# The End of the Real Seat Theory (*Sitztheorie*): the European Court of Justice Decision in *Ueberseering* of 5 November 2002 and its Impact on German and European Company Law

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## A. INTRODUCTION

[1] In a long awaited judgement delivered on 5 November 2002,(1) the European Court of Justice (ECJ) has ruled that it is **incompatible** with the freedom of establishment guaranteed in Arts. 43 and 48 EC for a member state to deny a company formed in a member state which moves its central place of administration to another member states, legal capacity (and standing to sue or be sued in courts). Against the expectations of many German legal commentators and the recommendation of the Advocate General, (2) the ECJ also held that where a company incorporated in another member state exercises its freedom of establishment in another member state, that other member state is **required to recognise** the company's legal capacity (and capacity to be a party to legal proceedings) which it enjoys under the laws of its state of incorporation.

[2] Following this ECJ judgement, a company incorporated in a EU member state is entitled to rely on the principle of freedom of establishment to contest any refusal by a host state to recognise it as a legal person with the capacity to enter into contracts and to be a party to legal proceedings. As a matter of German law, this decision signals the end of the current practice, whereby the legal capacity of foreign incorporated companies is not recognised, where the effective seat of administration is in Germany. It is also certain to provoke much academic discussion on the question of whether, and if so the extent to which, the accepted phenomenon of full recognition of the legal capacity of the "pseudo-foreign company" within the single market will be extended to other areas of company law.

[3] In this case note, we summarise the main line of argumentation in the ECJ judgement against the backdrop of previous German case-law and doctrine. We then proceed to discuss how this ruling will affect German conflict of laws rules, with a particular emphasis on cross-boarder M&A transactions.

## B. REAL SEAT THEORY PRIOR TO ECJ RULING

[4] Under German law, conflicts of laws relating to companies are decided by reference to the law applicable to the company's actual domicile (or *real seat*). In the absence of any statutory provision, the so-called Sitztheorie traditionally represented the preferred, albeit not uncontested doctrine in German legal writing and case law. (3)

[5] When the German Federal Court of Justice (*Bundesgerichtshof* [BGH], *FCJ*) made the referral order to the ECJ, (4) the prevailing case law of the *FCJ* denied a company formed under foreign law legal capacity, and hence the capacity to sue or be sued before a German court, when it moved its place of administration to Germany, unless that company reincorporated under German law. According to German law, the place of administration of a company is the place where the management of a company is active, or, in the words of the *FCJ*, the place

*"where the fundamental governance decisions are effectively transformed into ongoing managerial acts."* (5)

[6] To a limited extent, German Courts acknowledged exceptions from a strict application of the *Sitztheorie*, for example if the real company seat could not be determined. (6) As a general rule, however, foreign corporations were precluded from walking into German territory without facing severe, if not to say prohibitive consequences.

### *I. Practical effects for foreign companies operating in Germany*

[7] Foreign companies moving their seat to Germany were required to re-incorporate under German law in order to enjoy legal personality and limited liability in Germany. As German law did not recognise a foreign incorporated legal entity with its seat in Germany, such companies initially were denied standing in the German courts and were not able to enforce any contractual rights it may have had. This was also the case where a company did not intend to move its place of administration, but was deemed to have done so by operation of German law. This leads to the absurd situation whereby foreign companies would not have been able to enforce their claims for repayments of loans due and payable under loan agreements (7), or for breach of contract (8), in German courts, if they had a seat in Germany, or were deemed to have had made most operative management decisions in Germany.

### *II. Alleged Advantages for Creditors, Minority Shareholders and Employees*

[8] To be fair to the proponents of the *Sitztheorie*, it was not their (initial) intention to prevent companies from moving. Rather a certain consistency between the effective seat of administration and applicable law was considered to be a requirement of public policy. The provisions of German corporate law protecting creditors are fairly strict by international standards and German courts have developed considerable case law, in particular relating to the corporate form of the limited liability company (*GmbH*), in order to safeguard that the statutory minimum capital of EUR 25,000.00 actually is paid up and not, at a later stage, repaid. Further, German courts have consistently been proponents of stronger rights of minority shareholders, who, also in case of a joint stock company, would enjoy the status of shareholders as opposed to reducing their position to the role of mere investors. In addition, the rather unique (for European standards) system in Germany of co-determination which provides for employees' participation in the management of companies, is considered to work only with German incorporated companies. In sum, the predominant, stake-holder oriented approach in German corporate law found favour with the *Sitztheorie*.

*III. Differing Results: Real Seat Theory and Incorporation Theory*

[9] Within the EU, two different conflicts of laws rules are applied leading to contradictory results regarding the cross-border relocation of the headquarters of a company. Member states, such as the UK, Ireland, Denmark, Spain and (to a certain extent) the Netherlands, (9) which adhere to the incorporation doctrine allow companies to relocate their headquarters to another member state without losing its original legal status. The real seat member states, Belgium, France, Luxembourg, Austria, Portugal and Italy, (10) do not permit a relocation of the company headquarters, without re-incorporation.

[10] After the ECJ decision in *Centros* (11) the contrasting effects of the two approaches became more controversial. In this decision, the ECJ in effect denied a Danish authority's refusal to register a branch of a company validly incorporated in the UK, but which had never conducted business nor had its seat in the UK, as matter of freedom of establishment. It has long been held that it is an important element of the internal market that companies can move freely and establishment themselves throughout the member states, with the implication that a company should be able to freely move its seat (registered office) or its headquarters from one member state to another. The *Centros* decision can be understood as allowing an entrepreneur to freely choose a corporate form within the European Community. On the other side of the coin academic debate flourished as to the extent to which *Centros* undermined the real seat doctrine, i.e. whether the real seat countries could maintain their position, or whether it is a requirement of European law that a company may be able to move its headquarters within the European Community. (12)

*IV.* FCJ *addresses anomaly: the Civil law partnership "GbR" model*

[12] After the referral order for a Preliminary Ruling was made to the ECJ in 1999, the *FCJ* in its decision of 1 July 2002 (13) reconsidered the question of whether a foreign company which had moved its seat to Germany could have standing before German courts. This case concerned the question whether a Jersey company, with a seat either in Germany or Portugal, could enforce its claims under a guarantee before the German courts. The District Court (*Landgericht*) of Munich I had dismissed the matter on the grounds that the plaintiff was not recognised to have any legal capacity or standing in Germany (14) However, following the approach of the Advocate General in *Überseering*, the *FCJ* held the foreign company did have standing, but in the form of a pre-incorporated German vehicle, i.e. as a civil law partnership (*GbR*) or general commercial partnership (*OHG*). Without overruling the real seat principle or endorsing the incorporation theory, the *FCJ* considered the treatment of a foreign company seated in Germany as a civil law partnership an "alternative" to these theories, providing such companies with legal standing in the courts, but denying the principle of limited liability.

**C. THE ECJ RULING**

*I. The referral for a Preliminary Ruling from* FCJ

[13] In Germany doubts had arisen as to the compatibility of the real seat principle with the freedom of establishment in the EC Treaty, particularly following the ECJ decision in *Centros*.

[14] Against this background, the *FCJ* decided to stay proceedings in *Überseering BV and Nordic Construction Company Baumanagement GmbH* and refer the following questions to the Court for a preliminary ruling:

*1. Are Articles 43 EC and 48 EC to be interpreted as meaning that the freedom of establishment of companies precludes the legal capacity, and capacity to be a party to legal proceedings, of a company validly incorporated under the law of one Member State from being determined according to the law of another State to which the company has moved its actual centre of administration, where, under the law of that second State, the company may no longer bring legal proceedings there in respect of claims under a contract?*

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*2. If the Court's answer to that question is affirmative:*

*Does the freedom of establishment of companies (Articles 43 EC and 48 EC) require that a company's legal capacity to be a party to legal proceedings is to be determined according to the law of the State where the company is incorporated?*

*II. Findings of the ECJ*

[15] The ECJ reaffirmed the principle, established in *Centros*, that companies incorporated in EU member states are entitled to carry on their business in another member state. A necessary precondition for such exercises of freedom of establishment is that those companies be recognised by any member state in which they wished to establish themselves.

[16] The claimant, and supporting governments, particularly Germany, relied on the dicta of the ECJ in *Daily Mail*, (15) which they claimed supported the view that a company exists only by virtue of the domestic law, which in turn determines that company's legal capacity and functioning. This interpretation was rejected by the ECJ. *Daily Mail* was held not to be relevant, dealing as it did with a wholly unrelated relationship between a company which intended to transfer its centre of administration to another member to avoid taxation in the original member state.

[17] The German government argued in the alternative, that should the ECJ find that the application of the company seat principle entails a restriction on freedom of establishment, such a restriction is justified by the overriding requirements of the general interest in protecting creditors, minority shareholders and employees.

[18] The ECJ rejected this argument. Indeed the ECJ excluded - as an *"outright negation of the freedom of establishment"* - the application of the company seat principle where this leads to the denial of the legal capacity of a company incorporated in another member state.

[19] However, the ECJ did concede that

*"[i]t is not inconceivable that overriding requirements relating to the general interest, such as the protection of the interests of creditors, minority shareholders, employees and even the taxation authorities, may, in certain circumstances and subject to certain conditions, justify restrictions on freedom of establishment.* " (paragraph No. 92)

[20] On these grounds that ECJ concluded that:

1. The principles of freedom of establishment (*Niederlassungsfreiheit*) in Arts. 43 and 48 EC **preclude** a member state ('B') from denying the legal capacity (and capacity to be a party to proceedings) of a company validly incorporated in another member state ('A'), where that company has subsequently transferred, or is deemed to have transferred, its centre of administration (*Verwaltungssitz*) to member state B.

2. Furthermore, where a company incorporated in another member state exercises its freedom of establishment, member state B is required to recognise the company's legal capacity (and capacity to be a party to legal proceedings) which it enjoys under the laws of its state of incorporation.

**D. IMPACT OF ECJ RULING**

*I. Legal Implications: A Farewell to the Real Seat Principle*

[21] As is often the case, interpreting the ECJ judgement will not be straight forward. This is even more so as the referral by the *FCJ* is rather unique, in view of both the underlying factual and legal assumptions. Looking at the facts of the case, the informed reader wonders why a limited liability company having exclusively German shareholders shall be deemed to have its real seat in Germany, without intending so. As a company, be it recognised as limited liability company or not, undoubtedly represents some sort of entity distinct from its shareholders, the nationality of the shareholders does not really give sufficient evidence for determining the real seat of administration. Turning to the legal premises of the referral, the assumption that a foreign company not being recognised as a legal entity has no legal standing in the courts, is not very convincing either, as it seems to confuse the ability to bear rights (*"Rechtsfähigkeit"*) with the limitation of the shareholders' liability (*"Haftungsbeschränkung"*). Nevertheless, in view of previous ECJ case law, in particular *Daily Mail* and *Centros*, the following (tentative) conclusions can be drawn:

*1. The end of the real seat theory?*

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[22] The ECJ judgement signals the end of the real seat theory, at least to the extent it applies to the recognition of the legal capacity of companies incorporated in other EU states. Member States are now clearly required to fully recognise the legal capacity a company enjoys under the laws of state of incorporation. This, moreover, will require the German courts to **recognise the foreign incorporated corporation as legal entity with limited liability.**

[23] The recent approach adopted by the *FCJ*, whereby a foreign company with its seat in Germany may become a party to legal proceedings on the basis of recognition as a German pre-incorporated entity, i.e. a civil law partnership (Gesellschaft bürgerlichen Rechts-- GbR) or a general commercial partnership (offene Handelsgesellschaft), cannot be upheld. In its decision of 1 July 2002, the *FCJ* had followed the approach adopted by the Advocate General in *Überseering*. As previously mentioned, while not explicitly overruling the real seat principle or adopting the incorporation theory, the *FCJ* found an alternative means of recognising the legal standing of a foreign company. Following the ECJ judgement, in particular the requirement of full recognition by member states of the legal capacity enjoyed by a foreign corporation, the recent approach of the *FCJ* is inconsistent with freedom of establishment. For a company (and, even more importantly, its shareholders) it is entirely different to operate as a civil law partnership, with unlimited liability for each of its partners, than to enjoy the limited liability accorded to it in its place of incorporation. Moreover, the ECJ has clearly established in *Centros*, and now *Überseering*, it is a necessary precondition of freedom of establishment that companies be recognised by any member state in which they seek to establish themselves, without having to undergo a change to a legal form of that other jurisdiction.

[24] To "recognise" a foreign incorporated legal entity without extending the privilege of limited liability to its shareholders is nothing but an ill concealed discrimination of foreign incorporated entities, which is neither consistent with the wording nor in keeping with the spirit of the articles of the EC Treaty.

*2. A more diversified legal regime governing corporations?*

[25] In addition to the abolition of the real seat principle, the ECJ judgement is likely to require a **critical rethinking of the principle of applying uniform conflicts of law rules (Einheitslehre)** . According to the *FCJ* as well as the predominant opinion in German legal doctrine, one corporation, as a matter of principle, shall be governed by one legal order (which, in turn, is to be determined through application of the real seat principle). Pursuant to the uniform approach, the "corporate statute" (Gesellschaftsstatut) comprises incorporation of the company, its capacity to bear and grant rights, internal organisation and liquidation of the company, the limitation of its shareholders' liability, financing of the company, protection of creditors, the rights and duties of management, rules of co-determination as well as the transfer of shares. (16) The intention is to subject as many aspects as possible to one single legal order and to prevent contradictions between different legal orders. A situation where different legal orders governing different aspects of a company's life is considered to bring about "legal uncertainty" and shall, thus, be avoided.

[26] Following the *Überseering* decision, the intriguing question is how will the German courts reconcile the stricter laws in Germany relating, in particular, to creditor protection, minority shareholder rights, co-determination rights with the requirement to recognise (at least) the legal capacity of "pseudo-foreign" companies operating in Germany.

[27] Two constellations arise:

*a) Uniform conflict of laws rule and public policy*

If the *FCJ* decides to adopt a uniform conflict of laws rule, as it tended towards in the referral to the ECJ, (17) this will see the introduction of the incorporation theory. The incorporation theory will inevitably lead to an increased elevation of certain German principles to the status of public policy (*ordre public*) within the meaning of Art. 6 EGBGB. (18) In this way, companies incorporated in states where the rights of creditors or small investors are more restrictive would be subject to the stricter application of German law to the extent it operates in Germany. This raises the question of whether a shift to the incorporation theory can actually help to keep the uniform conflict of laws rule.

*b) Diverging rules and overriding laws in general public interest*

[28] Today, day-to-day operations of an international corporation are inevitably governed by several legal orders, and changing economic realities may make it quite difficult to further adhere to the uniform conflict of laws rule. Some areas such as anti-trust and regulatory requirements have always been outside the scope of the "corporate statute". Further, German conflict of laws doctrine has long accepted a choice of law other than the corporate statute in respect of shareholders' and joint venture agreements. In addition, the increasing importance of capital market related regulations, whose applicability, on the international level, is determined by the market on which particular securities are traded (as opposed to the law under which the issuer is incorporated) has added to limiting the importance of the corporate statute in practice. From this it follows that the traditional arguments invoked in order to support the uniform conflict of laws rule have lost much of their justification. Instead, international corporations today are governed by a

plurality of legal orders that have (and can in practice be) reconciled one with the other.

[29] Whereas the ECJ fully rejected the effects of the application of the real seat principle to deny the legal capacity and standing of foreign companies, the ECJ did concede that there could be overriding interests of the individual member states that could require application of rules other than the ones of incorporation. (19) This leaves the door open for the German courts to consider that overriding requirements relating to the general interest, such as the protection of the interests of creditors, minority shareholders and co-determination may be taken into consideration through submitting these areas to the laws in force at the company's place of business. This approach by the EJC comes close to the German *"Überlagerungstheorie"* (20) whereby only the formation and the legal capacity of a company will be determined by reference to the state of incorporation. The laws of the state of incorporation may be overridden if a mandatory statutory law of the state where the company seat serves private company law interests more.

[30] Such an approach will increase pressure on the harmonisation process of areas such as creditor protections, minority shareholder rights and co-determination. In the interim, German lawmakers will face the challenge of justifying any overriding of freedom of establishment in the public interest. In doing so, it must be kept in mind that a restriction on freedom of establishment can be justified only if that provision pursues a legitimate aim compatible with the Treaty, it is justified by pressing reasons of public interest, and is of such a nature as to ensure achievement of the aim in question and not go beyond what was necessary for that purpose.

[31] Whichever approach is pursued by the German courts, it is to be expected that, in future, German rules protecting creditors and the public at large can, albeit to a limited extent, be also applied to foreign incorporated companies. This at least if such foreign incorporated entities carry on their entire business activities in Germany, so that they are "pseudo foreign corporations."

*3. Cross Boarder Mergers*

[32] From the perspective of the M&A community, the ECJ judgement will be most welcome as it increases flexibility when structuring cross-boarder transactions. One of the topical issues in this connection will be whether legal mergers ("*Verschmelzungen*") pursuant to the German Transformation of Companies Act ("*Umwandlungsgesetz*") will now be permissible between a German and a foreign incorporated company as well.

[33] The traditional approach is that the German Transformation of Companies Act only allows for a merger of one company into another existing company, or two companies into a newly incorporated companies resulting in the liquidation of the target compan(y)ies where (a) both companies are incorporated in Germany (21) and (b) both have their real seat in Germany. (22) Following the ECJ decision in *Überseering*, the principle that pursuant to the freedom of establishment companies validly incorporated in a member state are entitled to carry on their business in another member state was confirmed. Impediments to a company's ability to move its seat, at least as regards to legal capacity and standing, are inconsistent with the freedom establishment. The interesting question is whether this principle also extends to impediments to the mode of moving, in other words, whether the company is free to opt for a legal merger as opposed to moving its company seat. The confirmation by the ECJ that companies incorporated in the EU are entitled to freely establish themselves in other members will pressure member states to consider whether they should widen their company law in order to receive a transferring company. A broad interpretation of the ECJ judgement may already lead to such a result.

*II. Policy Implications: Towards a Free Market of Corporate Form?*

[34] Following the ECJ judgement in *Centros*, there was a lot of debate about the competition of legal orders and its – allegedly – detrimental effects. We believe that the fears traditionally associated with the concept of competing legal orders in the European Union are, considering the case at hand, not justified: On the one hand, free competition of legal orders is unlikely to be triggered by the ECJ judgement and because competing corporate regimes do not automatically lead to a "race to the bottom", on the other.

[35] The fear of a race to the bottom is traditionally associated with the US state of Delaware, home country to the vast majority of US corporations. However, looking at the corporate law of Delaware more closely, one finds that it is not only the alleged laxity that attracts investors from all over the US. Instead, the free market of company forms seems to favour "reasonable" high standards of investor protection and corporate governance, hereby avoiding unnecessary hurdles and formalities. A public company targeting institutional investors, for instance, simply cannot afford being incorporated under a legal order that falls short of the basic requirements of investor protection. When incorporating an investment company, it would not be wise to choose a legal order with undeveloped corporate governance rules or little transparency. What is correct, however, is that investors are attracted by a jurisdiction that has a developed and flexible problem solving capacity. For this reason English commercial law has so successfully

spread around the globe (in spite of the fact that neither English lawyers nor English Courts are particularly inexpensive). And this also applies to jurisdictions like Delaware, which have a rich experience in incorporating and administering corporations of various kinds. Competition among corporate regimes in Europe will, therefore, lead to a certain concentration of corporations in "favourable" jurisdictions while it is unlikely that this will be accompanied by a general erosion of standards in corporate law ("race for laxity").

[36] From a more practical angle, it remains to be awaited whether a general shift towards the incorporation principle will actually stimulate competition of legal orders in Europe. In view of the discussion pertaining to the merger of European stock exchanges it became apparent how parochial investors' behaviour still is. In stark contrast to the purely economic considerations of the scenarios underlying the structure of these mergers produced by investment banks, investors seem to be culturally biased towards investing in their "home country" which seems to favour both incorporation under national laws and listing at the domestic stock exchange. These cultural factors will remain a factual barrier to the free competition of corporate forms in the European Union, also if there should be a general application of the incorporation principle allowing for a choice of corporate form.

[37] Irrespective of the intensity of competition among corporate regimes, a further harmonisation of company law, including the controversial subject of co- determination, will be highly desirable.

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(1) Preliminary Ruling on a referral from the *Bundesgerichtshof* (German Federal Court of Justice) in the proceedings *Überseering NV and Nordic Construction Company Baumanagment GmbH* (Case C-208/00).

(2) *See*, Opinion of the Advocate General Colomer of 4 December 2001 in Case C 208/00.

(3) Cf. the discussions in *Palandt (ed.)* , Bürgerliches Gesetzbuch, Anh. zu Art 12 EGBGB; Münchener Kommentar, Vol. 10, 3rd ed., Einl. IPR, Nos. 149-151; *Staudinger/Grossfeld*, Vol. Arts. 7-12 EGBG, Part 7.3.

(4) *See*, Referral Order to the ECJ of 30 March 2000, DB 2000 1114.

(5) BGHZ 97, 269, 272 citing Sandrock in Festschrift für Beitzke, 1979, P. 669, 683; Staudinger/Großfeld aaO, No. 167.

(6) OLG Frankfurt, RIW1999, 783 citing BGH, NZG 2000, 1025.

(7) Cf. Facts in Decision of BGH of 1 July 2002, II ZR 380/00 discussed at 2.D. below.

(8) Cf. Facts in *Überseering* in Case C-208/00.

(9) *See*, *Soergel/Lüdertz*, 12 ed, Art. 10, Fn. 9 and 13.

(10) *Soergel/Lüdertz*, 12 ed, Art. 10, Fn. 4.

(11) Case C-212/97, ECJ, 9.3.1999, [1999] ECR I - 1459.

(12) Cf. *Behrens*, Das internationale Gesellschaftsrecht nach dem Centros-Urteil des EuGH, Praxis des internationalen Privat- und Verfahrensrechts, 1999, Volume 5, P. 323; *Ebke*, Das Schicksal der Sitztheorie nach dem Centros-Urteil des EuGH, Juristenzeitung, 1999, Volume 13, P. 656; *Roth*, Gründungstheorie, ist der Damm gebrochen?, Zeitschrift für Wirtschaftsrecht, 1999, Volume 21, P. 861; *Sandrock*, Centros: ein Etappensieg für die Überlagerungstheorie, Betriebsberater, 1999, Volume 26, P. 1337; *Steindorff*, Centros und das Recht auf die günstigste Rechtsordnung, Juristenzeitung, 1999, Volume 23, P. 1140; *Wouters, Private International Law and Companies' Freedom of Establishment*, European Business Organisation Law Review, 2001, Volume 2, P. 101; *Zimmer*, Mysterium Centros': von der schwierigen Suche nach der Bedeutung eines Urteils des Europäischen Gerichtshofes, Zeitschrift für das gesamte Handelsrecht und Wirtschaftsrecht, 2000, Volume 1, P. 23.

(13) II ZR 380/00.

(14) LG München I, 25 November 1998 (29 O 16900/97 – not published) and OLG München 21 March 2000 (25 U 2710/99 – not published).

(15) Case No. 81/87, The Queen v Treasury and Commissioners of Inland Revenue, *ex parte* Daily Mail and GeneralTrust [1988] ECR 5483.

(16) Cf. Palandt/Heldrich, Anh Art. 12 EGBGB no. 6-17, with further references.

(17) BGH, Order of 30.3.2000 - DB 2000 1114, 1115.

(18) Großfeld, in Staudinger (ed.), Kommentar zum Bürgerlichen Gesetzbuch Einführungsgesetz zum BGB/IPR, Internationales Gesellschaftsrecht, 14 ed., Berlin 1998.

(19) Case C-208/00, Note 92.

(20) For a recent discussion of this approach, *see* Sandrock, "Deutschland als gelobtes Land des Kapitalgesellschaftsrechts?," Betriebs-Berater 2002, 1601 seq. and *id.* "Centros: ein Etappensieg für die Überlangerungstehorie," Betriebs-Berater 1999, 1337 seq.

(21) Cf. sect. 3 German Transformation of Companies Act.

(22) Cf. sect. 1 German Transformation of Companies Act.