

Legal Capital and Limited Liability Companies: the European Perspective*

by

MASSIMO MIOLA**

The debate over the future of legal capital in Europe has begun. Inspired by the American system centered on the solvency test and by the forthcoming changes in accounting rules, Jonathan Rickford and others have launched an attack on the Second Directive. The European Union has recently commissioned a "feasibility study". However, resistance is still strong, as creditor protection achieved by legal capital rules has still not been proved less efficient. Working groups have been constituted and a considerable amount of research is being carried out. This article provides an overview over the current state of the debate and tries to work out a compromise between attack and defence.

Table of Contents

ECFR 2005, 413–486

I. Introduction	414
II. The principles of the legal capital system	418
III. The main criticisms of the legal capital rules	425
IV. Legal capital and limited liability companies	430
V. Capital rules in the UK private company and similar corporate forms of EU Member States	436
VI. The simplification of capital maintenance rules in limited liability companies: the case for share repurchasing	448
VII. Alternative creditor protection systems: the solvency tests	454
VIII. Legal capital rules in comparison with insolvency law	460
IX. Legal capital rules and the structure of corporate finance: Corporate distributions to shareholders and accounting standards	468
X. Legal capital rules and categories of corporate creditors	472
XI. Legal capital as minimal, but not exclusive system of creditor protection	478
XII. Conclusion	484

* Professor of Law and Director of the Department of „Diritto comune patrimoniale“ at the University „Federico II“ of Naples.

** This article has been developed by a paper conceived for the Working Group “Kapital in Europa” directed by Prof. Marcus Lutter. The author is grateful to Prof. Lutter for the opportunity and to Prof. Giuseppe B. Torcale for his essential suggestions and the constant support.

I. Introduction

The debate over whether legal capital is useful or even necessary in public limited companies is reflected in the current state of EU company law, e.g. see the Second Company Law Directive (77/91/EEC).¹ Likewise, the implications and perspectives of the legal capital doctrine are diverse and constantly changing, especially with reference to *law & economics* and the cost-benefit approach;² interdisciplinary and comparative analysis also play a major role.³

Currently, legal capital rules are undergoing drastic revision because they are considered cumbersome and “archaic”, an instance of a “historical anomaly”,⁴ e.g. from the viewpoint of US company law. For that reason, it must be thoroughly investigated whether our only option is to repeal legal capital rules or whether there may be some intermediate solution that could maintain the legal capital regime through more effective gains and fewer costs. Thus, it is opportune to look carefully at the various aspects of the legal capital doctrine, i.e., the general framework of tools for protecting creditors and their possible competition.

In particular, given the most recent reports, it bears examination whether creditors should be protected through mandatory rules or if the liability of the indebted company towards their creditors should be the subject of free

1 On the crucial issues of the current debate, see Mülbert – Birke, “Legal Capital – Is There a Case Against the European Legal Capital Rules?” 3 EBOR (2002) 695 *et seq*; Mülbert, “Zukunft der Kapitalaufbringung/Kapitalerhaltung”, Der Konzern (2004) 151 *et seq*; Schön, “Die Zukunft der Kapitalaufbringung/-erhaltung”, Der Konzern (2004) 162 *et seq*; Merkt, “Der Kapitalschutz in Europe – ein rocher de bronze?”, ZGR (2004) 305 *et seq*; Couret – Le Nabasque (eds), “Quel avenir pour le capital social?” (2004); Le Cannu – Parleani, “Le financement du Capital”, Rev. soc. (2005) 13 *et seq*; Eidenmüller – Engert, “Rechtsökonomik des Mindestkapitals im GmbH-Recht”, GmbHR (2005) 433 *et seq*.

2 Enriques – Macey, “Creditors Versus Capital Formation: The Case Against the European Legal Capital Rules”, Cornell Law Rev. (2001) 1165 *et seq*; Armour, “Share Capital and Creditor Protection: Efficient Rules for a Modern Company Law”, Modern Law Rev. (2000) 355 *et seq*; on the lack of comparability between the European legal capital rules and the U.S. system of creditor protection, see Merkt, “Creditor Protection and Capital Maintenance from a German Perspective”, EBLR (2004) 1057; Kuhner, “Zur Zukunft der Kapitalerhaltung durch bilanzielle Ausschüttungssperren im Gesellschaftsrecht der Staaten Europas”, Cologne Working Papers on Banking, Corporate Finance, Accounting and Taxation, 01/2005. On the statistics about the different percentages of bankruptcies, with and without legal capital, see Grundmann, *Europäisches Gesellschaftsrecht* (2004) n 320 *et seq*, with a summary of the main criticisms of legal capital.

3 See Rickford (ed), “Reforming Capital. Report of the Interdisciplinary Group on Capital Maintenance”, EBLR (2004) 919 *et seq*.

4 Hamilton, “Corporation Finance” (2nd edn. 1989) 69 *et seq*.

bargaining.⁵ What is at issue here is whether mandatory protection should focus on the net assets of the company. Only in the first case are there further questions, such as favouring, in the net assets system, the formation of legal capital, and more specifically, the establishment of the various ways in which that system works.⁶

The answer cannot be expected to be unambiguous because in addition to a potential reduction of transaction costs due to mandatory regulations, especially when contractual remedies are not available, the costs of a regime that is too strict should also be taken into account.⁷

In this context, the study of the legal capital regime and of the techniques of creditor protection is particularly helpful with regard to the corporate forms traditionally used by “closed companies”, which are limited liabilities companies (*GmbH* in Germany, *società a responsabilità limitata* in Italy, *société a responsabilité limitée* in France, *sociedad de responsabilidad limitada* in Spain, etc.). These are also named, in contrast to public (limited) companies but in accordance with English company law, *private companies*.

For greater convenience, we can consider these corporate forms from a unitary viewpoint; these companies are not covered by the legal capital regime of the Second Directive.⁸ This set of companies is multifaceted not only in connection with the legal capital doctrine, but also in the context of the EU’s

5 Hertig – Kanda, “Creditor Protection”, in Kraakman – Davies – Hansmann – Hertig – Hopt – Kanda – Rock (eds), *The Anatomy of Corporate Law. A Comparative and Functional Approach* (2004) 72 *et seq*; Mülberty, *Zukunft der Kapitalaufbringung*, 153.

6 Denozza, “A che serve il capitale? (Piccole glosse a L. Enriques – J. R. Macey, Creditors Versus Capital Formation: The Case against the European Legal Capital Rules)”, *Giur. comm.* (2002) 585 *et seq*.

7 Hertig – Kanda (n 5) 72, who singles out the case of creditors unable to negotiate a suitable protection of their interests.

8 See Art. 1, para 1°, directive 77/91/CEE; Habersack, *Europäisches Gesellschaftsrecht* (2nd edn 2003) n 136 *et seq*. For an overview of the main characteristics and the development of limited liability company law in a number of EU Member States, see Lutter, “Die Entwicklung der GmbH in Europa und in der Welt”, in Lutter – Ulmer – Zöllner (eds), *Festschrift 100 Jahre GmbH-Gesetz* (1992) 49 *et seq*; Lutter, *Europäisches Unternehmensrecht* (4th edn 1996) 62; Lutter, “Limited Liability Companies and Private Companies” in *International Encyclopedia of Comparative Law*, vol. XIII (1998); and recently, Lutter, “Zur Entwicklung der GmbH in Europa und in der Welt”, *GmbHHR* (2005) 1 *et seq*; Behrens, *Die Gesellschaft mit beschränkter Haftung im internationalen und europäischen Recht* (1997); De Kluiver – Van Gerven (eds), *The European Private Company* (1995) especially, De Kluiver, “Europe and the Private Company. An Introduction”, 21 *et seq*; Drury, “Private companies in Europe and the European Private Company”, in McCahery – Raaijmakers – Vermeulen (eds), *The Governance of Close Corporations and Partnerships. US and European Perspectives* (2004) 375 *et seq*.

demand for company law structures capable of providing limited liability and being suitable for closely held firms.⁹

The usefulness of this study depends on the current lack of European restraints on these corporate forms as they pertain to legal capital, and permits a better evaluation of the regimes intended to protect creditors within the EU, which are more or less consistent with legal capital rules derived from the Second Directive. Moreover, it is helpful to review whether a differentiation between the legal capital rules for the various corporate forms in the EU is permissible and justified and, also, whether it should be deepened by the national legislators, or, on the contrary, avoided. One of the means of achieving this aim may be to extend harmonisation in the field of legal capital to the limited liability companies.

Of course, the differing scope of the directive has consequences proportionate to the prevalence of the public limited company and the limited liability company within the EU Member States; where the number of the first is lower than the number of the second, the consequences are certainly greater.¹⁰

Several elements make an examination essential: first, the latest trends in the harmonisation of EU company law have undergone comprehensive revision insofar as mean and scope,¹¹ largely due to a perceived “loyalty crisis”; second, the Member States’ resistance to the implementation of the Directives;¹² and, third, the race towards a simplification and a greater flexibility of the legal capital rules as introduced by the Second Directive.¹³

9 McCahery – Vermeulen, “The Evolution of Closely Held Business Forms in Europe”, 26 *Jour. Corp. Law* (2001) 855 *et seq.*

10 Particularly, in Germany there are 950.000 *GmbH*; in Netherland 500.000 *BV* (*Besloten Vennootschap*); in France 700.000 *SARL*; in Spain 900.000 *societad de responsabilidad limitada*; in Great Britain 2.100.000 *private companies*. An up-to-date survey of the spread of the two types of companies in the various EU Member States, see Wymeersch, “A Status Report on Corporate Governance Rules and Practices in Some Continental European States”, in Hopt – Kanda – Roe – Wymeersch – Prigge (eds), *Comparative Corporate Governance. The State of the Art and Emerging Research* (1998) 1045 *et seq.*; *id.*, “Unternehmensführung in Westeuropa. Ein Beitrag zur Corporate Governance-Diskussion”, AG (1995) 299 *et seq.*; Schwarz, *Europäisches Gesellschaftsrecht* (2000) n 530 *et seq.*; Habersack (n 8) n 50 *et seq.*; Drury (n 8) 381; with particular reference to Germany, see Wiedemann, *Gesellschaftsrecht*, vol II, *Recht der Personengesellschaften* (2004) 25 *et seq.*

11 Especially, these is now a large number of techniques for the development of the EU company law: see Merkt, “Die Pluralisierung des europäischen Gesellschaftsrechts”, RIW (2004) 1 *et seq.*

12 See Behrens, “Krisensympome in der Gesellschaftsangleichung”, *EuZW* (1996) 193; Portale, *La riforma delle società di capitali tra diritto comunitario e diritto internazionale privato*, *Europa e diritto privato* (2005) 101 *et seq.*

13 On the debate on the reform of the Second Directive, see, with ample explaining, Baldamus, *Reform der Kapitalrichtlinie* (2002) 37 *et seq.*

The proposals for the simplification of the Second Directive, starting with the EU Commission-acknowledged¹⁴ Company Law SLIM-Working Group (part of the Simpler Legislation for the Internal Market initiative) have been more recently accepted and strengthened (“SLIM plus”) by the High Level Group of Company Law Experts¹⁵ and confirmed by the Action Plan of the Commission of May 21, 2003, which is faced by a more radical approach, for the introduction of an alternative regime to legal capital.¹⁶

The latest developments in the EU are characterized by prudence joined with a diligent cost-benefit approach.¹⁷ At least in the medium term, they have flowed into the draft of the amended Second Directive (21/9/2004 COM 2004), especially with respect to the rules concerning non-cash contributions, share repurchases and financial assistance.¹⁸

On the other hand, this essay will consider the spread of jurisdictional and regulatory competition within the European Union, e.g. due to recent judgments of the European Court of Justice (ECJ) that tend to subordinate the legal capital regime of EU Member States to the freedom of establishment. As a result, techniques of creditor protection are subject to legislative competition, with effects also evident on the more general issues of preservation of

14 See the *Recommendations of The Company Law Slim Working Group on Simplification of the First and Second Company Law Directives* (1999); for a specific exposition of the *Proposals* of the SLIM Working Group, see Baldamus (n 13) 91 *et seq*; Neje, “SLIM-Schlankheitskur für EU-Gesellschaftsrecht”, ZIP (1999) 1944 *et seq*; Drygala, “Die Vorschläge der SLIM-Arbeitsgruppe zur Vereinfachung des Europäischen Gesellschaftsrechts”, AG (2001) 291 *et seq*.

15 High Level Group of Company Law Experts, *Report on A Modern Regulatory Framework for Company Law in Europe* (2002) ch. IV, § 2 *et seq*, hereinafter referred as High Level Group.

16 EU Commission, *Modernising Company Law and Enhancing Corporate Governance in the European Union-A Plan to Move Forward*, § 3. 2, hereinafter referred as *Action Plan*. On general comments on the *Action Plan*, see Habersack, “Europäisches Gesellschaftsrecht im Wandel”, NZG (2004) 1 *et seq*; Ferrarini, “Armonizzare il governo societario in Europa?”, Riv. soc. (2004) 551 *et seq*; with more details on the legal capital debate, see Hopt, “Europäisches Gesellschaftsrecht und deutsche Unternehmensfassung/Aktionsplan und Interdependenz”, ZIP (2005) 461 *et seq*.

17 The results of the public consultation of the *Action Plan* (n 16) showed that a large number of respondents welcomed the Commission’s intention to launch a study into the feasibility of an alternative to the capital maintenance regime, but any idea about the possible introduction of an alternative regime in the Second Company Law Directive was forcefully criticized by close to half the respondents on the issue (see *Synthesis of the Responses to the Communication if the Commission to the Council and the European Parliament – A Working Document of DG Internal Market* (2003) 18 *et seq*; see also Merkt (n 2) 1045 *et seq*.

18 On that draft, see Menjucq, “Perspectives européennes du capital social”, in Couret – Le Nabasque (n 1) 145 *et seq*.

legal capital in public companies.¹⁹ In some EU Member States, recent company law reforms have more or less taken this statement into account.

First, this article aims to examine the main criticism leveled at the legal capital regime. Thus, it is necessary to consider the various incentives for improving the European legal capital regime, not only with regard to the amendments to the Second Directive, but especially to regulatory competition in light of ECJ rulings.

Then, we shall examine the specific perspectives of legal capital in limited liability companies with respect to regulatory competition, both the full removal of minimum capital requirements and the simplification of formation and maintenance of legal capital.

The last part attempts to insert the specific questions of legal capital rules for limited liability companies into the main issue of legal capital's usefulness, in comparison with the alternative creditor protection system and the evolution of the corporate finance structure.

II. *The principles of the legal capital system*

Legal capital is the total amount stated in the balance-sheet as a liability, which corresponds to the value of initial contributions made by shareholders and further, throughout the life of the company, the net assets firmly designated for business activity. Therefore legal capital binds the autonomy of the company's organs with the distribution of net assets to shareholders.²⁰

Due to this regime, deriving from the German company law, "*die persönliche Entlastung der Anlegergesellschaften [ist] mit der Sicherung der Kreditwürdigkeit der Unternehmen in idealer Weise [verbunden]*".²¹

The legal capital regime is closely connected to creditor protection, especially in limited liability companies. That idea began to spread in the nineteenth century and culminated with the promulgation of the Second Directive.²²

19 Mühlbert – Birke (n 1) 700.

20 For European literature, see especially Lutter, *Kapital, Sicherung der Kapitalaufbringung und Kapitalerhaltung in den Aktien- und GmbH-Rechten der EWG* (1964) 50 *et seq*; Dana – Démaré, *Le capital social* (1989) 17 *et seq*; Portale, "Capitale sociale e società per azioni sottocapitalizzata", in *Tratt. delle soc. per az.*, vol. 1** (2004) 3 *et seq*; Spolidoro, voce "Capitale sociale", in *Enc. dir.*, Agg. IV (2000) 208 *et seq*; Bezzenberger, *Das Kapital der Aktiengesellschaft* (2005).

21 Wiedemann, *Gesellschaftsrecht*, vol I (1980) 557 *et seq*.

22 An illustration, also from the historical perspective, of the techniques of creditor protection, and particularly of the spreading of the legal capital doctrine, although with different views, see Portale (n 20) 11 *et seq*; Escher – Weingart, *Reform durch Deregulierung im Kapitalgesellschaftsrecht* (2001) 59 *et seq*; Hertig – Kanda (n 5) 84.

For our purposes, it is not relevant whether the legal capital rules are directly intended to protect creditors, especially through the legal selection of non-cash contributions, or whether – as would be better – it is meant to provide the net assets which are essential or helpful for business activity and profitability, thereby indirectly protecting creditors.²³

In fact, the question is fundamentally related to the determination of the net worth of the company, through the selection of assets which shareholders may contribute to the company. We do not consider the organizational function of legal capital²⁴ because it could be realised by a merely symbolic amount,²⁵ or even without the legal capital regime.

In substance, the convenience of limited shareholder liability must be reconciled with the protection of corporate creditors. Therefore, as liabilities connected with running the company are externalised, it is necessary to avoid opportunistic behaviour on the part of shareholders, which is doomed to increase when insolvency is drawing near.²⁶

These behaviours – as pertains to dividends distribution – may consist either in accelerating the return, directly or indirectly, of residual net assets to shareholders to the detriment of creditors. This can be done through various forms of confusing corporate assets with shareholders' assets, or by making investments and divestments whose positive results, in relation to the assumed risks, may benefit shareholders, while negative results affect creditors.²⁷

In several legal systems, the most direct way to avoid these results involves imposing some duties on the directors during the company's winding up or, at least, imposing their liability for carrying on the firm's activity when the company is in the proximity of insolvency, without providing for its liquidation.²⁸

23 Pentz, in *Münchener Kommentar zum AktG*, vol 1 (2nd edn 2000) § 5 n 21; Portale (n 20) 18 *et seq*; Miola, "I conferimenti in natura", in *Tratt. delle soc. per az.*, diretto da Colombo-Portale, vol. 1*** (2004) 46 *et seq.* with further details; with difference, Hüfner, *AktG* (6th edn 2004) § 7 n. 1.

24 On the limited consequences of this function, due especially to the breaking of the rule *one share-one vote*, see Le Cannu, "Les rides du capital social", in Couret-Le Nabasque (n 1) 8 *et seq*; Sciuto-Spada, "Il tipo della società per azioni", in *Tratt. delle soc. per az.*, diretto da Colombo-Portale, vol. 1* (2004) 29 *et seq.*

25 See Pietrancosta, "Capital zéro ou zéro capital", in Couret – Le Nabasque (n 1) 127 *et seq.*

26 Cf. Easterbrook-Fischel, "Limited Liability and the Corporation", *Univ. Chicago Law Rev.* (1985) 89 *et seq*; Davies, *Introduction to Company Law* (2002) 78 *et seq*; *id.*, "Legal Capital in Private companies in Great Britain", *AG* (1998) 349; Cheffins, *Company Law. Theory, Structure and Operation* (1997) 496 *et seq*; Enriques – Macey (n 2) 1168 *et seq.*

27 Mühlbert – Birke (n 1) 709 *et seq*; Mühlbert (n 1) 153 *et seq.*

28 Hertig – Kanda (n 5) 73 *et seq.* with specific regard to the liability for wrongful trading (s. 214 IA), see below, VIII.

According to the economic analysis of law, the existence of rules intended to protect transactions with corporate creditors originates from the lack of perfect capital markets where, thanks to transparency requirements and contractual provisions, the advantages in terms of remuneration are fully related to the assumed risks, so that there is no danger of opportunistic behaviour.²⁹

In such terms, the legal capital doctrine has to be considered with regard to the various techniques of creditor protection, to their advantage and to the possibility and usefulness of the integration among them.³⁰

The pattern of protection varies in intensity and method in most jurisdictions, reflecting more general differences between the legal systems. In countries whose company law is creditor oriented, it leads to dualism, e.g. the EU Member States and chiefly Germany, precisely because of the legal capital regime, and other countries that must be considered debtor-oriented, like the U.S., which intends to favour the shareholders' interests, which is to say the investors' interests, emphasizing greater flexibility of corporate financing while creditor protection is moved out of the realm of company law.³¹

Nevertheless, as pertaining to the advantages-disadvantages test, and as to the effects of protection, there is already substantial equivalence of the legal systems; moreover, there is a trend towards further convergence among them, derived from pressure exerted by capital markets, in particular by the debt market.³²

29 Armour (n 2) 357 *et seq.*

30 Hertig – Kanda (n 5) 71 *et seq.* It is necessary to consider, to that end, a reasonable balance, or a proportionality, between the interest to generate a return for investors, by which companies could perform and contribute to general welfare, and the circumstances that any return of assets increases the risk to creditors. The question is the determine the limit, inside which this balancing may extend without limitations of freedom of contract, while outside there is the need for the market's protection, see Rickford (n 3) 967 *et seq.*

31 Enriques – Macey (n 2) 1173; Kübler, *Aktie, Unternehmensfinanzierung und Kapitalmarkt* (1989) 57 *et seq.*; Merkt (n 2) 1048 *et seq.*

32 Lutter, "Gesetzliches Garantiekapital als Problem europäischer und deutscher Rechtspolitik", AG (1998) 375; Hertig – Kanda (n 5) 97 *et seq.*, also with reflections about the importance of the differentiation between the various legal systems. This phenomenon is part of the wider legal convergence of Anglo-Saxon and continental European countries in the field of corporate governance practices, although the *path-dependence* differences: see, recently, Hansmann-Kraakman, "Towards a Single Model of Corporate Law?", and Hopt, "Common Principles of Corporate Governance in Europe?", both in McCahery – Moerland – Raaijmakers – Renneboog (eds), *Corporate Governance Regimes. Convergence and Diversity* (2004) 56 *et seq.*, 175 *et seq.*; Siems, *Die Konvergenz der Rechtssysteme im Recht der Aktionäre* (2005); see also Hansmann – Kraakman, "The End of History for Corporate Law", Harvard Law School, Discussion Paper

The core of creditor protection through legal capital lies in its preventive function, fulfilled by the legal capital itself. It offers a sort of financial “cushion” as a part of net assets, capable of functioning as an alarm when liabilities threaten to exceed assets, that is to say, when there will be difficulties in satisfying creditors and, in extremis, when there is a danger that the company will become insolvent.

In order to achieve these benefits, compliance with a set of rules is required, including minimum capital. As explained, the fundamental task of legal capital is to realize a threshold of seriousness for the business, avoiding or reducing the risk of the formation of companies with absolutely insignificant net assets, and thus the risk that shortly after formation, the company may become insolvent as a result of lacking a solid foundation.³³ Therefore, the coverage of minimum capital through shareholders’ contributions is like a sort of admission ticket for the privilege of limited liability.³⁴

There are rules referring to the formation and maintenance of legal capital, but like in the U.S., they can be applied apart from it.³⁵ The above mentioned rules aim at ensuring that the amount of legal capital is effectively covered through contributions suitable to increasing a company’s net assets. This explains the prohibition of issuing shares at less than their par value and the limitation of eligible non-cash consideration for shares, aside from their submission to an evaluation requirement.

During the operation of the company, the maintenance of capital is accomplished through a distribution rule, requiring that dividends be paid only when there is a sufficient surplus of net assets versus legal capital, indistributable reserves and sufficient accumulated earnings to cover the cost of the

No 280 (2000) 9 *et seq.*, reprinted in Gordon – Roe (eds), *Convergence and Persistence in Corporate Governance* (2004), 33 *et seq.*, which argues that a shareholder-oriented corporate law too should directly regulate some aspects of the relationship between the company and its creditors.

33 Lutter (n 32) 376; Wachter, “Auswirkungen des EuGH-Urteils in Sachen Inspire Art Ltd. auf Beratungspraxis und Gesetzgebung. Deutsche GmbH vs. Englische private limited company”, GmbHR (2004) 97; Schön, “Wer schützt den Kapitalschutz?”, ZHR (2002) 3; *id.* (n 1) 165; High Level Group (n 15) ch. IV, n 3, lett. a); Group of German Experts on Company Law, ZIP (2003) IV, 1–2, 871 *et seq.*; see too Krüger, *Mindestkapital und Gläubigerschutz* (2005) 33 *et seq.*

34 Wymeersch, “Current Company Law Reform Initiatives in the OECD Countries. Challenges and Opportunities”, Financial Law Institute. Universiteit Gent, Working Paper (2001-04) 39; see for criticism, Mülberr – Birke (n 1) 717 *et seq.*

35 About the history of legal capital in the U.S., disregarding the minimum capital requirement for lack of efficiency, see Conac, “Le capital social dans le droit américain des sociétés”, in Couret-Le Nabasque (n 1) 153 *et seq.*; see below, VII.

dividends³⁶. Moreover, there is the discipline of transactions between the shareholders and the company which could lead to a similar result, such as the repurchasing of shares and financial assistance to that end.³⁷

This set of rules has been fully reconstructed and harmonized within the EU by the Second Directive.³⁸ Besides, there are, on the one hand, the options offered to the single EU Member States on the implementation of the Second Directive and of the other company law directives; on the other hand, there is the possibility of considering, at least, some of the European regulations as guidelines capable of being specified and made more stringent by the single Member States,³⁹ as in particular in the case of hidden distributions.⁴⁰

The main criticism levelled at the legal capital doctrine is two-pronged: first, the fact that legal capital is based on mandatory rules that are too cumbersome and strict for the firm subject to them;⁴¹ second, the benefits of such rules are, as far as protecting creditors is concerned, doubtful to say the least, while their costs are certain, even substantial.⁴² In fact, creditor protection

36 On the discussed status of share premiums (share account, under European law), which seems clear it is not part of “subscribed capital” under the Second Directive, while is treated as part of capital in some Member States and not in others, see Rickford (n 3) 939 *et seq.*, who proposes to treat share premium as free reserves in the UK.

37 See below, VI. For a comparative conspectus of capital maintenance and distribution regimes, see Rickford (n 3) 998 *et seq.*

38 On the principles of legal capital formation and maintenance, in the Second Directive, see Lutter, *Europäisches Unternehmensrecht* (n 8) 48 *et seq.*; Grundmann (n 2) n 326 *et seq.*, 146 *et seq.*

39 Lutter, *Europäisches Unternehmensrecht* (n 8) 25 *et seq.*; Drinkuth, *Die Kapitalrichtlinie. Mindest- oder Höchstnorm?* (1998) 58 *et seq.* and 117 *et seq.*; Habersack (n 8) n 40 *et seq.*; 139 *et seq.*, 107; Grundmann (n 2) n 149 *et seq.*, n 315.

40 Mühlbert, “Kapitalschutz und Gesellschaftszweck bei der Aktiengesellschaft”, in *Festschrift für Lutter*, Köln (2000) 535 *et seq.*; Hirte, *Kapitalgesellschaftsrecht* (4th edn 2003) n 5.18 *et seq.*, 213 *et seq.*

41 On the costs of mandatory rules in the company law, particularly deriving from the mandatory EU company law harmonisation, see Cheffins (n 26) cp. 227 *et seq.*; and with special reference to *small firms*, McCahery – Vermeulen (n 9) 856 *et seq.*; on the Second Directive, as example of EU Company law which may be considered as optional, unimportant or avoidable, see Enriques, “EC Company Law Directives and Regulations: How Trivial Are They?”, ECG/Working Paper (39/2005) 20 *et seq.* For this reason, the proposal for an enabling approach, with a system of *opt-in*, *opt-out* default arrangements that firms will be free to choose, Hertig – McCahery, “An Agenda for Reform: Company and Takeover in Europe”, in Ferrarini – Hopt – Winter – Wymeersch (eds), *Reforming Company and Takeover Law in Europe* (2004) 38 *et seq.* On the usefulness of mandatory rules in this field, as a framework or as a supplementing the creditor’s self help, see Davies, *Introduction* (n 26) 78 *et seq.*

42 For a survey of criticisms, see Manning – Hanks, *Legal Capital* (3rd edn 1990) 91 *et seq.*; Enriques – Macey (n 2) 1167 and 1185 *et seq.*; Rickford (n 3) 931 *et seq.*

may be left to a more flexible market-based regulatory mechanism⁴³ so as to not create excessive obstacles for new competitors entering the capital market,⁴⁴ e.g. when the minimum capital requirement is fixed at a too high level.⁴⁵

Among the differing remedies is mandatory disclosure of information, which was developed in the U.S. under pressure from capital markets.⁴⁶ This concept is increasing in importance in EU company law as it offers a more efficient regulatory tool than substantive regulation.⁴⁷ Mandatory disclosure is capable of enhancing the accountability for and the transparency of the company's governance and affairs. This benefits creditors, especially when it comes to ascertaining the true economic value of the indebted company's assets. Thus, e.g. the domestic creditors of the branches of foreign companies are enabled by such a "self-help" approach to be adequately informed about the rules of the home State concerning the existence of a minimum capital and are protected against undercapitalization, not differently from the case of a domestic company, due to the disclosure requirements on branches of Eleventh Directive and the annual accounts rules of Fourth Directive. As a result, it may not be necessary to protect them via legal capital.⁴⁸ For this rea-

43 Ferran, "Legal Capital Rules and Modern Securities Markets – the Case for Reform as Illustrated by the U.K. Equity Markets", in Hopt – Wymeersch (eds), *Capital Markets and Company Law* (2003) 115 *et seq.*, in reference to mandatory legal capital rules intended to protect investors, and specifically to the pre-emption rights of shareholders on new shares, but with more general remarks.

44 Enriques – Macey (n 2) 1199 *et seq.*

45 Armour (n 2) 371 *et seq.*; Easterbrook – Fishel, *The Economic Structure of Corporate Law* (1991) 61 *et seq.*; Hansmann – Kraakman, "Towards Unlimited Shareholder Liability for Corporate Torts", *Yale Law Jour.* (1991) 1879 *et seq.*

46 See Kraakman, "Disclosure and Corporate Governance: an Overview Essay", in Ferrarini et al (n. 41) 95 *et seq.* On the suitability of capital markets rules for limiting the opportunistic behaviours of shareholders, see Enriques – Macey (n 2) 1170 *et seq.*

47 See High Level Group (n 15) Ch 2, § 3 *et seq.*; *Action Plan* (n 16) para 3.1; 3.3; 3.7; see the reconstruction of the debate from Merkt, "European Company Law Reform: Struggling for a More Liberal Approach", *ECFR* (2004) 3 *et seq.*; Grundmann "Die Struktur des Europäischen Gesellschaftsrechts von der Krise zum Boom", *ZIP* (2004) 2406 *et seq.*

48 European Court of Justice, Case C. 212/97, *Centros*, para 36; European Court of Justice, Case C-167/01, *Inspire Art*, para 135 *et seq.*, deducing it also from the conclusions of the High Level Group; see Merkt (n 47) 18 *et seq.* The principal argument is that the creditors of the Member State where the foreign company operates are informed enough of the fact that the company is regulated by a different jurisdiction, and thus the situation would not be different than if such a company operated directly in the home State. Regarding the ability of the foreign companies' creditors to be informed about the existence or not of legal capital, given also a uniform system of disclosure within the EU, through legal capital, without it posing a problem of externality, see

son, the ECJ seems to give prevalence to the capital market rules in comparison to the legal capital rules.⁴⁹ Other forms of creditor's self-help exist,⁵⁰ e.g. corporate governance monitoring mechanisms, the fixation of interest rates⁵¹ and the introduction of contractual provisions such as bond indentures and loan covenants with varying contents.⁵²

In particular, it has been pointed out that in the legal systems lacking minimum capital requirements, such as the U.S., financial covenants contain restrictions on distributions and subordinate them to the formation of an equity capital cushion.⁵³ In this way, it is demonstrated that the legal capital

Grundmann, "Regulatory Competition in European Company Law – Some Different Genius?", in Ferrarini – Hopt – Wymeersch (eds), *Capital Markets in the Age of the Euro. Cross-Border Transactions, Listed Companies and Regulation* (2002) 561, 585 *et seq*; Eidenmüller – Rehm, "Niederlassungsfreiheit versus Schutz des inländischen Rechtsverkehrs: Konturen des europäischen internationalen Gesellschaftsrechts", ZGR (2004) 171 *et seq*; for criticism, because of the impossibility of achieving a minimum standard of creditor protection through a system of disclosure, see Mülbart (n 1) 156 n 37. On the possible enforcement of the legal capital rules of the host State, see Wilhelm, "Umgehungsverbote im Recht der Kapitalaufbringung", ZHR (2003) 520 *et seq*.

49 Merkt (n 2) 1047.

50 Generally, see Keay, "Directors' Duties to Creditors: Contractarian Concerns relating to Efficiency and Over-Protection of Creditors", *Modern Law Review* (2003) 687 *et seq*.

51 In fact, the fixation of the interest rate can be the device to assume the risk of opportunistic behaviours, or to avoid it in exchange of a lower rate, Enriques – Macey (n 2) 1170 *et seq*.

52 The typology is extremely various, since they provide supply of information; negative pledge; restriction on disposal, and *pari passu* clause: in this frame, there are, among other things, the assignment to the lender of powers of control on the management; or of the power of appointment of directors, the fixing of higher interest rate and in general of events of default (for instance, a clause that makes a debt due and payable upon the occurrence of a significant default); moreover, change of control clauses to protect bondholders in case of LBO. A more specific category is represented by the financial covenants, which intend to reproduce on a conventional basis some of the legal capital rules: about the provisions of the covenants, see Wood, *International Loans, Bond and Securities Regulation* (1995) 31 *et seq*; Manning – Hanks (n 42) 104 *et seq*; Mülbart – Birke (n 1) 712 *et seq*; 723 *et seq*; Klein – Coffee, *Business Organization and Finance. Legal and Economic Principles* (8th edn 2002) 242 *et seq*; Bratton, *Corporate Finance. Cases and Materials* (5th edn 2003) 209 *et seq*; Ferran, *Company Law and Corporate Finance* (1999) 479 *et seq*; Böckmann, *Gläubigerschutz bei GmbH und close corporation* (2005) 142 *et seq*. about the function to signal the business' crisis, fulfilled by the financial covenants, v. Witting in Schmidt – Uhlenbruck, *Die GmbH in Krise, Sanierung und Insolvenz* (3rd 2003) 67 *et seq*.

53 Thus, there is no significant analogy between the indenture "boilerplate" arranged by the American Bar Association and the rule of dividends distribution stated in the sect. 263 Companies Act 1985, with the difference illustrated by the following note (Armour (n 2) 373).

regime, because it is profitable to creditors, should be spontaneously adopted, as if it were a market rule; or it should constitute an *opt-out* rule, instead of being mandatory.⁵⁴

The protection of creditors can also be achieved retroactively, for example through the imposition of fiduciary duties creating liability for directors and other company insiders, such as the controlling shareholders. There is also auditors' liability, which results from auditors' fiduciary duties in monitoring the financial statements made by the company.⁵⁵ Additional forms of protection derive from capital market and corporate groups rules, which protect the subsidiaries' creditors.⁵⁶

III. Main criticisms of the legal capital rules

The criticism of the legal capital regime cannot be abstractly judged. It requires profound analysis in terms of costs and advantages in comparison with alternative solutions. The optimal level of creditor protection, with particular consideration to their greater convenience for creditors, needs to be determined between either a reduction in costs without sacrificing the level of protection or a higher level of protection.⁵⁷ Moreover, it is necessary to consider how the company's dimensions, the eventual recourse to the capital market and the company law in question may affect creditors protection.

It is difficult to reconcile the function of minimum capital requirements⁵⁸ with their fixed amount, which is equal for all the companies belonging to a given type.⁵⁹ Thus the requirement is unrelated to the financial endowment actually needed for a specific firm.⁶⁰

54 Armour (n 2) 373 *et seq*; Enriques – Macey (n 2) 1192 *et seq*. The difference is represented by the greater flexibility of the share capital discipline stated by contract, because the prohibition against the distribution of profits may be proportionate for each creditors to the net assets existing at the moment of the supply of the credit, rather than to the net assets existing at the moment of the constitution of the company, Mühlbert – Birke (n 1) 716.

55 Hertig – Kanda (n 5) 88 *et seq*.

56 Hertig – Kanda (n 5) 74 *et seq*.

57 Mühlbert (n 1) 155 *et seq*.

58 In this sense, the function of legal capital may be held to be analogous to the function of the capital adequacy rules imposed to the banks and to other financial intermediaries, but with a largely inferior efficacy, because the capital adequacy for the banks is proportionate to the amount of the risks, see Kübler, "The Rules on Capital Under the Pressure of the Securities Markets", in Hopt – Wymeersch (n 43) 100.

59 About the difficulties in fixing the legal capital at an amount capable of avoiding the insolvency, see Mühlbert – Birke (n 1) 718 *et seq*.

60 Schön (n 1) 165.

The minimum capital requirement encounters two criticisms, respectively, first for being trivial, second for not being an effective filter and therefore disconnected from the various needs and risks of business activity pursued by a company.⁶¹ In addition to not providing enough creditor protection, minimum capital also implies excessive limitations on dividends distribution.

In fact, there is no agreement, at least in this sense, on a duty of reporting inadequacy of legal capital with regard to the business pursued by the company.⁶² It may be possible to reconcile legal capital rules with techniques intended to establish a debt/equity ratio. Moreover, with an *ex post* approach, directors may be held liable for undercapitalization.⁶³ The formation of legal capital is compatible with drawing up a financial plan.⁶⁴

To go into greater detail, the criticisms based on the cost of legal capital formation are based on limitations to eligible non-cash contributions.⁶⁵ Particularly, the prohibition against contributions in the form of work or services prevents the company from paying for qualified services through issuing shares, thereby making the financing of high tech start-up companies more difficult. Instead, legal capital demands a contribution of money from the shareholders. This causes a conflict between the needs of creditor protection and of not putting excessive obstacles in the way of launching New Economy businesses, at least when compared with the situation as it would be without the burdens of the capital formation regime.⁶⁶ Moreover, Member States adopting legal capital rules are put at a significant competitive disadvantage.

61 Davies, *Introduction* (n 26) 85. Especially as regards the limited liability companies, see below, VI.

62 Portale (n 20) 38 *et seq.*

63 See below, VI and VIII.

64 For that reason, particularly appreciable is the Belgian rule, requiring on incorporation either of public companies (art. 440 e 456, co. 4, *code soc.*) or of private companies (art. 215 e 229, co. 5, *code soc.*), the drawing up of a business plan, certifying the suitability of the stated capital, with the sanction of unlimited liability of shareholders in case the company becomes insolvent within three years from incorporation, and that the capital has proved insufficient for the needs of the firm's activity at least for two years (Wouters, "Towards an European Private Company? A Belgian Perspective", in De Kluiver – Van Gerven (n 8) 167; Drury – Hicks, "The Proposal for a European Private Company", *Jour. Bus. Law* (1999) 429 *et seq.*, 441; Woolridge, "Some Characteristics of the Belgian SPRL: Comparisons with the SA", *Company Lawyer* (2002) 161 *et seq.*; Fernandez, "Capital social manifestement insuffisant lors de la constitution de la société: une initiative économique contrôlée en droit belge", *LPA* (2004) n 4.

65 It is not always clear, however, whether the alternative proposals consist in completely repealing the rules regulating eligible contributions, or whether at least the existence of consideration is required, Enriques – Macey (n 2) 1195; for a critical view, Denozza (n 6) 587.

66 Enriques – Macey (n 2) 1186 *et seq.*; Kübler (n 58) 101 *et seq.*

On the other hand, the problem of evaluating so called intangible assets, from which future gains are expected, but which do not currently have a certain value, is known well by economists. This leads to a discrimination against the firms whose dividends distribution is strictly anchored to the assets emerging from the balance-sheet.⁶⁷

The rules on capital formation and maintenance also risk discouraging companies transitioning from bank financing to raising equity capital on the capital markets.⁶⁸

The costs of capital formation do not appear adequately compensated by the corresponding guarantee of value maintenance, when the creditors must rely on it. The decisions of the general meeting, in the event of serious loss of capital, which single jurisdictions have fixed this at the loss of half or more of called-up share capital (see Art. 17 of the Second Directive), are not immediate and may not give an early warning of an imminent financial crisis.⁶⁹ This is further the case because the trivial amount of legal capital means it is very quickly exhausted by losses and therefore cannot prevent the company's insolvency.⁷⁰ As a result, disclosure of the consistency of legal capital (Art. 3, lett. *b* and *c* of the Second Directive) does not protect creditors enough, especially if it dates a long time back from the formation of the company.⁷¹

Another rule is deserving of criticism: in many States, if the net assets of the company fall below a certain percentage of the legal capital (generally 50 %), it is compulsory for the general meeting to begin winding up proceedings for company, or to take other measures: this rule is known as "recapitalize or liquidate".⁷²

In fact, the main question is whether creditor protection should be considered a task of insolvency law or whether it should be anticipated through in-

67 About the evaluation of "intangible assets", see the accounting principle IAS 38 – defining them as the assets, bought or produced, whose expected economic benefits may be achieved and whose costs may be evaluated with reliability – whose relevance is destined to increase after the penetration of the EU accounting rules by the IAS/IFRS (see also below, IX).

68 Enriques – Macey (n 2) 1195; Hertig – Kanda (n 5) 88.

69 Cheffins (n 26) 531 *et seq*; Davies, *Introduction* (n 26) 86 and n 19, with regard to the s. 142 CA 1985; Wymeersch (n 34) 41.

70 Hertig – Kanda (n 5) 85.

71 Mühlbert (n 1) 157; on the opposite side, in relation to regulatory competition, see Grundmann, "Wettbewerb der Regelgeber im Europäischen Gesellschaftsrecht – jedes Marktsegment hat seine Struktur", ZGR (2001) 816 *et seq*; *id.* (n 48) 584 *et seq*.

72 Enriques – Macey (n 2) 1183 *et seq.* e p. 1201 *et seq.*, who consider that rule as being not mandatory in EU company law and a sign of the excessive rigidity of legal capital. In fact, the literal interpretation of art. 17 of the Directive prescribes that the general meet-

sertion into company law. In connection with this, there is the determination of whether the balance sheet should have a major or minor importance, for the sake of adopting such measures.⁷³

In addition, the chosen method of evaluating the company's assets plays a significant role in the assessment of capital losses. This is not only true for the choice between the criteria which are applicable to going concerns or those in the process of being wound up – this has been tackled by § 19, Subsection 2 of the German Insolvency Act, according to which the choice depends on the real situation of the firm⁷⁴ – but it is also true, e.g. in the first case, when it comes to the adoption of IAS/IFRS principles, which require an evaluation at 'fair value'. In this way, there is a danger that the value of the legal capital would be weakened considerably and become a less reliable factor in the company's assets.

Finally, during a capital increase, the obstacle posed by legal capital to the issuance of shares at a price lower than their nominal value must be consider-

ing must consider whether the company should be wound up or other measures should be taken; however, no measure is mandatory. As to s. 142 CA 1986 see Davies, *Gower and Davies' Principles of Modern Company Law* (7th edn 2003) 230. The duty of winding up the company applies only in connection with art. 34, which prescribes that the subscribed capital may not be reduced to an amount less than the minimum capital. The company's winding up, in the latest case, is prescribed in Italian company law, if recapitalization does not take place (artt. 2484, n. 4, 2447 c. c.). Differently, in French company law the company's winding up may take place as a result of capital losses, as an alternative to recapitalization, also if the capital isn't reduced below the minimum, when the general meeting does not decide its reduction in the next two years (art. L. 225-248, al. 1-2, Cod. Com; for the *société à responsabilité limitée*, see art. L. 223-42 Cod. Com., Le Cannu-Parleani (n 1) 15); a similar rule is prescribed in Spanish (art. 260, 1, 4 LSA) and in Sweden (see Armour (n 2) 371, who consider that rule as a protection especially of the involuntary creditors, avoiding the maintenance of companies with serious losses or with almost no assets). Also if the rule "recapitalize or liquidate" isn't prescribed, as in Germany, it may be inferred from the duty that requires corporate boards to initiate bankruptcy proceedings at the onset of insolvency (Mülbert (n 1) 153). It is not clear, moreover, if the alternative is to continue the business till the petition by creditors: the company should take advantage of insider information, to go out of business destined to bankruptcy on time, Denozza (n 6) 587 and 596.

73 In this way, the creditors can settle special terms, such as terms of default, and so on, in relation to the legal capital reduction before the company's winding up. The risk of abuses, which leads to exclude the decision of the legal capital reduction by the general meeting for the English private company (cf. Davies (n 72) 242 *et seq*) may be compensated by the bank liability for its sudden withdrawal, especially in case of private companies, which are mainly financed by bank overdraft repayable on demand.

74 The adoption of this criterion is provided when the circumstances require it, Kirchhof – Lwowski – Stürner, *Münchener Kommentar zur Insolvenzordnung* (2003) § 19, n 84 *et seq*, 356 *et seq*; Uhlenbruck in Schmidt-Uhlenbruck, (n 52) 403 *et seq*.

ed. This would permit an easier influx of new assets when its previous value has been drawn on.⁷⁵

From the point of view of capital maintenance, the basic criticism lies in the extreme limitation on the distribution of legal capital to shareholders, especially through dividend payments;⁷⁶ it is just the same with regard to the other distributions to shareholders, such as share repurchasing and other transactions pertaining to the company's shares.⁷⁷ Especially the rules on capital maintenance, which may be easily circumvented by preparing unreliable balance sheets, may not be able to prevent the payment of dividends by insolvent companies. This has been demonstrated by the fact that these same rules were not able to prevent financial crises, in particular the most recent, sensational ones.⁷⁸

More generally, few legal capital rules are considered effective, insofar as protecting creditors is concerned. They lack a regulation of financial leverage capable of checking creditworthiness, which is to say the specific ratio between a company's net assets and liabilities.

In other words, as soon as minimum capital has been determined, there are no restrictions on how much debt a company may adopt, notwithstanding theories of trying to ascertain limitations to the under-capitalization of the company. All depend upon the reliance of corporate creditors on the company's

75 Spolidoro, "The Legal Capital and the Raising of Funds through the Issuance of Securities in Italy", AG (1998) 363 *et seq.*

76 About the various options intended to protect creditors, through the limitations imposed on the net assets distribution, see Armour (n 2) 365 *et seq.*

77 However, jurisdictions without capital maintenance rules also enforce specific rules to prevent excessive flow of corporate assets to shareholders: on the different techniques, see Manning – Hanks (n 42) 63 *et seq.*, 105 *et seq.*; Rickford (n 3) 969 *et seq.* and 998 *et seq.*

Legal capital is criticized in U.S. from the opposite side, too, as it doesn't supply a suitable criteria for restriction on dividends distribution: that also considering the many rules about "stated capital", "capital surplus", "earned surplus" (and other types of "surplus"), and the lawful procedural way that may reconstruct the balance sheet so to make the dividends distribution possible, Manning – Hanks (n 42) 116 *et seq.*; § 6.40 RMBCA, *Official Comment*.

78 Enriques – Macey (n 2) 1193. In the U.S. shareholders could amend the corporate charter to reduce the amount of par value, in order to pay dividends, with creditors being neither notified nor consulted, see Kummert, "State Statutory Restrictions on Financial Distributions by Corporations to Shareholders". Part I, Wash. See S. Rev. (1980) 359 *et seq.* and Part II, *ibid.* (1984) 185 *et seq.*

assets, as well as on further guarantees, thus integrating and going beyond the legal capital doctrine.⁷⁹

IV. *Legal capital and limited liability companies*

The debate on the legal capital is destined to become central in relation to the limited liability companies and justifies the treatment of the subject with regard to those companies, in the various legal systems.

The basic question is whether and to which extent the legal capital rules may operate differently for limited liability companies, considering their characteristics, as compared with the rules applicable to public companies. EU company law harmonisation should also be considered. The matter is further complicated by the fact that the introduction and development of limited liability companies in the various legal systems has been irregular.

The specific solution for the legal capital depends especially on the major or minor proximity of limited liability companies to the discipline of public companies, which is subject, unlike the former, to EU-wide harmonisation.⁸⁰

To take the contrarian view, it is irrelevant – except when looking at the system as a whole – whether, when dealing with the two classes of companies, to distinguish between the civil law-specific dualistic system, which provides a specific discipline for the limited liability company, and the common law-typical monistic system, where the private company and the public company are both regulated in the same company law.⁸¹ In fact, within Great Britain's monistic system, the two disciplines have been differentiated. In particular, the private company has been moved out of the Second Directive, which limits its implementation to the public company.⁸²

80 More generally, there is a case for the limited liability company as it is actually over- or underregulated, as in the single Member States, as on the EU company law, see De Kluiver (n 8) 33 *et seq.*, with the prevailing of the harmonization as a mechanism to safeguard the free movement of companies, Wouters (n 64) 182 *et seq.* Moreover, EU harmonization philosophy seems mainly addressed to the larger companies, and so probably will be in the future too, Wymeersch, "About Techniques of Regulating Companies in the European Union", in Ferrarini et al (n 41) 171 *et seq.*

81 Lutter, *Die Entwicklung* (n 8) 57 *et seq.*; Neuling, *GmbH und private companies limited by shares in England* (1996) 187 *et seq.* differently, as methodological issue, Bachmann, "Grundtendenzen der Reform geschlossener Gesellschaften in Europa", ZGR (2001) 353 *et seq.*; see also the attempt to go beyond the dualism, made by Roth, "GmbH und AG: Versuch einer Neuorientierung" in Roth (ed), *Das System der Kapitalgesellschaften im Umbruch – Ein internationaler Vergleich* (1990) 1 *et seq.*

82 See below, V.

79 See Wiedemann, in Hopt – Wiedemann (eds), *Großkommentar zum AktG* (4th edn 1997) § 182 n 22 *et seq.*

On account of the whole system of creditor protection offered by such countries, and in general due to the available financing techniques, the question is whether or not legal capital should at all be held to be essential. In fact, moving on from the debate over the advantages and disadvantages of limited liability for small companies,⁸³ legal capital may be regarded as less essential, given the existence of other forms of creditor protection.

In this regard, it may be pointless to consider the suitability of limited liability companies to small or medium sized firms and the support and facilitation they receive in the EU under the “think small first” strategy.⁸⁴ This especially applies to company formation.⁸⁵ Neither of these aspects bears any relevance from a legal point of view, nor on legal capital rules.

On the one hand, there is no maximum dimensional limit for limited liability companies. Hence this parameter cannot be invoked to exclude the necessity of legal capital. No doubt it is not decisive in determining the internal structures of limited liability companies, which is to say, they are basically “close companies”. This is demonstrated by countries such as Italy, where even the “società per azioni” may be considered as “close” companies, at least in the sense of not being present on the capital markets or having a small number of shareholders.⁸⁶ They are governed by partially different rules.

We do not intend to exclude the reasonableness of a specific evaluation of the role of legal capital in limited liability companies, in the light of the fact that such companies do not have recourse to the capital market, particularly the equity market.

On the other hand, although in such companies there is some need to protect shareholders insofar as the health of the business is concerned, it is also possible that some rules may result in less protection for creditors. First, accounting rules: limited liability companies are bound, in principle, to mandatory

83 See Freedman, “Limited Liability: Large Company Theory and Small Firms”, in *Modern Law Rev.*, vol. 63, (2000) 327 *et seq.*; for criticisms, see Easterbrook – Fischel (n 26) 89 *et seq.*, spec. p. 107; Hansmann – Kraakmann (n 45) 1933.

84 In accordance with the principles of the *European Charter for Small and Medium Enterprises*. SME represent more than 99 % of the EU enterprise and 53 % of employees (Observatory of European SME). Think Small First is also adopted by the current Company Law Reform in the UK, Whitepaper 2005, 10.

85 Besides legal capital, the facilitation of company formation concerns the length of the procedure: in almost Eight EU Member States it takes two days or less, and costs less than 500 €, see *Report of the Commission on the Implementation of the European Charter on Small and Medium Enterprises* (COM/2002/0068), § 2. 2.

86 See art. 2325-*bis* cod. civ. In some cases, for such company a maximum of shareholders is established: thus, the medium number of shareholders for SARL in France has been raised from 50 to 100; Saintourens, “L’attractivité renforcée de la SARL après l’ordonnance n. 2004-274 du 25 mars 2004”, *Rev. soc.* (2004) 209 *et seq.*

disclosure of company related information and to making financial statements on the public company's progress. Moreover, EU regulations on this point are stricter than U.S. regulations which, for such companies, limit the duty of keeping accounts.⁸⁷

Nevertheless, EU company law provides a series of exceptions allowing smaller companies, under certain circumstances, to provide simplified financial disclosures.⁸⁸ This simplification gives no consideration to the legal form of the company, but there is no doubt that it covers especially the field of limited liability companies.⁸⁹ On the same note, small companies, in particularly limited liability companies, may be exonerated from recourse to a professional auditor, nor are they bound to provide auditing standards, which saves costs.⁹⁰

In addition, considering the tendency, particularly in certain legal systems, toward greater flexibility of corporate structures and governance of limited liability companies – given that the potential for opportunistic behaviour is stronger when the directors are the shareholders (or are effectively controlled by the shareholders)⁹¹ – the need for legal capital could be greater than in the public company,⁹² where such techniques of protection are more sophisticated.⁹³

Broadly speaking, the usefulness of legal capital formation rules in the limited liability companies must be discussed with respect to the characteristic ways of corporate financing for such companies, especially for start-up firms, and the risks following from a lack of resources. This is reflected, on the one hand, by widespread rules that preclude such companies from raising capital, either on the stock market as the debt market, and, on the other hand, by the necessity

87 Hertig – Kanda (n 5) 79

88 Art. 11 of the Fourth Directive.

89 With reference to public disclosure requirements, it is held that a high percentage of the limited liability companies is exonerated from them: in particular, between 80 % and 95 % of the German *GmbH*, Habersack (n 8) n 90; Hertig – Kanda (n 5) 80 n 50.

90 Art. 51 (1) of the Fourth Directive.

91 See Davies, *Introduction* (n 26) 96 *et seq.*

92 Cheffins (n 26) *cit.*, 509 *et seq.*; Freedman (n 83) 317 *et seq.*, 352.

93 Minimum capital is more useful for small, rather than large companies. By empirical research relating to Belgian companies, the company type with lower minimum capital showed an insolvency ratio – being the ratio of insolvencies to total number of existing companies – that was clearly less than that of the higher capitalised companies, Wymeresch (n 34) 46. Limited liability companies are more in need of harmonization than public companies, in order to provide an adequate level of creditor protection: unreasonable behaviour of shareholders or directors in the latter case is constrained by the market, Thompson, “The Private Company and our Two Corporate Laws”, in De Kluiver – Van Gerven (n 8) 187; see also Hirte, “The European Private Company: a German Perspective”, *ibid* 105 *et seq.*

to rely basically, apart from self-financing, on shareholders loans⁹⁴ and on bank financing⁹⁵ with the risk of more diffused undercapitalization.⁹⁶

The method of financing limited liability companies represents an attractive feature of such a type, but causes greater instability and stimulates forms of self-help by creditors, especially banks, through personal guarantees or charges over the fixed assets of the company.⁹⁷ The greater difficulty of raising funds for small companies is known and results in the greater power for creditors. Banks, for example, negotiate covenants, especially in the form of interest rates and guarantees on assets for single shareholders: thus grows the risk of a significant spreading of costs, above all for less sophisticated creditors.⁹⁸

Besides, with regard to limited liability companies, either by law or through judges, techniques have been introduced intended to involve directors and shareholders, especially those with a controlling interest, in liability towards corporate creditors, especially through piercing the corporate veil, or the subordination of shareholder loans or their equiparation to legal capital, and in general the determination of a corporate assets/debts ratio.⁹⁹

These remedies are widespread in countries adopting a minimum capital requirement and tend to strengthen the protection of legal capital in order to impede avoidance: their effect will be evaluated throughout, e.g., when they have to face the total absence of the legal capital rule. Their capacity to permit the full elimination of such rules must also be considered, not only in general, but also with regard to limited liability companies.

There is the need to verify whether, for such companies, legal capital may, due to proper simplifications, still perform a more positive function of strengthening creditor protection,¹⁰⁰ especially given the frequency of winding up limited liability companies immediately after their formation. This is relevant in

94 Shareholders loans are widely common in limited liability companies, and for this reason many EU Member States have issued rules to avoid abuses in the company's funding, see Von Gerken – Hommelhoff, *Handbuch des Kapitalersatzrechts* (2nd edn 2003).

95 Lutter, *Europäisches Unternehmensrecht* (n 8) 72 *et seq.*

96 De Kluiver (n 8) 26.

97 Davies, "Legal Capital" (n 26) 350, referring to the UK private company. It is proposed that trade creditors, in particular, should have access to the information of the banks, Drury – Hicks (n 64) 442 *et seq.*

98 Cf. Cheffins (n 26) 501; Freedman (n 83) 338 *et seq.*

99 Freedman (n 83) 342 *et seq.*; Drury – Hicks (n 64) 442; Lutter, "A Mini-Directive on Capital", in De Kluiver – Van Gerven (n 8) 201 *et seq.*

100 On the increasing urgency of EU legislation on behalf of the creditors of limited companies, see Hirte (n 93) 95 *et seq.* On the proposal to extend the applicability of the second directive to private company, see Grundmann (n 2) n 351; see below, V.

particular for rules on legal capital maintenance,¹⁰¹ but may be better understood in light of the broader question of the usefulness of legal capital.¹⁰²

In limited liability companies, the minimum capital requirement is usually lower, sometimes considerably lower, than the minimum amount fixed for a public company.¹⁰³ This may, on the other hand, call into question the specific usefulness of legal capital in the limited liability company since the lower amount is less suitable to fulfill the general function of creditor protection; giving the shareholders limited liability is in essence, therefore, fallacious;¹⁰⁴ on the other hand, this would reduce costs, and this is the basis for most arguments which are used to criticize legal capital.

The lower amount of minimum capital constitutes a feature of the limited liability company which tends to satisfy the need for simplification. Nevertheless, it is not capable of serving as a criterion for the selection of corporate types in accordance with the business' characteristics. This is a function which is fulfilled by an entirely different discipline.

In any case, it may be held that lower minimum capital encourages small firms, along with other elements, to adopt the limited liability company. At the same time, the higher minimum capital required for the public company tends to limit the use of such companies to firms of more significant size.¹⁰⁵

Nevertheless, in the absence of a maximum amount of legal capital for each type,¹⁰⁶ nothing in the current circumstances precludes the adoption of a

101 In that same pattern falls the application of such rules to the limited liability company, even more severe than the Second Directive, of the obligatory winding up of the company in case of loss of a certain measure of capital, apart from losses of minimum capital (see, for the French *société à responsabilité limitée*, art. L. 223-42 Code com; for public companies, see above n 72). Supporting the issue of an EU directive on that matter, see Lutter (n 99) 206.

102 See below, VI *et seq.*

103 In Germany, 25.000 €; Austria, 35.000 €; Spain, 3.006 €; Portugal, 5.000 €; Greece, 8.805 €; Belgium, 18.600 €; Netherlands, 18.000 €; Denmark, 150.000 Kroner (= 20.000 €); Sweden, 100.00 krona (= 11.000 €). Even though the range of the difference, and so the evaluation of the convenience, will actually depend on the minimum capital requirement for such companies, in relation to public company: thus, in Italy the difference (10.000 € versus 120.000 €) is different from the Belgian (18.600 € versus 62.200 €) and the German (12.500 € versus 50.000 €).

104 With regard to the French *société à responsabilité limitée*, see Hebert, "The French Limited Liability Company", in De Kluiver – Van Gerven (n 8) 81.

105 Wiedemann (n 21) 565; Portale (n 20) 24 *et seq.*; Schmidt, *Gesellschaftsrecht* (4th edn 2004) § 33. III *et seq.*

106 In the 18th and the 19th centuries, a maximum amount of legal capital was provided for U.S. corporations, in accordance with the antitrust law, but this rule was progressively removed in the beginning of Twentieth century. Hamilton (n 4) 70; Krüger (n 33) 130 *et seq.*

corporate type which requires a lower minimum capital to also perform large-dimensional activity, assuming that further significant reasons and advantages would suggest that adoption would be desirable.¹⁰⁷

Since minimum capital is established previously and generally, it leaves the firm's dimensions out of consideration. What is more, the wide possibility of using the limited liability company with a minimum capital even for the largest firms gives rise to the risk of undercapitalisation. As a result, it may not be held that the lower amount of minimum capital represents an extreme advantage provided by law to the benefit of limited liability.

Access to limited liability depends on other rules too. On the other hand, the law may especially in recent times, introduce rules intended to increase limited liability's convenience even for the public company. For instance, in the abstract, deregulation can make the adoption of the public company more attractive for small companies, as well, apart from the higher minimum capital requirement.

Therefore, the advantage of the limited liability company is not only connected to minimum capital requirement, but rather to other rules, relative or not to the legal capital. Even better, its lower amount and the consequent benefits may be counterbalanced by the imposition of liabilities or duties on the shareholders.

Not coincidentally, the debate on legal capital in small companies, with regard to the dimensions of firms, is destined to bear a specific relevance to the proposals of English company law reform. It emerged from the need to consider, within the Companies Act, a class of company not displaying the full range of core features of company law, at least according to features on which the class of private companies is based. Thus, private companies have been considered in light of the introduction of a simplified regime for small companies, providing deregulatory measures to be applied to the private companies regardless of their size, instead of the creation of a new type of small

107 In Switzerland a maximum amount of the share capital is fixed at 2 million CHF for the *GmbH*, in order to ensure that this company is adopted by the small and medium firms; beyond this limit, the *GmbH* has to be changed to an AG (v. Meyer – Hayoz and Forstmoser, *Schweizerisches Gesellschaftsrecht* (2nd edn 1998) § 18 N 19 *et seq.*, 491. Against the provision of a maximum amount of legal capital, as unsuitable to the function of creditor protection, see Lutter, *Europäisches Unternehmensrecht* (n 8) 65. A maximum amount is prescribed too in Spain for the *Sociedad limitada Nueva Empresa* (see below, V).

company.¹⁰⁸ Even better, this recent pattern led to incorporation and access to limited liability being unrestricted and unattractive for small companies: the assumption is that the free availability of incorporation under the Companies Act has to be counterbalanced by a “think small first” approach to meet the needs of small companies, which would mean radically adjusting the legislation in order to reduce the regulatory hurdles involved in setting up and running a private company.¹⁰⁹

V. Capital rules in the UK private company and similar corporate forms of EU Member States

After *Inspire Art*, there is plenty of room for a regulatory competition, and thus for a Delaware effect which allows to choose the more convenient State for incorporating or restructuring a company.¹¹⁰ The emerging jurisdictional

108 See Company Law Reform Steering Group, *Modern Company Law for a Competitive Economy. Final Report*, 2.7; Freedman (n 83) 325 *et seq*; Rider – Andenas (eds), *The Quest for an Ideal Legal Form for Small Business, Developments in European Company Law*, vol. 2/1997 (1999).

109 Cf. Davies, *Introduction* (n 26) 282 *et seq*; Sheikt, “A Modern Regulatory Framework for European Company Law”, *Company Lawyer* (2003) 362 *et seq*; Company Law Reform Steering Group, *Modern Company Law for a Competitive Economy. Final Report*, Ch. 2, 23–37; Ch. 4, 65–87; Ferran, *Company Law Reform in the UK. A Progressive Report*, ECGI Working Paper (2005) 12 *et seq*. On the whole regulation proposed for such companies, see Bachmann (n 81) 357 *et seq*.

In this wake, a minimum capital requirement for *private companies* has been considered insufficient to prevent the abuse of limited liability, eg through “phoenix companies”. For specific remedies against the “phoenix syndrome” see ss. 216, 217 IA 1986, *ESS Production Ltd (in administration) v Sully* [2005] EWCA Civ 554 = EWIR (2005) 19 (noted Schall); *Ricketts v Ad Valorem Factors Ltd* [2003] EWCA Civ 1706 = [2004] 1 All ER 894 = EWIR (2005) 11 (noted Schall).

110 ECJ Case C 167/01 *Inspire Art*, noted De Kluiver, ECFR (2004), 121. On the jurisdiction of the ECJ cf. the report by Klinke, “European Company Law and the ECJ: The Court’s Judgements in the Years 2001–2004”, ECFR (2005) 270, 282 *et seq*; on the consequent Delaware effect see Kirchner – Painter – Kaal, “Regulatory Competition in EU Corporate Law after *Inspire Art*: Unbundling Delaware’s Product for Europe”, ECFR (2005) 159 *et seq*; for scepticism Ventoruzzo, “Experiments in Comparative Corporate Law: The Recent Italian Reform and the Dubious Virtues of a Market for Rules in the Absence of Effective Regulatory Competition”, ECFR (2005) 207, 260 *et seq*; on the latest developments regarding restructuring see Rickford, “Current Developments in European Law on the Restructuring of Companies: An Introduction”, EBLR (2004) 1225 *et seq*; Teichmann, “Restructuring Companies in Europe: A German Perspective”, EBLR (2004) 1325 *et seq*.

and regulatory competition about legal capital becomes obvious: such is shown, despite at a national level, by the forthcoming modifications of the minimum capital amount in many EU Member States.¹¹¹ The advantages of the harmonisation, either legal or factual, could be eliminated if a single State regulated a type of company limited by shares, without requiring a minimum capital.¹¹² In other words, the harmonisation in the matter of legal capital is destined to lose its strength, if it is not carried out in all the Member States or if it does not cover under the same conditions all the companies subject to the regulatory competition, as characterized by identical or similar features and then fungibles from the view of the potential users, to the point that the choice between them is completely neutral in regard to the legal capital rules.¹¹³

It is also evident, in a market for incorporations, the competitive disadvantage of the legal system which decides to protect creditors through the imposition of a mandatory minimum capital for the incorporation of a company. The limited liability company is most suitable for achieving jurisdictional and regulatory competition with regard to legal capital.¹¹⁴ Moreover, alternatives in this matter, i.e. between the complete abolition or merely the simplification of the relative regimes, emerge with more evidence in connection with the limited liability company.

With respect to the complete abolition of legal capital, the competitive potential of the English private company fully emerged thanks in particular to the significant boost from the ECJ decisions on the relationship between freedom of establishment and the legal capital regime. In this way the competitive

111 Freedman (n 83) 335 *et seq.* In Sweden the minimum capital has been raised from 50.000 to 100.000 SEK, whereas in Denmark it was been reduced in 1996 as a direct consequence of the *Centros* case, together with a wider simplification of the private companies rules (see Neville, "Nordic Company Law Reforms in a International Regulatory Perspective", in Neville – Karsten Sorensen (eds), *The Regulation of Companies*, Copenhagen (2003) 39 *et seq.*). Regulatory competition about minimum capital of the limited liability companies is particularly growing in the East-Europa countries: in the Baltic countries it amounts around 2.500 € (see Driesen, "Die 'GmbH' in den baltischen Staaten im Überblick. Estland – Lettland – Litauen", *GmbHR* (2003) 342 *et seq.*)

112 Grundmann (n 48) 584.

113 See Lutter, "Das Europäische Unternehmensrecht im 21. Jahrhundert", *ZGR* (2000) 10; Baldamus (n 13) 11 *et seq.*

114 See Westermann, "Die GmbH in der nationalen und internationalen Konkurrenz der Rechtsformen", *GmbHR* (2005) 4 *et seq.*; Happ, "Regulierung der GmbH im Wettbewerb der Rechtsformen", *ZHR* (2005) 10 *et seq.*; Wachter, "Wettbewerb des GmbH-Rechts in Europa. Vergleich der Rechtslage in ausgewählten Ländern", *GmbHR* (2005) 717 *et seq.*

advantages are emphasized by the wide possibility of exportation, through the establishment of branches in other Member States, this more flexible regime.¹¹⁵ However, all this was clear long before the decisions of the European Court of Justice on that subject, as reflected in the widespread use of the English private company by German companies.¹¹⁶ Such companies are often bought ready-made from a company formation specialist (so called “shelf companies”) to avoid the costs of engaging a solicitor in the incorporation procedure.¹¹⁷

The peculiarities of legal capital formation in the private company stem from the manner in which this corporate form was introduced into the English system: in contrast to what happened in other legal systems, the private company was not born as a separate corporate type, but slowly evolved, following the Companies Act 1907, through its detachment from the company limited by shares, and as a consequence of the extension of the benefits of corporate personality and limited liability to small firms.

The specific private companies rules alluded to here, in the beginning, principally had to do with the maximum number of shareholders, the limit to the transfer of shares and the prohibition against offering shares and other securities to the investing public; for legal capital, on the other hand, there were no distinguishing features.¹¹⁸

The emergence of a distinction on the point of legal capital occurred, with all its implications, when the Second Directive was implemented by the Compa-

115 McCahery – Vermeulen (n 9) 864 *et seq.*

116 Ebke, “The Limited Partnership and Transnational Combinations of Business Forms: ‘Delaware Syndrome’ versus European Community Law”, *Int. Lawyer* (1988) 195. On the main differences between the two types of company forms, see in particular the recent books by Lutter (ed), *Europäische Auslandsgesellschaften in Deutschland* (2005); Hirte – Bückner (eds), *Grenzüberschreitende Gesellschaften* (2005) and Eidenmüller (ed), *Ausländische Kapitalgesellschaften im deutschen Recht* (2004). Cf. further Fleischer, “Gläubigerschutz in der kleinen Kapitalgesellschaft: Deutsche GmbH versus englische private limited company”, *DStR* (2000) 1015 *et seq.*; Kallmeyer, “Vor- und Nachteile der englischen Limited im Vergleich zur GmbH oder GmbH & Co. KG”, *DB* (2004) 636.

117 It costs about 100 £ to buy a private company, with its own memorandum and articles of association, “from the shelf” (Goulding, “The Private Company in the United Kingdom”, in De Kluiver – Van Gerven (n 8) 58), whereas the solicitor would charge about 500 £. On the techniques of formation of the shelf companies that, on the track of ECJ decisions may use internet too, see Ulmer, “Gläubigerschutz bei Schein-auslandgesellschaften”, *NJW* (2004) 1201, n 6; among the practical guides on that matter, see Goldstein – Wulferding, *Euro-GmbH. So setzen sie eine englische Limited in Deutschland ein* (2004); Just, *Die englische Limited in der Praxis* (2005).

118 For the history, see Davies (n 72) 4 *et seq.*

nies Act 1980. Reversing the position followed until then, according to which companies of small dimensions which do not qualify expressly as “private companies”, were also considered to be public companies,¹¹⁹ the English legislator provided that all the companies limited by shares must be regarded as “private companies limited by shares” (ltd) – that is, unless they have further specific requisites, such as the entrance into the capital market – so that they become “public companies limited by shares” (plc), and governed by the new rules introduced in order to implement the Second Directive: particularly, by the a minimum capital rule.¹²⁰

The mechanism of delimitation and the implementation of the Second Directive in Great Britain have been completed in that way.¹²¹ It began with the rejection of the former proposal of the Second Directive, which covered classes of both private and public companies, considering that, contrasted with other legal systems, they did not constitute two wholly distinct types of corporate vehicle.¹²² The result was that the private companies, now exonerated from the observance of the Second Directive, grew to about 1.2 million, compared with only about 11,600 public companies.¹²³

Under English private company law, legal capital, despite being formally provided (“authorised capital”), does not have to be paid up to a minimum amount provided by law. Thus its function becomes merely symbolic: it is sufficient that only one of the shareholders subscribes one share and, since there is no minimum par value, its value may be equal to only one pound.¹²⁴ It follows that all the rules on capital formation and maintenance, which are peculiar to the jurisdictions based on the legal capital doctrine, may not be applied.¹²⁵

119 Probably just in order to limit the impact of the legal capital rules provided by the Second Directive and held as unconnected with the tradition of the company law, see Mühlbert – Birke (n 1) 699.

120 s. 1 (3) CA 1985: a private company is a company that is not public company. See Birds, “Die Britische Private Company”, in Roth (n 81) 144 *et seq.*; Bachmann (n 81) 354 *et seq.*; Lutter, *Die Entwicklung* (n 8) 55 *et seq.*

121 Edwards, *EC Company Law* (1999) 51 *et seq.*, with further references.

122 Welch, “The English Private Company – A Crisis of Classification”, *Jour. Bus. Law.* (1974) 277; Schmitthoff, “The Second EEC Directive on Company Law”, *Com. Mark. Law Rev.* (1978) 43 *et seq.*

123 See for statistics, Davies (n 72) 14; Bachmann (n 81) 355 n 23; Goulding (n 117) 57 *et seq.*

124 Davies “Legal Capital” (n 26) 347; Goulding (n 117) 58 *et seq.*; Eidenmüller (n 116) 337 *et seq.*; Fleischer, in Lutter (n 116) n. 57 *et seq.*

125 Among these, there are the rules on “hidden” contributions and on shareholders’ loan to the company, Wachter (n 33) 91 *et seq.* Such rules are applied however when a legal capital is formed in the private company, in spite of simplifications, as in the share repurchase (see below, VI).

As a consequence of this, creditors have to rely more than ever on other techniques, allowing more flexibility, in order to achieve real protection.¹²⁶ Particularly, creditor protection is based on directors' liability for wrongful trading under s. 214 Insolvency Act 1986 (IA) and on directors' disqualification under the Company Directors Disqualification Act (CDDA), through which the greater risk of losses of corporate assets can be prevented, especially when insolvency is drawing near. This is due to the absence of a minimum capital requirement; besides, there is the auditing system, not always provided in the corresponding types of companies adopting the legal capital: they are remedies that, subsequently, are not always fully equivalent to legal capital.¹²⁷

The English (and the Irish) private company discipline represents certainly the oldest example, characterized by a long evolution and the traditions of that legal system, and also of the simplification of the legal capital rules for limited liability companies. In fact, the private company is not covered by the Second Directive and does not have to comply with a minimum capital requirement.¹²⁸ Indeed, proposals are arising for greater deregulation of that regime.¹²⁹ This strategy had to be compared with the actual EU reform agenda

126 Micheler, "Gläubigerschutz im englischen Gesellschaftsrecht. Reformvorschläge mit Implikationen für Europa", ZGR (2004) 324 *et seq.*

127 Bachmann (n 81) 362 *et seq.*; about the mandatory imposition of the auditing on the small companies, see Cheffins (n 26) 505 *et seq.*, with criticism.

128 The debate on providing a minimum capital for private companies in Great Britain went on after the implementation of the Second Directive, though with considerable scepticism, as in the perspective of its repeal with means of disclosure (see *Company Law Committee Report: Jenkins Committee* (Cmnd 1749 (1962), § 27), or with the provision of a minimum paid-up capital equal to 1.000 £ (*Company Law White Paper*); it was taken up more recently, with the alternative of a "solvency margin" regime (Company Law Reform Steering Group, *Modern Company Law for a Competitive Economy: Developing the Framework* (2000, para. 9.61–9.71), but both refused, as minimum capital provides no protection against subsequent depletion, and the solvency margin is "disproportionate ... and over-regulatory"; on that point, in the view of the introduction of an European Private Company, see Boucourechiev – Hommelhoff, *Vorschläge für eine Europäische Privatgesellschaft* (1999) 85 *et seq.*

129 On the proposal for the abolition of the requirement to have "authorized share capital", with the result of disappearance of mandatory par value and its substitution with a solvency test, see The Secretary of State for Trade and Industry, *Modernising Company Law. White paper, vol. I*, § 6. 5; *vol. II, clause* para. 63; in the same way, Rickford (n 3) 989 *et seq.*, arguing that such a regime can provide substantial alleviation of the rigid legal capital rules under the Second Directive for company law, in the case of holding companies trading through private company subsidiaries.

on legal capital, which dealt with the dilemma of proceeding with autonomy or waiting for developments on the European Union level.¹³⁰

This model is also spreading in States which have tended to abandon legal capital, as in the U.S. “close corporations”¹³¹ or, more recently, “limited liability companies” (llc), which were introduced in various Federal States as a type of hybrid between partnerships and corporations, but were nevertheless marked by the limited liability and by the absence of a minimum capital requirement, a trade-off in favor of other techniques of creditors protection, such as fiduciary duties of directors and shareholders.¹³²

Most importantly, there is within the EU a crowded panorama of simplified legal capital rules which Member States have tried to introduce into the corporate types ascribable to the limited liability company (*GmbH-light*, or *Blitz-GmbH*) in connection with the guidelines laid out in the *European Charter for Small and Medium Enterprises*. Through which, by way of regulatory competition, a sort of Delaware effect is achieved.¹³³ An example of this is the French *société à responsabilité limitée*, as amended by the l. n. 2003-721 of August 1, 2003, *sur l’initiative économique*, which draws on various aspects of legal capital, in particular on minimum capital, with the intent to make company incorporation easier and less expensive. In particular, article L. 223-2 *Code com.* provides that the amount of legal capital has to be indicated in the articles of association, though this does not require a minimum capital, which was originally fixed at 7.500 €. This permits the fixing of legal capital at a merely symbolic one euro; the preference is given to more advantageous instruments of company financing,¹³⁴ among which, it should be

130 Ferran (n 109) 15 *et seq.*

131 Lutter, “Zur Entwicklung” (n 8) 64 *et seq.* in regard to the extra-European States, where minimum capital is purely fictitious. About the risk of greater attraction of the U.S. legal system to the capital market than to investors, due to regulatory competition, see Wachter (n 33) 91.

132 Külm, *Die US-amerikanische Limited Liability Company – Vorbild für eine deregulierte GmbH?*, ZVglRWiss (2003) 276 *et seq.*; Klein – Coffee (n 52) 103 *et seq.*; Freedman (n 83) 345 *et seq.*

133 With regard to the UK private company, see Cheffins (n 26) 441 *et seq.*; and to the French *société par actions simplifiée* (SAS), Guyon, “Les aspects communautaires ex internationaux de la société par actions simplifiée”, *Rev. soc.* (2000) 258; Bayer, “Die EuGH-Entscheidung ‘Inspire Art’ und die Deutsche GmbH im Wettbewerb der europäischen Rechtsordnungen”, BB (2003) 2357, 2366.

134 Le Cannu, “La loi pour l’initiative économique et le droit des sociétés”, *Rev. soc.* (2003) 414 *et seq.*; Lecourt, “L’avenir du droit français des sociétés: que peut – on encore attendre du législateur européen?”, *Rev. soc.* 2004, 250 *et seq.*; Massart, “Une grande réforme à petit budget: la SARL au capital d’un euro”, *Bull. Joly* (2002) § 289;

mentioned, by virtue of the *ordonnance* n. 2004-274 of March 25, 2004, is the power of issuing corporate bonds against high amounts.¹³⁵ Alongside these provisions, there are those introduced by the l. n. 2001-420 of May 15, 2001, relative *aux nouvelles régulation économique*, regarding the payment of cash contributions and the admissibility of work or services as consideration.¹³⁶ Also regulated is the *SARL à capital variable*.¹³⁷

The rule of statutory fixing of minimum capital risks reducing the role of legal capital in limited liability companies.¹³⁸ This rule may, in order to fully exploit its competitive potential, be also applied to companies already incorporated. It leads to the admissibility of reducing the minimum capital to a lower amount as fixed by shareholders, provided that the risk remains of

Nurit-Pontier, "La détermination statutaire du capital social: enjeux et conséquences", Dalloz (2003) 1612; Lienhard, "Loi pour l'initiative économique: quai de neuf pour les sociétés", Dalloz (2003, *Doctr.*) 1900 *et seq*; Becker, "Baldiges neues Gründungsverfahren in Frankreich: Die französische 'Blitz-S.A.R.L.'", GmbHR (2003) 706 *et seq*; Klein, "Die Europäische Aktiengesellschaft 'à la française'", RIW, 435 *et seq*; Simon, "A Comparative Approach to Capital Maintenance: France", EBLR (2004) 1037 *et seq*. More exactly, the legal capital "*est divisé en parts sociales égales*"; because it must be paid in Euro, and the share may be divided also in fractions named centimes, it will be sufficient to mention as legal capital one centimes, unless it is required to mention at least two parts. It is uncertain, from a logic point of view, if the amount of the legal capital may be fixed even at the amount of "0 €": see Pietrancosta (n 25) 132 *et seq*.

135 Saintourens (n 86) 211.

136 Work or services are allowed, according to some conditions provided in the articles of association. In regard to the cash consideration, it is allowed, differently from the SA, that only a fifth of the legal capital may be paid (then only 1.500 € versus a minimum capital of 7.500 €): art. l. 223-7 Cod. Com; however, the capital has to be paid up within five years, notwithstanding the high initial mortality of these firms, Le Cannu, "Les apports à une SARL et la libération du capital des sociétés à capital variable", Rev. soc. (2003) 634 *et seq*; Le Cannu, *Droit des sociétés* (2nd edn 2003) 743 *et seq*.

137 The *SARL à capital variable* may be incorporated with a paid up capital equal to 1/10 (not to 1/5, as in the companies with fixed capital), of the legal capital required for this corporate type, that is 15.000 € (art. L. 231-5 *Code com.*). Within this margin, maximum or minimum, each shareholder can withdraw his consideration afterwards, without necessity to alter the memorandum (DOM, "Les dispositions relatives à la libération du capital des SARL et des sociétés à capital variable: article 124 de la loi n. 2001-420 du 15 mai 2001", Bull. Joly (2001) 758 *et seq.*).

138 See Nurit – Pontier (n 134) 1613 *et seq*, who, as alternative, proposes to distinguish between the legal capital and the "capital d'engagement", which is different from the first, and shows how much the shareholders are liable for the corporate debts. Moreover, if this liability had to be fixed by the statute, instead by the law, there are non substantial differences with the creditor protection carried out by financial covenants.

covering legal capital through the losses of the current financial year,¹³⁹ as well as frequent occurrence of directors' liability for undercapitalization.¹⁴⁰

The Spanish *Sociedad Limitada Nueva Empresa*¹⁴¹ represents an approach to simplifying legal capital formation rules without dismantling the minimum capital requirement, and also the Italian *società a responsabilità limitata* following the company law reform of 2003.¹⁴² For that reason, the main question is the choice between encouraging simplifications of the legal capital discipline or, contrarily, reducing or even abolishing them through the extension of the Second Directive to limited liability companies, as a result of the legislative history of the EU.¹⁴³ Instead, the more radical solution seems to have remained rather insulated, as regards the introduction of a new separate legal statute

139 Le Cannu (n 134) 418.

140 See below, VIII.

141 See Ley 1-4-2003, n. 7, as an amendment to the *Ley de Sociedades de responsabilidad Limitada* (Ley 2/1995); particularly, the *Sociedad Limitada Nueva Empresa* has the same minimum capital of the *Sociedad de Responsabilidad Limitada* (3.200 €), and contributions may be only in cash, but legal capital may not exceed 120.000 €. Moreover, due to the simplification of the rules, the formation of the company may take place within 48 hours: see Vietz, "Die neue 'Blitz-GmbH' in Spanien", *GmbHHR* (2003) 26 *et seq*; Embid Irujo, "Eine spanische 'Erfindung' im Gesellschaftsrecht: Die 'Sociedad limitada nueva empresa' – die neue unternehmerische GmbH", *RIW* (2004) 760 *et seq*; Mateu, "The Private Company in Spain – Some Recent Developments", *ECFR* (2004) 60 *et seq*.

142 In detail, as regards cash consideration, shareholders may substitute the payment of the 25 % of the shares amount taking a bond, or an insurance policy (art. 2464, co. 4, c. c.); as regard the non-cash consideration, the admissibility of doing work or performing services as consideration for shares was introduced. The risk of lack of performances by the provider of work and services is covered requiring shareholders to take a bond or an insurance policy, which will cover the absence of execution of work or services (art. 2464, co. 6., c. c.). Moreover, as in the *società per azioni*, the shares may be allotted to each shareholders independently of the contribution made from each of them to subscribe the legal capital. It is only required that the value of all contributions not be lower than the total amount of subscribed capital (art. 2468, co. 2, c. c.). On that rules, see Miola, "Capitale sociale e conferimenti nella 'nuova' società a responsabilità limitata", *Riv. soc.* (2004) 657 *et seq*; Portale, "Profili dei conferimenti in natura nel nuovo diritto delle società di capitali", *Corr. Giur.* (2003) 1663 *et seq.* and in *Festschrift für Erik Jayme* (2004) 1559 *et seq.* Cassassottana – Pollio, "I conferimenti di servizi", *AGE* (2003) 370 *et seq*; Rosapepe, "Art. 2464", in Sandulli – Santoro (eds), *La riforma delle società*, vol. III, (2003) 30 *et seq*; Santoro, "I conferimenti e le quote nella società a responsabilità limitata", in Santoro (ed), *La nuova disciplina della società a responsabilità limitata* (2003) 73 *et seq.* with analogies, see High Level Group (n 15) ch IV, § 4.c).

143 Europäische Kommission, *Studie über die Erweiterung des Anwendungsbereichs der Zweiten Richtlinie auf Gesellschaften anderen Rechtsform*, (Brussels, 1993).

for the needs of closely held firms, as modelled on the U.S. limited liability company (llc).¹⁴⁴

Such debate firstly involves Germany, otherwise threatened by the competitive disadvantage now not only described in comparison with the private company,¹⁴⁵ but also the French *SARL*,¹⁴⁶ and exacerbated, as we shall see, by difficulties, or rather by the impossibility of restraining the EU freedom of establishment through the adoption of the international private law theory of the “real seat”.¹⁴⁷

In this framework, there are incentives, chiefly in that jurisdiction, to extend the Second Directive to limited liability companies and then to UK private companies,¹⁴⁸ as already pointed out in an EU Report from 1992, and this in spite of the difficulties in introducing minimum capital into the legal systems which lack it.¹⁴⁹ The solutions to this oscillate between the following: total preservation of the minimum capital discipline;¹⁵⁰ its adjustment through the fixation at an amount which would facilitate the firm’s activity, as demonstrated by the larger probability of the *GmbH* being wound up;¹⁵¹ the possible provision in the Directive of a maximum amount as well, in order to go beyond more permissive national legislations;¹⁵² or a more far-reaching discipline of legal capital in the *GmbH*.¹⁵³

144 McCahery – Vermeulen (n 9) 872 *et seq.*

145 Halbhuber, “National Doctrinal Structures and European Company Law”, CMLR (2001) 1403 *et seq.*; Fleischer (n 116) 1015 *et seq.*

146 Recq – Hoffmann, “Die französische S.A.R.L. als GmbH-Ersatz?”, *GmbHHR* (2004) 1070 *et seq.*; Merkt (n 1) 311; Fleischer (n 116) 1021.

147 Cf. Ulmer, “Schutzinstrumente gegen die Gefahren aus der Geschäftstätigkeit inländischer Zweigniederlassungen von Kapitalgesellschaften mit fiktivem Auslandsitz”, *JZ* (1999) 662 *et seq.*; Ballarino, “Sulla mobilità delle società nella Comunità Europea. Da Daily Mail a Überseering: norme imperative, norme di conflitto e libertà comunitarie”, *Riv. soc.* (2003) 669 *et seq.*

148 For the debate on the extension of the scope of the Second Directive, with the consequent harmonisation of the legal capital rules for the limited liability company, see, in favour of that, Lutter (n 113) 9 *et seq.*; Schön, “Gesellschafter-, Gläubiger- und Anlegerschutz im Europäischen Bilanzrecht”, *ZGR* (2000) 706, 725 *et seq.*; Habersack (n 8) n 43 *et seq.*; Lutter, “Konzepte, Erfolge und Europäischer Gesellschaftsrechts-harmonisierung”, and Hirte, “Kapitalschutz (Gläubiger- und Eignerschutz) im Europäischen Recht”, in Grundmann (ed), *Systembildung und Systemlücken in Kerngebieten des Europäischen Privatrechts* (2001) 137; 231 *et seq.*; Ulmer (n 147) 664; Fleischer (n 116) 1015 *et seq.*

149 Edwards (n 121) 54; Lutter, “A Mini-Directive on Capital”, in De Kluiver – van Gerwen (n 8) 201 *et seq.*

150 Bayer (n 133) 2364.

151 Wachter (n 33) 97.

152 Wachter (n 33) 104.

153 Schubel, “Bericht über die Diskussion”, *ZGR* (2000) 747.

On the opposite side, there are also proposals for a “re-launch”, intended to deregulate the *GmbH* so as to make it more flexible in accordance with regulatory competition, e.g. through the total dismantlement of the legal capital discipline,¹⁵⁴ as reflected in a recent reform draft which has however been rejected by the *Bundesrat* with a view to the premature elections. Instead of reforming the *GmbH*, the *CDU* (ie the German conservative party) is apparently planning to introduce a new company form without legal capital, the so-called “*Unternehmensgründergesellschaft*” (*UGG* = Business Founders Company) in order to facilitate start-ups while avoiding changes in the law governing the more than 1 million existing *GmbH*.¹⁵⁵ In the long run, this would leave it up to companies whether to be endowed with minimum capital or not. The adoption of the new corporate form may be supported by duties of disclosure and other guarantees in order to avoid repercussions to the protection of creditors, eg easier petition rights.¹⁵⁶

In this range of proposals, there is the insinuation that it is right to deal with legal capital rules in limited liability companies through regulatory competition within the EU, rather than in individual Member States. The *Centros* and *Inspire Art* decisions could, in principle, give an impulse to the project: an alternative to further harmonization of substantive private company law, furthering introduction of a *société privée européenne* (SPE), as presented at an earlier date and repropounded recently by the High Level Group and the EU Commission.¹⁵⁷ The basic philosophy of the project is to permit each Member State to operate with the same corporate form for small and medium firms within the whole EU. As a result, the limited liability companies could

154 On the proposal of a *MindestKapG*, see Eidenmüller – Engert (n 1) 433 *et seq.*; Barta, “Das Kapitalsystem von GmbH und AG”, *GmbHR* (2005) 657 *et seq.*; Grunewald – Noack, “Zur Zukunft des Kapitalsystems der GmbH – Die Ein-Euro-GmbH”, *GmbHR* (2005) 189 *et seq.* On the approach to the U.S.’ LLC, see Külms (n 132) 282 *et seq.*; in agreement on the rules of the private company, see too Micheler (n 126) 324 *et seq.*

155 See the report in the *Financial Times Deutschland* (06.09.2005), at p 9. For this idea see already Schall – Westhoff “Warum Deutschland eine neue Kapitalgesellschaftsform braucht”, *GmbHR* (2004) R 381.

156 Schall – Westhoff (n 155); *id.* *GmbHR* (2005) R 357; Bachmann (n 81) 365 *et seq.*; Escher – Weingart (n 22) 292 *et seq.*

157 Bachmann (n 81) 370 *et seq.*; about the SPE, see De Kluiver – van Gerven (n 8); Boucourechiev – Hommelhoff (n 128); Helms, *Die Europäische Privatgesellschaft* (1998); Hommelhoff – Helms, “Weiter auf dem Weg zur Europäischen Privatgesellschaften”, *GmbHR* (1999) 53 *et seq.*; Simon, “La société par actions simplifiée et la proposition de création d’une société privée européenne”, *Rev. soc.* (2000) 263 *et seq.*; Drury – Hicks (n 64) 429 *et seq.*; Drury (n 8) 383 *et seq.*

enable cross-border mergers¹⁵⁸ and the transfer of their seat into another Member State,¹⁵⁹ besides operating in the host States through branches which would remain subject to the regulations of the home State.¹⁶⁰

The key rationale of the SPE tends to repeat the original idea of the SE, which postulated a legal form that would be identical in all Member States, so as to facilitate cross-border cooperation and the integration of business in Europe. The SE Statute, as it has finally been agreed, after many years of negotiation between the Member States, is precisely not doing that. The SE is only partly governed by substantive rules in the Statute, as the vast majority of company law matters would be governed by the national company law of the Member State where the SE would be incorporated (art. 7 reg. n. 2157/2001 CE).¹⁶¹

It has to be questioned whether the SPE raises analogous interferences with single national laws. There is the risk that the lack of previous harmonisation would lead to a differentiation of the national disciplines, depending on the national legal systems where the SPE is incorporated, which is more significant than that occurring in regard to the SE.¹⁶² The lack of harmonisation favours the elaboration of a European common core of corporate principles for the private companies, and therefore makes the SPE a full supranational corporate form, as in the original project of the SE, able to compete with Member State company law.¹⁶³

158 For that reason, the project of the SPE is strictly connected to the project of Tenth Directive on cross-border mergers (*Action Plan* (n 16) § 3.5, 21).

159 High Level Group (n 15) Ch. VII, § 1; for this purpose, it is suggested that the SPE may be formed only from natural persons of different Member States.

160 See Bachmann (n 81) 371.

161 On the main attraction of the SE, to make possible a cross-border merger and a cross-border transfer of seat, see Miola, "Lo Statuto di Società europea nel diritto societario comunitario: dall'armonizzazione alla concorrenza di ordinamenti", *Riv. soc.* (2003) 322 et seq; Rescio, "La Società Europea tra diritto comunitario e diritto nazionale", *Riv. soc.* (2003) 965 et seq; Enriques, "Capitale, azioni e finanziamento della Società europea", *Riv. soc.* (2003) 375 et seq.

The SE must have its registered office in the same Member State as there is its central place of administration, and thus a SE is forced to transfer its legal seat to another Member State, when it moves its central administration there (art. 7 reg. n. 2157/2001 CE). Under that, and other rules, the SE Statute seems to accept the "real seat" doctrine, and so it is directly contravening with the freedom of establishment as explained by ECJ, Winter, "EU Company Law at the cross-roads" in Ferrarini et al. (n 41) 10; Magnier, "La société européenne en question", *Rev. crit. dr. int. priv.* (2004) 583 et seq.

162 On that risk, see Winter, *ibid.*, 15.

163 See High Level Group, Ch. VII, n. 3, where a fundamental role in resolving the conflicts of laws that may arise from those rules is ascribed to the ECJ; Bachmann (n 81)

The task of harmonizing EU company law with equivalent standards is not pertinent to this: meanwhile, the SE offers a system of floodgates, which allow the import and export of national company law between the Member States.¹⁶⁴

In the first case, with regard to the *société privée européenne*, a case parallel to the SE could take place, i.e. its utilisation in preference to the corresponding corporate types of each Member State; then the SPE may be used, through its incorporation in, say, Great Britain, as a method of subjecting a foreign company to the more favourable legal capital rules of the private company. This would, for example, overcome the obstacles posed by the English system vis-a-vis the transfer of the seat of a company incorporated abroad.¹⁶⁵

An indication of these options derives from the circumstance that, in the debate on the SE, and also in the projects elaborated, there is a mandatory minimum capital of 25.000 €, which is equivalent to that provided by article 6 of the Second Directive for the public companies; this is part of the effort to create an atmosphere of economic credibility¹⁶⁶ apart from major or minor suitability to creditor protection. Even better, it is proposed that the provision of minimum capital be not less than the higher amount fixed within the EU for corporate structures corresponding to the limited liability companies.¹⁶⁷ This is a significant obstacle to the full autonomy of the corporate model of the SPE.¹⁶⁸

373 *et seq*; the advantage, in comparison to the english private company, is that the SPE may be used in all EU Member States without changing its rules, Eidenmüller – Rehm (n 48) 187.

164 See Winter (n 161) 4 *et seq*; about the differences between the single Member States jurisdictions, in spite of the harmonisation, in regard to the Second Directive, see Halbhuber (n 145) 1406 *et seq*.

165 Behrens, *Centros and the Proper Law of Companies*, in Ferrarini et al. (n 48) 520; Enriques (n 161) 393.

166 Chambre de Commerce et d'Industrie de Paris, "Draft for a regulation relating to the Rules governing the European Private Company: a Close Company", in appendix to McCahery et al. (n 8) 427 *et seq*, art. 3, and art. 26–28; see Boucourechliev – Hommelhoff (n 128) 109 *et seq*, 201 *et seq*; Lutter (n 149) 201 *et seq*.

167 Drury – Hicks (n 64) 435 e 443; the aim is to avoid resistance of Member States to the introduction of the SPE, due to the fear of excessive competition with the national company laws.

168 McCahery – Vermeulen (n 9) 869 *et seq*.

*VI. The simplification of capital maintenance rules
in limited liability companies: the case for share repurchasing*

Some perspectives on simplification of capital maintenance rules in limited liability companies concern capital maintenance; especially the discipline of share repurchases and financial assistance. These rules may perform the same function as limitations on dividend distributions, but they also reveal the common purpose of legal capital rules, which is the imposition of a limitation on the distribution of net assets to shareholders as compared with *solvency tests*.

The scope of these rules, issued by directive 77/91/EEC, caused widespread debates since they generated another source of rigidity, precluding the company from pursuing the aim peculiar to transactions on its own shares.¹⁶⁹ This increased the costs of legal capital rules in comparison to other legal systems, such as in the U.S.¹⁷⁰ The reforms adopted by numerous Member States, concerning eg share repurchasing,¹⁷¹ and the proposals for the simplification of the directive 77/91/EEC¹⁷² have to be seen in this context.

169 Cf. Davies, *Introduction* (n 26) 87 *et seq*; Kübler (n 58) 102; on the goals which may be pursued, see Baldamus (n 13) 146 *et seq*; among these costs, there are those for use the alternative possibility, in order to overcome the limitation of 10 % of the share capital, of altering it previously though the issue of new shares. In particular, the aim of achieving a replacement of equity finance by debt finance would be thwarted anyway, apart from the legal capital discipline, by a debt/equity ratio.

170 In the U.S. the share repurchase is generally allowed, as a form of assets distributions, and it may take place, similar to any other net assets distribution to shareholders, through the balance sheet test and the equity insolvency test (*sect.* 6.40 RMBCA: see below, VI); that rules are supported by the SEC regulations, to prevent insider trading and market manipulation (Cary – Eisenberg, *Corporations and Other Business Organizations. Cases and Materials* (8th edn 2000) 1267 *et seq*; Clark, *Corporate Law* (1986) 610 *et seq*; Cox – Hazen, *Corporations* (4th edn 2004) 570 *et seq*.

171 In France (art. L. 225-209 Cod. Com) and in Germany (§ 71 (1) AktG as amended in 1998 by the *KonTraG*) the general meeting may deliberate the own share repurchase, if the limits of the Second Directive are observed. In Great Britain the CA 1985, as amended in 2003, allows to the listed public companies on some condition, to holding the repurchased share in own treasury, without being cancelled, Davies (n 72) 248, 251. Morse “The Introduction of Treasury Shares into English Law and Practice”, [2004] JBL 303 *et seq*.

172 The Company Law SLIM Working Group (proposal 4) and the High Level Group (n 15) Ch. IV, § 3, lett. f) have proposed simplifying the point of art. 19 of the Second Directive, by eliminating the limitation of 10 % of the legal capital, and only the maintenance of the limitation, that the repurchasing of own shares may not exceed the amount of the profits and the reserves available for this purpose, cf. also Rickford (n 3) 941 *et seq*. The proposals of the SLIM Working Group, which also are accepted by the EU Commission *Action Plan* (n 16), are contained now in the proposal draft of

The need remains for stringent requirements in financial services regulation, especially for listed companies, in order to give full enforcement to the “safe harbour” for share repurchasing, as provided for in the *Market Abuse Directive* (6/2003/CE; reg. n. 2273/2003/CE).¹⁷³

The rules on share repurchases in limited liability companies are not always analogous to what is typical for public companies; alternatively, they are further-reaching, or more flexible.¹⁷⁴ In this way, for example in Italy’s *società a responsabilità limitata*, there is an absolute prohibition against both share repurchases and financial assistance (art. 2474 c.c.); there is greater rigour in comparison with the same discipline in the Second Directive.

The reasons for these wide-ranging prohibitions raise perplexities which must be considered throughout. It must be held that the prohibition against share repurchasing does not lie in a more extensive protection of legal capital as compared with the public company, since it is also applied in the event that legal capital is not drawn. This accentuates the rigidity of those rules; rather, and indeed, there are different reasons, such as the need to separate the discipline of the share repurchasing from legal capital rules.

However, such prohibitions do not depend on the possible absence of a share certificate in the limited liability company.¹⁷⁵ The protection of shares against the risk of extinguishment by confusion is not only applied in the case of share certificates, given that the coincidence of the ownership of the shares in the same person of the company and of the shareholder is allowed: this gives

amendment of the Directive 77/91 EEC (21/9/2004 COM (2004), also if the Member States may decide to retain the limit of 10 % of the legal capital. For criticism to the limitation to own share repurchase, see Enriques – Macey (n 2) 1197. In favour of the increasing the limit of 10 %, see Baldamus (n 13) 184 *et seq.*

173 See High Level Group (n 15) Ch. IV, n. 3, lett. f); Rickford (n 3) 942. On the requirement for the exemption from the prohibition of market manipulation and insider dealing, see Ferrarini, “La nuova disciplina europea sull’abuso di mercato”, Riv. soc. (2004) 69 *et seq.*

174 The same regime is provided in the Netherlands, whereas the regulation of § 33 GmbHG is formally less strict, since, differently from the § 71 AktG, it does not state an explicit prohibition. However, the repurchase must comply with the general limits on hidden distributions (“*Verdeckte Gewinnausschüttungen*”) in the GmbH, cf. Baumbach/Hueck *Kommentar zum GmbHG* (17th edn 2001) § 29 n 68 *et seq.* In France, share repurchases are prohibited unless accompanied by capital reductions (art. L. 223-34 Cod. Com).

175 In some countries, as in the UK private company, there is a share certificate: for that company, unlike for the public company (above n 171), the repurchased own shares shall be treated as cancelled, but only the issued capital, not the authorized capital, may be consequently reduced (see s. 171 CA).

cause for a unilateral legal relationship. As a result of this, the prohibition of share repurchases can be based more plausibly on the personalistic feature of limited liability companies, namely that, by limiting the share's transfers, this also leads to ban share repurchases.

The need for a discipline more favourable to own-share transactions in limited liability companies again comes from the English debate on this subject, where benefits connected to the widely permitted share repurchases in private company have been pointed out: e.g., as a way to favour the liquidation of shares, notwithstanding the absence of a regulated market for these.¹⁷⁶ On the foundation of this debate, as illustrated by the *Green Paper*, the Companies Act 1985 enlarged share repurchasing in private companies, even if it involved watering down the legal capital, which thus goes beyond the same provisions of the Second Directive.¹⁷⁷

Even more so, the absolute prohibition against financial assistance may appear incoherent and full of consequences with regard to regulatory competition. Such prohibition has been introduced within the EU mainly under the influence of the English tradition in this field.¹⁷⁸ However, in Great Britain, this prohibition is principally intended to regulate transactions capable of increasing the risk of default, e.g., in the wake of the *ultra vires* doctrine. Particularly, it is intended to combat various malpractices in the company field,

176 Cf. Davies, *Introduction* (n 26) 89, where the possibility of transferring the corporate control to a public company is pointed out.

177 More specifically, it is required a statutory declaration of solvency from directors, and each creditor may do opposition in order to ban the share repurchase or subordinate it to his protection.

The system of protection is equivalent to the legal capital system in that it aims to reduce share capital by returning unwanted assets; in other words, the opposition by creditors, since also in case of stock repurchase is required that afterwards "the company's capital will be set at a new and lower point". Notwithstanding, in private companies the absence of a minimum capital requirement implies that share repurchases and the consequent reductions may intervene without limitation. Then creditor protection must be founded on other grounds (Davies, "Legal Capital" (n 26) 347 *et seq.*). The Company Law Review Steering Group goes beyond, and requires that for the *private company* the limitations to the stock repurchase would be completely eliminated and that the capital reduction would be subordinate merely to a declaration of solvency (*Company Formation and Capital Maintenance*, para. 3.27–3.35).

178 Cf. Wymeersch, "Article 23 of the Second Company Law Directive: the prohibition of financial assistance to acquire shares of the company", in Basedow – Hopt – Kotz (eds), *Festschrift für Ulrich Drobnig* (1998) 725 *et seq.*, also in regard to the ways in which the directive is transposed in the various Member States; Edwards (n 121) 73 *et seq.* Not by chance, the prohibition has been meant in a "broader issue, such as selling assets to the target company, in order to use the proceeds of the sale to finance the share deal".

such as take-over bids, preventing the target from fending off the bidder by financing or guaranteeing third parties the right to secretly acquire its shares, instead of protecting legal capital, i. e. creditors.

On the contrary, article 23 of the Second Directive conceived the prohibition against financial assistance as a further refining of the rules appertaining to the repurchasing of own shares. The prohibition was an instrument for protecting the company's legal capital, and this led to difficulty in delineating clearly the scope of the prohibition and the need for a restrictive interpretation, especially with regard to *merger leveraged buy-outs* (MLBO), the distribution of dividends or other means available to the target for financing the purchase of own shares.¹⁷⁹

As result, this prohibition is not always automatically reproduced; neither has it the same scope and extent for limited liability companies in the various Member States.¹⁸⁰ This is particularly the case with the French *société à responsabilité limitée*¹⁸¹ and the German *GmbH*, where the prohibition against financial assistance is not expressly mentioned, even though it could be derived from more general rules prohibiting indirect distributions.¹⁸²

Above all, this prohibition is pointed out in the debate on company law reform in Great Britain. In fact, the elimination, or at least the simplification¹⁸³ of the already relaxed prohibitions of financial assistance applicable to the private company have been proposed ("whitewash" procedure: *sect. 155–158*

179 In case of MLBO, the prejudice toward older creditors would stem not so much from the purchase of the target company's shares through financial assistance, but rather from prevention of "asset-stripping" takeovers, where the subsequent fast selling of the company assets in order to pay the debt may be considered an indirect return of the corporate assets, in which older shareholders are preferred to the detriment of creditors, Armour (n 2) 368 *et seq.*; 374 *et seq.*, with examples of LBOs not attributable to this issue and therefore unduly penalized.

180 For a detailed overview, see Wymeersch (n 178) 729 *et seq.*

181 French rules prohibit only loans to directors and officers of the *société à responsabilité limitée* (art. L 223-21 Cod. com.).

182 Baumbach-Hueck (n 174) § 30, n 18 *et seq.*, 351 *et seq.*

183 See Company Law Reform Steering Group, *Modernising Company Law, White Paper*, July 2002, vol. I, cap. II, para. 6.5; see Goddard, "Modernising Company Law": the Government's White Paper", *Modern Law Rev.*, (2003) 402 *et seq.*; Ferran, "Creditor Interests and "Core" Company Law", *Company Lawyer*, (1999) 314 *et seq.*

The EU debate on that subject has already moved on to a more radical level than at the time when the British Company Law Steering Group was formulating its proposal. Now the dilemma is arising whether or not to wait and see what happens at the EU level, Ferran (n 109) 13 *et seq.*

Companies Act 1985).¹⁸⁴ These rules are most frequently applied in considering the possibility of a public company reorganizing as a private company when the target of a LBO. This prohibition is, in fact, held as a source of arbitrary effects and, as such, it criminalizes many entirely innocuous transactions, which are often unenforceable and subject to wide and damaging civil sanctions.¹⁸⁵

In particular, it has been observed that there are more general remedies which can prevent abuses: in particular, the protections and sanctions offered by insolvency law, such as the provisions on fraudulent and wrongful trading (ss. 213, 214 IA), or the director's fiduciary duties of fairness and use of powers for proper purposes, and the duty of care, as well as other protections for minority shareholders.¹⁸⁶

The prohibition against financial assistance, especially if absolute, is inconsistent, as it is not applied if the financial assistance is not oriented to the repurchasing of shares; at the same time, if the purchase is allowed, it is difficult to understand why financial assistance oriented to this aim is not similarly allowed.

184 Financial assistance for private companies is admissible, if the net assets are not reduced, or, to the extent that they are reduced, if the assistance is provided out of distributable profits (s. 155 (2) CA 1985; see Davies (n 72) 267 *et seq.*). Moreover, "the provisions on net assets are of limited relevance to private companies, where there is no minimum capital requirement and net assets can be reduced to a minimum" (Company Law Review Steering Group, *Developing the Framework*, para. 7.21). The way how the European harmonisation has been accomplished in this field risks to create an evident imbalance between creditors, considering the differences between legal systems where also the smaller firms are organized as public companies, and those allowing to deviate towards more flexible rules dealing with private companies, attributing competitive advantages in comparison to the former also at internal level, see Wymeersch (n 178) 734, 745.

185 An ordinary shareholder resolution is required, to the exclusion of those interested in the transaction; moreover, the financial assistance must not reduce net assets of 30 % or beyond; otherwise, it must be provided out of distributable profits, or, failing that, it must be supported by a solvency declaration by the directors; and there would be no special minority protection: cf. Company Law Review Steering Group, *Modernising Company Formation and Capital Maintenance. A Consultation Document*, October 1999, para. 3.41–3.48. For public companies, the proposal concerns the refinement of the "purpose" component of the offence and the restriction of the remedies. In spite of this, such limitation risks being too wide and blurred, compared to the provision of U.S. loans covenants, which focus on the case that the LBO leads to a change of control, permitting in this case to satisfy in advance the bondholders pre-existent to the LBO through terms of "poison out" (Armour (n 2) 374 *et seq.*).

186 Company Law Review Steering Group, *Modern Company Law for a Competitive Economy. Developing the Framework. The Second Document*, para. 7.20–7.24.

In effect, the prohibition against financial assistance tends to protect creditors, but it cannot be absolutely compared with the case of share repurchases. Apart from financial assistance not necessarily being a case of indirect purchasing of own shares, it is worth pointing out that financial assistance does not draw net assets: the operation consists in the recording of credit against a third party in the balance-sheet. As financial assistance is not detrimental to the company's assets, restrictions such as percentage-based limitations on capital, are not applicable to the repurchasing of own shares.

Moreover, such prohibition is not extended to loans and other transactions with third parties, which are no less risky than those with shareholders, especially considering that the risk springing from the loan, as granted to a buyer of shares, is lower. If anything, the investor will find other means of rewarding himself for the investment aside from giving back the sum.¹⁸⁷ Hence a company loan to the shareholders is not forbidden in general, but only if the loan is oriented to the repurchasing of shares.

Nor in financial assistance may a conflict of interests be found. The risk that the company's funds are used for a private purpose is the reason. In fact, the prohibition is not directed in principle against the company's directors, but against loans made to shareholders which are oriented to the repurchasing of shares. In that event, there can be no conflict between directors and shareholders; on the contrary, there is total independence. Furthermore, this type of financing does not constitute an absolute misuse of the company's acquired assets since its evaluation depends on the capability of the cash flow generated by the acquisition to pay back the loan.¹⁸⁸

Therefore, it is right to hold that article 23 of the Second Directive, as formulated, addresses "*the wrong answer to the wrong question*".¹⁸⁹ It may also be cited as a significant example of the rigidity produced by recourse to mandatory rules.¹⁹⁰

These reasons elicited the proposals made by the *SLIM Working Group* (proposal 6) and the *High Level Group*¹⁹¹ to the effect of permitting financial

187 Wymeersch (n 178) 741 *et seq*; on that argument, see yet, the *British Review of Company Law* (Jenkins Committee), Cmd 1749, 1961, § 170–187.

188 See the rules concerning the MLBO in Italy (art. 2501-*bis*, civil code).

189 Wymeersch (note 178) 747. On the techniques to avoid the financial assistance prohibition, see Ferran, "Corporate Transactions and Financial Assistance: Shifting Policy Perceptions But Static Law", 63 CLR (2004) 225 *et seq*.

190 Cheffins (n 26) 228 *et seq*. Thus, the alternative strategy to obtain lenders financing the acquisition of the company is to have the purchased company re-registered as private company, with a more favourable regime, but with many inconveniences.

191 High Level Group (n 15) Ch. IV, § 3, lett. g).

assistance within the limits of the amount of distributable net assets.¹⁹² These proposals have been included in the amended draft of article 23 of the Second Directive, which allows the Member State to make financial assistance possible, on certain cautionary conditions.¹⁹³ Even more so, this should favour simplifications proposed for limited liability companies.

VII. *Alternative creditor protection: the solvency tests*

The perspectives on regulatory competition with regard to legal capital in limited liability companies are ideally linked to efforts to attenuate the rigour of legal capital rules, and especially to the more general questions of those rules being mandatory or convenient.

In effect, from the standpoint of full elimination, legal capital doctrine is more and more frequently compared to alternative models which are above all based on the ability of creditors to negotiate techniques of their protection directly with the indebted company. In practice, creditors, either actual or potential, pay attention to parameters of the company's solvency which are more reliable than the legal capital, and that with the object of considering whether credit should be granted. For example: compliance with a business plan made with banks in the act of a loan's endowment, and cash flow, especially with regard to trade creditors and employers.¹⁹⁴ Thus these criteria are utilized before taking recourse to legal capital to determine the ratings issued by credit rating agencies so as to measure the creditworthiness of a corporate debtor.¹⁹⁵

192 Against the amendments to Article 23 of the Second Directive, Baldamus (n 13) 192 *et seq.*

193 As there are: the directors may be liable for that operations; the financial assistance has to conform with the market conditions and must be approved by the general meeting; it needs to verify the creditworthiness of the third parties; the company must remain solvent during the next five years; all the limits required for share repurchase are to be observed: see Ferran, "Simplification of European Company Law on Financial Assistance", EBOR (2005) 93 *et seq.*

194 Kübler (n 58) 107; Walter, "Gesetzliches Garantiekapital und Kreditentscheidung der Banken", AG (1998) 370 *et seq.*; High Level Group (n 15) Ch. IV, n. 2.

195 On the credit rating agencies, see Schwarcz, "Private Ordering of Public Markets: The Rating Agency Paradox", Univ. Ill. Law Rev. (2002) 6 *et seq.*; Schwarcz, "The Role of Rating Agencies in Global Market Regulation", and Jackson, "The Role of Credit Rating Agencies in the Establishment of Capital Standards for Financial Institutions in a Global Economy", both in Ferran-Goodhart (eds), *Regulating Financial Services and Markets in the Twenty First Century* (2001) 297 *et seq.*, 311 *et seq.*; Zimmermann – Couret, "Les agences de notation", Rev. soc. (2003) 765 *et seq.*; see too, IOSCO, *Code of Conduct Fundamentals for Credit Rating Agencies* (2004); on the rating criteria, see, e.g. Standard & Poor, *Corporate Rating Criteria*, at www.standardandpoor.com/rating.

In fact, even a legal capital of low or trivial amount, to which creditors cannot give significant weight anyway, may be compensated by a high cash flow, capable not only of repaying the cost of the borrowed capital and avoiding a surplus of liabilities, but also of generating a capital gain. For this reason, attention should be paid not only to legal capital, but to the whole of net assets, which, exceeding the legal capital, are destined to vary in relation to the profitability of the company.¹⁹⁶ As far as insolvency law is concerned, this kind of evaluation contributes to reducing the risk that a company with a trivial legal capital will, according to the balance sheet test, become insolvent immediately after starting up, and that it would automatically lead to charging the directors with civil and criminal liability; the same applies before the company's winding up, apart from taking unjustifiable risks with the conduct of company business.¹⁹⁷

In particular, it deserves mention that the financial markets require the correct capital structure and also leverage,¹⁹⁸ through both financial ratios and the determination of the debt-equity ratio. This is especially important if there is widespread raising of capital on the credit market. This aims at acknowledging some economic rules according to which the financial structure, when there are some market imperfections, e.g. imperfect available information, relates to the company's value and the costs involved in formation of its assets, as it happens in the limited liability companies.¹⁹⁹

The most recent tendencies in U.S. corporate law point in this direction. They tend to completely replace legal capital with par value rules, which arise in order to radically avoid the phenomenon of watered stock and the consequent stock watering stemming from the initial difficulties in representing the amount of eligible consideration received by the corporation for its shares, or from abusive transactions pursuing this goal.²⁰⁰ By the early 1980's, there are about six different statutory approaches to dividend restrictions and creditor protection techniques.

There is the more radical solution proposed by the *California Corporation Code* which demands, as a condition and limitation on the distribution of

196 Cheffins (n 26) 532 *et seq*; Saintourens (n 86) 251; Portale (n 12) 102 *et seq*. In this regard, much depends on the calculation of the company's net assets, on the adoption of the historical value as opposite to fair value standard, and on the assets which may not be registered in the balance-sheet.

197 In regard to the private company, see Davies, "Legal Capital" (n 26) 348 *et seq*; on the directors liability as alternative to the legal capital doctrine, see however below, VIII.

198 About the role of the capital structure and of the leverage, in the assignment of the rating, see Standard & Poor (n 195) 24 *et seq*.

199 Modigliani – Miller, "The Cost of Capital, Corporation Finance and the Theory of Investment", *Am. Econ. Rev.*, vol. 48, 1958, 261 *et seq*; Bratton (n 52) 474 *et seq*.

200 Klein – Coffee (n 52) 213 *et seq*; Hamilton (n 4) 72 *et seq*.

dividends out of undivided profits – which always are distributable – the compliance, once it has been made, with two financial ratios, precisely with a *solvency test*.²⁰¹ This requires the preservation of assets up to the 125 % of net liabilities, as well a *liquidity test*, pursuant to which current assets must at least be equal to the current liabilities (or, under some circumstances, at least equal to 125 % of the same); this is to say, payable at less than one year.²⁰²

The first test is a proper leverage ratio: because the assets must be equal to the 125 % of liabilities, it means that the debt-to-equity ratio cannot exceed four-to-one (§ 500 (b) California Corporation Code).²⁰³ On closer inspection, this solution demonstrates the same risk of rigidity as the legal capital. In fact, especially for start-ups, net assets of the company always must be fixed without any distinction between the different needs and the diverse features of the firm's activity. This is because the debt must be proportional to assets whenever there is the intention to distribute profits.²⁰⁴ In other words, that rule has the same fixity as the legal capital regime, with the difference that surplus assets, which generate the 'cushion-effect', are calculated not only on the basis of the legal capital, but also on total net assets, as "shareholder equity".²⁰⁵

For that reason, the rules formulated in the *Revised Model Business Corporation Act* (RMBCA), published in 1984, are more widespread in the U.S. They have been adopted by a number of States, but not all.²⁰⁶ This regulation does away with legal capital concepts such as "stated capital", "capital surplus"

201 About the incidence of this ratio on the capital structure of the company, see Klein – Coffee (n 52) 328 *et seq*; Hamilton (n 4) 484 *et seq*. In theory, an equilibrate capital structure make it possible a dividends distribution, although the lack of gains and reserve, because creditors are protected more than when a dividends distribution is made in the perspective of a future solvability default, Conac (n 35) 170.

202 See Ben – Dror, "An Empirical Study of Distribution Rules Under California Corporations Code § 500: Are Creditors Adequately Protected?", U. Cal. Davies L. Rev. (2003) 375 *et seq*.; Conac (n 35) 169; Maier, *Der Grundsatz der Kapitalerhaltung und die Durchgriffhaftung wegen Unterkapitalisierung im deutschen und amerikanischen Gesellschaftsrecht* (1986) 152 *et seq*. The 125 % percentage is applied when the surplus are less than the sum which approximatively occur to pay the bondholders.

203 Cheffins (n 26) 534.

204 Cf. Manning – Hanks (n 42) 176 n 3.

205 Portale (n 20) 31 *et seq*.

206 Manning – Hanks (n 42) 177 *et seq*; Hamilton (n 4) 70; Cox – Hazen (n 170) 555 *et seq*. For instance, there is the exclusion of Delaware, which is particularly used to pose the seat of corporations, within the U.S. competitive federalism, Kirchner – Painter – Kaal (n 110) 171 *et seq*.

The Delaware General Corporation Law (§ 170(a)), and, with analogies, the New York Business Corporation Law (§ 510 (b)), albeit with the mentioned devaluation of the par value of shares and the possibility to issue them below par value, on providing the legal capital formation.

and “earned surplus”, as per the Model Business Corporation Act 1950, which renders these accounts irrelevant for distribution purposes.²⁰⁷

The distribution of the “surplus” to shareholders depends on a double test, in the sense that it is inadmissible when, once it has been distributed, *a*), “the corporation would not be able to pay its debts as they become due in the normal course of business” (“*equity insolvency test*”; § 6.40 (c) (1)); *b*), the corporation’s total assets would be less than the sum of its total liabilities, plus the amount needed to satisfy the preferential rights of shareholders upon dissolution (“*adjusted net worth balance test*”) (§ 6.40 (c) (2)).²⁰⁸ The accounting criteria for calculating the “surplus” are determined in connection with that.²⁰⁹ In some States it is also provided that the distribution should occur at the rate of the economic value, rather than the par value of the shares, so as to achieve an additional protection of creditors.

However, legal (or stated) capital has not been completely eliminated: the concept survives in many jurisdictions, most notably Delaware and New York but, as in the original MBCA, it is reduced to a vestigial concept and is on the way to being removed entirely.²¹⁰

In detail, in the RMBCA there is the definitive dismantlement of stated capital and the connected rule of par value. Rather, there is a distinction between authorized capital, as the whole value of the shares which may be issued, and issued capital. This way, the incorporation is not affected by the subscription

207 Manning – Hanks (n 42) 78 *et seq*; Hamilton (n 4) 137 *et seq*. The criterion of legal capital undergoes criticism, because “has no relation to the kind of business being conducted, the liquidity of assets, the net current asset position and the ability to meet or refinance obligations as they fall due”.

208 Manning – Hanks (n 42) 182 *et seq*; Cox – Hazen – O’Neal, *Corporations*, vol. 3 (2002) § 20.19. The double criteria aim at reducing the directors’ difficulties in verifying exactly the terms of the solvency test Hamilton (n 4) 163 *et seq*. In particular, as to the balance-sheet test, § 6.40 (d) authorizes asset and liability determinations to be made for the purpose on the basis of either (1) financial statements prepared on the basis of accounting practices and principles that are reasonable in the circumstances or (2) a fair evaluation or other method that is reasonable in the circumstances. It is not required the adoption of US-GAAP, neither the recourse to a balance-sheet, also if that may be the most rationale choice: the directors may adopt at their discretion other methods of calculating the distributable amount indicated by the circumstances, and as to depend the emergence of profits and their measure, Conac (n 35) 171. Notwithstanding the sanctions against directors and shareholders for the breach of these criteria, as regards the amount of the dividends, are evident the risks of the dividends distribution made in compliance with this method: see below, IX.

209 See below, X.

210 Rock – Kanda – Kraakman, “Significant Corporate Actions”, in Kraakman et al. (n 5) 146 *et seq*.

of the shares and their coverage, even though below the par value, is determined *in concreto* by directors and, above all, occurs without limiting eligible considerations.²¹¹ Substantially speaking, minimum legal capital is no more.²¹²

Allowed are not only the distribution of the “earned surplus”, but of the “capital surplus” as well, and generally even of any “surplus”.²¹³ Moreover, directors may manipulate the balance sheet to increase shareholders’ equity, e.g. through revaluation of assets (“reevaluation surplus”)²¹⁴ – due to fair value and the going concern principles, as to the US-GAAP – and to reduce the stated capital (“reduction surplus”).²¹⁵ The maintenance of legal capital rules is compatible with a distribution of net assets up to the limit of driving the company into insolvency: so, the most effective criteria for distinguishing between techniques of creditor protection appears to be the level of directors’ freedom to select net assets which may be distributed.²¹⁶

This alternative regime is characterized by a solvency test which is composed of a *balance sheet test* (or *net assets test*) and a *liquidity test* (or *current assets/*

211 Rock – Kanda – Kraakman, *ibid.* It is eligible any sort of property right, including services performed, contracts for services to be performed, or other securities of the corporation (§ 6.21 (b) RMBCA).

212 On the progressive removal of minimum capital and of par value in U.S., see Conac (n 35) 158 *et seq.*

213 The Delaware General Corporation Law and the New York Business Corporation Law tend to release at least partially the payment of dividends from the legal capital: dividends distribution is authorized within the limits of the balance-sheet “surplus”: at least for the *no par* shares, which may coexist with the *par* shares, the directors are fully entitled to fix the amount of net assets to charge to capital and that to charge to capital surplus, as share premium (paid-in surplus) as to which the distribution to shareholders is not restricted; moreover, the payment of dividends is allowed in the current year, notwithstanding the losses of legal capital occurred in the previous years (“nimble dividends”: see Manning – Hanks (n 42) 82 *et seq.*; Palmiter, *Corporations. Examples and Explanations* (4th edn 2003) 523 *et seq.*; see as example s. 170 Delaware Gen. Corp. Law: distributions are allowed only “out of surplus”, which is defined as the amount by which “net assets (assets minus liabilities) exceed capital stock (stated capital)”; on the various criteria of distribution’s restriction, in the U.S., see Palmiter, *ibid.*, 521 *et seq.*; Cox – Hazen (n 170) 501 *et seq.* Peterson – Hawker, “Does Corporate Law Matter? Legal Capital Restrictions on Stock Distributions”, Akron L Rev. (1998) 183 *et seq.* More in general, the directors are entitled to alter the amount of the legal capital and to record the net assets (according to the market value), so as to allow the distribution of dividends.

214 For a significative example of court decisions specifically allowing good faith revaluation of assets by the boards, see *Klang v. Smith’s Food & Drug Ctrs.*: Delaware Supr. Court, 702 A.2d 150 (1997) p. 154; Palmiter (n 213) 526 *et seq.*; Conac (n 35) 165 *et seq.*

215 See Delaware Gen. Corp. Law, § 244; N.Y. Bus. Corp. Law., § 516 (a) (3).

216 Conac (n 35) 167; see too Baker – Abinal, “Le capital social en droit francais et en droit américain: le point de vue du praticiens”, in Couret – Le Nabasque (n 1) 179 *et seq.*

current liabilities test) and is intended to protect creditors and shareholders; it was been proposed by the *High Level Group of Company Law Experts*, although with some modifications,²¹⁷ and with the statement that this system should firstly be joined to EU company law principles and secondly preserve shareholders' rights.²¹⁸ According to the *High Level Group*, the adoption of the alternative regime, though preferred, should be left to the discretion of the Member States on the basis of an equivalent efficiency test. Therefore, the alternative regime is destined to co-exist with the legal capital system. The criticism levelled at the dismantlement of legal capital,²¹⁹ as induced the EU Commission, represents the abolition of legal capital as a long-term initiative (since 2009), and is preceded in the medium term (2006–2008) by a study as to the feasibility of an alternative to the capital maintenance regime.²²⁰

A similar approach – perhaps with a more radical disapprobation of the legal capital – is contained in the reforms proposed in Great Britain in the *Report of the Interdisciplinary Group on Capital Maintenance*,²²¹ which at the same time predicts that more areas of UK public company law will liberalise within EU constraints.²²²

217 Such as the formulation of a margin of solvability, intended to strengthen the two parameters of the insolvency test, and making the adoption of the criterion of the going concern, or that of liquidation values, with the object of the balance-sheet test (Ch. IV, n. 4, a).

218 A regulatory competition on that matter will of course arouse: see British Institute of International and Comparative Law (BIICL), Press Release of 17 June 2004, n. 10 “we hope that EU law will be changed to allow member states to adopt a modern law along the lines we propose if they wish, without preventing states which wish to keep the 19th century rules (also said, Victorian capital maintenance rules), from doing so”.

219 On that subject, with many criticism, see, Group of German Experts on Corporate Law (n 33) IV, 1–2, 871 *et seq.*

220 *Action Plan* (n 16) § 3.2, 17 *et seq.*

221 In particular, the additional “balance sheet test” is considered redundant, on the (arguable) economic argument that there is no difference between an assessment of the net asset position of a company, once the accounting figures are subjected to proper business appraisal, and an assesment of solvency, see Rickford (n 3) 971 *et seq.*, in particular 977 *et seq.*

222 See Rickford (n 3) 988 *et seq.* Among all, there are the proposal to prevent the private companies from the prevision of art. 33 of the Fourth Directive, which require that the special “revaluation reserve” can only be reduced by capitalization or by reduction of capital; this would be a more stringent regime on distribution of unrelised profits of private companies (a stricter “earned surplus” test) than public companies.

VIII. *Legal capital rules in comparison with insolvency law*

The alternative regime to legal capital is characterized by the fact that it shifts creditor protection from company law to contract law, especially to insolvency law. This implies shifting from shareholders to directors the powers of disposing the company's net assets, as well as, concurrently, compliance with relative rules and the consequent sanctions for their breach (e.g., personal liability, director's disqualification).²²³

Broadly speaking, the *ex-post* remedies are considered preferable to legal capital rules for punishing opportunistic behaviour on the part of shareholders. Such remedies consist essentially in the imposition of fiduciary duties on company insiders for the sake of creditors (directors and controlling shareholders) and professional partners (auditors and 'inside' creditors, which are preferred by the company at the expense of other creditors).²²⁴

In this framework, special attention has to be paid to the situation preceding the insolvency, rather than the point of time when the insolvency occurred. In such circumstances creditors, especially unsecured creditors, are exposed to directors' gross negligence and the limitations of their powers under threat of liability: this serves to internalise such risks.

It is very important that the liability for wrongful trading under s. 214 IA is imposed on the directors and "shadow directors" (s. 251 IA) vis-à-vis the creditors, in case of the company's insolvency. Such liability occurs when, before insolvency, the directors did know or ought to have concluded that there was no reasonable prospect that the company could avoid an insolvent liquidation, and these directors failed to take every step they ought to have taken to minimize the potential loss to the company's creditors.²²⁵

223 In fact, in the UK private company without minimum capital, it is required that the directors of the company, in the case of share repurchases and financial assistance, issue a solvency certificate, in which they explicitly confirm that the proposed distribution meets the solvency test (ss. 156 (2) and 173 (3) CA 1985): see Cheffins (n 26) 535. On the director's solvency certificate, see High Level Group (n 15) Ch. IV, n. 4, a). Moreover, where the audited accounts of the company indicate that the proposed distribution cannot meet the solvency test, directors should not be allowed to issue a solvency certificate.

224 Hertig – Kanda (n 5) 88 *et seq.*; on the fiduciary duties of the directors, see too Fleischer, "The Responsibility of the Management and its Enforcement", in Ferrarini et al. (n 41) 373 *et seq.* On the debate on the efficiency of the directors fiduciary duty to creditors, in the light of the contractual approach in corporate law, see Keay (n 50) 672 *et seq.*

225 Cheffins (n 26) 537 *et seq.*; Goode, *Principles of Corporate Insolvency Law* (1997) 446 *et seq.*; Finch, *Corporate Insolvency Law* (2002) 513 *et seq.* Habersack-Verse, "Wrongful trading – Grundlage einer Europäischen Insonvenzenverschleppungshaftung?", ZHR

This is similar to the French *action en comblement du passif* (art. L. 624–3 *et seq* Code Com.) through which, in the event of a company's winding up, the directors are liable for the loss of assets resulting from the breach of their managerial duties ("*faute de gestion*")²²⁶ and especially for the continuation of the business with an absolutely inadequate legal capital; this is the case for liability in case of undercapitalization of the company.²²⁷

Such liability is destined to come into force when the firm's activity is carried on during a particularly delicate moment, which is to say when the company is becoming insolvent; opportunistic behaviours may endanger corporate creditors, especially those dealing with the company under such circumstances.²²⁸

Since it tends to prevent opportunistic behaviours through internalising the risk of losses when directors make decisions in such situations when a company is near insolvency, wrongful trading is the functional equivalent of a minimum capital requirement and is useful also as a substitution, e.g. in the case of private companies.²²⁹

Creditor protection, therefore, does need not necessarily be founded on the minimum capital rule, nor in general on company law, but can also be achiev-

(2004) 174 *et seq*; Schall, "The UK Limited Abroad – How Foreign Creditors Are Protected after Inspire Art", EBLR (2005) to be published in December; Hirt, "The Wrongful trading Remedy in UK Law: Classification, Application and Practical Significance", ECFR (2004) 71 *et seq*. Another statutory mechanism, which complements the wrongful trading provision, is provided by the Company Directors Disqualification Act 1986.

226 See Guyon, *Droit des affaires*, T. 2, *Entreprises en difficultés. Redressement judiciaire. Faillite* (8th edn 2001) 425 *et seq*; Jacquemont, *Droit des entreprises en difficulté* (3rd edn 2003) 377 *et seq*; Habersack-Verse (n 225) 202 *et seq*.

227 See Cass. com. 19-3-1996, *Rev. soc.*, 1996) 840, obs. Bruguier; Cass. com. 23-11-1999, *RJDA*, 4/00 n. 457; App. Aix-en-Provence, 16-5-2001, *Rev. dr. banc. fin.* (2001) 291, obs. Lucas; Dana – Demaret, *Le capital social*, 342 *et seq*; Portale (n 20) 84 n 127 and 68 n 91; moreover, it is frequent the risk that a wide use of the *action en comblement du passif*, when the legal capital is merely symbolic and then a liability for the undercapitalization of the company lead to the end of the limited liability: see Conac (n 35) 159. On the similar directors' liability in case of the bankruptcy of a *private company*, under art. 248 of *Dutch Company Code*, see De Kluiver, "The European Private Company? A Dutch Perspective", in De Kluiver – van Gerven (n 8) 120 *et seq*.

228 In particular, wrongful trading will, within groups, trigger the liability of a parent company which has caused the insolvency of the subsidiary because of its adversely affecting influence, without trying promptly to relieve the company or liquidate, see Forum Europaeum Konzernrecht, "Konzernrecht für Europa", *ZGR* (1998) 754 *et seq*.

229 Davies, "Legal Capital" (n 26) 350 *et seq*; Hirt (n 225) 113 *et seq*.

ed through director's and auditor's liability, which is destined to effectively occur after the company's winding up. This touches the field of insolvency law without itself being a disadvantage. Contrarily, such remedies, particularly those based on wrongful trading, permit greater flexibility and efficacy since directors' fiduciary duties may be tailored to the specific situation facing the firm or business, without any barriers to entry such as the ones imposed by the rigid duties of minimum capitalisation at the moment of the company's incorporation.²³⁰

In this sense, the rule of directors' liability, with regard to efficiency, must be compared to the hypothetical bargaining model. Creditors may pursue it in order to impose restrictions on the conduct of directors, thus ensuring advantages and saving costs comparable to those offered, as regards *ex post* protection, by legal capital, as opposed to financial covenants.²³¹

On the other hand, it is often difficult for a judge to check the actual existence of wrongful trading. Also, it is difficult to determine the degree of foreseeability of the insolvency and the ability of directors to prevent it; consequently, this limits the effective possibility of offering compensation to creditors.²³² Creditor protection focused on directors' liability seems, however, to impose an excessive penalty on their conduct and risks restraining their managerial discretion.²³³ The lower is the legal capital, the more the conduct of business is taken to bring the ruin of insolvency and concurrent liability for undercapitalization.

Greater flexibility in a company's operations is not separate from greater risks of prejudice, which could affect in particular the less sophisticated creditors, such as suppliers or involuntary creditors who have not obtained guarantees, through which insolvency law may achieve its greatest effect. Remedies aside from legal capital could turn, in fact, into techniques directed at shifting onto the managers the consequences of a company's bad financial situation in exchange for greater freedom of shareholders in the distribution of dividends or in operations implying a return of the corporate assets. For

230 Davies, "Legal Capital" (n 26) 352 *et seq.*

231 Cheffins (n 26) 540 *et seq.*

232 On the wrongful trading remedy's presumed failure, considering the lack of reported cases, see eg Hirt (n 225) 102 *et seq.*; but contrast Schall (n 225). For that reason, the grounds for directors' disqualification, which are unfit to be concerned in the management of companies – also, but not only – in relation to their insolvent liquidation, are held wider and easier to rebut: Cheffins (n 26) 548 *et seq.*

233 Mülbert – Birke (n 1) 726; just for that, in addition to the poor results of these actions, creditors are scarcely interested in a regime by virtue of which those who manage a company are personally accountable for corporate debts.

that reason, it must be held that subsequent remedies do not alone exhaust creditors' protections from opportunistic behaviour, but should coexist with preventive techniques based on legal capital.

The capital maintenance rules, though unable to prevent the explosive beginning of an insolvency, may serve as an index to determine the extent of the directors' duty of care: first, as regards the liquidation of a company, second, the continuing of business with eventual recapitalization, assuming there is a desire for it, and third, to assess their liability for wrongful trading, as an alternative to the recourse to a solvency test, as in the U.S.²³⁴

In substance, between company law and insolvency law, there is no distinction as regards creditor protection systems, especially considering the duties and the liabilities of the directors in the proximity of insolvency. The only difference lies in the presence or, on the contrary, in the absence of an index for their enforcement, which is objectively noticeable with respect to legal capital. In fact, a series of opportunistic behaviours on the part of directors which are capable of constituting wrongful trading include, e.g., the request for further loans while simultaneously disregarding the difficulties of the firm. The consistency of legal capital offers a preventive protection to creditors, similar to the eventual liability of directors who requested such loan.

On the other hand, the repression offered by wrongful trading or the *action en comblement du passif* vis-à-vis directors' opportunistic behaviours which harm corporate assets (especially the undercapitalized conduct of business) is applied also to public companies, aside from legal capital rules. This clearly demonstrates that such rules are not exclusive, but capable of coexisting with other forms of creditor protection.

Therefore, in a legal system which accepts the legal capital doctrine, for example the Italian *società a responsabilità limitata* (s.r.l.), the dissolution of the company is called for when the capital is reduced below its minimum level – unless it recapitalizes or changes into another business association (art. 2482-ter c.c.). This, criticized as excessively penalizing, coexists with another rule, pursuant to which directors are also liable towards corporate creditors for loss of a company's net assets from carrying on business activity; this would not be intended only to preserve the integrity and value of net assets (art. 2486, 1° comma, c.c.).

234 Hertig – Kanda (n 5) 85. The same measure of the legal capital may be an adequate sign of the director's diligence, see Eidenmüller – Engert "Die angemessene Höhe des Grundkapitals der Aktiengesellschaft", AG (2005) 100 *et seq.*

The Italian perspective is broader than the English one because directors' liability does not depend on the fact that the insolvency is drawing near; this is connected with the company's winding-up and liquidation for a number of reasons, among them the effective reduction of the legal capital below its minimum level, or even its entire loss.²³⁵

However, in the last case the situation could be very close to insolvency. Apart from the difference in accounting criteria used for their assessment – respectively, the liquidation value, rather than the going concern basis, in case of improbable prosecution of the business²³⁶ – consequently, the director's liability could be connected with the decision to carry on business activity without requiring a filing for bankruptcy, e.g. a compulsory request in accordance with the German law (§ 64 (1) GmbHG: “*Insolvenzantragspflicht*”; see also § 92 (1) AktG). This draws the line between company law and insolvency law²³⁷ without affecting the distinction between either of the two fields.²³⁸ In fact, this can be qualified as a subspecies of tort liability.²³⁹

235 Portale (n 20) 82 *et seq.*, n 127.

236 About the loss of legal capital as indicator of the financial crisis, see Wellensiek, in Schmidt – Uhlenbruck (n 52) 21. In anything, the duties of net assets maintenance, from which this liability derives, could be evaluated in a more rigorous manner, when the reduction of capital below the minimum is accompanied by a state of insolvency.

237 See Schmidt (n 105) § 36.II.5, 1082 *et seq.*; Schmidt – Uhlenbruck (n 52) n 1249 *et seq.*; Hirte, “Abschied vom Quotenschaden. Das Urteil des BGH vom 6. 6. 1994”, ZIP Sonderdruck (1994); see too, for a comparison with Italian company Law, Hirte – Vicari, “La responsabilità degli amministratori di società di capitali verso i creditori in caso di omessa o ritardata presentazione della richiesta di fallimento al tribunale, nel diritto tedesco ed italiano”, Giur. comm. (1996) II 337 *et seq.* The liability for wrongful trading too may stem from lack of directors' initiative when the company nears insolvency, but it is wider, because it may also be based on conduct anterior to the occurrence of the conditions to order the company's winding up, ie inability to pay the debts (“cash flow test”) or over-indebtedness (“balance sheet test”).

238 Schön (n 1), 162. This director's liability laid down in company law, not in insolvency law, because has its most important effect prior to insolvency and is part of an appropriate corporate governance regime: see High Level Group, Ch. IV, n. 3, lett. i).

239 It is the case of the “*Insolvenzverschleppungshaftung*” in Germany, see Merkt (n 2) 1057; about the differences to wrongful trading, see Schall, “Englischer Gläubigerschutz bei der Limited in Deutschland”, ZIP (2005) 965, 970; *id.* (n 225); Hirt (n 225) 116; Habersack – Verse (n 225).

Arguably, the *Insolvenzverschleppungshaftung* may be applied by the host State to the foreign companies under Art 3 and 4 European Insolvency Regulation, see Eidenmüller (n 116) § 9 n 25 *et seq.*; Huber, in Lutter (n 116) 307 *et seq.*; but contrast Hirte, in Hirte – Bücker (n 116) § 1 n 74; Mock/Schildt, in Hirte – Bücker (n 116) § 16 n 35 *et seq.*; Schall, (n 225); *id.*, ZIP (2005) 974 *et seq.* (freedom of establishment infringing by duplication of directors' duties).

Besides, it is possible that all the shareholders, not only the shadow directors, may be liable under these circumstances, e.g. during evident undercapitalization of the company.²⁴⁰ Equally, the introduction in the EU of such liability is considered a way to raise the efficacy of the legal capital doctrine, rather than to provide a substitute for it.²⁴¹

The same may be stated with regard to the criticism that legal capital rules affect only operations which lead to its direct distribution. This does not exclude such prohibitions as may extend to operations which consist in indirect restitution. Freely, this result may also be achieved by supplementing the legal capital discipline with the rules of insolvency law, which are particularly suitable to protect creditors, as well as fraudulent transfer law, used in absence of legal capital. Dividends distributions and other transfers of company assets, such as share repurchases, do not take effect when made at an undervalue;²⁴² that may reinforce legal capital rules, e.g. if during undercapitalization there is a fraudulent lack of net assets to the extent that the insolvency of the company could have been prevented.²⁴³

240 On the possible application of the German “*Existenzvernichtungshaftung*” (i.e. piercing the veil) see Lutter – Banerjee, “Die Haftung wegen Existenzvernichtung”, ZGR (2003) 402 *et seq*; Wiedemann, “Reflexionen zur Durchgriffshaftung”, ZGR (2003) 283 *et seq*; Böckmann (n 52) 235 *et seq*. Portale (n 12) 112 *et seq*, with further wide references; but contrast AG Bad Segeberg, ZIP (2005) 812; noted EWIR 2005, 425 (Mock): “no veil-piercing for mere low capitalisation”. This ruling reflects the prevailing opinion in Germany denying any liability for “material under-capitalisation”, cf. Fleischer, in Lutter (n 116) 118 *et seq*; Eidenmüller (n 116) § 4 n 27; Schall (n 239) 972; the same holds in the UK, see *Re Polly Peck International plc* [1996] 2 All ER 433; Sealy, *Cases and Materials in Company Law* (7th edn 2001) 74 *et seq*; Davies (n 72) 184 *et seq*, but not necessarily in the US.

241 High Level Group (n 15) Ch. 3, lett. i); and in accordance with that, see the Group of German Experts on Corporate Law (n 33) III, 13, 870. The introduction of fiduciary duties towards creditors, at an earlier stage of the insolvency, when there is “a substantial probability of insolvent liquidation”, is also provided by the Company Law Reform Steering Group, *Modernising Company Law. Final Report*, § 3.8 *et seq*.

242 This is (still) the law for the UK private limited, cf. *Aveling Barford v Perion Ltd* [1989] BCLC 626 and s.263 CA 1985; but contrast now DTI, *Company Law Reform, White Paper* (2005) 40 *et seq*, 42, available at <http://www.dti.gov.uk/cld/WhitePaper.htm>. About the *verdeckte Gewinnausschüttung* (above n 174) which is not prohibited as such in the GmbH see Schmidt (n 105) § 29. II, 2, 890 *et seq*; about the creditor protection accomplished through the fraudulent transfer law, see Drury – Hicks (n 64) 443; Conac (n 35) 172.

243 See Lecourt, “De l’utilité de l’action paulienne en droit des sociétés”, in *Mélanges en honneur de Guyon* edited by Dalloz (2003) 62.

The use of the fraudulent conveyance law is relevant in a regulatory competition system because it is not subject to the “*incorporation*” theory for the solution of conflicts of law. Thus it permits discouraging the establishment of foreign companies lacking a legal capital and it strengthens the application of the law of the State where the business is effectively being carried out.²⁴⁴

The restrictions on the distributions of the company’s net assets, as posed by the legal capital rules, sound objectively and in abstract contrary to the economic principle of reconciling creditor protection with maximum flexibility in a company’s operations. Thus it would appear disadvantageous compared to the U.S. model. It allows restitution of net assets up to the threshold of insolvency, but in reality it may reveal itself as more practicable.

The rule which prevents restitution of assets to shareholders at the insolvency threshold – thus allowing restitutions which, according to an *ex post* evaluation, may lead to the insolvency – is not censurable in the abstract, but appears less effective than the legal capital system *in concreto*, which is able to prevent such transactions *ex ante* due to its function as a kind of insolvency prophylaxis.²⁴⁵ This is much more relevant if the assessment of distributable net assets depends on directors’ diligence;²⁴⁶ if criteria are based on favouring the assessment of profits, this erodes every possible margin for tolerance between preservation of the company’s solvency after the restitution and its insolvency. This confirms that creditor protection may not be separated from company law and indeed depends on accounting rules above all.²⁴⁷

In this framework, the duty of legal capital formation in accordance with a given amount constitutes the absolutely necessary prerequisite for protecting creditors. It remains to be ascertained whether legal capital rules, given their convenience, have to be provided for by mandatory law, or may be derived from private bargaining.

It may be held that mandatory rules ensure protection which otherwise the creditors could obtain only after bargaining; this would reduce transaction costs in accordance with a classical contract oriented statement of corporate law. Furthermore, unsophisticated creditors would be advantaged, and creditors would be given a more believable index of the shareholder’s confidence,

244 Kahan, “Legal Capital Rules and the Structure of Corporate Law: Some Observations on the Differences Between European and U. S. Approaches”, in Hopt – Wymeersch (n 43) 147 *et seq.*

245 Mülbert (n 1) 160 *et seq.*

246 Wymeersch (n 34) 42.

247 Schön (n 1) 170.

as shown by the investment in the company's capital and not by their being favoured when it comes to its restitution.²⁴⁸

It has no relevance that, through direct bargaining, creditors may obtain conservation of net assets at a more convenient amount than the sum deriving from the application of the legal capital rule.²⁴⁹ Neither is it important that the unsophisticated creditors, lacking contractual power, may benefit from restrictions on dividends paid, as even from any type of financial covenant which only a sophisticated creditor would be capable of negotiating.²⁵⁰ Even, it may be said that the presence of just one sophisticated creditor is enough to advantage all the creditors.²⁵¹ Truly, the obstacle placed by the company against such negotiations may also restrain other creditors from 'freeriding'.²⁵²

Moreover, the protection of unsophisticated creditors, realized in such a way, only seems indirect because financial covenants may be changed or cancelled by the sophisticated creditor, leaving other creditors in their power.²⁵³

Also, the different consequences springing from sanctions imposed for the breach of a covenants, as compared with breach of legal capital rules, go far to demonstrate that legal capital cannot be substituted completely by covenants.²⁵⁴

248 See Davies, *Introduction* (n 26) 83; Mühlbert – Birke (n 1) 729 *et seq*; Kübler (n 58) 105 *et seq*; for instance, the U.K. bond financial covenants, unlike the U.S. covenants, do not provide restrictions on the dividends distribution, as already provided by the legal capital discipline, with consequent saving of costs (Armour (n 2) 373).

249 See Davies, *Introduction* (n 26) 91; see also Armour (n 2) 373 *et seq*, with a significant example.

250 Mühlbert – Birke (n 1) 720; Davies, "Legal Capital" (n 26) 350.

251 Enriques – Macey (n 2) 1172.

252 Mühlbert (n 1) 157. Moreover, an obligation assumed by the company towards a single creditor, but capable to benefit all the others, would risk to distort the market's rule, Denozza (n 6) 593.

253 Merkt (n 2), 1050; Hopt, "Gesellschaftsrecht im Wandel", in *Festschrift für Wiedemann* (2002) 1019; the sophisticated creditor is in a certain sense an agent of the others.

254 Mühlbert – Birke (n 1) 156; in particular, the fact that the minimum capital protects all the creditors, brings also with it that the breach of the duties concerning the distributions to shareholders does not advantage the only creditors for whose benefit they have been provided, as happens in case of contractual obligations, but compel shareholders to return to the company's assets what they unduly received.

*IX. Legal capital rules and the structure of corporate finance:
corporate distributions to shareholders and accounting standards*

A valuation based on legal capital rules is also useful from the perspective of corporate finance perspective. However, since legal capital is a component of the financial structure of the company, it is destined to interact with the valuation, though incapable of affecting it.²⁵⁵

In this regard, the prevalent financing system of companies in the EU must be taken into account: recourse is taken to bank financing rather than to the venture capital market.²⁵⁶ On this common playing field there are some features which pertain to shareholders, creditors, and the market rules which regulate relations between the company and its financier.

As regards shareholders, one reason for preferring, or at the least accepting the legal capital system lies in the limitations imposed on dividends distribution. These limits are particularly suited to a financing system only minimally focused on the venture capital market; such a system would tend not to incentivize remuneration for private investment and the development of the stock market through high dividends.²⁵⁷ Equal consideration, especially given the sparse attention to the capital market, justifies the limits imposed by legal capital rules on utilizing the net assets of the company to carry out patrimonial transfers to shareholders; these can be accomplished through share repurchases or other similar transactions affecting the company's shares.²⁵⁸

As a corollary to the creditor-oriented system there are the financial accounting and disclosure standards deriving from EU harmonization; these standards are intended to promote self-financing of the firm through restrictions on distribution of dividends. They allow the balance sheet, on the basis of prudent evaluation criteria, to function as a means of assessing profits and dividend distribution in such a way as to support the effectiveness and strengthen the efficacy of legal capital rules, though this may, in fact, be deleterious to the aim of up-to-date disclosure to shareholders.²⁵⁹

Nonetheless, legal capital rules have not precluded companies from increasing their presence on the capital market, either in regard to equity financing or debt financing. The former is favoured by the set of rules which is intended to protect the investor, either through strengthening shareholders' speak-

255 In this sense, with more emphasis, Enriques – Macey (n 2) 1166.

256 Hertig – Kanda (n 5) 87.

257 Enriques – Macey (n 2) 1196 *et seq.* and p. 1202 *et seq.*

258 Kübler (n 58) 105. NB the limits to the financial assistance, which impede LBOs involving smaller EU firms, Hertig – Kanda (n 5) 88.

259 Kübler (n 58) 105.

ing rights or through some form of public supervision, or even through more completely harmonised financial markets laws: in connection with this set of rules, the legal capital discipline can not be held to be an impediment, strictly speaking.²⁶⁰

On the other hand, the constant updating of EU accounting standards, as a result of the introduction of the IAS/IFRS international principles,²⁶¹ is considered to be an implicit, albeit not irrelevant boost to overcome the legal capital system.²⁶²

Under a diffuse opinion, the strict linkage of distributable dividends to accounts does not reflect the company's real capacity to make distributions. The adoption of the 'fair value' approach, especially with respect to financial instruments, presents a particular difficulty. The results generated through this method provide an unreliable and volatile basis for a prudent distribution policy: the accounts may in fact produce surpluses which do not correspond to the real prospects of solvency; these same values may cause an unduly restricted outcome. This undermines the consistence of the company's net assets, the then same function of the legal capital.²⁶³

In any case, the greater precision of these criteria lead to showing management's whole result; this allows values which ordinarily cover legal capital

260 In the sense that investor protection (by the capital market) and creditor protection are not alternative, see Portale (n 20) 35 n 51; Schmidt (n 105) 18.II.2. c, 519.

261 See Reg. n. 1606/2002/CE, on the mandatory compliance to the IAS principles adopted by the EU Commission, with the object of drawing the consolidated balance sheet of the listed companies and moreover, pursuant to the options provided by the art. 5, for the ordinary balance sheet: besides, the modifications of the IV and the VII Directives due to the Directive 2003/51/UE (see Heuser – Theile, *IAS Handbuch. Einzel- und Konzernabschluss* (2003) 29 *et seq*; Lüdenbach – Hoffmann, "Enron und die Umkehrung der Kausalität bei der Rechnungslegung", DB (2002) 1169 *et seq*; van Hulle, "Financial Disclosure and Accounting", in Hopt – Wymeersch (n 43) 153 *et seq*; Schulze – Osterloh, "Internationalisierung der Rechnungslegung und ihre Auswirkungen auf die Grundprinzipien des deutschen Rechts", Der Konzern (2004) 173 *et seq*; Grundmann (n 2) 275 *et seq*, n 587 *et seq*.

262 Kübler, "Institutioneller Gläubigerschutz oder Kapitalmarkttransparenz?", ZHR (1995) 550 *et seq*; Kübler (n 58) 100, 105.

263 See High Level Group (n 15) Ch. IV, 1) 79; *Synthesis of the Responses to the Communication of the Commission to the Council and the European Parliament*, Working Dokument of the DG Internal Market (15 Nov 2003) 19; Rickford (n 3) 937 *et seq*, with reference non only to the changes in accounting standards, but also to the accounting prescribed for pension fund performance and the costs of share and share option schemes in the Italian Law, see Strompelli, "L'adeguamento della disciplina del bilancio ai principi contabili internazionali" Doctorate diss., Università Catholica di Milano (2004) 187 *et seq*.

end to emerging as profits, which in turn eliminates a multiplying effect with respect to creditor protection and consequently, this jeopardizes its financial basis and effect.²⁶⁴

It may be held that whereas in the U.S., at least for companies taking recourse to the capital market, the duty of disclosure is more detailed and the relative discipline may be considered as ‘debtor-oriented’, being that it tends to highlight capital gains and thus encourage share investment through higher expectations of remuneration. In the EU, accounting standards are characterized by the criteria of prudent evaluation, intended to protect creditors.²⁶⁵

Establishing comparability of financial information is essential for an efficient capital market. It requires the use of identical standards by all market players.²⁶⁶ The current differences between accounting standards in the various legal systems must partly be connected to the adoption of legal capital rules; and ironically, the efficacy of these very rules depends on the nature of the accounting standards which are applied.²⁶⁷

In fact, regarding the dismantlement of legal capital rules and the lack of pursuing creditor protection, in the U.S., directors are not bound to use the US-GAAP when it comes to dividend distribution and in particular when applying the insolvency test and balance sheet test. It is up to their discretion to determine, from time to time, both the accounting standards and the evaluation methods which would be “reasonable in the circumstances”; the earnings emerging from the balance sheet are only an indication.²⁶⁸

This leads to the differences contained in the European legal capital system, and to that system’s greater convenience, as characterized by a system for distributing dividends which depends on the assessment of a surplus, as reflected in the balance-sheet, which is in turn drawn up in accordance with legal capi-

264 Merkt (n 2) 1046 *et seq.*; *id.*, (n 1) 307 *et seq.*; Mühlbert – Birke (n 1) 698 *et seq.*; Mühlbert (n 1) 152; Schön (n 33) 3; Schön (n 1) 164; Schön, “The Future of Legal Capital”, EBOR (2004) 429; Hertig – Kanda (n 5) 84.

265 Hertig – Kanda (n 5) 81 *et seq.* However, the adoption of the true and fair view by the Fourth Directive, deriving from the Anglo-Saxon accounting tradition, indicates a tendency to a switch of protection towards shareholders.

266 On the internazionalisation of the financial transparency, see Ebke, “The Impact of Transparency Regulation on Company Law”, in Hopt – Wymeersch (n 43) 192 *et seq.*

267 Manning – Hanks (n 42) 37: “the efficiency of the legal capital can rise non higher than the level of verity that can be achieved trough “generally accepted accounting principles and the consistency with which they are followed”.

268 See § 6.40 RMBCA. On the different evaluation methods, see Pellens – Jödicke – Richard, “Solvenzttests als Alternative zur bilanziellen Kapitalerhaltung?” DB (2005) 1393 *et seq.*

tal protection rules (see art. 15, 1° comma, litt. *a*, Second Directive).²⁶⁹ There is more than only a solvency certificate, provided and published by the directors, without any mandatory auditor's certificate.²⁷⁰ The suitability of legal capital may depend, for that reason, more on techniques of assessing the surplus than from the actual amount of legal capital.

However, modifications of accounting standards within the EU through the implementation of a duty of disclosure, as in the U.S., turned out being no less capable of protecting creditors than investors;²⁷¹ the capital markets can, at a more general level, offer criticism of that method of corporate financing, but this most likely will not directly impact the discipline and operation of the legal capital system.

In fact, it is possible to reconcile, through different techniques, capital maintenance rules with more accentuated informative functions deriving from the balance sheet. This is done in the context of IAS-IFRS principles, i.e. either drawing up a double balance sheet, in compliance with the European accounting base profit distribution discipline, or drawing up, with a reduction of costs, proper connecting accounts in relation to items such as those originat-

269 The close anchorage of the earned surplus, then of creditor protection, to an accounting-based dividends distribution, leaving the criteria to draw the balance-sheet out of consideration, makes the legal capital system more reliable, as founded on objective rules, (see Schön (n 148) 706 *et seq*; about the U.S. accounting standards, see Kübler, (n 262) 554) in comparison with the regime that, due the enforcement of the solvency test, allows the directors to derogate at their discretion to the historical cost stemming from the accounting principles, so as to permit the capitalization of "re-evaluation surplus" arising from unrealised assets, making reference to a fair valuation or to other chosen methods (RMBCA, § 6.40 (d)): see Cox – Hazen – O'Neal (n 208) § 20.13 *et seq*; moreover, the California Corporation Code requires observation of the US-GAAP, and prescribes the level that the ratios may respect); about the disadvantages connected with the application of the balance sheet-based scheme in order to restrict distributions to shareholders, see Manning/Hanks, *Legal Capital*, 65 *et seq*. On the discussed superior efficiency of the alternative dividends distribution system, based on *ex-post* regulation, as the solvency test, see, with economic analysis, Kuhner (n 2) 23 *et seq*.

270 The need that the solvency certificate be audited, so as to "whitewash" for financial assistance in private companies, (ss. 155–158 CA 1985) is denied, as it would add expense and delay for arguably relatively little advantage: it is sufficient the audit report for the year in which the distribution takes place, except for small companies, which are not subject to audit (see Rickford (n 3) 974 *et seq*; Micheler (n 126) 338 *et seq*. The intention is to avoid a worse system, in comparison to legal capital, in which the creditors generally requires a review of the company solvency conducted by third parties, see Simon "A Comparative Approach to Capital Maintenance", EBLR (2004) 1042 *et seq*.

271 Kübler (n 262) 1045 *et seq*.

ed in the fair value standard, where there are still discrepancies with EU rules.²⁷²

Failing that, creditor protection could be achieved through the formation of higher reserves pursuant to the assessment of profits as per the standards outlined in IAS-IFRS. Alternatively, the higher the legal capital, the more significant is the index in favour of creditors, which is intended to discourage, through budget manoeuvring, the emergence of fictitious earnings.

The compromise thus achieved, between opposite exigencies, is not in substance more burdensome than the standardized contractual restrictions to distribution of dividends as provided in the U.S., e.g. through dividend covenants, which are negotiated by the company with each individual creditor. On the contrary, the contractual techniques correspond, as to their effects, with the principles of prudence manifested in EU accounting standards.²⁷³

X. Legal capital rules and categories of corporate creditors

The relation between legal capital and creditors is even more diverse. It has been said that the system of mandatory protection through legal capital rules should be compared with the protection which creditors can obtain from the indebted company by contract law, which undoubtedly depends more or less on the attitude towards a change in creditor protection, or the prevalence of the path dependence.

The answer in this regard cannot be general, but must necessarily take into account the different categories of creditors and the different techniques of protecting them which the legal system can offer, even apart from legal capital rules. In fact, the basic aim pursued here does not require that the forms of protection be identical. On the one hand, it is true that techniques based on contract law offer greater flexibility; but on the other hand, it is evident as well that not all creditors have an effective bargaining relationship allowing them to tailor-make the protection best suited to them.

It is typically agreed that legal capital rules substantially advantage involuntary creditors. Considering the source of their credit, these are not able to

272 Schön (n 148) 738. According to that, the accountability of the gains, originating from the fair value standard, in a specific not optional reserve, as prescribed in Italy (art. 6 d. lgs. 38/2005) will be possible. However, adjusting IAS/IFRS accounts by establishing restricted “faire value” reserves would result to separate “creditor protection oriented” accounts, to be continuously adapted to the dynamically changing IAS/IFRS (see Pellens – Sellhorn, “A proposal for the Future of Capital Maintenance and Creditor Protection”, Working Group “Kapital in Europa”, (preliminary draft) 2 *et seq.*

273 For an overview of these private contractual agreements, see Merkt (n 2) 1054.

evaluate the financial situation of the debtor in advance, nor are they able to remedy it subsequently; indeed, for them, corporate law does not usually provide any specific protections.²⁷⁴ Furthermore, unlike analogous credits to natural persons, these creditors run greater risk of company undercapitalization. Such creditors certainly benefit from legal capital, which promises company liability.²⁷⁵

While it is undeniable that legal capital does not eliminate the risk of insolvency, it is also true that it tends to prevent it, and thus it protects involuntary creditors in advance, at least compared with the equity-insolvency test. Moreover, legal capital does not depend on the capacity of sophisticated creditors to protect themselves.²⁷⁶

Actually, the number of the creditors potentially advantaged by legal capital is wider, and partly includes even voluntary creditors: it involves creditors, such as employees or service and trade creditors, who are unsophisticated since they are generally not capable of negotiating contractual safeguards and collateral. However, they bear specific interests in corporate finance which they seek to guarantee: such interests, in particular, as the short-term liquidity of the company, for which the rules of legal capital are not completely irrelevant.²⁷⁷

Such interests are the reason for directors' liability, especially when the company is approaching insolvency. The possibility that small creditors could obtain these protections through contract law, assuming that the advantages to the company are greater their cost,²⁷⁸ is a fact which does not cancel out the

274 Hertig – Kanda (n 5) 76 *et seq.* Among the proposed forms of protection, there are the lifting of the corporate veil, with the consequent unlimited liability of shareholders for the corporate torts: see Hansmann – Kraakman (n 45) 1869 *et seq.*; Escher – Weingart (n 22) 138 *et seq.*; in this sense, it is also justified the more frequent use of the veil piercing in favour of such creditors, Mülbert – Birke (n 1) 724 *et seq.*

275 Schön (n 1) 167; Mülbert – Birke (n 1) 714 *et seq.* especially when alternative remedies, such as the liability insurance to compensate tort victims, are not available, Hertig – Kanda (n 5) 77 n 33. These remedies are particularly suitable for the foreign companies without legal capital, Eidenmüller, “Wettbewerb der Gesellschaftsrechte in Europa”, ZIP (2002) 2236; Grundmann (n 48) 819 *et seq.*

276 With criticism, see, Enriques – Macey (n 2) 1193 *et seq.* Sophisticated creditors may lack in a limited liability company, which undertakes dangerous activities as part of a group of companies.

277 However, there is the tendency to limit the sophisticated creditors, especially considering the possibility for them to prevent either the risks connected with the grant of credit, through the evaluation of its patrimonial condition, or those of opportunistic behaviours by the shareholders, Manning – Hanks (n 42) 98 *et seq.*; Enriques – Macey (n 2) 1188 *et seq.*

278 Enriques – Macey (n 2) 1191. Also the argument based on the market power of the

usefulness of a mandatory regulation. Different remarks have to be made with regard to sophisticated creditors, such as banks and other financial intermediaries. In regard to these, it is worth noting that the role of legal capital in granting credit, albeit shared in the past,²⁷⁹ has diminished over the years. This is because banks have more complete and effective information and instruments at their disposal for assessing the financial situation of a company; and indeed, they may arrange, parallel to the increasing amount and longer duration of the loan, sets of financial covenants equal or even superior to the advantages connected with legal capital.²⁸⁰

In fact, the more thorough the evaluation of the borrowing company's creditworthiness (which is required of the banks anyway, considering their fiduciary duties as lenders), the greater the liability under tort law or contract law towards other creditors or third parties in general, especially if the bank can be characterized as a 'shadow director' of the company and is involved in restructuring the company, if it is distressed.²⁸¹

This aspect of the legal capital rules could be confirmed and increased by the imminent introduction of the *Basle-2* accord on capital adequacy rules, the aim of which is to impose on the bank stricter duties of evaluating credit risk.²⁸² The whole system is intended to ensure the financial stability of the bank by mandating a solvency test, which is to say the minimum capital required with respect to the total amount of assets on the balance sheet which are loans or loan-related, with due consideration given to specific risk assets ratios.

This system has been integrated in such a way as to give banks more flexible methods of evaluating various credit risk ratios; this culminates in the possibility of using a credit rating to ascertain the creditworthiness of the firm receiving financing – the internal rating based (IRB) approach – issued by the same lender bank.²⁸³

indebted company (*ibid.*, 1198) justifies the recourse to the mandatory rule rather than to exclude it. In the same ways, it is fallacious to think that the sophisticated creditor may act as agent for the others: see above (n 253).

279 Kübler (n 58) 107.

280 Moreover, the banks have a preference for a market-oriented corporate system, and especially for the fee-earning on equity, in comparison to the interest rates on loans, Hopt (n 253) 1019; Merkt (n 2) 1051.

281 See generally, Ferran (n 52) 481 *et seq.*; Armour, "UK Bank's Liability in Rescue Situations" (forthcoming).

282 Bank for International Settlement, *Basel II: International Convergence of capital Measurement and revisited Framework* (Basel Committee publications n. 107 (2004); see Dalhuisen, *International Commercial, Financial and Trade Law* (2000) 810 *et seq.*; Kirstein, "The New Basle Accord, Internal Ratings, and the Incentives of Banks", *Int. Rev. L. & Econ.* (2002) 393 *et seq.*

283 Schön (n 33) 4; Schwarcz, "Private Ordering" (n 195) 5 *et seq.*; Wittig, "Bankaufsichts-

In effect, through the variety of methodologies for calculating the credit risk ratio, its aim is to achieve the greatest possible improvement of evaluating the probability of debtor insolvency, by way of applying the same proportioning as in the solvency test as a whole, which remains fixed in the sense that the qualifying capital should never be less than 8 % of total risk assets. That makes possible a wide differentiation of the capital adequacy requirements in relation to criteria, both more and less sophisticated, as used by banks in the measuring credit risk; however, this system could penalize small and medium enterprises.²⁸⁴

On the other hand, the application of the IAS/IFRS standards boasts greater potential as far as assets are concerned, whilst simultaneously reducing liabilities. This leads to increased creditworthiness, which is fixed by the use of the credit ratings system. Moreover, in this fashion, medium-sized companies are internationally better comparable, and therefore they can operate on international capital markets with ease.²⁸⁵

Assuming that legal capital rules are compatible with IAS/IFRS standards, then for the same reason it is not detrimental to assignment of the credit rating of the borrowing company by credit rating agencies. On the contrary: it is undeniable that especially with regard to small companies, the existence of a mandatory minimum level of net assets and its maintenance at the time when the bank makes a loan could be an advantage in determining the credit rating.

From another viewpoint, recourse to legal capital rules to protect creditors could, due to the transformation of debt markets, be seen as being increasingly out-of-date when compared with various other typologies of financing techniques.²⁸⁶ The common aim is to involve, either initially or afterwards – as in the case of securitization – a large number of small investors in financing

rechtliche Grundlagen des (internen) Ranking und seine Transformation in das Darlehensverhältnis mit Unternehmen”, ZHR (2005) 212 *et seq.*

284 For the latter, in fact, the adoption of methodologies of rating, based on objective criteria, is near to causing an excessive increase of the credit risk, owing to the thin capitalization and, on the contrary, the existence of evaluation criteria founded on the reciprocal confidence, on the effective bargaining relationships established between bankers and firms in the course of time, which would be otherwise neglected. Because of that, the original proposal of *Basel II* accord about the capital adequacy has been amended in such a way to mitigate the ratio between the minimum capital required for bank and credit risks, especially in correspondence to the peak of the scale, in relation to higher value of insolvency probability. On the usefulness of legal capital for the assignment of the rating, in the limited liability companies, see Barta (n 154) 660.

285 On a current study with identical conclusions, by analysing and evaluating the accounting practices of a large selected German companies, see Merkt (n 2) 1046 *et seq.*

286 Kübler, “A Comparative Approach to Capital Maintenance: Germany” EBLR (2004) 1032.

transactions reserved for financial institutions beforehand. This spreads and facilitates, and even on occasion substitutes, traditional sources of the firm's financing.

This phenomenon is hardly new. Nowadays, however, it has experienced ever greater development thanks to the increasing penetration of the financial markets, as well as of strategies devised by financial intermediaries aimed at developing this financing channel in order to reduce their direct indebtedness towards a given client. Sometimes, even, there are more elusive purposes. In any case, now, besides traditional corporate bond issues, there are more sophisticated forms of secured debt such as subordinated bonds, perpetual notes and preferred shares; all these contribute to the increasing participation of the investor in the performance of the business, which goes beyond the mere claim to the borrower.

With regard to these typologies of creditors and the contractual relationships involved in company financing, there is the question of the eventual superfluity of legal capital rules and the protection they offer. In effect, the need for stricter creditor protection has been taken into account by some EU Member States, including Italy, through the determination of a financial ratio between the amount of the legal capital and the corporate bond issue, e.g. in the specific case of raising debt financing among investors.²⁸⁷

This kind of regulation may not be compared at all to a debt/equity ratio since limits to indebtedness are imposed only in the case of corporate bond issues.²⁸⁸ In substance, at least as pertains to the company's financing through the debt markets, not only the preservation of net assets from a quantitative point of view is provided for through legal capital rules, but also a strengthened protection on a qualitative basis: it is required, in any case, that the amount of corporate bonds does not exceed a certain proportion in relation to the legal capital.²⁸⁹

287 See, in Italy, the art. 2412 c. c.

288 On the need of a directors duty for a well-balanced debt/equity ratio, as to avoid reckless business, see Lamandini, *Struttura finanziaria e governo nelle società di capitali* (2001) 154 *et seq.*

289 On that purpose, see especially Campobasso, "Le obbligazioni", in *Tratt. delle soc. per az.* diretto da Colombo-Portale, vol. 5 (1985) 396 *et seq.*; Portale (n 20) 63 *et seq.* and n 97, with further references

This peculiar limitation of the corporate bond issue tends, however, to be old-fashioned, either for the unlisted companies, for which pursuant to the Italian law the relationship has been raised to the double of the legal capital and the reserves (art. 2412, 1° co, c. c.), or in particular for the listed companies, where it was repealed at all on the assumption that the regulations of the financial market have to be held as enough to protect those bearing the risk of default (art. 2412, 4° co., c. c.). Therefore, they would

This choice of the majority of the EU Member States to not limit the corporate bond issues could lead to the conclusion that legal capital rules may soon be dismantled, especially when the rules of the capital market offer alternative creditor protection systems.²⁹⁰ Fundamentally, EU Member State company laws do not consider legal capital rules as such to be superfluous, but rather the more accentuated protection of a qualitative nature derived from a ratio consisting of legal capital and corporate bond issues.

The diffusion of hybrid securities, whose classification as credit capital or venture capital is uncertain, may cast doubt on legal capital rules. If the details of financial transactions and the rights assigned to holders of securities suggest to set those in venture capital, there are still some values belonging to the company's net assets, even though not referred to in the form of legal capital, but as reserves, especially if they cannot be disposed.²⁹¹

It is evident that at this rate the protection offered to holders of such securities does not lie in the financial cushion-effect of legal capital, but rather in the regime to which the hybrid instrument is ascribed, i.e. as a part of net assets. In other words, they need only be reimbursed in the event of company liquidation after corporate creditors have been satisfied. Such operations tend to differentiate and facilitate, and sometimes substitute for, traditional sources of a firm's financing. Simultaneously, this leads to the elimination of legal capital maintenance rules and to the application of financial market rules, where the investor is protected through public supervision, the duty of disclosure and, above all, market evaluation of an issuer's creditworthiness. These all influence investment or disinvestment choices.

In all these cases, recourse to debt markets implies that the protection of holders of such securities is entrusted to techniques external to company law, but which are deemed to be fulfilled under capital market law. Among these, there are tools of public supervision which provide information in addition to mandatory disclosure, e.g. the ratings issued by rating agencies. And, more

be able to accomplish a more efficacious filter, in relation to the more disadvantageous initiatives, than the guarantee offered by the legal capital and the relationship with the amount of the issued bonds.

290 The legal capital/corporate bond ratio has been dismantled in the Italian company law reform as regard the corporate bonds issued from the *società a responsabilità limitata*, depending from their being reserved to the institutional investors only, and being sold to the investors only with a guarantee of the first (art. 2483 c. c.).

291 See in particular Lutter, "Von formellen Mindestkapital zu materiellen Finanzierungsregeln im Recht der Kapitalgesellschaften", in *Festschrift für Riesenfeld* (1983) 185 *et seq*; Wiedemann, in Hopt – Wiedemann (n 79) Vor § 182 n 121 *et seq*; Lucas, "La distinction des titres de capital et des titres de créance", in Couret – Le Nabasque (n 1) 21 *et seq*.

generally, information is supplied by the markets with respect to the evaluation of the creditworthiness of an issuer of securities.²⁹²

Thus protection of creditors from the risk of default is no longer realized through the duties of the indebted company, but through an external person, such as credit rating agencies, which are required to allow satisfaction of the debt in the form of compensation for incorrect and untruthful certification provided to the public. Indeed, this system is destined to spread, a part from its presence in the capital markets, considering the introduction of internal banking ratings in regard to bank financing. And furthermore, consideration must be given to private credit ratings concerning debt securities issued to professional investors.

XI. Legal capital as minimal, but not exclusive system of creditor protection

Minimum legal capital constitutes the minimum level of creditor protection granted to those creditors who cannot or do not want provide independently for more intensive tools; this is typical for a mandatory rules system which coexists with contractual autonomy.²⁹³ This is especially true when, as happens for corporate types other than the public company, such as the limited liability company, the minimum level of capital would otherwise be lower. In this case, minimum capital may prevent frivolous incorporations, without being too harsh at the same time.²⁹⁴ Even better: legal capital is not considered damaging by itself,²⁹⁵ but is rather endowed with a function suitable to the system of creditor protection as a whole.²⁹⁶

Therefore, minimum capital may be held as a sort of invitation to enter into a contract with current and future creditors of the company,²⁹⁷ or even as a kind of financial covenant provided for by law (more accurately, an implied covenant).²⁹⁸ The decision of the shareholders to contribute to the formation of the company with a given amount of equity capital should be seen as signal of their confidence in the business; this brings with it consequences in the event

292 Hertig – Kanda (n 5) 82. On the credit rating agencies, see above (n 195).

293 Under mandatory rules, not depending on the freedom of contract, the creditors are protected from unexpected and arbitrary changes of the articles of association at their detriment and without their knowledge. On the limits of creditor protection depending on the company law, for that reason, see Merkt (n 2) 1052.

294 Freedman (n 83) 336 *et seq.*

295 Lutter (n 32) 375.

296 Baldamus (n 13) 85 *et seq.*

297 Schön (n 1) 166 *et seq.*; on the limits of that comparisons, because the contractual freedom would be limited by the conclusive nature of the rules relating to legal capital, see Merkt (n 2) 1055.

298 See Mülberr – Birke (n 1) 729 *et seq.*

of a breach.²⁹⁹ Through legal capital rules, the involuntary and unsophisticated creditors in particular are protected through legal provisions which attempt to reproduce results which may be obtained by way of a contract with the company, i.e. a standardized contract; accordingly, this makes it possible to equiparate, at least from a formal point of view, both systems of protection.³⁰⁰

As opposed to covenants, minimum capital rules ensure in principle that creditors are protected by law and treated equally. Legal capital aims, through a sort of legislative paternalism, at avoiding transactions costs which originate from the unfettered rules of the capital market. These transaction costs, otherwise, would be offloaded onto individual creditors, especially those who may not be able to bear the weight of that;³⁰¹ and besides, covenants impose restrictions on the independent management of firms, especially when combined as concerning a single creditor, and sometimes as well in conflicting among them, for example start-up firms and other small enterprises.³⁰²

Especially when the market rules, then creditor and debtor bargain freely on the basis of the information available on the financial situation of the company. Creditor protection then depends on this information. When comparing costs and advantages of information provided by the indebted company with its need to be favoured in obtaining a loan, a set of variables including the reliability of the financial information and its different weight and consequences, depending on the creditors involved, must also be taken into account.³⁰³

The only peculiarity of the legal capital rules, in comparison with contract law-based creditor protection, consists in the fact that the company's assets as

299 Schön (n 1) 4; Mülberr (n 1) 156; Mülberr – Birke (n 1) 726 *et seq.* This does not mean that the legal capital offers a direct creditor protection, because the assets which constitute it are liable to execution. For criticisms on that matter see Portale (n 20) 18 *et seq.*

300 See Merkt (n 2) 1050; Hopt (n 253) 1018 *et seq.* On the other side, the freedom of contract may reproduce the mandatory rules of the legal capital through the financial covenants.

301 Apart from the difficulties of a cost-benefit analysis, the lower costs coming from the abolition of the legal capital system might well be equalised by higher costs of the directors' liability actions and the other techniques of the insolvency law that support the covenants for creditor protection, see Merkt (n 2) 1051.

302 Schön (n 148) 710 *et seq.*; Merkt (n 2) 1050; Hopt (n 253) 1019; Armour (n 2) 373; Krüger (n 33) 271 *et seq.* On a conflict caused by a "super-creditor rule" in favor of football creditors and at the expense of the tax authorities see *Exeter City AFC Ltd v The Football Conference Ltd* [2004] EWHC 831 = [2004] BCC 498 = EWIR (2004) 385 (noted Schall).

303 Denozza (n 6) 589 *et seq.*

raised through contributions are not set aside in order to satisfy reimbursement claims when necessary, but rather are directly used in the company's business. Thus, the contribution to the formation of legal capital also performs a function in the company's business activity; on the part of the company, only the conservation of an equivalent amount is required.³⁰⁴

When companies are permitted to have a lower minimum capital, as in the case of the limited liability company, the risk is greater that the limited liability regime will be exploited to the detriment of creditors, although this concern is counterbalanced by greater restrictions on credit capacity.

This protection is capable of coexisting and even being intensified, either through individual agreements or through covenants³⁰⁵ with individual creditors, especially banks, or through the legal capital rules, e.g. by fixing a higher amount, as provided for on occasion by the legislator vis-à-vis certain activities.³⁰⁶ Another solution may be the transformation of the earned surplus into legal capital, as expressly provided for by the Second Directive. This is widespread among firms, in spite of tighter restrictions on the dividend distribution.³⁰⁷ Also noteworthy are the different techniques, such as an insurance policies for the benefit of involuntary creditors, which sometimes are even required by law.³⁰⁸

Besides, the more strictly the financial covenant binds the company, the easier it is to make sophisticated creditors liable as shadow directors when the company becomes insolvent: thus it would be possible to classify their loans as capital.³⁰⁹

304 A different creditor protection techniques would be to require companies to raise a certain minimum amount of capital and to put it on one side, or to take out a bond to a certain amount, so that the capital, or the bond, can be made available to meet the claims of the creditors. This system makes the corporate form very unattractive for business, see Davies, *Introduction* (n 26) 84 *et seq.*

305 Schön (n 1) 167; see for criticism, due the rigidity of the plurality of techniques of protection, Merkt, *Creditor Protection*, 1056. Moreover, as voluntary, the accumulation will depend from benefits which are greater of the costs: the legal capital offers to the unsophisticated creditors, which are indirectly protected by covenants, a direct protection too. First of all the evaluation on the adequacy of the level of legal capital chosen by shareholders depends on the market, Barto (n 154) 661 *et seq.*; Eidenmüller – Engert (n 234) 105 *et seq.*

306 Besides, for the company's listing: see Baldamus (n 13) 88.

307 Mülbert – Birke (n 1) 716 *et seq.*

308 Freedman (n 83) 340 *et seq.* An example for this is the higher premium required for the obligatory liability insurance in the *Anwalts-GmbH* (cf. § 59j BRAO), see Schön (n 1) 165; Sangiovanni, "La società a responsabilità limitata tra avvocati nel diritto tedesco", *Riv. soc.* (1999) 934 *et seq.*

309 See Merkt (n 2) 1051; on lender liability of banks see above (n 282).

Of course, though the legal capital may be low, insofar as it is above the minimum, the protection of creditors will be strengthened. For this reason, it is preferable that the flexibility inherent in the legal capital regime should be based on a mandatory mechanism, rather than on default rules. This would reserves for shareholders a system of *opting out of* or *opting into* various legal options and, in particular, the choice of alternative default terms which correspond to a range of loan covenants.³¹⁰

Above all, with respect to avoiding opportunistic behaviour on the part of shareholders through confusion between shareholders' assets and company assets, especially in the default phase (which is, in fact, the main reason for legal capital rules and extends itself to the law of groups of companies)³¹¹ what is necessary is the prohibition against the asset distributions to the shareholders if net assets do not remain equivalent at least to the amount of the legal capital, rather than the amount of the minimum capital.

In fact, a substantial continuity can be assumed between legal systems accepting legal capital rules and those based on financial ratios since they meet a common requirement, apart from the higher or lower amount of minimum capital required according to the type of company and the legal system in consideration.³¹² The mechanisms of creditor protection, in order to limit the distribution of assets to shareholders, may operate abstractly if, in regard to the capital maintenance, the legal system provides legal capital rules, even if it does not require a minimum capital or fixes it at a merely symbolic amount (e.g., 1 €) as for the English private company and the French *société à responsabilité limitée*; such legal capital, of course, lacks the effect of a 'financial cushion'.³¹³

310 Armour (n 2) 375 *et seq*; on the role of contract in corporate law, see generally, Fleischer, "Gesetz und Vertrag als alternative Problemlösungsmodelle im Gesellschaftsrecht", ZHR (2004) 673 *et seq*.

311 Schmidt, "Gesellschafterhaftung und 'Konzernhaftung' bei der GmbH – Bemerkungen zum "Bremer Vulkan"-Urteil des BGH vom 17.9.2002", NJW (2001) 3577 *et seq*; Altmeppen, "Zur Entwicklung eines neuen Gläubigerschutzkonzeptes in der GmbH", ZIP (2002) 1553 *et seq*; Roth, "Gläubigerschutz durch Existenzschutz", NZG (2003) 1081 *et seq*; see too before, VIII.

312 Schön (n 33) 5. At worst, the lower amount of the minimum capital may be substantially assimilated to the insolvency *surplus test* in the U.S., then to the withdrawal of the prohibition against the return, with reference to an insolvency caused by a deficit.

313 Davies (n 72) 86 *et seq*. In this case, it may be applied the rules concerning the reduction of capital for losses (s. 142 CA 1985); see too Grunewald – Noack (n 154) 193 *et seq*. The same, in the French *société à responsabilité limitée* it may be a mandatory winding up of the company, if the net assets of the company become less than half of the legal capital, as consequence of losses (art. L. 223-42 Cod. Com): see above n 72. It's obvious, too, that "*la société dont les capitaux propres SE retrouveraient inférieurs*

It is evident that, especially in this last case, capital maintenance rules and evidence of losses – even with an objective assessment not dependent on the judgement of directors – have the same effect as solvency tests in countries where legal capital is absent. This meets the primary interests of creditors, namely avoiding a distribution of resources capable of making the company insolvent or quickly ascertaining insolvency when it happens.³¹⁴

The amount concretely fixed as legal capital meets other requirements, such as a seriousness test for the purpose of the business³¹⁵ or to establish a kind of debt/equity ratio, the absence of which is deplored by those opposing minimum capital because of the assumption that this relationship could be integrated conventionally by way of financial covenants, without introducing *ab origine* a much more penalizing mandatory discipline.

However, there are some advantages to endowing the company articles with a specification on the amount of legal capital. In this way, the legislator allows the implementation of a function performed principally by legal capital, which in this case may be shaped and graduated through the autonomy provided for by the company articles; through this, the protection offered by minimum capital may eventually be strengthened by the various different techniques co-existing with it.³¹⁶

In that way the legal capital system always has strict mandatory content, but it also offers a flexible mechanism with respect to discretionary decisions on whether and to which extent to use it or not, and furthermore on whether to reduce its consequences to an extremely low level, putting it next to other techniques considered to be preferable.³¹⁷

That criticism which claims that the legal capital is not able to avoid a company's insolvency should similarly be rejected.³¹⁸ In fact, that is not the function of legal capital, except with a view to avoiding a discrepancy between net assets and liabilities at the moment of incorporation; rather, it is to inform before the fact, through the financial cushion effect, that such a situation could happen and, at worst, lead to the company's liquidation.

à la maitié d'un euro serait quasi inévitablement en situation de cessation des paiements" (Lienhard (n 134) 1901).

314 On the short relevance of that distinction, see Micheler (n 126) 341 *et seq.*

315 See above, II.

316 The experience shows in fact the tendency of the companies to choose a capital, also considerably higher than the minimum; so as it is allowed the gratuitous increase, Mülbart – Birke (n 1) 716 *et seq.*

317 That corresponds to the position of Group of German Expert on Corporate Law (n 33) 872.

318 Kübler (n 58) 100 *et seq.*

Therefore, legal capital has a preventive function. In fact, insolvency does not actually depend on the amount of legal capital, whatever it may be, since there is no assurance that it will be preserved throughout the course of business. That is related to the managerial skills of directors and to their liabilities. Rather, the risk of insolvency is connected to the debt/equity ratio; the lower the equity, the higher the risk that the costs of creditors' remuneration will exceed net assets, so that they cannot be drawn on successfully.³¹⁹

For this reason, directors' liability for material undercapitalization of the company or for destruction of the economic basis of the company does not depend on the inefficiency of legal capital rules, but establishes a useful corollary to it on a legal or judicial basis.³²⁰

This demonstrates that the two techniques differ from each other and can coexist, but need not necessarily do so.³²¹ However, the determination of the debt/equity ratio is implicitly similar to minimum capital, whereas the reverse is not true. The reduction of the risk of insolvency due to a well-balanced net assets/debt ratio may be fixed conventionally on the granting of credit. That does not exclude minimum capital from serving as an advanced device for protection against the risk of altering the debt/equity ratio. In other words, minimum capital may be the means to prevent alteration of the mentioned ratio and to protect creditors before such alteration even occurs.

Coexistence is further clearly demonstrated by the special discipline imposed vis-a-vis the internalisation of risks in certain hazardous industries: given an excessively risky investment policy, the minimum capital rule is supposed to protect creditors by specific rules. If supported even when fixed at a higher amount than ordinary law³²² it would be considered insufficient in relation to the aims pursued.³²³ That is what happens with respect to the rules on capital adequacy (e.g., patrimonial coefficients in the banks, solvency margin in the

319 Mülbert – Birke (n 1) 718 *et seq.*

320 For criticism on that motive, see Merkt (n 2) 1049.

321 Ferran (n 183) 316 *et seq.* It is revealing a rule provided by the recent reform of the Italian company law for the co-operative companies: also in a system of variable capital, requiring however a basic minimum capital, the article 2545 *quinquies* c.c. provides that the distribution of dividends and other returns to shareholders may be made if the net assets/debt ratio is superior to one to a quarter, with evident analogy to the California Corporation Code (see above, VII). On the Italian reform cf. further Montalenti, "The New Italian Corporate Law: an Outline", ECFR (2004) 368 *et seq.*; Ventoruzzo (n 110) 207 *et seq.*

322 About the provisions of a higher amount of the legal capital in Italy, see Portale (n 20) 17 n 29.

323 Armour (n 2) 371 *et seq.*

insurances). These also are the object of EU harmonisation, as well as the mandatory insurance schemes for other industries.³²⁴

The different purpose of capital adequacy rules derives from the fact that the debt/equity ratio is intended to prevent the company's insolvency, and as such it constitutes a rule of fair management of the firm, whereas the legal capital rules, thanks to the financial cushion effect, are intended, as said before, to provide an alarm for creditors in the event of its erosion; this in turn avoids opportunistic behaviour on the part of shareholders.

In other words, legal capital avoids asset distribution and permits the establishment of a forward line of creditors' defence when it comes to encompassing the major risk situations involving shareholder exploitation,³²⁵ especially when contrasted with the application of solvency tests (or, since they are identical, the former is also again *en vogue*), provided that the prohibitions would have to be extended to the hypothesis of dividend distributions by an insolvent company, though without loss of capital.³²⁶

XII. Conclusion

The preservation of the legal capital system seems to be directed to a reduction of costs and to an increase of efficiency, compared with what would happen in the case of its radical removal and its substitution by other techniques. In this sense, capital maintenance rules may be seen as inspired not only by effective convenience, but also by path dependence, as a technique intended to make more efficient the adjustment of the corporate structures to the changeable economic conditions as directed to a reduction of costs and to an increase of efficiency,³²⁷ as compared with what would happen because of its radical removal and its substitution for other techniques.³²⁸

One should consider the use of piercing the corporate veil as an alternative to legal capital or even to a stricter system of directors' and shareholders' liabil-

324 Mülbert – Birke (n 1) 725 *et seq.*

325 Schön (n 1) 168 *et seq.*

326 About the inconsistency of a capital maintenance system that allows an insolvent company to distribute dividends unless there are losses of the legal capital, see Denozza (n 6) 597 *et seq.*

327 Lutter (n 32) 375, about the equivalence among the various systems, weighing out advantages and disadvantages.

328 On the difference among the costs necessary for the removal of the legal capital rules and their substitution with an alternative system of creditor protection, and the costs for coexistence of the legal capital with another system, see Merkt (n 2) 1056.

ity; this applies in particular to controlling shareholders' liability, in case managerial choices drain corporate assets to the detriment of creditors. However, these forms require a more complete arrangement of the corporate structure³²⁹ and as result, they are less efficacious in the repression of facts which constitute confusion of assets.³³⁰

More generally, the removal of legal capital involves increasing change in the powers between the shareholder's general meeting and the directors, in favour of the latter, as is already happening in some countries, like in Italy. This is directed at achieving, in the absence of legal capital rules, for example, flexibility of corporate financing through giving a choice directors as to whether to issue new shares without the shareholders' consent.³³¹

Substantially, the removal of legal capital rules would require the adoption of a set of more sophisticated and stricter techniques than those already used, especially for limited liability companies; this would serve the purpose of repressing forms of material and nominal undercapitalisation. Given that such techniques are often not mandatory, the adoption of legal capital may be more justified from a systematic point of view in the Civil Law, where judges prefer to enforce relatively bright-line rules, rather than developing standards for the protection of corporate creditors, such as fiduciary duties, as in the Common Law.³³²

In other words, the legal capital system may be considered only one of the features available to distinguish debtor oriented systems from creditor oriented systems. This distinction undoubtedly diminishes, a fact evidently reflected in the evolution of balance-sheet rules. But it seems extremely premature for the EU to take a position on legal capital systems without a full awareness of the overall development of EU company law. Above all, such a radical change should not happen before capital markets develop all their numerous facets, as this will afford a sense of balance during a change of the legal system with respect to creditor protection and furthermore make it less traumatic.³³³ However, the dismantlement of the legal capital system might not be generalised, because the relevance of the creditor protection arising from the capital market is varied, and depends on the corporate forms.

329 See Mülbert – Birke (n 1) 724 *et seq.*

330 Kübler (n 58) 105 *et seq.*; about path dependence in general, see Bebchuck – Roe, "A Theory of Path Dependence in Corporate Law", *Stanford Law Rev.* (1999) 127 *et seq.*; Roe, "Chaos and Evolution in Law and Economics", *Harv. Law Rev.* (1996) 641 *et seq.*

331 High Level Group (n 15) Ch. IV, n. 1.

332 Hertig – Kanda (n 5) 87

333 Hopt (n 253) 1019; on the close link between capital markets and company law, see Winter (n 161) 10 *et seq.*

The abolition of legal capital should return the limited liability rule and corporate personality to a normal state; this will have the consequence that the limited company will become similar to the individual enterprises, as concerns the conduct of business. In both of these, it is possible to dispose of the enterprise's net assets with considerable freedom, insofar this does not make the company insolvent, i.e., it must comply with solvency tests.

If the enterprise became insolvent, as a voluntary choice regarding the conduct of business, this would cause damage to creditors; but there are remedies, such as those related to the tort law, which generate unlimited liability of shareholders.³³⁴

Given these terms, the U.S. offer a wide range of remedies due to the lifting of the corporate veil: the removal of legal capital may be part and parcel of the need for a complete alternative system of creditor protection.

An indication in that direction may come from the way legal capital doctrine is shaped by the various EU legal systems with respect to limited liability companies. In fact, the area reserved by the European Court of Justice for jurisdictional and regulatory competition on legal capital raises the problem as to the relative consequences, in general, if competition will engender a race to the "top" or to the "bottom".

The result will depend chiefly on the evaluation of the legal capital system as compared with other creditor protection systems. This comparison would follow along lines of costs and advantages and go deeper than in the past, especially in light of what emerged has from the preceding pages.³³⁵ It may be assumed, however, that as a constant factor in regulatory competition, the issue would not result in a rigid alternative between certain States which adopt legal capital and others States which completely reject it. More likely, the issue will melt into different forms of deregulation and lead to solutions trying to combine legal capital with other forms of creditor protection, perhaps though harmonisation from the top down, as was shown in the perspectives above, as outlined in this paper.

334 See Conac (n 35) 177 *et seq.*

335 See Böckmann (n 52) 142 *et seq.* For example, the lower the legal capital (maybe even reduced to zero), the more the corporate creditors will require guarantees from the shareholders or managers, with a substantial lifting of the corporate veil, as the shareholders are in a more burdensome position than with the unlimited liability, especially if the amount of the guarantees is fixed in proportion to their own assets, see Brocard, "De l'utilité de constituer une SARL?", *Rev. soc.* (2004) 825 with reference to the French *société à responsabilité limitée*.