factor. I.e., under English law Courts have a rather big discretion to disqualify directors they find unfit²¹⁶.

²¹³ Case, ECJ C-2008/00 *Überseering v NCC* [2002] ECR I-9919 para. 92

²¹⁴ K.E. Sørensen, op. cit. *supra* 173 p. 423

²¹⁵ *Ibid* p. 423

²¹⁶ T.H. Tröger, op. cit. p. 32

Liability also differs within EU Member States. In the English doctrine a compelling director may have to carry the whole risk in moment of crises.²¹⁷

5.2.2 Creditors

The *Centros* case illustrates how the relationship *vis-a-vi* creditors might influence incorporation decisions. The intention behind the regulatory arbitrage in that case was to avoid mandatory Danish laws designed for the protection of creditors.

5.2.3 Codetermination rules

The ambition to – still within the dimension of company law – avoid other provisions intended to protect stakeholders, might include employee participation or codetermination rules, as so far these are a function of the legal domicile of the company. The principle of territoriality tends to determine the application of most labour laws, but this is not always the case. The famous German rules on strong stakeholder participation in supervisory boards, relates to the legal entity through which an organisation is constituted.²¹⁸

As mentioned in the introductory chapter, such regulatory arbitrage have been notched in relation to *Societas Europaea*. It is likely that it might be used in relation to ordinary national companies as well.

Categorized under domain should be any mandatory regulation on composition of board – as introduced regarding gender quotas in some Member States.

5.2.4 Capital markets

In relation to the capital markets there are several aspects that the company may want to circumvent through regulatory arbitrage.

Dominant shareholders might use reincorporation, combined with *business as usual* in the home Member State, in order decrease minority owner protection. It has been claimed that the weak minority rules, is one factor behind Delaware's success in America. Under economic theory, though, capital markets would penalise such conduct.²¹⁹

²¹⁷ *Ibid* 32

²¹⁸ S. Deakin, 'Two Types of Regulatory Competition: Competitive Federalism versus Reflexive Harmonisation. A Law and Economics Perspective on *Centros*' (1999) 2 *Cambridge Yearbook of European Legal Studies* 24

²¹⁹ T.H. Tröger, *op. cit.* p. 28

Consequently you could therefore boost corporate value through incorporation in a shareholder friendly legislation. For the same reason as dominant shareholders might re-incorporate to weaken minority protection, re-incorporation could also in theory be used to increase the takeover defence. Regulatory arbitrage could thus be used in order to attain recognition by a legislation with more evolved capital markets.

Other factors – relating to the capital markets – that might instigate a regularoty movement, is listing rules, transparency legislation and accounting and auditing rules.

6 Concluding remarks

It is worthwhile to begin a conclusion of the subject covered in this thesis, by reflecting over the timeframe in which the studied subject have evolved. If nothing else, perhaps such time perspective provides understanding for any presence of inconsistencies on the area. The *Centros* case – opening up for regulatory arbitrage - was given just before the millenium. Meanwhile the *Emsland* ruling – establishing a formal abuse of rights doctrine, as eventually applied in *Cadbury* – was presented shortly after the millenium. All in all, the important evolution of a EU abuse of law doctrine and the reconciliation of this with the freedom of establishment, have been realized within less than ten years.

Without commenting on the substance of it, this marks the significant efficiancy from the ECJ to cope with, and come up with solutions to, new legal challenges. It also bears account of ECJs (in)-famous ability to act as catalyst and instigator for immersed economic and judicial integration – especially when the political movement is lagging.

6.1 Substance

As is often the case when scrutinizing a ruling in detail, the practical learnings to draw from *Cadbury* – and preceding and succeeding case law – is not crystal clear. The matter is still complex and evolving, and the rulings are not entirely coherent.

Nonetheless, it is possible to assess the legal opportunities to regulatory arbitrage based on Article 49 TFEU, in light of the *Cadbury* ruling and its embracing of the abuse of right doctrine.

The usage will be – if scrutinized, restricted or impeded - assessed in line with the abuse test, as established in *Emsland* and *Halifax*. Thus, consisting of two elements: a *objective* assessment, and a *subjective*. Whilst the former assess the very nature of the legislation, the latter assess the nature of the strategy.

Whithout neglecting the difficulties in assessing the objective element, the main concern amongst commentators lies with the subjective element. As presented there are seemingly inconsistencies over what it should involve and how such an evaluation is to be made. Most likely, ECJ's resistance to use a coherent language when providing the subjective element, is due to the inherent difficulties within that very element. That is, being *per definition* subjective, the process of applying the subjective element is inherently incoherent. Ultimately, to coherently construct a generic process to assess such a subjective element ends up in the epistemological question: How do you from the outside assess a subjective notion?

There is yet another potentially problematic feature with the subjective element. As described (see 4.4.1.) the assessment of the wholly artificial arrangement is, in practice, done through the examination of whether the arrangement 'reflect economic reality'. This solution offers a practical way around the intrinsic problems described in the preceding paragraph. Nonetheless, such an assessment becomes a matter of circular reasoning. For when examining a potential artificial arrangement, it must be analysed whether there were other reasons for its adoption - ie., whether it reflects economic reality or is entirely fictitious.

All this suggests that an outspoken recourse to AG Maduro's reasoning in *Halifax* – and the very wording on these matter in that ruling -, might be suitable in order to provide legal stringence and coherence. A subjective element clearly consisting of an objective assessment of alternative economic explanations behind the arrangement, would increase legal certainty.

One final remark reflecting on the subjective element. As concluded in preceding paragraphs, it eventually boils down to a matter of assessing whether the legal transaction reflects economic reality or not. It is logic from the perspective that the fundamental freedoms are essentially meant to be economic, eg., increasing the economic integration amongst Member States. But this reasoning lacks to take into consideration that the regulations that are circumvented, might not be of economic art. For example, resistance against gender quotas in management boards, tends to be purely ideological – rather than economic. Regulatory arbitrage to circumvent such legislation would thus be lacking – notwithstanding that such a situation would most likely pass anyway, on the logic applied in *Centros*.

An elegant formulation of the fundamental question – whether there can be regulatory arbitrage without abuse of the right to establishment – was raised above. The conclusion is yet after scrutiny of ECJ's case law that, whilst 'abuse' always presuppose circumvention – *regulatory arbitrage* – of the applicable national provisions, regulatory arbitrage does not necessarily result in abuse.

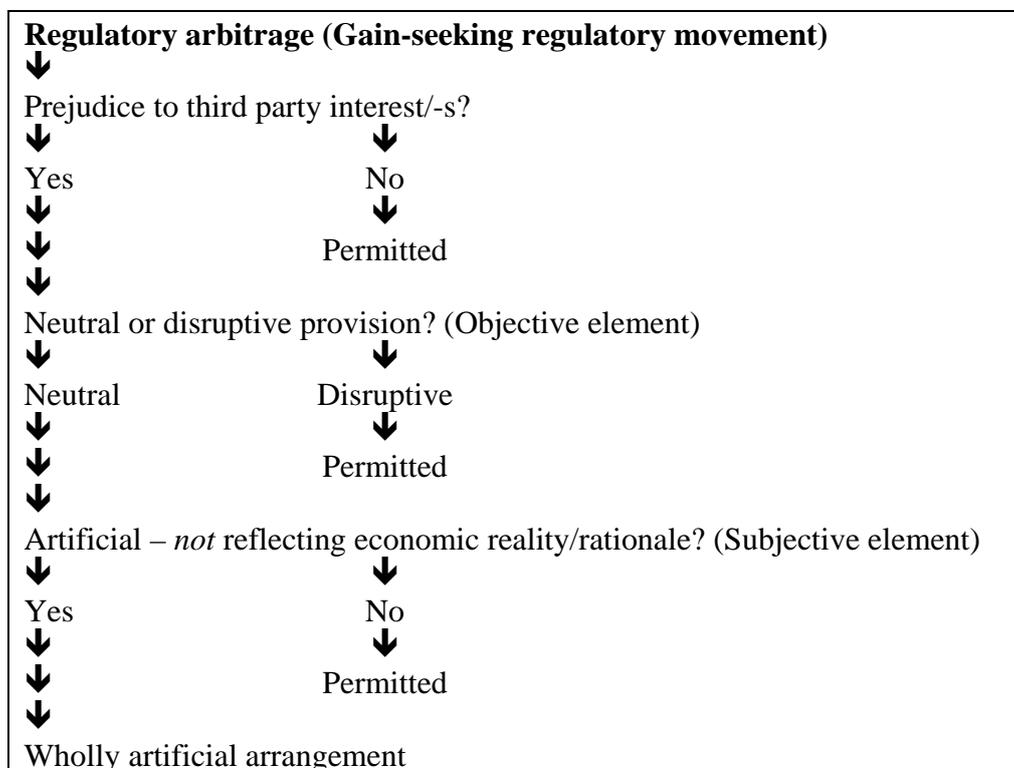
So is *Cadbury* to be consider as restricting – a *mutilation* - of the opportunities for regulatory arbitrage enounced from the right of establishment? As has been shown, it is possible to merge the reasoning presented in *Cadbury* with the outcome in *Centros*; implying that the rulings are children of the same logic. Meanwhile, it would be to ignore several indications to suggest that the ECJ had the solution to *Cadbury* in mind when delivering *Centros*. Most likely the correct way to interpret *Cadbury* is to acknowledge an enhanced role for the abuse of rights doctrine. Thus, indicating a restriction of the opportunities for regulatory arbitrage.

As described regulatory arbitrage and abuse of rights can be considered as situated on opposing ends – hence, the structure of Part Three of this thesis. A strengthening of one end is likely to diminish the other. It is worthwhile to reflect on the political symbolism of this. Despite the *Cadbury* case’s Anglo-Saxon origin, the concept of abuse of rights has its affinities to Continental Europe. Recall how France complained over abuse of rights already in its submission to *Centros*. This implies that *Cadbury* hints an enhanced adherence to the French principle of *fraude à la loi*.

It is also to remember that the subjective element brings with it an insensitized judicial focus on intentions. It is probable that this strengthen the abuse doctrine, rather than the opportunities for regulatory arbitrage.

Perhaps it is in the light of the French generic notion of abuse of law that *Cadbury* is to be seen. Maybe the conclusion to draw from *Cadbury* – as well as *the Greek cases* and *Lammer & Van Cleeffs* – is that the Court prefers a generic (and principled) doctrine on abuse, before specific provisions aiming at certain conducts – thus, bordering to a general assumption of abuse.

Below is a schematic description on the methodology to assess whether regulatory arbitrage is abusive – according to the process established in case law:



6.2 Judicial activism or judicial surrender?

It is probably not to be seen as a coincidence, that the two legal areas covered in the most prominent cases – *Centros* and *Cadbury* – is also two of the most disputed areas for integration and/or harmonisation – company and tax law.

To large extent an evaluation of *Cadbury* have to begin in a discussion on *Centros*. It has been proposed in the thesis that ECJ's ruling in *Centros* – marking a shift both in its attitude towards the fundamental freedom as such, but also deflecting from the evolved abuse of rights doctrine – is to be seen as an attempt of a further push towards revitalised European integration.

The logic is this. The interventionist approach taken in *Centros* consisted in entitling legal persons to choose the most beneficial legal regime as long as no harmonisation rules applies. That created following situation for the Member States. Either – if the legal discrepancies within the Union consisted – the regulatory competition, as a result of regulatory arbitrage, would increase. Or – if the Member States disapproved of such judicially stimulated competition – harmonisation would be implemented, as the only attainable alternative. Either way, the ECJ, would thus evoke further European integration.²²⁰

Following through on such logic, it is against the background of the EU legislature's inability to adress the situations open for regulatory arbitrage such *judicial activism* is to be assessed. It was the legislature's inactivity that forced the ECJ to adress the tension between regulatory arbitrage and abuse of rights. Such an analysis relies on a rather simplified perception that there is a institutional context, expressed by an inadequacy and incapability to clarify by the legislatures, forcing the ECJ to progressively act.

It is not so that such an explanation is self-evident. It is certainly a comfortable argumentation in order to allocate more power to the judicial arm – 'the *de lege lata* is inconsistent, so let's create some *de lege ferenda*'. But the argumentation misses a political dimension implying that not all legislation have to be consistent, but rather fair and practical. It could be expressed so as to claim that *Centros* lacks the notion of *realpolitik*.

This remonstrance to *Centros* could be useful, when understanding and assessing *Cadbury* and, subsequently, the current situation for regulatory arbitrage based on Article 49 TFEU. But that very remonstrance is dependent on the presented logic behind *Centros*, meaning that *pari passu Centros* was necessary to foster further integration, *Cadbury* was necessary

²²⁰ I owe this explanation of the *modus operandi* of ECJs stance to Rita de la Feria in R. de la Feria, op. cit. *supra* 32 p. 408

to stifle drifts stemming from *Centros*. Hence, without *Centros*, with its consequences, no *Cadbury*, with its consequences.

The seemingly relative and vague logic, introduced through the definition of the subjective element, will most likely be tested. The room of manoeuvre for regulatory arbitrage will be examined by economic actors – it is implied by the values at stake. This will further increase the pressure for a more judicially consistent and stringent solution.

All this speaks for a crossroad with following developments:

- (i) further harmonization – driven by the legislature, in order to promote integration (eg., extinguishing openings for regulatory arbitrage)
- (ii) deepened regulatory competition – driven by regulatory arbitrage and, as a result, adopting Member States, resulting in decreased differences between Member States (eg., extinguishing openings for regulatory arbitrage)
- (iii) increased legal uncertainty – discretionary application by the methodology established in *Cadbury*, and consequently, a threatened unitary approach

In this context it should be noted that by introducing the concept of wholly artificial arrangement to stifle regulatory arbitrage the Court actually branches off from the paradigm of regulatory competition. Under the rationale of regulatory competition, 'exit', is desirable as a fundamental constituent of the competitive process. The concept of wholly artificial arrangement effectively blocks this competitive process.

As explained in 5.1.1.2. there is a rationale behind the position taken by the ECJ. But ECJ is obviously taking into consideration the wide implications of a too liberal – company-friendly – doctrine on the division between legitimate regulatory arbitrage and abuse of rights. The former would instigate a fierce regulatory competition. Whether such competition is the objective behind the Treaty provision, is unclear.

There is also a logic in the methodology set up by ECJ. Especially, contrary to claims it is possible to reconcile the conclusions in *Cadbury*, with the presequent case law on reliance of the right of establishment (particularly *Centros*). There is a coherent logic behind the *laissez-faire* attitude in *Centros* – not to impede the Member States control of citizenship – and the more onerous approach taken in *Cadbury* – were it was the home Member State acting.

The scenario (iii) as presented above deserves further explanation. Legal certainty is one of the most appraised guiding values of the European legislative process. The ECJ have been strict in safeguarding this principle. But the introduction of a subjective factor in the evaluation of whether it is

abusive practice or not, may have introduced uncertainty, in the abuse assessment.

The stringency problems becomes apparent not compared to the *Centros*-line of cases, but rather compared to the abuse of right doctrine-cases (eg., *Emsland* and *Halifax*). The emphasized significance of the subjective element, risks (apart from the methodological challenges presented in 6.1.) being nothing else than a weakening of the rights conferred on legal persons by the Treaty. Despite safeguards – such as the general principles of Union law, eg., proportionality, and the *breakthrough* effect of genuine economic activity – the discretion for Member State authorities might be increased.

Finally, a concluding remark regarding the very application of a abuse doctrine. There is room for a theoretical debate on whether the abuse doctrine should at all be used to assess the justifications presented by the Member State. Under such reasoning, the fact that the company is involved in abuse, should remove the very opportunity to rely on the treaty provisions. This logic was seemingly presented *e contrario* by AG Léger in *Cadbury*. In the end the outcome should be similiar – if the abuse is found to justify a restriction of the right or there is no right to begin with is in practicality equivalent.

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