Company law in the European Community

European File

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4/85
February 1985

A cornerstone of the European Community is the creation, maintenance and development of the common market. The essential elements are the four fundamental freedoms: free movement of persons, goods, capital and services. These are complemented by provisions to ensure free competition and to coordinate economic policies. The Community thus strives to further economic and social progress and involves much more than a mere free-trade zone.

These freedoms, while of undisputed value for individuals, are in practical terms of the greatest importance to the companies and firms which undertake the bulk of economic activity within the Community. Article 58 of the Treaty of Rome guarantees the exercise of such freedoms to all companies and firms, and other legal persons, provided they pursue an economic objective.

Transnational dimension and company law

Companies are essentially organizations for economic enterprise set up and run pursuant to legal requirements. Their relationship with their shareholders, employees, creditors or other third parties is in all Member States the subject of detailed legal provisions giving appropriate protection to such persons. Those safeguards, which often predate the Community, may vary widely from one Member State to another.

Furthermore, the very exercise of the freedoms of the common market by companies means that the transnational dimension in their relationship with third parties, whether shareholders, employees, creditors or others, is ever increasing. That increase brings with it conflict between the differing national safeguards to the detriment of those they were designed to protect. The greater the development of the common market the more such disparities inevitably contradict the very principles on which it is based. For those dealing with companies uncertainty results. For companies themselves the result may well be distortion of competition but at very least greater burdens than necessary are imposed on the exercise of the freedoms in question.

Two basic legal approaches provide potential solutions. Both are available to the Community legislator:

- ☐ The first is the introduction of a uniform law at Community level which supersedes or complements national law. To achieve this result the appropriate Community instrument is the regulation which takes effect without any further implementation in the laws of the Member States.

- ☐ The second is the harmonization of national laws by way of directives binding on the Member States as to their results but nonetheless integrated into national law by implementing legislation.

Whichever course is adopted, the European Commission, with whom the right of initiative lies under the Treaties, consults thoroughly with national bodies,

experts and interested parties before formulating a proposal. The proposal is thereafter examined by the European Parliament and the Economic and Social Committee which give their opinion. The Commission may then amend the proposal and the matter passes to the Council of Ministers for final adoption.

Harmonization: achievements to date

Despite the wide scope of Article 58 of the Treaty of Rome, the work of the Community has to date been confined largely to limited companies since these are economically and socially the most important enterprises in the Community. The work has, however, been wide-ranging. Seven major company law directives have been adopted of which three concentrate on accounting.

- The First Directive of 1968 [1] provides a system of publicity for all companies. The Member States must maintain registers open to the public, and also ensure the publication of information in a gazette. The system ensures that information on the same areas is available to the public in respect of all companies in the Community. Disclosure began with matters such as the memorandum and articles, the identities of the persons entitled to act for the company whether jointly or alone, and details on the termination of the company's existence. All subsequent directives have also relied on the system to ensure disclosure of essential matters relating to their specific fields of application.

  The First Directive also dealt with the validity of obligations entered into by a company. Thus a company cannot, as against a third party, rely on the fact that it has exceeded the powers conferred by its memorandum and articles. Member States may, however, allow the company to do so where the third party himself was aware of the breach. Further to protect third parties the directive severely restricted the permitted grounds of nullity of companies.

- The Second Directive of 1976 [2] provides common standards and procedures for the raising, maintenance and alteration of the capital of public limited companies, since their capital represents the major essential guarantee for creditors and shareholders. Thus the minimum subscribed capital of a public limited company must exceed 25 000 ECU.[3] Subscribed capital may be in cash or in kind but in the latter case the consideration must be valued by an independent expert. Profits are defined in order to prevent distributions as 'profit' which would in reality erode capital and reserves. On any increase of capital the existing shareholders must be given the opportunity to take up the new issue of shares proportionate with their existing holdings.

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[1] *Official Journal of the European Communities*, L 65, 14.3.1968, p. 8.
[2] *Official Journal of the European Communities*, L 26, 31.1.1977, p.1.
[3] One ECU (European currency unit) = about £0.61, Ir. £0.71 or US $0.70 (at exchange rates current on 7 January 1985).

☐ The Third and Sixth Directive make available the legal elements necessary for important types of company reconstruction.

- The Third Directive of 1978 [1] introduces in the legal systems of all Member States the transaction of merger, whereby simultaneously the assets and liabilities of the acquired company are transferred to the acquiring company. The process avoids cumbersome procedures by way of winding-up to effect mergers. The shareholders of the acquiring and acquired companies receive an equivalent stake in the merged company guaranteed by the valuation of the share exchange ratio by an independent expert. Prior creditors are also protected and, where the financial state of the companies justifies it, they may require a guarantee.

- The Sixth Directive of 1982 [2] provides for the process of scission whereby an existing company divides into entities. The Member States are not obliged to introduce this means of reconstruction but where they do it must be in conformity with the directive. The allocation of assets and liabilities among the various beneficiary companies requires specific provisions to protect creditors. In the end result joint and several liability for debts ensures their protection.

These two directives apply to transactions confined to a company or companies in the same Member State. Given the increasing diversity of capital holdings and intra-Community trade, the necessity to extend the possibility of mergers to companies in different Member States is clear. In March 1984, the Council of Ministers stressed that progress on international mergers was essential for the economic and industrial development of the Community. The Commission has just proposed a draft directive on such form of reconstruction.

The introduction of the legal potential for intra-Community mergers goes hand in hand with agreement on the taxation of such transactions. The Commission hopes for agreement in 1985 of its proposal in respect of their common tax treatment.

In the longer term the services of the Commission are also working on the allied field of takeovers which achieve the same practical, if not legal, results as a merger.

While the measures for company reconstruction are of value to the Community they cannot be considered in isolation. The European rules requiring free competition and prohibiting the abuse of a dominant position may well require an objective review of their implications. The Commission has there-

[1] *Official Journal of the European Communities*, L 295, 20.10.1978, p. 36.
[2] *Official Journal of the European Communities*, L 378, 31.12.1982, p. 47.

fore proposed that mergers between larger undertakings be regulated at Community level in the interests of competition.[1]

Equally, rights of employees acquired prior to the reconstructions in question are protected to ensure, so far as is possible, that they are not placed in a worse position as a result.[2]

☐ The Fourth, Seventh and Eighth Directives provide a codex of European accounting law, harmonized at a high level although by no means fully complete.

- The Fourth Directive of 1978 [3] fulfils the commitment of the Community in the First Directive to cover the accounts of all limited companies. Standard layouts and detailed requirements on the contents of the notes are given for the balance-sheet and profit and loss account of companies, with the possibility of a more flexible regime for small and medium-sized undertakings. Accounts must give a true and fair view of the company's assets, liabilities, financial position and profit or loss in accordance with principles such as the going concern, consistency, prudence and attribution to the financial year in question. The valuation rules are also defined. The usual basis is historical cost, but Member States may permit alternatives such as current cost valuation provided two basic conditions are respected. Firstly, any additional value thereby achieved cannot be treated as profit but must be entered in a reserve not available for distribution. Secondly, a comparative table must permit the reader to determine both the historical and the current cost basis of valuation.

- The Seventh Directive of 1983 [4] deals with the consolidated accounts of 'groups' of undertakings i.e. of parents and subsidiaries, the Fourth Directive being necessarily confined to individual company accounts. The first question is the definition of the undertakings to be consolidated, i.e. the accounts of which must be taken together to give a financial view of the group as a whole. The basis for consolidation adopted by the Seventh Directive is the legal power of control exercised by a parent over a subsidiary and established either by a majority of voting rights or the right to appoint the majority of board members or a contract giving control. Under the directive the consolidated accounts aim to give a true and fair view of the assets, liabilities, financial positions and profit and loss of the undertaking in the group if they were a single entity. In particular, therefore, the book values of shares of the undertakings consolidated are set off against the proportion they represent of the capital and reserves of those undertakings. Intra-group transactions are also eliminated.

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[1] See *European File* No 2/83: 'European competition policy'.
[2] See *European File* No 9/84: 'Workers' rights in industry'.
[3] *Official Journal of the European Communities*, L 222, 14.8.1978, p. 11.
[4] *Official Journal of the European Communities*, L 193, 18.7.1983, p. 1.

- The Eighth Directive of 1984 [1] defines the qualifications required of those who audit the accounts required by Community law. Both the Fourth and Seventh Directives provide for an independent audit of the relevant accounts. Without high common standards for the auditing profession, results might vary widely. Pursuant to the directive, auditors must undergo defined theoretical and practical training and pass an examination. Thereafter the approval of the auditor must be by a specific act of the competent authority of the Member State.

Future perspectives

The directives adopted to date fulfil the basic groundwork laid down in the 1960s and 1970s but by no means all work has been completed. Current proposals and outstanding initiatives remain.

☐ In respect of the accounts of credit institutions and insurance undertakings the application of the relevant parts of the accounting directives has been postponed until the adoption of specific complementary measures. The Council of Ministers Experts' Group has just begun discussing the amended proposal about the accounts of banks while the latter proposal is being drafted by the services of the Commission.

☐ Following the detailed opinion of the European Parliament discussion has also recently begun in the Council of Ministers Experts' Group on the amended proposal for a Fifth Directive on company structure. This involves a reassessment of the structure and management of the public limited company, including the question of employee participation. While preserving the unitary board structure as an option to the dualist company structure with separate management and supervisory boards, the Commission has sought to achieve equivalence by the recognition in both systems of the distinct functions of board members in respect of management and supervision. So far as employee participation is concerned, the diverse traditions in the field of industrial relations in the Member States led the Commission, in accordance with the opinion of the European Parliament, to offer four equivalent options allowing participation at the supervisory level. These permit the Member States to legislate for elected members of both dualist or unitary boards, coopted board members of a dualist board, a body elected by employees at board level but separate from the board, or for agreements by collective bargaining which achieve an equivalent result. All elections are democratic and by secret ballot.

☐ It would be over ambitious for the Fifth Directive to deal with all outstanding questions relating to 'groups' of companies. A substantive law on groups of undertakings, covering such matters as liability of a parent to subsidiaries, the

[1] *Official Journal of the European Communities*, L 125, 12.5.1984, p. 20.

rights of minority shareholders and of employees and creditors has, however, been the subject of considerable work often referred to as the 'Ninth' Directive. As yet, no formal proposal has been adopted by the Commission.

- In general terms, the future should also see an examination of those directives (Second, Third, Fifth, Sixth) which are restricted to public limited companies, with a view to determining to what extent their provisions should be applied to, and modified for, private limited companies, which are of increasing economic significance.

Beyond company law harmonization

The national nature of companies cannot be overcome by harmonization. The creation of European legal forms could clearly go further in offering possibilities for cooperation and enterprise within the Community. Two proposed regulations have been put forward which would allow undertakings the possibility of cooperation at a Community level, namely the European Economic Interest Grouping and the European Company Statute:

- The Statue is work of a long-term nature and will in due course offer a European incorporation for limited companies as an alternative to national incorporation;

- The EEIG will offer the possibility of cooperation in a flexible structure having legal personality. The members retain their national incorporation and economic independence, but the Grouping works to their mutual advantage. The proposal has proceeded well in the Council of Ministers, being supported by the majority of Member States.

Criticisms and answers

The Community has succeeded to a very considerable extent in the areas tackled to date. That success has, however, also brought a measure of criticism and it is perhaps pertinent to consider why.

- The first answer must be general. Recent years have seen a climate of relative economic uncertainty within the Community. This has caused increased questioning of the need for legislative change including that required by Community provisions, notwithstanding their European dimension. All measures further tend to be judged on their likely short-term alleviation of current problems. Harmonization of laws can, however, only be fully appreciated in the context of longer-term solutions, which cannot be ignored by the Community.

- In more specific terms the directives have been criticized as being low profile and adopting a 'lowest common denominator' or 'minimum harmonization'

approach. This criticism is wholly misconceived. Examples can be taken from all the directives of the overall advances made by the Community in respect of company law. They show that the achievements to date have been effected at a relatively high level.

- Certain Member States had no registers of limited companies prior to the First Directive.

- The First Directive also changed the rules which defined the extent of a company's liability in respect of acts outside its permitted objects (the *ultra vires* principle in 'common law' countries).

- No minimum capital requirement for public limited companies existed in the majority of Member States prior to the Second Directive.

- The protection conferred by an independent assessment of the proposed share exchange ratio in respect of mergers or divisions is, in effect, an innovation. In certain Member States the legal operation of a merger was not even recognized.

- The Fourth and Seventh Directives have to a considerable extent succeeded in reconciling continental and Anglo-Saxon accounting law and practice. They are, as a result, examples of high profile harmonization. It is all too easy to point to 'options' available to the national legislator in the accounting directives to argue that nothing has changed. A superficial examination will place those options in perspective. They do not affect the 'core' provisions of the directives. They must always be explained to permit comparability, usually by way of extensive detail in the notes to the accounts. In short, they allow flexibility while retaining an equivalent degree of protection.

- Further, as a result of the Fourth Directive certain Member States treat public and private limited companies on the same basis for financial reporting and disclosure for the first time, the only distinction being not of legal form but of size, determined by criteria related to balance-sheet total, net turnover and the number of employees. Appropriate recognition has been given of the difficulties of small and medium-sized undertakings. Pursuant to the review clause contained in the Fourth Directive the thresholds for balance-sheet total and net turnover relied upon to determine such undertakings were increased in October 1984.

- The obligation to prepare consolidated accounts pursuant to the Seventh Directive fills a whole or partial vacuum in most Member States. It recognizes the need to legislate for a harmonized solution at Community level.

- By the Eighth Directive the qualifications of auditors have been defined for the first time in several Member States.

The agreements and compromises achieved on such technical and complex problems reflect the desire of the Community to achieve genuine progress. The backlash comes with their implementation and teething troubles. As the Member States put the measures into practice discussion is naturally stimulated. While such discussion is in large measure positive, the work involved on the part of national officials, and, more importantly perhaps, the companies and professionals may well explain a certain short-term negative reaction. This must be put in perspective and viewed in the light of the achievements.

Where, however, this problem produces practical effects, the European Commission does not ignore it. The Commission is taking steps against Member States which have failed to implement directives into their national law in due time in order to build a more effective and a more European environment for companies.

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The Community's aim in respect of company law is by the processes described to create a homogeneous legal environment for business and investment in the Community. In a European context national law converges in favour of common rules and common standards. The process is necessarily gradual but the achievements to date offer ample scope for the conclusion that such an environment is within the Community's grasp ■

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Office for Official Publications of the European Communities
L-2985 Luxembourg

ISSN 0379-3133

Catalogue number: CC-AD-85-004-EN-C