

The European Private Company: An Opportunity from an Economic Crisis?

Rhidian Lewis

Principal Lecturer
Anglia Law School
Anglia Ruskin University
United Kingdom

Aleksandar Buzdrev

Anglia Law School
Anglia Ruskin University
United Kingdom

Tom Mortimer

Director of Strategy for Law
Law and Criminal Justice Studies
Canterbury Christchurch University
United Kingdom

Abstract

The European Commission is undertaking a legal modernisation initiative in order to facilitate small and medium-sized enterprises in unlocking their full potential as active players on the Single Market, being also the backbone of the Union's economy. The flagship of this initiative is going to be a novel European legal form - the European Private Company (EPC) or as it is known the Societas Privata Europea (SPE). Designed as an instrument to do business in the Single Market the SPE aims to be transparent, flexible and offer a strong label everywhere. As with the Societas Europea, there are certain gaps in the SPE Statute, which prompt for the application of national laws. This could result in 27 different SPE forms in the EU, which leads to financial implications regarding the formation and day-to-day operations of the company. A detailed exploration of the corporate finance issues is followed by plausible solutions based on corporate governance theories.

Keywords: European private company, Societas Privata Europea Regulatory Competition, Corporate Finance, European Community Forms of Incorporation, European company law

Introduction

The European Union at a Glance

The European Union is a unique economic and political partnership of twenty-seven independent states. The synergy between Member States is created via a whole range of principles, policies, laws, practices, obligations and objectives, commonly known as *acquis communautaire* (Fairhurst, 2012). With an overall population of more than 500 million citizens the European Union has more citizens than in the USA and Japan put together (<http://epp.eurostat.ec.europa.eu>, 2011). The great variety of the Union's population is accompanied by a variety of "juristic personalities" including companies, corporations, trade unions, political parties and a number of other entities. This list is dominated by a relatively small number of national company forms, such as the British Ltd, the German *GmbH* and the French *SARL* in addition to which supranational company forms such as the European Economic Interest Group, the European Public Company and the European Cooperative Society exist. The dynamic, multifaceted relationships between business entities continue to shape an agenda of modernization of the legal frameworks surrounding the business enterprise, ultimately shaping both the economic and legal structure of the European Community and subsequently the European Union.

The driving forces behind company law reform initiatives have over time been influenced by different economic and socio-political factors such as internationalisation, the development of financial markets, the switch from agriculture-based economies to newer industries including communications and information technologies. In the period between 1975 and 1985 the governments of the Member States became increasingly focused towards European-level, market-oriented solutions as opposed to exclusive, national, strategies as a consequence of the collapse of the different national strategies for economic growth and development (Sandholtz and Zysman, 1992). However, to maximise the opportunities available within an integrated European market place a need exists to implement mechanisms that support entrepreneurial activity across the spectrum of enterprise forms. It is against such a background that the limitations of corporate mobility within the EU are considered. With the bulk of entrepreneurial activities within the EU accounted for by the small/medium enterprise sector (SME) (Makowicz and Saifee, 2009) it appears almost inevitable that modernisation of the European business landscape would look to establish the European private company (Societas Privata Europaea SPE). However, the fate of this new European legal form will be ultimately determined by its capacity to encourage economic growth within the European marketplace as well as cutting operating costs which are often limiting factors for the SME sector. In proposing a statute for the SPE an attempt to develop the principles already established for larger, public limited companies through the statute for the SE (Makowicz and Saifee, 2009) and therefore encourage flexibility and mobility to those entrepreneurs who wish to participate in European, cross border activities.

Obstacles and Costs Facing European Small/Medium Enterprises

In preparing the underlying principles of the statute for the SPE impact assessments scrutinised the potential of the SPE form in respect of the expectations of the interested entrepreneurs (eur-lex.europa.eu, 2008). This working paper underlined the importance of the SMEs to the overall economy of the EU as the sector represents 99% of all European companies and approximately 70% of all jobs in the Union. In addition to which the overarching ambition of the Lisbon Agenda in which greater dynamism and competition within the business sector both within and beyond the EU will ultimately depend on the ability of the SME sector to maximise opportunities irrespective of national boundaries (http://europa.eu/legislation_summaries/employment_and_social_policy, 2005).

Further evidence from public consultation identified that the most significant obstacle for companies to operate beyond their own national markets, is actually the lack of European instruments that favour such operations (www.business-europe.eu, 2007).

Options available to entrepreneurs wishing to expand their business across EU borders include the creation of branches that do not have a separate legal personality or to form foreign subsidiaries with their own legal personality. The introduction of a foreign subsidiary may be regarded as more appropriate for entrepreneurs wishing to engage in cross-border activity as the subsidiary may adopt a cultural personality more in keeping with localised markets and gain potential advantage over other organisations more closely associated with transnational providers. In turn, this may enable the subsidiary an increased element of acceptance amongst local stakeholder groups and benefit from localised taxation regimes which may be more attractive than those in the state in which the parent company is based (Simon, 2006). However, the introduction of a subsidiary whose sole purpose is to have company recognition within another member states brings with it the stigma of a “brass plate” or “letter box” company which may limit the attractiveness to potential business partners (Teichman, 2004). The persistent legislative environment within the EU underpins a range of problems often faced by SMEs wishing to expand beyond their national boundaries through the introduction of secondary establishments. Other issues related to the setting-up of a small subsidiary in the EU, such as high costs to enter new markets, regulatory restrictions, administrative burdens, tax compliance obstacles, limited access to information and others have also caused the low participation on the Single Market by SMEs (Radwan, 2007).

The financial burdens SMEs are facing in their creation and their day-to-day operation of business impede their development and drain their resources. This effect increases when relatively small enterprises with limited financial and human resources have to comply with different company law regimes regulating the formation, cross-border mobility and management of a company (Peters & Wullrich, 2009). Furthermore, company forms from Central and Eastern Europe are less known to their trading partners and customers from the western countries and hence cannot realize their full potential in cross-border activities.

The equivalents to the Limited or the *GmbH* from the new Member States of the Union (EU12) are less recognisable abroad, which automatically makes them less competitive, because their trading partners would have to spend financial resources on investigating legal questions related to their liabilities and other matters (Radwan, 2007). A uniform SPE would provide entrepreneurs from this less economically developed part of the continent with a potent vehicle to conduct cross-border activities. A strong echelon of internationally-active SMEs based in Central and Eastern Europe would inevitably promote sustainable growth and social welfare on a regional basis. Thus, these economically under-developed regions would no longer be a burden to the European Union by draining one-third of its budget through the EU structural funds (www.ft.com, 2010).

The creation and management of companies in different Member States, each complying with a different legislative framework is a heavy burden for entrepreneurs wishing to manage SMEs. First of all, they have to deal with the minimum capital requirement, which has different margins across the Union. There is a great diversity ranging from £1 for a British Ltd., to 35 000 Euro for an Austrian *GmbH*. It is interesting to note that the Austrian government is planning a company law reform, which proposes to lower the minimum capital to 10 000 Euro in order to incentivise entrepreneurs from Austria and other countries to use the Austrian *GmbH* as a vehicle to operate their businesses. Nevertheless, there is still a strong scepticism in Austria regarding such a high requirement for a minimum capital, even if it is being lowered by over two-thirds. Scholars argue that the reform should introduce a similar entity to the German Mini-*GmbH* form, which requires only 1 Euro for incorporation (www.conserio.at, 2010). One argument of the Austrian representatives when criticizing the minimum capital requirement for establishing the SPE as formulated in the Commission's proposal was that there would be no barriers for entrepreneurs, who would rather abuse the market, if allowed to create companies with practically no start-up capital. Nevertheless, there are other expenses that would increase the overall costs for setting up a company far more than 1 Euro. Such expenses cover registration and notary fees, administrative and publication fees, indispensable on the formation of a new company. Therefore, one of the arguments of the proponents for the SPE is the cost-savings effect of the latter regarding the incorporation of companies in each of the Member States.

Reducing the compliance costs arising from the operation of businesses in different Member States with diverse legal frameworks should be a priority in the company law modernization agenda, part of which is the SPE Statute (<http://ec.europa.eu/yourvoice/ebtp/consultations>, 2007). The introduction of a uniform SPE could, theoretically, reduce the costs of setting up a company or a subsidiary abroad, in particular costs related to the formation of companies and the drafting of articles of association regulated by diverse legislation. Furthermore, the SPE could reduce costs related to the management of companies in other Member States, in particular including the cost of expensive legal advice on diverse national legislation regulating the company organization and structure, shares and shareholders' rights. This issue has been referred to in the European Business Test Panel (EBTP) survey by 65% of the respondents (<http://ec.europa.eu/yourvoice/ebtp/consultations>, 2007). Finally, these objectives would be accomplished through the use of a transnational legal entity, rather than by the imposition of significant amendments to the legal systems of the Member States. If we consider the situation regarding the SE and the reduction of the costs of running groups by making it possible to reduce existing national subsidiaries into a single SE, we might come to a different conclusion. According to Kirshner (2009), the intra-group impact of the SE has been rather insignificant compared to the former expectations. Nevertheless, in highly regulated industries, the SE seems to reduce compliance costs, because the company has to comply with only one set of rules rather than with the different rules applicable to each subsidiary.

Administrative requirements for the formation of the SPE

The formation of the SPE is intended as a quick and inexpensive process, which will further incentivise investors with limited financial capacity. The proposal incorporates a closed list of all required documents upon registration, consisting of information about the name of the company, its address or addresses, depending on the outcome of the seat debate, the share capital and the articles of association (Article 11 of the Proposal for a Council Regulation on a European private company, 2011). Consistent with the approach under s.31 of the UK Companies Act 2006, the proposal for the SPE Statute does not require the shareholders to specify the objects which the company will pursue while it is active on the market. This is a delicate touch by the legislator, which may be regarded as insignificant compared to other issues surrounding the corporate governance of the SPE. Nevertheless, the deliberate omission of such a requirement enables a wider spectrum of options available to the SPE, which would presumably be very active on the field of European tenders.

Thus, theoretically SPE's can have unrestricted initial access to various bid procedures and win them, if they have the capacity to do so. Another attempt to relieve entrepreneurs from administrative burdens is the incorporation of the 'one-stop-shop' (Walke, 2009) and the 'e-justice' (EU, DG Justice, Freedom and Security, 2008) initiatives, which provide companies with the option to comply with all formalities needed as a requisite for the establishment of a legal entity at a single point by electronic means. The registration document and particulars of the SPE are subject to either administrative/judicial check or a certification process. From a UK perspective the formation of the SPE will depend on the written statement of compliance to the Registrar of Companies.

Minimum capital requirements for the incorporation of the SPE

In its initial proposal the Commission set up the minimum capital requirement at €1.00, thus demarcating its formation from the more conservative approach which considers that a high initial commitment by the company's shareholders inevitably guarantees strong creditor protection. A second proposal opted for a minimum capital requirement ranging from €1.00 to €8000, depending on the applicable national law. A third proposal provided a more sophisticated approach, interrelating concepts within the areas of freedom of establishment and creditor protection. It proposed for a diversification between Member States which forbid or allow a company to have its registered office and central administration in different countries. Thus, companies registered in countries that negate this freedom would be subject to a lower minimum capital requirement, while the incorporation of an SPE in Member States of the second group would be possible only if €8000 are being provided as a start-up capital. The long-awaited meeting of the Competitiveness council on 30th May 2011 dismissed all the aforementioned options. Unfortunately, and rather unexpectedly, at the meeting which took place in June 2011 the delegations did not debate this issue regarding the SPE and the matter of minimum capital requirement remains unresolved (European Council, 2011).

One concept that plays a vital role for private companies is the legal capital, as a means of creditor protection. Prior to modernizing company laws around Europe, many regulatory frameworks have used the 2nd Company Law Directive as a legal reference beyond its pre-defined margins set out by the Commission. Thus, the complex system of legal capital for public companies was applied to private companies, whose shareholders had to invest a minimum level of equity capital in their company. This concept of creditor protection was influenced by the German model and opposed the Anglo-American model, which promoted creditor protection mostly by contract, rather than by law. The position towards legal capital *vis-à-vis* creditor protection regarding public companies is not going to be changed in the foreseeable future, according to DG Internal Market and Services (2009). Nevertheless, legal capital regarding private companies in Europe has been the object of modernization in the last decade and different countries have chosen various regimes of capital and creditor protection. In the context of the SPE, this diversification of regimes has been detrimental to the adoption of it statute. The proposal of the Competitiveness Council to allow a wider margin for a minimum capital requirement ranging from 1 Euro to 8000 Euros according to the applicable national law, as discussed above, was dismissed by the German delegation. The reasons behind this decision can be understood only if the concepts of the German and Anglo-American doctrine regarding equity capital and creditor protection are being distinguished and compared. This is the purpose of the following analysis.

Corporate governance pre-defines corporate finance

The EU Commission (http://ec.europa.eu/internal_market/company/docs/epc/proposal_en.pdf) proposed that creditors nowadays are more interested in the cash-flow of a company and protect themselves by contract rather than mere reliance on the legal capital. Furthermore, the relatively small amount of legal capital cannot provide sufficient protection for creditors, but can prove highly burdensome for entrepreneurs with limited financial capabilities at the outset of their business endeavour. The function of the 'equity cushion' does not provide efficient creditor protection in the case of insolvency. Involuntary debtors to the company, who are not protected by any contract with the company, can nevertheless find protection within compulsory insurance. These factors underpin the importance of retaining the initial concept of an insignificant legal capital required for the formation of the SPE. However, after the latest failure of the Council to reach agreement towards the requirement for a legal capital, it seems rather unlikely that the German legal doctrine can be completely ignored. Hence, any subsequent compromise proposal has to bear this in mind and work towards a model of convergence. One possible solution could be the partial implementation of the concept, which has been introduced with the new corporate form in Germany, namely the *Unternehmergeellschaft (UG)*, also known as the *Mini-GmbH*.

The rules regulating the *UG* require no minimum legal capital on the formation of the company. However, the company has to save one quarter of its yearly income in order to raise its capital until it reaches the sum of 25 000 Euros. If this concept, slightly amended, can be implemented unanimously in the regulation for SPE Statute, this might still provide SMEs with a potent, yet accessible vehicle for their cross-border activities. The proposal could set a lower limit for the capital that has to be reached and for the percentage of yearly saved income in order to reduce the negative financial impact of setting-up and managing a SPE. On the other hand, one of the major incentives for entrepreneurs to form a SPE is the lack of requirement for investments towards the legal capital. Even the less burdensome concept of the *UG* could hinder the financial condition of the majority of newly formed small companies, which would rather suffer losses in their first years of business activity or in some limited cases would register limited profit.

The German company law model has had a somewhat weak reformatory spirit and has moved slower through the modernization agenda of the European institutions in many aspects, such as freedom of establishment, minimum capital requirements and employee participation. The legal framework behind the SE has been influenced strongly by the German doctrine, in order to be adopted with the required unanimity. Nevertheless, the Report on the European Company Statute in 2010 showed that many problems still exist in practice (European Commission Report, 2010). One of the negative drivers and a major practical implication are the set-up costs faced even by financially capable entrepreneurs aiming to set-up a large company. The same problem would be faced by entrepreneurs willing to form a SPE, if the German approach regarding the legal capital is implemented. Since its enactment in 1892, the *GmbH* Act provides strong creditor protection on the basis of statutory minimum capital requirement. The required legal capital in 1892 was 20 000 Deutsche Mark, which is comparatively a much higher burden than the capital required nowadays. The rationale for this was the social disapproval regarding a company with limited liability, which at that time was a novel form that was met with suspicion within commercial circles (Leuring, 2006). Thus, the introduction of the equity capital in limited liability companies was necessary for their affirmation. However, the market has evolved at a rapid pace and nowadays the concept of limited liability is the norm, rather than the exception, in a sense that in addition to SMEs, many large businesses choose this model of incorporation (Koch Industries, Chrysler, PricewaterhouseCoopers International).

The function of the minimum capital requirement can be observed as three-fold. It provides the company with a working capital, which is fully available to the company's business and serves as a first basic asset. Furthermore, it provides precautionary creditor protection as a capital buffer against the risk of insolvency, which promotes financial stability and indirectly protects the stakeholders. A third function of the legal capital is that it establishes a seriousness threshold (Dähnert, 2009). The latter feature is considered by Hommelhoff and Teichmann (2008) as very important regarding the SPE in which they observe that there is a strong correlation between the concept of minimum capital requirement and the seriousness test and an entrepreneur, who cannot provide sufficient equity capital for his company, should not have the privilege of a limited liability. German law provides mechanisms of creditor protection based on the above mentioned three-fold pillars of minimum legal capital requirement. However, the German legislator seems to apply this concept somewhat inconsistently, if we observe the *Unternehmersgesellschaft (UG)*, which requires no initial investment at all. It is true, that the shareholders have to increase the capital during the first years of the life of the company, until it reaches 25 000 Euro. Nevertheless, a fraudulent entrepreneur would theoretically be able to raise this amount, or otherwise his venture would be rendered insolvent by himself or the shareholders. Another argument against the seriousness test, if we observe the *GmbH*, which requires 12 500 Euro initial investment, is the fact that this sum is easily achievable by shareholders, who might wish to be involved in a criminal activity. Once again, this measure proves to be inappropriate mainly because of its disproportionate effect.

Another aspect of the legal capital is its role as a substitute to the limited liability of the shareholders. If we scrutinize the first function, we may ask ourselves the question, whether it is necessary that the issue of legal capital is regulated? If there is no such necessity, than the removal of the minimum capital requirement should be to a great extent satisfied. A comparison of the financial implications that German private companies have been facing upon formation in the beginning of 20th Century and are facing now might provide the correct answer. In the beginning of the 20th century the average level of legal capital raised by the shareholders has been 10 times higher than the statutory minimum of 20,000 Deutsche Mark.

In the beginning of 21st century, only 13.8% of the SMEs in Germany invested their own resources in the form of private equity capital (Meyer and Hermes, 2005) of which 68% had to rely on loans from the banking sector in order to meet the capital requirements, secured through the German equivalent of fixed and floating charges (ibid). A similar process can be expected to take place regarding the SPE, if we scrutinize the Compromise proposal, which repeats the Parliament proposal, even though both were refuted by the German delegation. Where the management body have not signed a solvency certificate, the capital of the SPE should be at least 8000 Euro. The majority of small enterprises would still have to seek a bank loan in order to raise the capital. This mechanism has been supported in 2008 by the Committee on Legal Affairs (CLA), the Committee on Employment and Social Affairs (CESA) and the Committee on Economic and Monetary Affairs (CEMA). Nevertheless, the CLA expressed its view, that the equity capital should not represent a serious obstacle to the establishment of SMEs. Moreover, the present economy environment, shaped by the latest economic crisis, requires business-friendly legal frameworks, which would promote the incorporation of SMEs and their successful management.

Another argument against the German model is the fact that the legal requirement for a minimum capital rarely satisfies the debtors of an insolvent company. In addition to that, it is not either economically optimal for most SMEs, because the majority of them can function with limited financial instruments. Hence, entrepreneurs who plan to set-up a small company are facing a highly burdensome requirement, which might prevent them from establishing a company in a Member State with higher capital requirements. The factual financial requirements for the setting-up of different SMEs and their effective management vary greatly and therefore any imposition of legal capital would be a great disincentive for most entrepreneurs. The majority of SMEs are service businesses, which require very small initial investment. Furthermore, it is not uncommon for British companies, which are practically formed without minimum capital, to increase their capital shortly after incorporation, thus providing some minimum creditor protection by means of equity capital. There seems to be a major disproportion between the attained efficiency of the minimum capital and the negative effect on economic activity, where the latter is much stronger. Moreover, the concept of creditor protection is also undermined, because even 25 000 Euro do not offer the required level of protection for the debtors of a company. Furthermore, it has been suggested that SME's which go into liquidation pose no systematic risk to the economy hence the application of rules regulating financial institutions such as high levels of minimum capital remains disproportionate (Armour, 2006).

As seen from the discussion above, the concept of minimum capital requirements for newly formed private legal entities has become a highly criticized topic. Hence, many European countries have chosen to abolish this concept, in order to promote efficiency and performance of SMEs. A prominent team of scholars, analysing the SPE also welcomed the abolition of legal capital, which overly deters entrepreneurs from establishing companies, while it does not offer single-handed creditor protection (Zaman *et al.*, 2010). The negative effects of the minimum capital requirement are amplified *vis-à-vis* the current European economic environment. Only an economic analysis that can outline the extent of creditor protection needed for SMEs, without hindering its formation and operation, can have a strong political impact on the SPE agenda. If a future proposal for an SPE Statute wants to succeed in gaining unanimity, while still deflecting the concept of creditor protection away from the minimum capital requirement, the legislator should provide other workable solutions for unsecured creditors. There should be a shift from the concept of minimum capital requirement as means of creditor protection in SMEs, towards enhancing the regime of capital maintenance. While these concepts may seem interrelated, each of them is self-sufficient and can be implemented separately to the required extent. If equity capital appears to be irrational for SMEs, than focusing on capital maintenance should be a priority for the legislator.

Conclusions

The latest compromise proposal of the Hungarian presidency was rejected in May 2011 by the German and Swedish delegations. The minimal capital requirements turned out to be one of the greatest hurdles on the road to the SPE, because of the notion that the formation of a SPE with a minimum capital of 1 Euro would create a market with numerous underdeveloped, yet active companies (www.gmbhrecht.at, 2011). Almost simultaneously in Germany, a company law reform has introduced a novel company form UG (*Unternehmergeellschaft*), which does not require initial investment. The legislative framework behind this limited liability company has not entirely embraced the Anglo-American model for a minimum legal capital and still requires yearly financial contributions up until the capital reaches 25 000 Euro.

Nevertheless, the reform indicates that even the most conservative legal systems are evolving under the pressure from other company law regimes. The prospects for diminishing the capital requirement for the formation of an SPE are plausible, since this is the trend for the European company law. After all, high minimum capital requirements are neither an effective means of creditor protection nor a plausible seriousness test as observed above. It should be stressed that the basic level of creditor protection provided by the SPE Statute can be improved by adopting mechanisms such as personal guarantees, floating charges or retention of title. SMEs would welcome the adoption of an SPE Statute that would deal with the aforementioned issues in a business-friendly way. This would reduce the costs of setting up a company and the compliance costs resulting from diverging company law regimes throughout the Union.

A single legal form across the Union would also greatly reduce the cost of operating a group of companies in different Member States while at the same time promote legal certainty. Initially, the SPE model is expected to be adopted by SMEs that are already involved in cross-border activities and wish to enhance their operations abroad. In the medium and long term, when more entrepreneurs become aware of the new corporate form, the SPE would display its full potential by facilitating cross-border investment and joint ventures. From a sociological perspective, the economic growth resulting from the increase of cross-border activities conducted by SMEs, would potentially foster job creation and employment in the Union.

It is to be hoped that agreement upon the SPE Statute can be achieved in the subsequent meetings of the Competitiveness Council and that the broadly supported idea by both entrepreneurs and scholars would manifest into an *optimus* legal entity that can mitigate the damage caused to the Community by the current on-going financial crisis. By encouraging entrepreneurs from all Member States to establish new businesses that can grow rapidly and compete effectively on the global market, the European Union will be able to effectively boost economic growth and employment rates, thus reaching another milestone on the way to becoming the most competitive and dynamic knowledge-based economy in the world. But it may be tempting fate to speak of an economic placebo just as the continent experiences its biggest financial crisis in decades. These are straitened times and entrepreneurship has never been a more risky endeavour. But as we have seen SME's could thrive in the face of different political and economic conditions Perhaps the continent's present crisis could actually be the impetus for a new generation of European entrepreneurs.

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