Corporate conflict of laws

Issues of corporate conflict of laws

Previously, the importance of the role of company law has been made clear. Company law gives form to corporate structure, regulates internal organization, and steers corporate behavior. More importantly, when conflicts arise within a company, it is company law that (usually) determines the outcome of the conflict. In a hypothetically enclosed (autarkic) society, we could now move on to discuss the implications of the company law in place. In a more realistic setting, however, several company laws coexist and interact. Companies from state A may do business in state B. States A and B could have (and likely will have) different company laws, which raises questions about which company law applies and how it affects interstate commerce.

In other words, there arises a problem of a corporate conflict of laws. I use the term "conflict of laws" broadly to refer to two related, but distinct, issues: (1) which company law applies (i.e., the issue of applicable law or conflict of laws in the strict sense), and (2) which courts will decide when conflicts or difficulties arise (i.e., the issue of jurisdiction). We will deal with both issues successively.

Applicable law and corporate mobility

Choice of applicable law and freedom of choice

<u>Introduction</u>

The *lex societatis* or applicable company law generally regulates the internal organization of the company (e.g., fiduciary duties of the board of directors, shareholders' rights etc.) and some of how the company acts in relation to others (most importantly, the matter of corporate representation, e.g., the German *Prokura*-system which influenced EU law overall).

Confronted with several possibilities for the *lex societatis*, which company law should prevail? Overall, two main theories exist:

(1) According to the real seat theory, the law of the state where the company has its "real seat" should determine the applicable company law. This is a substantive criterion: a company's real seat is where the company's primary interests lie. Generally speaking, this is the location principal place of business.

(2) According to the incorporation theory (or its modified form, the statutory seat theory), the law of the state where the company was incorporated or has its statutory seat applies as the *lex societatis*. This is a purely formal criterion, in contrast to the real seat theory.

Since it is generally easier to move the company's statutory seat than to move its real seat, the statutory seat theory enhances corporate mobility, whereas the real seat theory diminishes corporate mobility.[1] Both the real seat and incorporation (or statutory seat) theory have their advantages and drawbacks which mirror each other.

REAL SEAT	**INCORPORATION/STATUTORY SEAT**
Advantages	***Disadvantages***
Reduces risk of letterbox companies for evasion purposes	Increases risk of letterbox companies for evasion purposes
Homogenous application of different fields of law	Dispersed (and possibly conflicting) application of different fields of law
Disadvantages	***Advantages***
Criterion difficult to establish, especially in a globalized world	Criterion easy to establish
Possibility of unwanted or unclear change of change of LS	Change of LS relatively easy to determine

Note, however, that *lex societatis* does not determine everything. In particular, tax law, insolvency law, labor law, contract law and tort law provide additional rules that generally govern the external relationship of the company towards third parties or the state.

[1] Technically, incorporation theory in its strictest form would restrict corporate mobility even further (to the extent of disallowing it), but no country applies this theory to its fullest extent.

Note also that different states may apply different rules to determine the applicable *lex societatis*. As a result, this could lead to situations in which a company is either stateless (e.g., a company incorporated in state A – which applies the real seat theory – with its principle place of business in state B – which applies incorporation theory), or is subject to two (possibly conflicting) company laws at the same time (e.g., a company with its principle place of business in state A – which applies the real seat theory – and incorporated in state B – which applies incorporation theory).

<u>Internal affairs and pseudo-foreign companies</u>

In the United States, the "internal affairs doctrine" prevails. According to this theory, the law of the state of incorporation applies at least to issues that can reasonably be considered to be "internal affairs" of the company. Oftentimes, that delineation does not require much further thought. Other times, however, it is unclear whether a case relates to "internal affairs" of the company (governed by the law of the incorporation state) or not. Moreover, a generally accepted exception to the internal affairs doctrine exists when the law of another state has a "more significant relationship" to the occurrence and the parties (Rst. 2nd).

Read: § 302 Rst. 2nd Conflict of Laws

John Carbone v. Nxegen Holdings **(Superior Court Connecticut, 2013)**

CTS Corp v. Dynamics Corp of America **(SCOTUS, 1987), only the majority opinion by Justice Powell**

Do you understand the facts, issue and holding of these cases?

Do you understand why John Carbone v. Nxegen Holdings has a corporate conflict of laws aspect to it? Why does the court first delve into the substantial difference of Delaware and Connecticut law before looking into the conflict of laws aspect?

What criteria does the court in John Carbone v. Nxegen Holdings use to implement the "more significant relationship exception" to the internal affairs doctrine?

How should we interpret the position of shareholders for the purpose of the internal affairs doctrine? Do they qualify as internal affairs? Is there a tension between the ruling of the Supreme Court and the ruling of the Connecticut Court of Appeals?

In addition to the general exception to the internal affairs doctrine, some states have adopted specific statutes to subject so-called “pseudo-foreign companies” to certain rules of their own company law. A pseudo-foreign company (or letterbox company) is a company that is formally incorporated under the law of state A, but actually has its entire (or most of its) business in state B. For example, § 2115 of the California Corporate Code contains a provision subjecting companies that meet a certain threshold to a variety of Californian rules, regardless of their state of incorporation. From a US constitutional point of view, however, the validity of these pseudo-foreign company statutes is debatable.

Read: § 2115 California Corporate Code

Do you understand the rationale behind pseudo-foreign company statutes? Do you agree with this rationale? Why (not)? Can you formulate counterarguments (besides the constitutional point specific to the US) against the adoption of pseudo-foreign company statutes?

Suggested reading (for an application): *Wilson v. Louisiana Pacific Resources (Court of Appeals, California, 1982)*

Suggested reading (for those specifically interested in the constitutional argument; compare with the evolution in the EU – see below): *Vantage Point Venture Partners 1996 v. Examen Inc.* (Supreme Court of Delaware, 1996)

Freedom of establishment and its limits

Formally, European Union law has not harmonized the connecting factor to establish the *lex societatis* (art. 54 TFEU). Hence, both the real seat theory and incorporation theory/statutory seat theory continue to apply across the European Union. However, the fundamental economic freedoms on which EU law is based, also come into play. In particular, the freedom of establishment cannot be overlooked (art. 49 TFEU). The right to primary and secondary establishment has been the subject of an extensive body of case law of the CJEU.

On the basis of this case law, a Member State can still freely determine the connecting factor of its own company law (i.e., it can adhere to the real seat theory and require that the real seat of a company is in its territory). However, Member States must (1) let go of companies who wish to switch to the law of a different Member State and (2) recognize validly incorporated companies from other Member States to allow them to operate on their territory under the same conditions as domestic companies.

Read: Art. 49 and 54 TFEU

***Daily Mail* (CJEU, 1988)**

***Centros* (CJEU, 1999)**

***Überseering* (CJEU, 2002)**

***Inspire Art* (CJEU, 2003)**

***Cartesio* (CJEU, 2008)**

***Vale* (CJEU, 2012)**

***Polbud* (CJEU, 2017)**

A. Fillers, *Free Movement of Companies after the Polbud Case* (2018)

Do you understand the facts, issues and holdings of the cases above? Based on the cases and Fillers' analysis of them, can you make up a summary of the current state of the law on an EU level? You may want to use the previous paragraph as a framework to build up a summarizing table.

Do you understand the impact of this case law? How does it influence the relevance of the real seat theory and incorporation theory/statutory seat theory?

What are the broader effects of the case law of the CJEU beyond its immediate impact on the connecting factor to establish the lex societatis? Taking into account art. 54 TFEU and the impact of this case law, do you believe the Court is acting ultra vires?

The current state of the law raises some concerns about the existence of letterbox companies (i.e., pseudo-foreign companies – see above) and the (im)possibility for Member States to act against them. One theoretical option to circumvent the case law of the CJEU is to invoke the "national interest exception" included in article 49 TFEU. However, that has never (successfully) been done. Yet other ways of limiting the negative effects of letterbox companies exist.

Read: *Kornhaas* (CJEU, 2015)

European Commission, *Letterbox companies: overview of the phenomenon and existing measures* (Executive Summary, 2021)

Do you understand the facts, issue and holding of the case? Do you understand how Kornhaas uses the borders of company law to mitigate the effects of the lex societatis? Do you understand how this fits in a broader array of measures aimed at dealing with letterbox companies?

<u>Regulatory competition: race to the…</u>

Offering companies the flexibility to choose the applicable law (i.e., improving corporate mobility) has both been criticized and lauded at the same time. Opponents are quick to point out that companies will choose for the most lenient laws that offer the least protection to third parties and (minority) shareholders), while strengthening the power of the board of directors. Moreover, opponents fear that this ultimately puts undue pressure on states to relax their own rules and engage through regulatory competition in a race to the bottom. Supporters argue, on the other hand, that regulatory competition leads to a race to the top and favors efficient rule-making.

Read: O. Eldar and L. Magnolfi, *Regulatory Competition and the Market for Corporate Law* (2020).

According to the authors, which factors contribute more to the attractiveness of a company law system? Why do you think these factors are decisive?

Corporate Movement

<u>Reincorporation in general</u>

It is one thing to create a new company under the law of State A, but an entirely different thing to move a company from state A to state B. The impractical way of doing this, would be to found a new company in State B and then transfer all the assets via an asset-deal to the new company. It would be much more practical, however, to keep change the law of incorporation (assuming, *arguendo* that this will also change the *lex societatis*) without loss of legal personality and without having to go through the hassle of an asset deal. In other words, we want to reincorporate the company under the law of a different state. There are two main ways to arrange reincorporation: (1) via a cross-border conversion/domestication or (2) via a cross-border merger.

A cross-border conversion means that a company from state A converts to a company from state B, without losing its legal personality or going into liquidation. For example, a French SA converts into a German AG or vice versa. Under US law, this is known as domestication: a "foreign" company[2] (e.g., a Texan company) becomes domestic (e.g., reincorporates under Delaware law) or vice versa.

A cross-border merger on the other hand, implies the creation of a new company under the laws of the desired state (e.g., a wholly owned subsidiary). Then, the original company and the new company are merged, with the new company being designated as the surviving one.

Cross-border conversions

The case law of the CJEU discussed above, facilitated cross-border mobility of EU companies by restricting the potential of Member States to impose barriers against cross-border conversions. The Court did not, however, create much guidance on how a cross-border conversion should take place.

The lack of an adequate legal framework for cross-border conversions and especially the lack of EU harmonization on this matter was widely construed as a shortcoming of EU company law. In 2019, the Mobility Directive was adopted (now part of the CLP).

The rules for cross-border conversions are set out in Articles 86a et seq. of the CLP. Structurally, a cross-border conversion presupposes the consecutive application of two Member State laws. Hence, the Member State law of departure will apply to the pre-conversion phase (especially the pre-conversion report), whereas the Member State law of arrival will apply to the post-conversion phase (especially the verification of the conversion). The EU-rules for cross-border conversion follow the procedural framework that also applies to mergers in six phases:

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[2] Taking on the perspective of the state of Delaware as that of the "domestic state" in this example.

(1) The creation of the draft terms of the conversion (86d)
(2) The management report (86e)
(3) The independent expert report (86f)
(4) The disclosure of the draft terms (86g)
(5) The approval of the draft terms by the GM (86f)
(6) *Ex post*-scrutiny by the departure (86m) and arrival (86o) Member State

Read: Article 86a-86t CLP
§ 9.20-9.24 MBCA

What are the main interests that are deemed worth of protection by the rules on cross-border conversions in the EU's CLP? How are these main interests protected? What specific rules contribute to what?

Can you draw up a timeline of the main steps to be taken when arranging for a corpore conversion in the EU? Try to keep track of the ratio behind the main formalistic rules and how this could be relevant.

How do the EU rules in the CLP compare to the rules of the MBCA? Anything that strikes you as particularly different? Why would this be?

Jurisdiction and forum shopping

In the previous part, we addressed what company law applies substantively, i.e., which is the *lex societatis*. However, this does not answer the question which court has jurisdiction to decide on a dispute, involving the company. Jurisdiction and applicable law do not need to coincide. This is particularly relevant when courts have to apply foreign (company) law.

Suggested reading: *SBK Art/Fortenova STAK* (CJEU, 2026)

Why do you think the difference between jurisdiction and applicable law matters? Apart from convenience, are there other arguments you might want to take into account when selecting the forum?

In the United States, State courts of the state of incorporation have general jurisdiction to hear almost all disputes on the internal affairs of a company. Similarly, in the European Union, the courts of the state of incorporation have exclusive jurisdiction for the validity of the constitution, the nullity or the dissolution of companies or other legal persons or associations of natural or legal persons, or the validity of the decisions of their organs, the courts of the Member State in which the company, legal person or association has its seat (art. 24 Brussels I recast).

One important question is whether a choice of court clause can be inserted in the formative documents of the company (e.g., the statutes or bylaws).

Read: *North v. McNamara* (District Court S.D. Ohio, 2014)
***Powell Duffryn PLC/ Wolfgang Petereit* (CJEU, 1992)**

Do you understand the facts of the case, the issue at hand and the holdings of these cases?

The CJEU greatly emphasized the contractual nature of the bylaws of a company. Do you think this is a relevant aspect of the law? How does this relate to the views on corporate theory we discussed earlier?

Do you think that a rule of forum non conveniens should be inserted when deciding on jurisdiction in matters as these?