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The Place for Creditor Protection on the Agenda for Modernisation of Company Law in the European Union

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Eilís Ferran
University of Cambridge and ECGI

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Abstract

The European Commission's Action Plan for Company Law, Modernising Company Law and Enhancing Corporate Governance in the European Union, signals a reorientation of the approach to company law at the European level, away from the protection of those who deal with companies and in favour of concentrating instead on business efficiency and competitiveness. This reorientation undermines the 2nd Company Law directive, which is rooted in dated notions about company law's functions and assumptions about the need for safeguards against abuse. If the reorientation is genuine, it should provoke a more meaningful engagement with questions about company's law role in creditor protection and the regulatory strategies that can best be employed to discharge it. Yet, despite the new emphasis on business facilitation, the Commission's current approach to reform is to use the 2nd Directive as the benchmark against which to assess the feasibility of an alternative regime that might be introduced on an optional basis for Member States. This approach is liable to create confusion and to lead to muddled policy choices. The failings of the 2nd Directive are certainly relevant to the debate on the extent to which, and how, creditors' interests should be addressed within a flexible company law framework for competitive business but the directive should not be presented as a touchstone against which the merits of alternative schemes are to be measured. This paper contributes to the debate on the recognition of creditors' interests in modern European company law in the following ways. It reviews important strands in the existing literature on the European legal capital doctrine and adds to the literature by examining the impact of recent trends in accounting, in particular the transition to International Financial Reporting Standards (IFRS), on the operation of the 2nd Directive. It suggests that accounting trends are set to undermine further the (already weak) arguments in favour of retaining the 2nd Directive. Whilst much of this paper questions the wisdom of the way in which the current proposal for an optional alternative to the 2nd directive has evolved, there is now considerable momentum behind that proposal. The paper therefore concludes by reviewing the substance of the proposal for a solvency-based alternative to the 2nd Directive and comments also on the associated proposal to adopt an EU-wide standard on wrongful trading liability.

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Eilís Ferran
Professor of Company and Securities Law
University of Cambridge, Law Faculty
10 West Road
Cambridge CB3 9DZ, United Kingdom
e-mail: evf1000@cam.ac.uk

THE PLACE FOR CREDITOR PROTECTION ON THE AGENDA FOR MODERNISATION OF COMPANY LAW IN THE EUROPEAN UNION *

ABSTRACT

The European Commission's Action Plan for Company Law, *Modernising Company Law and Enhancing Corporate Governance in the European Union*, signals a reorientation of the approach to company law at the European level, away from the protection of those who deal with companies and in favour of concentrating instead on business efficiency and competitiveness. This reorientation undermines the 2nd Company Law Directive, which is rooted in dated notions about company law's functions and assumptions about the need for safeguards against abuse. If the reorientation is genuine, it should provoke a more meaningful engagement with questions about company's law role in creditor protection and the regulatory strategies that can best be employed to discharge it.

Yet, despite the new emphasis on business facilitation, the Commission's current approach to reform is to use the 2nd Directive as the benchmark against which to assess the feasibility of an alternative regime that might be introduced on an optional basis for Member States. This approach is liable to create confusion and to lead to muddled policy choices. The failings of the 2nd Directive are certainly relevant to the debate on the extent to which, and how, creditors' interests should be addressed within a flexible company law framework for competitive business but the Directive should not be presented as a touchstone against which the merits of alternative schemes are to be measured.

This paper contributes to the debate on the recognition of creditors' interests in modern European company law in the following ways. It reviews important strands in the existing literature on the European legal capital doctrine and adds to the literature by examining the impact of recent trends in accounting, in particular the transition to International Financial Reporting Standards (IFRS), on the operation of the 2nd Directive. It suggests that accounting trends are set to undermine further the (already weak) arguments in favour of retaining the 2nd Directive.

Whilst much of this paper questions the wisdom of the way in which the current proposal for an optional alternative to the 2nd Directive has evolved, there is now considerable momentum behind that proposal. The paper therefore concludes by reviewing the substance of the proposal for a solvency-based alternative to the 2nd Directive and comments also on the associated proposal to adopt an EU-wide standard on wrongful trading liability.

* Eilís Ferran, Professor of Company and Securities Law, Centre for Corporate and Commercial Law (3CL) and Law Faculty, University of Cambridge; email evf1000@cam.ac.uk. I am grateful for comments from John Armour, Luca Enriques, Carsten Jungmann and Richard Nolan. The usual caveats apply.

A. Introduction and Overview

In *The Anatomy of Corporate Law*,[1] a comparative study of company law[2] by leading international scholars including Klaus Hopt, Hertig and Kanda identify three regulatory strategies that systems of corporate law in major jurisdictions employ to address creditors' interests: mandatory disclosure, especially of financial statements; rules governing legal capital and corporate groups; and standards that they label 'fiduciary', though it is evident that they are not using this term in precisely the way that it might be employed by a scholar on the law of equitable obligations.[3] They identify a marked divergence between Continental Europe, which prefers the rules-based strategy to the standards strategy, and the US, in whose State corporate laws rules on creditor protection are noticeable largely by their absence and where creditors' interests are addressed through a standards-based strategy under the heading of Federal 'fraudulent transfer laws'.[4] This divergence, and whether it should be maintained, is at the heart of a lively international debate. Klaus Hopt has contributed significantly to this debate through his writings and latterly through his participation in the High Level, or Winter, Group of Company Law Experts, which was established to advise the European Commission on company law and which has largely shaped the current company law policy agenda at EU level.[5]

The vulnerable party in this debate is the rules-based strategy, which is the one adopted in the 2nd Company Law Directive.[6] The 2nd Directive's approach to creditor protection, namely quite specific rules on minimum capital, and on the raising, maintenance and reduction of capital, together with various offshoots such as the ban on financial assistance, is under attack from many quarters, including from within Continental Europe, although it also retains some staunch defenders. In international discourse, opposition to change is most readily associated with elements of the German legal academy and profession but even in Germany there are some strong supporters of a shift towards standards rather than rules.[7] The predominant British opinion, in contrast, favours dispensing with detailed legal capital rules. For example, informed by the findings of a major review of domestic company law conducted over

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[1] R.R. Kraakman, P. Davies, H. Hansmann, G. Hertig, K.J. Hopt, H. Kanda and E.B. Rock, *The Anatomy of Corporate Law: A Comparative and Functional Approach* (Oxford, OUP, 2004).
[2] The terms 'company law' and 'corporate law' will be used interchangeably in this paper.
[3] G. Hertig and H. Kanda, 'Creditor Protection', ch. 4 in Kraakman et al, *Anatomy*. In British legal discourse the question – which duties are properly labelled 'fiduciary?' - has recently attracted considerable debate: *Bristol and West Building Society v Mothew* [1998] Ch 1, where Millett LJ noted that 'The expression "fiduciary duty" is properly confined to those duties which are peculiar to fiduciaries and the breach of which attracts legal consequences differing from those consequent upon the breach of other duties'.
[4] Further, M. Kahan, 'Legal Capital Rules and the Structure of Corporate Law: Some Observations on the Differences between European and US Approaches' in K. Hopt and E. Wymeersch (eds.), *Capital Markets and Company Law* (Oxford, OUP, 2003) 145 – 149.
[5] High Level Group, *A Modern Regulatory Framework for Company Law in Europe* (Brussels, November 2002). The High Level Group was chaired by Professor Jaap Winter, hence the common references to the 'Winter' Group.
[6] Second Council Directive 77/91 [1977] OJ L26/1, on co-ordination of safeguards which, for the protection of the interests of members and others are required by Member States of companies within the meaning of the second paragraph of Article 58 of the Treaty, in respect of the formation of public limited companies and the maintenance and alteration of their capital with a view to making such safeguards equivalent.
[7] F. Kubler, 'A Comparative Approach to Capital Maintenance: Germany' [2004] *European Business Law Review* 1031.

several years, the British Government has recently unequivocally stated its support for more flexibility than is permitted by the 2nd Directive.[8] However, it is not entirely clear that all interested parties in the UK, especially practitioners who are accustomed to working with the present regime, would favour radical reform. As in Germany, the spectrum of British views on the merits of the 2nd Directive and on deeper underlying questions about the role of company law in addressing creditors' interests may be wider and more nuanced than is sometimes supposed.

The European Commission's Action Plan for Company Law, *Modernising Company Law and Enhancing Corporate Governance in the European Union*,[9] signals a reorientation of the approach to company law at the European level, away from the protection of those who deal with companies and in favour of concentrating instead on business efficiency and competitiveness. This reorientation undermines the 2nd Directive, which is rooted in dated notions about company law's functions and assumptions about the need for safeguards against abuse. It can no longer simply be assumed that EC company law should protect creditors. Instead creditor-related concerns can only justifiably retain a place on the company law policy agenda where this is shown to be needed on efficiency and competitiveness grounds, and where subsidiarity and proportionality considerations are satisfied. This reorientation thus demands a more meaningful engagement with questions about company's law role in creditor protection and the regulatory strategies that can best be employed to discharge it.

Despite the new emphasis on business facilitation, the Commission's current approach to reform is to use the 2nd Directive as the benchmark against which to assess the feasibility of an alternative regime that might be introduced on an optional basis for Member States. It has been led in that direction by the High Level Group, which argued that 'the alternative regime should at least be as effective in achieving the objectives of creditor and shareholder protection as the regime based on legal capital'.[10] This approach is liable to create confusion and to lead to muddled policy choices. Whilst experts on legal capital know that the reality is that the 2nd Directive does not effectively achieve creditor protection objectives and can thus discount the constricting effect of a stipulation that any alternative should be at least as good, non-experts, a group that will surely include many of the members of the European Parliament and Council who will eventually pass the laws creating the alternative regime, cannot be expected to cut through the froth to the substance with the same confidence and may be misled by language that is unclear if not disingenuous. To assist the process of policy formation, there should instead be a clear and unambiguous debate on the extent to which there is room for the recognition of creditors' interests within a flexible framework for competitive business and on the form that such recognition should take. The failings of the 2nd Directive are certainly relevant to this debate but the Directive should not be presented as a touchstone against which the merits of alternative schemes are to be measured.

The Commission's current approach is also open to criticism for excluding from the discussion the possibility of taking the bold deregulatory step of simply repealing the 2nd Directive and leaving it to Member States to address creditor concerns within their

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[8] DTI, *Company Law Reform* (Cm 6456, March 2005), pp. 42 – 3.
[9] COM (2003) 284
[10] High Level Group, *A Modern Regulatory Framework*, n. 5 supra, p. 14.

domestic company law to the extent that they consider it appropriate to do so. Dismantling the 2nd Directive and putting nothing in its place by way of recognition of creditors' interests may be too big a step to command political support but there is a risk that the lack of a principled assessment of the superiority of Community level intervention over unilateral action by Member States at delivering efficiency gains, such as in the cost of capital for European companies, will impoverish the debate in ways that could result in poor legislative choices.

This paper contributes to the debate on the recognition of creditors' interests in modern European company law in the following ways. Part B reviews important strands in the literature on the European legal capital doctrine, as embodied in the 2nd Directive, to explain why many have concluded that the Directive provides little meaningful benefit to creditors that can be put on the scales as a counterweight to the costs associated with it. Part C examines the impact of recent trends in accounting, in particular the transition to International Financial Reporting Standards (IFRS), on the operation of the 2nd Directive. It suggests that although it is early days with IFRS, overall the signs are that accounting trends will further undermine the (already weak) arguments in favour of retaining the 2nd Directive. Should warnings about the adverse impact of IFRS on the accounting measurement of companies' profitability prove well-founded, the case for reforming a regime that limits distributions to accounting profits, that is the 2nd Directive, is likely to become irresistible. Part D returns to the need for a deeper and more wide-ranging debate on the treatment of creditors' interests within a system of facilitative company law than is currently taking place in Europe. It suggests that the option of simply dismantling the 2nd Directive and putting nothing in its place at EU level merits more serious consideration. Recognising that such radical deregulation may be a political non-starter, however, this Part also cautions against adopting a new regime for creditors in company law at EU level on the basis of an unduly restricted debate that is likely to fail properly to inform the law-makers and thus to increase the chances of poor legislative choices that could impose new costs on the corporate sector that are disproportionate to the benefits gained. A deeper, more wide-ranging debate on creditors' interests in company law would make EU policy and law-makers better equipped to make rational, conceptually-defensible, evidence-based choices that are in tune with market conditions. If the process is to be compromised, this can only be justifiable on the basis that the costs associated with the 2nd Directive are so great that any alternative regime, however inadequately thought through, can only be better. Closer examination of IRFS-related concerns is appropriate as such concerns have the potential to tip the balance that way.

Whilst much of this paper questions the wisdom of the way in which the current proposal for an optional alternative to the 2nd Directive has evolved, it would be unrealistic not to recognise that there is now considerable momentum behind that proposal. Part E therefore concludes the paper by reviewing the substance of the proposal for a solvency-based alternative to the 2nd Directive and comments also on the associated proposal to adopt an EU-wide standard on wrongful trading liability.

B. Debate on the 2nd Directive

Do legal capital rules affect the pricing of debt?

Under the costly contracting hypothesis developed by Smith and Warner, covenants can be incorporated into debt contracts to prevent internal controllers from taking actions that reduce the value of the borrowing company.[11] However, there are also costs associated with covenants because they restrict a borrowing company's flexibility and may prevent it from pursuing certain investment and financing opportunities. The costly contracting hypothesis is that companies will search for an optimal financing structure by comparing the benefits and costs of each contractual covenant so as to determine a value-maximizing set of borrowing terms.

Numerous studies have examined the trade-off between the costs imposed on borrowers when covenants are imposed and the benefits of restrictive covenants that reduce the scope for controllers of companies to behave opportunistically at creditors' expense.[12] Many such studies establish that bond covenants are indeed priced.[13] It has been shown that the price impact of including covenants restricting investments and distributions can be economically significant.[14]

There is not, so far as I am aware, any study that tries to determine the price impact of the 2nd Directive. This is not surprising because of the difficulties of disentangling the 2nd Directive from other elements of creditor protection in Member States' national laws. Some clues as to price impact of the 2nd Directive might be found if it were possible to make meaningful comparisons between the price of debt offered to European businesses that are subject to national regimes that give effect to the 2nd Directive and that offered to European businesses that operate outside mandatory capital maintenance regimes. However, at national level Member States have been inclined historically to over-implement the 2nd Directive, in particular by applying many of its techniques and requirements to private companies as well as to public companies. Over-implementation complicates the task of finding suitable entities to form a useful comparator group.

Do legal capital rules reduce transaction costs by replicating the creditor protection effects of contractual mechanisms?

Proponents of the relaxation of legal capital rules see the prevalence of creditor self help through contractual covenants, security devices and other such instruments as an argument for deregulation in favour of market mechanisms that are superior because they are more flexible and provide more choice.[15] A counterargument is that legal capital rules mimic what can be achieved through contractual bargaining. As such, legal capital rules can be seen as being helpful to the market because they provide a ready-made, off the rack, solution that reduces transaction costs.

[11] C.W. Smith and J.B. Warner, 'On Financial Contracting: An Analysis of Bond Covenants' (1979) 7 *Journal of Financial Economics* 117.

[12] Recent examples are: S. Chava, P. Kumar, A. Warga, 'Agency Costs and the Pricing of Bond Covenants', SSRN abstract=611801; M. Bradley and M.R. Roberts, 'Are Bond Covenants Priced?' http://repec.org/esNASM04/up.21166.1069857472.pdf

[13] Bradley and Roberts, ibid. Contrast, however, L. Moir and S. Sudarsanam, 'Determinants of Financial Ratio Covenants and Pricing of Debt in Private Debt Contracts: The UK Evidence' (unpublished paper (2004), copy on file with author), where the data studied (supplied by 72 of the largest 200 non-financial quoted firms in the UK) was not found to support the view that the type of covenants included in loan agreements affected the pricing of debt.

[14] Chava, et al, 'Agency Costs', n. 12 supra.

[15] Kubler, 'A Comparative Approach', n. 7 supra, 1032.

There are differing opinions on how closely the legal capital regime in the 2nd Directive and contractual solutions replicate each other. One strand of analysis focuses on restrictions on distributions or payout constraints as they are also described. Covenants that directly restrict dividends are rare in UK[16] and German[17] debt contracts. This is in contrast to the US position where covenants imposing payout constraints are common.[18] A possible explanation for this difference in international debt market practice is that US practice demonstrates that payout restrictions are important to creditors and their non-inclusion in European loan agreements merely reflects the fact that they are redundant because creditors rely on the general law in this respect.[19] Article 15 of the 2nd Directive limits distributions to net profits accumulated since the company's incorporation and imposes the further restriction that distributions must not reduce net assets to an amount that is lower than subscribed capital and undistributable reserves.[20] It would go too far to claim that European law regarding capital maintenance is being precisely replicated contractually in the US[21] because in detailed respects the measurements and assumptions used in standard US dividend covenants differ from those employed in the 2nd Directive.[22] Furthermore, contractual adaptability means that dividend covenants can always be left out where they do not meet the parties' needs, something that is not possible under the rigid statutory model. Yet the basic contention that lending practices in the US and Europe may be closer than is sometimes supposed because borrowers are often subject to functionally similar payout constraints is plausible.[23]

However, dividend restrictions are but one element of the debt financing contractual framework. The inclusion of a range of financial covenants is a common feature of lending in the UK and Ireland.[24] Continental European lending practices have been

[16] J.F. S. Day and P.J. Taylor, 'The Role of Debt Contracts in UK Corporate Governance' (1998) 2 *Journal of Management and Governance* 171-190.
[17] C. Leuz, D. Deller and M. Stubenrath, 'An International Comparison of Accounting-Based Pay-Out Restrictions in the United States, United Kingdom and Germany' (1998) 28 *Accounting and Business Research* 111; C. Leuz, 'The Role of Accrual Accounting in Restricting Dividends to Shareholders' (1998) 7 *European Accounting Review* 579, 580; C. Leuz and J. Wüstemann, 'The Role of Accounting in the German Financial System' *Centre for Financial Studies* Working Paper No. 2003/16.
[18] A. Kalay, 'Stockholder-Bondholder Conflict and Dividend Constraints' (1982) 10 *Journal of Financial Economics* 211.
[19] Leuz, Deller and Stubenrath, 'An International Comparison', n. 17 supra. The idea that regulation can substitute for covenants is explored in a range of different contexts: e.g. E.L. Black, T.A. Carnes, M. Mosebach and S.E. Moyer, 'Regulatory Monitoring as a Substitute for Debt Covenants' (2004) 37 *Journal of Accounting and Economics* 367 (study examining whether banks substituted regulatory monitoring for covenants by investigating debt issues of 105 banks between 1979 and 1984, a period when monitoring increased).
[20] It is not entirely clear which reserves are required to be regarded as 'undistributable' for this purpose. See n. 73 infra and accompanying text for discussion relating to the classification of share premiums.
[21] Leuz, Deller and Stubenrath, 'An International Comparison', n. 17 supra, 127 are careful to note that they do not suggest there are no differences in the way distributable profits are calculated in each of the countries surveyed because at the in-depth level there are still marked differences.
[22] J. Armour, 'Share Capital and Creditor Protection: Efficient Rules for a Modern Company Law' (2000) 63 *Modern Law Review* 355, 374 – 5.
[23] H. Merkt, 'Creditor Protection and Capital Maintenance from a German Perspective' [2004] *European Business Law Review* 1045, 1053-4.
[24] J. Day, P. Ormrod and P. Taylor, 'Implications for Lending Decisions and Debt Contracting of the Adoption of International Financial Reporting Standards' (2004) 19 (12) *Journal of International Banking Law and Regulation* 475.

less dependent on financial covenants historically but recent reviews indicate a trend towards greater use.[25] This occurrence is attributed to market integration and globalisation pressures that are moving business practices towards Anglo-American models.[26]

British studies indicate that the most common covenants relate to minimum net worth, interest cover and gearing.[27] There has been a recent tendency for covenants to move from primarily balance sheet-based measurements towards the increased use of data from profit and loss accounts and cash flow statements.[28] This trend is consistent with evidence derived from the consultations in the UK that were conducted for the purposes of its review of company law between 1998 and 2000, which found that measures such as cash flow and interest cover were of particular importance to creditors.[29] Available data thus appears to suggest that the financial ratios that figure most in creditors' assessment of the contractual terms on which they are willing to advance credit to companies are rather different from the relationship of net assets to undistributable capital that lies at the heart of the legal capital rules contained in the 2nd Directive.[30] So even if it is true that the payout restriction in Article 15 of the 2nd Directive provides a basic element of the agreement that the parties would have bargained for, thus giving them a foundation on which to build additional terms if they so choose,[31] this foundation appears to be very shallow.[32]

Some studies of the negotiation process associated with determining covenants in the bank loan market in several countries with Anglo-American financing systems indicate that the process can be intensely contentious and that a range of borrower-specific considerations (such as size, internal governance structure, ownership, management reputation and business risk) and contract-specific characteristics (such as term and size of loan) act as determinants of the terms in any particular case.[33]

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[25] Ibid. Historically German banks have tended to rely on contractual provisions giving them the right to ask for further security/collateral or to accelerate the maturity of a loan agreement if the financial condition of the debtor's business worsens substantially. It is consistent with British evidence to suggest that lenders are more relaxed about the degree of covenant protection they look for when their lending is secured: P. Brierley and and M Young, *The financing of smaller quoted companies: a survey* (2004), http://www.bankofengland.co.uk/publications/quarterlybulletin/qb040204.pdf (accessed February 2006).

[26] Day, Ormrod and Taylor, 'Implications for Lending Decisions', n. 24 supra.

[27] D.B. Citron, 'Financial Ratio Covenants in UK Bank Loan Contracts and Accounting Policy Choice' (1992) 22 *Accounting and Business Research* 322-335; D.B. Citron, 'Accounting Measurement Rules in UK Bank Loan Contracts' (1992) 23 *Accounting and Business Research* 21-30; J.F.S. Day and P.J. Taylor, 'Loan Contracting by UK Corporate Borrowers' [1996] *Journal of International Banking Law* 318-325; J.F.S. Day and P.J. Taylor, 'Loan Documentation in the UK Market for Corporate Debt: Current Practice and Future Prospects' [1997] *Journal of International Banking Law* 7-14.

[28] L. Moir and S. Sudarsanam, 'Determinants of Financial Ratio Covenants', n. 13 supra.

[29] P. Davies, *Introduction to Company Law* (Oxford, Clarendon, 2002) 92-3.

[30] In particular, art. 15.

[31] Hertig and Kanda, 'Creditor Protection' n. 3 supra, p. 72.

[32] Part C considers the further divergence between creditors' interests and the legal regime that may result from new trends in accounting.

[33] P. Mather, 'The Determinants of Financial Covenants in Bank-Loan Contracts' (2004) 19 *Journal of International Banking Law and Regulation* 33; J.F.S. Day and P.J. Taylor, 'Evidence on Practices of UK Bankers in Contracting for Medium-Term Debt' (1995) 10 *Journal of International Banking Law* 394; J.F.S. Day and P.J. Taylor, 'Bankers' Perspectives on the Role of Covenants in Debt Contracts' (1996) 11 *Journal of International Banking Law* 201- 205; J.F.S. Day and P.J. Taylor, 'Loan Contracting by U.K. Corporate Borrowers' (1996) 11 *Journal of International Banking Law* 318; J.F.S.

Loan officers have considerable discretion to depart from standard form contracts to suit individual circumstances.[34] So, unlike legal capital rules which provide one rigid, universally applicable model, contractual terms in the bank lending market are not homogenous and can differ from case to case as a result of context-specific considerations. This feature makes it unlikely that contractual provisions will frequently bear close resemblance to the legal model.[35]

US practice relating to dividend restrictions can be used to illustrate further the point that contract-based systems, unlike statutory models, are infinitely adaptable. Whilst the practice of including covenants restricting payouts is common, it is not universal and lending decisions are instead made on a basis that reflects the specific needs of the contracting parties. For example, one study found that firms with high growth opportunities were keen to preserve flexibility and were thus less likely to include covenants restricting dividends in their publicly-issued bond contracts.[36] The authors of this study concluded that their results emphasised that contractual relations between firms and bondholders reflected the specific needs of the contracting parties. Another study found that high-growth companies tended to prefer conversion rights to covenants in their public market bond issues.[37] This finding is consistent with the view that preserving managerial flexibility is of particular importance in sectors where investment opportunities are plentiful. The absence of covenants in bond issues by high-growth firms is also explicable by reference to the difficulties in that context of renegotiating terms that prove unduly restrictive. By way of contrast, studies of privately-negotiated loan agreements indicate that loans made to high-growth firms are more likely to include restrictive covenants than loans made to low-growth firms.[38] This finding is consistent with various studies that establish greater variability in the terms of privately-negotiated debt than in public bond issues where terms tend to be relatively standardised.[39]

Even if, for argument's sake, we assume that legal capital rules have some use as a market-mimicking device for reducing transaction costs, this is not a compelling argument for retaining them as mandatory, rather than optional, rules. A justification for legal capital rules that is based on their function as a transaction cost-reducing mechanism is only plausible where market participants are allowed the flexibility to choose between the ready-made model provided by the law or a contractual model that may cost more to negotiate but which may be cheaper in the long run because of lower interest charges or otherwise more favourable financing terms. Furthermore, for the legal capital regime convincingly to be characterised as facilitative and

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Day and P.J. Taylor, 'Loan Documentation in the Market for U.K. Corporate Debt: Current Practice and Future Prospects' (1997) 12 *Journal of International Banking Law* 7; R.N. Nash, J.M. Netter and A.B. Poulsen, 'Determinants of Contractual Relations Between Shareholders and Bondholders: Investment Opportunities and Restrictive Covenants' (2003) 9 *Journal of Corporate Finance* 201.

[34] Mather, ibid, 36.

[35] L. Enriques and J. Macey, 'Creditors Versus Capital Formation: The Case Against the European Legal Capital Rules' (2001) 86 *Cornell Law Review* 1165, 1193.

[36] Nash, Netter and Poulsen, 'Determinants of Contractual Relations', n. 33 supra.

[37] M. Kahan and D. Yermack, 'Investment Opportunities and the Design of Debt Securities' (1998) 14 *Journal of Law, Economics and Organization* 136.

[38] Bradley and Roberts, 'Are Bond Covenants Priced?', n. 12 supra.

[39] Moir and and Sudarsanam, 'Determinants of Financial Ratio Covenants', n. 13 supra; I. Ramsay and B.K. Sidhu, B K (1998) Accounting and Non-accounting Based Information Market for Debt: Evidence from Australian Private Debt Contracts' (1998) 38 *Accounting and Finance*, 197.

market-mimicking, it would have to be sufficiently flexible to accommodate midstream changes – that is, negotiated departures from the regime where its constraints are no longer appropriate for the business relationship between the debtor company and its creditors.

Why, in any case, should official lawmakers assume that they are the optimal suppliers of standard terms for the debt financing market? Arguably, it would be preferable for the legislature to leave it to market participants, who are directly in touch with market needs, to assume the role of provider of standard lending terms. Where the market is able efficiently to provide its own ready-made solutions to creditor protection concerns, the case for the legislature to step in to do that job is weak. A point of concern about reliance on standard terms supplied by the private sector would be if the courts were able to deny legal effect to such terms, on grounds of fairness or other broad, good faith principles. The English law of contract does not have a general doctrine of good faith so, at least from this perspective, this concern is not substantial.

Legal capital rules impede economically worthwhile transactions and activities.

Mandatory legal capital rules may sometimes add to transaction costs where economically valuable transactions have to be ingeniously structured so as to avoid an intrusive rule.[40]

The ban on companies providing financial assistance for the acquisition of their own shares is often criticised on this ground. Financial assistance law is best seen as an offshoot of the capital maintenance regime because it has only a limited overlap with the idea that a company should maintain its capital. Other legal capital rules that are closer to the core of the doctrine, such as those restricting the return of value to shareholders by means of dividends or share buy-backs except out of distributable reserves, can also be attacked under this heading, as can rigid requirements regulating non-cash consideration for shares. For example the restriction on distributions may be obstructive where it stands in the way of a return of value to shareholders in circumstances where the managers of the company are unable to identify worthwhile new investment opportunities. Concern about the restrictive nature of the distribution rules has recently acquired a particular intensity with the shift to new accounting systems because of warnings that companies could find themselves unable to pay dividends just because the basis for measuring financial performance has changed.[41] Rules excluding undertakings to perform services as an acceptable type of consideration for shares may hinder start-up companies, where the pressures on cash flow are likely to be significant and the prospect of being paid in shares may be distinctly attractive to contractors because of the high growth potential of the business.[42]

The legal, accounting and investment banking industries contain many highly intelligent, creative and determined people, whose ingenuity is unlikely to be defeated for long by legal capital rules that appear to stand in the way of otherwise legitimate and economically valuable activity. It is thus simply not credible to suppose that the

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[40] Hertig and Kanda, 'Creditor Protection', n. 3 supra, pp. 72-3.
[41] See Part C infra.
[42] High Level Group, *A Modern Regulatory Framework*, n. 5 supra, p. 83.

legal capital regime frequently operates as an absolute bar on transactions. As Enriques has noted, even though the ban on financial assistance is often said to be an impediment to leveraged buy-out activity, it has not prevented the development of a significant European LBO market in recent years.[43] The distribution rules that limit companies to returning value to shareholders only to the extent of distributable reserves can often be sidestepped, for example by means of a court-approved reduction of capital,[44] although there are differences between Member States in the extent to which such flexibility is available.[45] Strategies are also available to bypass some of the rules restricting acceptable forms of consideration for shares.[46]

However, there are potentially significant costs involved in securing access to top-quality professional advice and to court sanctions. Transactions may well proceed more slowly than they would have done but for the need to structure them very carefully so as to avoid technical infringements of the legal capital rules. Legal capital rules thus generate transaction-obstructing costs. Are these costs likely to be disproportionate? This depends on the corresponding benefits. If we accept that sophisticated creditors can protect themselves contractually and we are sceptical about the value of the 2nd Directive as a contract-mimicking mechanism, it is hard at this point to see any benefits to set against the transaction-obstructing costs now identified. At this point the debate turns to weaker creditors for whom contractual protection may not be a viable option because they lack the necessary bargaining power, and to involuntary creditors.

Legal capital rules protect involuntary and weak creditors

It is sometimes argued that legal capital rules are needed to protect involuntary creditors and creditors that are technically voluntary but who do not have the bargaining power to protect themselves through covenants, security or similar instruments.[47] However, others question whether the legal capital regime of the 2nd Directive actually does much to protect the interests of these groups.

One strand of debate centres around 'free-riding'. The point is made that weaker creditors can free-ride on the contracts of sophisticated creditors because the benefits of the restrictions on managerial autonomy imposed via contractual covenants will flow through to all creditors: 'even if only one sophisticated creditor has imposed such covenants on a corporate debtor, all of that company's creditors will gain protection from wrongdoing'.[48] One argument against covenants being beneficial in this way is that they can spill over in a negative way by interfering with the interests

[43] L. Enriques, 'EC Company Law Directives and Regulations: How Trivial are They?' ECGI - Law Working Paper No. 39/2005. http://ssrn.com/abstract=730388
[44] Armour, 'Share Capital and Creditor Protection', n. 22 supra, 374.
[45] Lex Column, *Financial Times,* 16 May 2005, p. 16 for example, notes that court-authorised restructurings to create distributable reserves can be difficult in Continental Europe where few precedents exist and courts can be excessively focused on creditors.
[46] J. Rickford (ed), 'Reforming Capital. Report of the Interdisciplinary Group on Capital Maintenance' (2004) 15 *European Business Law Review* 919, 935.
[47] For example, one of the arguments put forward by the Danish authorities in the *Centros* case was that mandatory legal capital requirements protected public creditors against the risk of seeing the public debts owing to them become irrecoverable since, unlike private creditors, they could not secure those debts by means of guarantees: *Centros Ltd v Erhvervs- og Selskabsstyrelsen*, Case C-212/97.
[48] Enriques & Macey, 'Creditors Versus Capital Formation', n. 35 supra, 1172.

of investors that are willing to take risks.[49] Yet, since a competitive marketplace allows providers of credit to shop around for investment opportunities, this objection to covenants does not seem strong. A second argument against covenants being generally beneficial is that overly-restrictive covenants may impede a company's operations to such an extent that its financial position is undermined rather than preserved so that, in an extreme case, its ability to meet its obligations under the loan comes under threat.[50] However, as implied by Smith and Warner's costly contracting hypothesis,[51] there are incentives for both parties to a loan contract to search for an optimal contractual structure that balances the interests of the lender in minimising the risks involved in lending and the borrower's need for sufficient freedom to run its business effectively. That a careful trade-off of the costs and benefits involved in including covenants in loan contracts does occur in practice is borne out by numerous studies.[52]

What is certainly true is that the spill-over benefits for weaker creditors that flow from covenants may sometimes not be significant because the contractual negotiation or creditor monitoring processes have not worked effectively. For example, one analysis of the relationship between banks and major corporate borrowers in the UK during the boom period of the 1980s suggested that severe competition had compelled banks to lend without asking the right questions, an injudicious practice that left them (and therefore also the weaker creditors left trailing in their wake) exposed in the subsequent market downturn. [53] Low levels of monitoring by sophisticated creditors may also stem from a rational policy choice to rely on loan portfolio diversification strategies rather than active monitoring to manage risks.

Furthermore, at the end of the day covenants are designed to protect the individual interests of the creditors who are parties to the relevant contracts rather than the collective interests of all creditors. An individual creditor who is well protected contractually can be expected to pay increasing attention to its own interests as a borrower's financial situation declines but what is in that creditor's interests may diverge sharply from the interests of other, less-protected, creditors. For instance, the individual creditor's interests may be best served by demanding repayment of its loan in accordance with contractual entitlements even though accelerated repayment could provoke a cash flow crisis that acts as the tipping point for the borrower's insolvency. Collective action problems of this sort limit the role of covenants as a form of collective creditor protection.[54]

The 2nd Directive can thus be viewed as an attempt to do something that cannot be achieved contractually: to address the collective interests of creditors and to shield them from opportunistic behaviour. Since it is open to stronger creditors to

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[49] Merkt, 'Creditor Protection', n. 23 supra.

[50] Lister, RJ, 'Debenture Covenants and Corporate Value' (1985) 6 Co Law 209. The lender's commercial reputation may also suffer and in a competitive lending market its ability to attract new business may be undermined: Fischel, DR, 'The Economics of Lender Liability' (1989) 99 *Yale LJ* 131, 138-139.

[51] Smith and Warner, 'On Financial Contracting', n. 11 supra.

[52] See Part B supra.

[53] J. Charkham, *Keeping Good Company* (1995) 298-299.

[54] On collective action problems between creditors see further Armour, 'Share Capital and Creditor Protection', n. 22 supra, 362.

complement the legal framework with contractual provisions, it is weaker creditors that can be expected to benefit most from this collectively-oriented intervention.

Recent literature has picked up the idea of the 2nd Directive as a collective guarantee that cannot easily be replicated contractually to develop a new way of thinking about the legal capital regime. Rather than this being essentially a set of rigid requirements that are imposed by the State in the interests of creditor protection, it is argued that it may be more appropriate to regard it as a kind of 'enabling' or permissive' regime, which is mandatory only to the extent that corporate controllers choose to opt into it.[55] Unlike a contractual covenant, which could be varied, waived or enforced by the contracting creditor without regard to the interests of other creditors, by opting into the regime provided by the general law the controllers of a company are committing themselves to the creditors collectively. Once the 'bargain' is made it cannot be changed except by a process that is sensitive to creditors' collective interests and, if the bargain is not honoured, enforcement will be on a collective basis rather than being driven by individual creditors' preferences. Since this collective guarantee is not something that could easily be achieved contractually, in making this possibility available, the law is adding to the optionality available to the corporate sector regarding the variety of financing structures.

Schőn uses the fact that the vast majority of Europe's publicly traded companies offer an amount of share capital that is far above the required minimum to support the characterisation of the capital maintenance regime as an enabling rule. Corporate financing practice, it is said, makes it clear that there is no general reluctance to enter into collective guarantees relating to capital maintenance.[56]

However, it is questionable whether the levels of equity financing that exist in practice can be taken to indicate that capital maintenance considerations are a driving, or even a particularly significant, factor in companies' decisions to raise equity finance. In practice complex, context-specific considerations affect the determination of corporate capital structures, although certain financial patterns and trends relating to factors such as industry sectors, firms' age and size, and their financial conditions can be discerned. For example, new equity issuance is known to be a response to poor financial performance.[57] One study, by Franks, Mayer and Renneboog, found that of 34 firms that were both below average performers and had high levels of debt, 18, or about 54% of the sample, raised new equity finance.[58] An equity issue is an understandable response to financial difficulties from the trade-off theory of corporate

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[55] Schőn, 'The Future of Legal Capital' (2004) 5 *European Business Organization Law Review* 429, 438 – 442.

Generally, on the classification of some company law rules as 'permissive': rules B.R. Cheffins, *Company Law Theory, Structure and Operation* (Oxford, OUP, 1996) p. 218.

[56] Schőn, ibid, 440. P.O. Mülbert and M. Birke, 'Legal Capital – Is There a Case against the European Legal Capital Rules?' (2002) 3 *European Business Organization Law Review* 695, 716 – 7 refer to casual empiricism suggesting that firms choose legal capital levels that are significiantly higher that the minimum stipulated by the 2nd Directive. They acknowledge that there may be reasons for this other than firms' preference for legal capital rules but conclude that 'it should be a puzzle to those arguing that legal capital rules have no fucntion whatsoever in today's capital markets.'

[57] D. Hillier and P.M.L. McColgan 'Managerial Discipline and Firm Responses to a Decline in Operating Performance', ssrn abstract=650167

[58] J. Franks, C. Mayer and L. Renneboog, 'Who Disciplines Management in Poorly Performing Companies?' (2001) 10 *Journal of Financial Intermediation*, 209–248.

finance (the debt-equity decision being a trade-off between tax shields and the costs of financial distress) because it reduces reliance on debt and lowers the associated costs of financial distress. It is also consistent with the 'pecking order' theory of corporate finance in which equity issues are a last resort because they are associated with higher risks of mispricing resulting from informational asymmetries.[59]

A recent study, conducted for the UK DTI by Paul Myners, focused specifically on the financing needs of small, high technology companies with unpredictable or zero revenues and large cash requirements for research and product development.[60] It noted that such companies had few physical assets to offer as collateral to banks and no credit ratings to access bond markets. They therefore had to come to the public or private equity markets to broaden their capital base. The features of equity that made it an appropriate form of financing for companies in this industry segment were that it was long-term, high-risk financing that offered investors the potential for high returns if projections were met. The reliance on equity by small, high tech industries can also be explained by reference to corporate finance theory in that the costs of financial distress are high in firms with few assets and alternative options are limited.[61]

Despite the considerable work that has been done in understanding corporate finance, financial economists acknowledge that existing theories do not successfully explain all of the different capital structures that occur in practice.[62] Paul Myners concluded in his study: 'different companies, in different sectors, and at different stages of their development, have quite different financing needs and the cost-benefit calculation around the various options can produce quite different answers depending on individual circumstances.' *Brealey and Myers*, one of the leading texts on corporate finance, likewise notes that corporate financing policy varies greatly from industry to industry and from firm to firm.[63] Within individual firms, constraints imposed contractually by their existing financiers will form the boundaries within which new financing choices can be made unless those facilities can be renogotiated.

In the light of such comments and considerations it would seem dangerous to seek to assert strong connections between levels of equity financing and a desire by firms to provide a collective guarantee that capital, once invested, will not be distributed by the company's controllers to shareholders. Other features of equity – such as that it ranks behind debt or cannot be withdrawn at will by individual shareholders - could well matter far more. This paper has earlier discussed the fact that sophisticated creditors do not much value the distribution regime of the 2nd Directive. For obvious reasons there is likely to be a great deal of common ground between what major creditors and the firms with which they deal regard as important. It would thus be oddly inconsistent with the evidence of creditors' views now to regard the ability to offer a 'collective guarantee' as something especially significant amongst the myriad

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59 R.A. Brealey and S.C. Myers, *Principles of Corporate Finance* (Irwin McGraw Hill, 7th edn, 2002), pp. 512 –3.
60 Myners, *Pre-emption Rights: Final Report* (London, DTI, 2005, URN 05/679).
61 Brealey and Myers, *Principles*, n. 59 supra, pp. 512 –3.
62 C. Mayer and O. Sussman, 'A New Test of Capital Structure', Centre for Economic Policy Research Discussion Paper No 4239 (2004) reviews the main existing capital structure theories and reports inadequacies in their ability to describe certain dynamic features of corporate financing.
63 Brealey and Myers, *Principles*, n. 58 supra, pp. 379-80.

range of factors that may be relevant to controllers when they make decisions about their firm's financial structure.

For the sake of argument, however, let us briefly assume that being able to offer a collective guarantee against distributions to shareholders may be a relevant consideration in capital structure decision-making and that legal systems that offer firms this feature are providing them with something that is potentially attractive. This assumption does not point us inexorably towards the conclusion that it is correct to characterise the legal capital regime in the 2nd Directive as permissive. Rather, it remains possible to argue that the 'collective guarantee' against distributions is not in fact truly optional. When a company chooses to issue equity it is opting into the priority rule, whereby the firm's creditors have first claim on its assets ahead of its shareholders. The priority rule is a universal feature of corporate law systems of developed economies and there is no dispute as to its value. Restrictions on distributions, even where creditors' claims can be met in full, are a gloss on this core feature. However, under the capital maintenance regime of the 2nd Directive, opting for the priority rule brings with it the gloss of the distribution restrictions, whether this is wanted or not: the different rules are bundled together. Seen in this way, the regime is hardly 'enabling'. The lack of true optionality is particularly evident in Member States such as the UK and Germany, where, over-implementing the 2nd Directive, share premiums, as well as par value amounts, are undistributable.

At this point we can move on from debating the correct classification of the legal capital regime in the 2nd Directive to consider a more fundamental issue: whether it is best regarded as an immutable or an optional regime matters little if it fails in its substantive objectives. If protection of weaker creditors is identified as an underlying objective of the 2nd Directive, there is good reason to view it as a failure because its crude, poorly-targeted mechanisms fail to perform effectively the function of protecting weaker creditors. [64]

The main collective device that, in the past, was considered to be especially significant in relation to weaker creditors was the requirement for minimum capital but even those who would favour retention of other legal capital rules now acknowledge that a mandatory minimum capital rule serves no substantially useful practical purpose because it is not tailored to the financial needs of specific companies and does nothing to prevent capital being lost in the course of business.[65]

Tort victims are often seen as being in principle the category of creditor that is most deserving of protection from the legal system. However the minimum capital requirement in the 2nd Directive is not aimed at requiring companies to hold sufficient capital to cover potential tort claims. So, even if we assume that the protection of tort victims is a purpose that should be served by company law (though many would argue that regulatory intervention should target hazardous activities through mandatory insurance or licensing requirements rather than focusing on the business form through which that activity is conducted),[66] the 2nd Directive does not perform it effectively.

[64] Mülbert and Birke, 'Legal Capital', n. 56 supra, 715 – 722.
[65] E.g., Schön, 'The Future of Legal Capital, n. 55 supra. M. Miola, 'Legal Capital and Limited Liability Companies: the European Perspective' (2004) 4 *European Company and Financial Law* Review 413, 425 – 7 reviews the arguments against minimum capital.
[66] Mülbert and Birke, 'Legal Capital', n. 56 supra, 725-6.

The distribution and reduction of capital provisions of the 2nd Directive at first sight do appear to offer creditors collectively a guarantee against opportunistic withdrawal of assets by corporate controllers.[67] However, several features of the rules in fact undermine their supposed protective effect in this respect.

First, legal capital rules that restrict distributions to shareholders and reductions of capital may do little to protect weaker creditors because the balance-sheet information on which they rely bears little relation to the company's true financial position.[68] As noted in the Rickford Report, a detailed British study of capital maintenance conducted under the auspices of the British Institute of International and Comparative Law, the amount of the capital fund, which is a historic fact, bears no necessary connection with the company's financial needs on a going concern basis.[69] By focusing on balance sheet information rather than cash flows, the rules leave open the possibility that a company could put itself into a position where it is unable to pay its debts as they fall due because it has distributed all of its cash and readily realisable assets to its shareholders.

Secondly, distribution constraints only ever seek to protect creditors against selected acts potentially damaging to their interests: they focus only on distributions to shareholders and do not protect creditors against losses incurred in the ordinary course of business.[70] Admittedly where, for whatever reason, a company's assets fall to half or less of its subscribed capital, the 2nd Directive requires the calling of a meeting of the shareholders to consider whether the company should be wound up or any other measures taken.[71] Subscribed capital in this context appears to mean only the element of the amount raised through share issues that represents their par value: share premiums are excluded. The exclusion of share premiums means that the obligation to convene a shareholders' meeting is likely only to be triggered in extreme financial circumstances, indeed at a time when the shareholders' investment in the company will usually be already wiped out. Thus this additional rule does not add significantly to creditor protection. Some individual Member States go beyond the 2nd Directive by requiring recapitalisation or liquidation when assets fall below a certain level. 'Recapitalise or liquidate' rules can protect creditors but they are subject to some serious efficiency concerns.[72]

Thirdly, the analysis of share premiums as not being part of the subscribed capital leads into a further limitation on the supposed creditor-protective effect of the 2nd Directive's distribution constraints. The Rickford Report has forcefully made the point that because the 2nd Directive does not require share premiums to be treated as a undistributable reserve, the extent to which the 2nd Directive restricts companies' room for manoeuvre in the making of distributions is actually rather less than might

[67] Principally arts. 15 - 16 (distributions) and arts. 30 – 38 (reductions).
[68] Enriques and Macey, 'Creditors Versus Capital Formation', n. 35 supra, 1190.
[69] Rickford (ed), 'Reforming Capital', n. 46 supra, 938.
[70] Schön, 'The Future of Legal Capital, n. 55 supra, 442 correctly makes the point that it would be wrong entirely to discount the value of legal capital on this ground alone because shielding the company's assets from the shareholders is regarded as one of the essential features of company law.
[71] Art. 17.
[72] Enriques and Macey, 'Creditors Versus Capital Formation', n. 35 supra, 1201-2.

be supposed from a superficial understanding of the provisions.[73] This finding underscores the Report's conclusion that the protective effect of the 2nd Directive's dividend constraints is substantially valueless. Again, it is true that some Member States (including the UK and Germany) 'gold-plate' the Directive by also treating share premiums as undistributable but this practice is not universal across Europe.

This section began by asking whether the capital maintenance regime in the 2nd Directive was worth keeping because it provided collective protection from which weaker creditors would benefit most. Looking at capital maintenance as an enabling regime has been a detour to the extent that it has taken the discussion on to whether the regime increases firms' optionality. We have established that the regime is not truly optional in that it comes as a part of a mandatory legal package when a company chooses to raise equity finance. We have doubted that capital structure decisions by European firms are influenced significantly by the consideration that they can be regarded as providing a collective guarantee against distributions. Such decisions are based on complex balancing exercises between the benefits and costs of different options. Where, for whatever complicated set of reasons, a company decides to raise finance by issuing shares, the capital maintenance doctrine will apply at least to the amount of the finance that is raised that is equivalent to par values and, in some Member States, to the entire amount. At this point then our detour effectively takes us back to where we started: the regime does provide modest collective protection but only against a limited category of value diminishing actions. It does not offer any assurance that cash flow will be maintained at a level that will be adequate to pay debts as they fall due even though evidence suggests that the negative effects of late payment impact disproportionately on smaller creditors.[74]

The thrust of the arguments in this section is that the 2nd Directive provides little meaningful benefit to weaker creditors that can be put on the scales to balance out its costs. This conclusion is further reinforced by the analysis of the impact of recent accounting trends on the 2nd Directive, which follows in Part C of this paper Before moving to that, the remaining part of this section briefly considers some of the subsidiary arguments surrounding the 2nd Directive.

Ex ante rules are preferable to ex post controls

Legal capital rules can be said to be superior to *ex post* protection in the form of personal liability sanctions against directors who engage in conduct that is detrimental to creditors' interests because they apply at the right time, that is before the harm is done, are not exposed to the uncertainties and unpredictabilities of the litigation process (and its high costs), and are more stable. However, the dark side of stability is transaction-impeding rigidity. Moreover, an inelastic legal framework may be unable to stretch to catch opportunistic conduct that is actually within the scope of the mischief targeted by the rules. Divergent preferences for precise *ex ante* rules or open-ended *ex post* standards are sometimes linked to deep-rooted difference in

[73] Compare, however, Mülbert and Birke, 'Legal Capital' n. 56 supra, 704 (arguing that art. 15.1 (c) requires share premiums to be treated as undistributable).
[74] V. Finch, 'Late Payment of Debt: Rethinking the Response' (2005) 18(3) *Insolvency Intelligence* 38 ('Between one-tenth and one-quarter of small business insolvencies have their roots in late payments--many involving the cynical tardiness of large companies in settling accounts with their smaller brethren'); Mülbert and Birke, 'Legal Capital', n. 56 supra, 713.

civilian and common law legal cultures.[75] However, civil law judges may be much more adept at after-the-event moulding of broad concepts to fit new situations than is sometimes assumed. [76] Differences in legal culture alone do not provide a compelling argument for retaining an otherwise discredited legal strategy.

Legal capital rules insulate creditors from liability in insolvency.

The argument here is that a creditor of a company in financial difficulties that has relied on financial covenants to protect its position could have a position of influence that results in it becoming liable in the company's insolvency on the ground that it is somehow responsible for the poor management of the company.[77] At least so far as UK shadow directorship liability for wrongful trading is concerned, it is widely recognised that a lender would have to step outside the parameters of normal lender-borrower relationships to be at risk of being held to be a shadow director.[78] Whilst the view may be different from the Continent, from the British perspective this is not a powerful argument and I will not examine it further.

C. Accounting Trends and the 2nd Directive

The 2nd Directive imposes a mandatory requirement to use a company's annual accounts to measure whether it is able to make distributions without infringing the Article 15 constraint that distributions must not cause net assets to fall below the amount of subscribed capital and undistributable reserves. It is less clear that reference to these accounts is also required for the purposes of measuring the 'earned surplus' or 'retained earnings' limb of Article 15 – that the amount to be distributed may not exceed the total accumulated net profit – but this is the approach adopted in the UK and it has been described as logical to measure both limbs on the same basis. [79] European companies have been accustomed to preparing their annual accounts under a framework established by the 4th Company Law Directive.[80] However, the approach to accounting in Europe is now in a period of significant change.

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[75] Hertig and Kanda, 'Creditor Protection' n. 3 supra, p, 87.
[76] T. Bachner, *After Centros: Creditor Protection in Europe at the Crossroads of Contract, Tort and Company Law* (unpublished draft PhD thesis, on file with author).
[77] Merkt, 'Creditor Protection', n. 23 supra, suggesting that this could be a problem under French or Italian law. See also Miola, 'Legal Capital and Limited Liability Companies', n. 55 supra, 474 and 480.
[78] Case law establishes that for a person to be a 'shadow director', there has to be proof of a pattern of conduct in which the de jure directors of a company were accustomed to act on the instructions or directions of the alleged shadow director: *Secretary of State for Trade and Industry v Becker* [2003] 1 BCLC 555; *Ultraframe Ltd v Fielding* [2005] EWHC 1638 (Ch) especially at [1267] where Lewison J commented that: "In my judgment, where the alleged shadow director is also a creditor of the company, he is entitled to protect his own interests as creditor without necessarily becoming a shadow director. For commentary discussing the position of lenders specifically: Sir P. Millett, 'Shadow Directorship - A Real or Imagined Threat to the Banks' [1991] *Insolvency Practitioner* 14; P. Fidler, 'Banks as Shadow Directors' (1992) 3 *Journal of International Banking Law* 97; D. Turing, 'Lender Liability, Shadow Directors and the Case of Re Hydrodan (Corby) Ltd' (1994) 6 *Journal of International Banking Law* 244; G. Bhattacharyya, 'Shadow Directors and Wrongful Trading Revisited' (1995) 16 *Company Lawyer* 313.
[79] Rickford (ed), 'Reforming Capital', n. 46 supra, 938.
[80] 4th Company Law Directive, EEC/78/660, [1978] OJ L222/11.

Under the framework of the IAS Regulation,[81] listed companies are now required to compile their consolidated financial statements in accordance with International Financial Reporting Standards (IFRS). Individual company accounts, which are the accounts that are the financial basis for the application of the legal capital rules in the 2nd Directive, are not directly affected by this mandatory EU-wide rule. However, by a variety of routes IFRS are likely also to become increasingly significant at the level of individual company accounts for both listed and unlisted companies, although the extent of the trend towards extended use of IFRS may vary between Member States.[82]

The first way in which IFRS may become relevant in relation to individual company accounts is through the option in the IAS Regulation whereby Member States can in their national law permit or require companies to use IFRS in preparing their individual accounts.[83] Luxembourg, the Netherlands, the UK and Norway are among the countries that will allow companies the option of using IFRS in individual accounts; Austria, France, Spain and Sweden are among those that will not permit (or require) this; and Germany occupies a distinctive intermediate position whereby companies will be allowed the option of using IFRS in individual accounts for the purposes of information only but must continue to produce financial statements drawn up in accordance with national accounting rules for the purposes of profit distribution, taxation and financial services supervision.[84] The second route is via ‘bottom up’ convergence whereby national accounting standard setters bring their domestic requirements more closely into line with IFRS. The EU corporate accounting framework for individual accounts in the 4th Directive, which pre-dated IFRS and still applies save to the extent displaced by the IAS Regulation,[85] has recently been updated, the effect being to make that framework more consistent with IFRS and to provide room for national standard-setting bodies to move their domestic regimes further in that direction.[86] However, the pace of convergence towards IFRS in national regimes is likely to vary between Member States. [87]

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[81] Regulation (EC) No 1606/2002 of the European Parliament and of the Council of 19 July 2002 on the application of international accounting standards, OJ [2002] L243/1.
[82] IAS Regulation, art. 5.
[83] IAS Regulation, art. 5.
[84] Data derived from a Commission study on implementation of IAS, published at http://europa.eu.int/comm/internal_market/accounting/docs/ias/ias-use-of-options_en.pdf (accessed May 2005).

Italy offers yet another modification: listed companies will have to draw up accounts under IFRS and non-listed companies will have that option. However, profits arising from the application of fair value accounting cannot be distributed and must be treated as an undistributable reserve.

[85] European Commission, *Comments concerning certain Articles of the Regulation (EC) No 1606/2002 of the European Parliament and of the Council of 19 July 2002 on the application of international accounting standards and the Fourth Council Directive 78/660/EEC of 25 July 1978 and the Seventh Council Directive 83/349/EEC of 13 June 1983 on accounting* (Brussels, November 2003) http://europa.eu.int/comm/internal_market/accounting/docs/ias/200311-comments/ias-200311-comments_en.pdf (accessed May 2005)

Also, Rickford (ed), ‘Reforming Capital’, n. 46 supra, 951 explains (in n. 125) the legal effect of the IAS Regulation as substantially displacing the Accounting Directives (4th and 7th Company Law Directives) as they apply to the form and content of company accounts.

[86] Directive 2001/65/EC of the European Parliament and of the Council amending Directives 78/660/EEC, 83/349/EEC and 86/635/EEC as regards the valuation rules for the annual and consolidated accounts of certain types of companies as well as of banks and other financial institutions, [2001] OJ L283/28 (‘Fair Value’ Directive); Directive of the European Parliament and of the Council amending Council Directives 78/660/EEC, 83/349/EEC, 86/635/EEC and 91/674/EEC on the annual

The High Level Group was clearly aware of arguments to the effect that changes in accounting standards were undermining the legal capital regime in the 2nd Directive. In its Report, the Group noted arguments that accounts were becoming an 'inadequate yardstick' and 'less and less an indicator of the ability of companies to pay their current and future debts'; and, moreover, that 'capital protection based on such accounts is becoming a delusion'.[88] In the period since the High Level Group reported, problems surrounding the operation of the 2nd Directive in conjunction with new accounting systems have moved even further towards the foreground of policy discussion. It is thus appropriate at this juncture to elaborate further on issues surrounding the 2nd Directive and accounting trends, some of which were briefly mentioned by the High Level Group, and to consider their implications.

The issues can be addressed under three headings. First, as discussed in Part B, one strand of the general debate on the 2nd Directive relates to whether it reflects creditors' preferences. Accounting trends are relevant to this line of discussion because IFRS and similar accounting systems are not designed specifically with creditors' interests in mind. Where accounts drawn up under such a system are the relevant accounts for the purpose of measuring the payout constraints in the 2nd Directive, it is possible that the calculations may produce results that are out of line with creditors' preferences, perhaps because they are overly favourable to the borrowing company or are (from a lender's viewpoint) excessively volatile.

Secondly, as Part B indicated, another facet of the debate about the 2nd Directive is whether it blocks economically worthwhile activities or unjustifiably adds to the costs associated with them. There is concern that modern accounting trends on the measurement of profitability could inhibit companies from paying dividends to a greater extent than under older accounting systems. This is potentially troubling because it could result in financially sound companies having to retain value within the business despite the absence of positive investment opportunities rather than returning it to shareholders for investment elsewhere.

The third heading under which to examine accounting trends and the 2nd Directive is that of fundamental incompatibility. This issue is also an undercurrent in the previous two. The degree of divergence between the objectives that underpin IFRS and those that underlie the 2nd Directive creates technical uncertainties but, more significantly, also prompts the question whether the regimes are actually compatible with each other.

Do accounting trends increase the chances of mismatch between the 2nd Directive and creditors' preferences?

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and consolidated accounts of certain types of companies, banks and other financial institutions and insurance undertakings ('Modernisation' Directive).

[87] For discussion of the convergence project at Member State level see, e.g., Accounting Standards Board, *Accounting Standard-setting in a Changing Environment: The Role of the Accounting Standards Board* (London, 2005), http://www.frc.org.uk/asb/technical/projects/project0040.html (accessed, April 2005).

[88] High Level Group, *A Modern Regulatory Framework*, n. 5 supra, p. 79.

The conceptual framework that underpins the IFRS approach is set out in an International Accounting Standards Board (IASB) document entitled *Framework for the Preparation and Presentation of Financial Statements*. The *IASB Framework* is intended to serve as a guide to the Board in developing accounting standards and as a guide to resolving accounting issues that are not addressed directly in standards or interpretative statements.[89] According to the *IASB Framework* the principal classes of users of financial statements are present and potential investors, employees, lenders, suppliers and other trade creditors, customers, governments and their agencies and the general public.[90] The *IASB Framework* concludes that because investors are providers of risk capital to the enterprise, financial statements that meet their needs will also meet most of the general financial information needs of other users.[91] This conclusion, in effect, narrows the conceptual framework down to serving the needs of investors.[92] These needs, according to the *IASB Framework* are for information to help them determine whether they should buy, hold or sell and, in the case of shareholders, to enable them to assess the ability of the enterprise to pay dividends.[93] According to one major Guide to IFRS, this means that the objective of financial statements, therefore, becomes to predict future cash flows.[94] In being primarily driven by the needs of the capital markets, the IASB is now working within a context that is very similar to that developed many years earlier by the US Financial Accounting Standards Board (FASB).[95]

It has been suggested that the IASB's emphasis on the role of accounts as a predictor of cash flows for investment decisions may not in fact meet the needs of the range of users of financial information.[96] Some business groups have voiced concerns to this effect.[97] It is not clear that lenders necessarily will be dissatisfied with accounts drawn up under IFRS. Evidence of increased use of cash flow data in debt covenants[98] suggests that at least to some extent lending practice may be evolving in line with accounting trends. However, the fact that Germany has determined that companies must continue to produce financial statements drawn up in accordance with national accounting rules, rather than IFRS, for the purposes of, inter alia, profit distribution, may be thought to point in the opposite direction and to indicate reservations about the suitability of accounts drawn up under IFRS for creditor protection-related purposes. To the extent that lenders do become increasingly dissatisfied with the quality of the information provided by companies' published financial information that has been drawn up under IFRS or similar sets of accounting standards, it is reasonable to suppose that they will negotiate for alternative contractual protection and will tailor financial covenants so as to require borrowers to operate within constraints that have been drawn up more specifically with creditors'

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89 *IASB Framework*, para. 1.
90 Ibid, para. 9.
91 Ibid, para. 10.
92 Ernst & Young, *International GAAP 2005 –Generally Accepted Accounting Practice under International Financial Reporting Standards* (London, LexisNexis, 2004), p. 100.
93 *IASB Framework*, para. 9 (a).
94 Ernst & Young, *International GAAP 2005*, p. 100 .
95 Ibid, 63 – 130 ('The quest for a conceptual framework') develops this point generally.
96 Ibid, pp. 100-1.
97 Ibid, p. 101 cities efforts by UNICE (a group representing European industry) and Nippon Keidanren (the Japanese Business Foundation) to persuade the IASB to conduct further reseach on the needs of users and preparers of accounts before extending the use of fair value concepts.
98 See Part B supra.

interests in mind. This is, some observers suggest, exactly what has happened in the USA, which is ahead of Europe in having a public accounting system that is oriented towards capital markets' rather than creditors' needs.[99] If European market practice were to follow the US, this would remove the last vestiges of credibility from the argument that the distribution rules in the 2nd Directive are worth retaining because they save lenders from having to make their own tailored provision.

The introduction of the use of fair values illustrates the way in which standard-setters are increasingly intent on providing financial information that is relevant to the needs of investors in capital markets, relevance in this context denoting information that is capable of affecting users' decisions.[100] IAS 39 and the Fair Value Directive allow fair value accounting for certain assets and liabilities, 'fair value' being generally understood to mean 'the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction'.[101] The use of fair value accounting will result in regular changes in values, which generally will be dealt with in the profit and loss account. The Institutes of Chartered Accountants in England and Wales and in Scotland in their [draft] guidance on the implications of the transition to IFRS on the determination of realised profits and losses for British company law have indicated that the evolution of accounting practice in this respect means a broadening of the circumstances in which profits arising from fair value accounting are to be regarded as realised profits.[102] The principles of realisation, say the Institutes, may change over time in accordance with developments in accounting practice.[103]

This is not to say that new accounting trends necessarily will produce results that are more favourable to companies. Advantages that result from broadening the circumstances in which profits are recognised and regarded as realised may be more than off-set by changes in the accounting treatment of losses. That new accounting systems may damage companies' dividend-paying capacity is discussed further shortly. Here it suffices to make the point that to the extent that the new rules lead to the possibility of an improvement in dividend-paying capacity, banks and other lenders will be in a less favourable position. Lenders that are concerned about this erosion in their position could make contractual provision to restore it. If so, this would reinforce the trend for creditors to look to specially-tailored contractual provisions rather than the general law to protect their interests.

Modern accounting trends, such as fair value accounting, make financial statements more transparent, but may also increase the volatility of the balance sheets and

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[99] Leuz, Deller and Stubenrath, 'An International Comparison', n. 17 supra outline modifications to US GAAP that are commonly found in US debt covenants. The authors characterise such modifications as 'conservative'. On the basis of comparative analysis they conclude (at 127) that: 'the number and extent of the modifications are particularly pronounced for those accounting systems that are generally characterised as more investor-orientated and less conservative.' See also, Merkt, 'Creditor Protection', n.23 supra, 1054.

[100] *IASB Framework*, para. 26 provides that 'Information has the quality of relevance when it influences the economic decisions of users by helping them evaluate past, present or future events or confirming, or correcting, their past evaluations.'

[101] IAS 39.9.

[102] TECH 21/05, *Distributable Profits: Implications of IFRS* (Institute of Chartered Accountants in England and Wales, and Institute of Chartered Accountants Scotland, 2005 (draft)), paras. 3.4- 3.5.

[103] Ibid.

reported profits of some companies.[104] The risk of increased volatility is compounded by other elements of the IFRS framework that give directors' discretion with respect to measurement, recognition, disclosure and presentation.[105] There is no doubt that earnings volatility is economically significant,[106] as it is a basis for measuring firm risk.[107] However, if the explanation for increased volatility lies in the way that performance is measured rather than in underlying economic performance, some lenders may conclude that the benefits of increased transparency under IFRS do not offset the uncertainty generated by volatility; if so, this may lead lenders to depart contractually from IFRS measurements so as to create a more stable framework for assessing corporate performance and gauging compliance with covenants.[108]

Although it is early days with IFRS, overall the signs are that accounting trends are indeed likely further to undermine the (already weak) argument that the 2nd Directive is useful as a cost-saving mechanism because it matches creditors' preferences and thus saves them the trouble and cost of contractual bargaining.[109]

Do accounting trends make the 2nd Directive more of an impediment to otherwise legitimate activity?

The reorganisation of the way in which the corporate sector's financial performance is measured and presented has widespread ramifications. It affects prospective lending decisions by banks and other financial institutions and necessitates a review and possible renegotiation of existing covenants to avoid technical defaults.[110] It also impacts on the application of the distribution rules that are part of the legal capital regime in the 2nd Directive. The evidence on whether the adoption of IFRS will depress corporate profits is mixed[111] but there is some evidence that it could have this

[104] DTI, *Fair Value Accounting. A Consultation Document on the Use of Fair Value Accounting for Certain Financial Instruments and Disclosure of Dividends by Companies and Other Undertakings* (URN 03/960, June 2003), para. 3.7

[105] J. Day, P. Ormrod and P. Taylor, 'The Adoption of International Financial Reporting Standards: Implications for Volatility and Uncertainty in Relation to Accounting Earnings and Valuation' (2005) 20 *Journal of International Banking Law and Regulation* 120.

[106] Ibid.

[107] S. Sarkar and F. Zapatero, 'The Trade-off Model with Mean Reverting Earnings: Theory and Empirical Tests' (2003) 113 *Economic Journal* 834.

[108] Day, Ormrod and Taylor, 'The Adoption of International Financial Reporting Standards', n. 105 supra, 127-8; Miola, 'Legal Capital and Limited Liability Companies, n. 55 supra, 469.

[109] J. Rickford, 'Legal Approaches to Restricting Distributions to Shareholders – Balance Sheet Tests and Solvency Tests' (2006, publication forthcoming), makes the point that prudential regulators, including the Basel II Committee and the UK FSA have rejected IFRS as a sound basis for prudential decisions. If they are not suitable for determining the solvency of banks, Rickford argues, this undermines the case for using them as the basis for measuring the prudence of company distributions. The Committee of European Banking Supervisors (CEBS) has produced guidelines on prudential filters in the context of IFRS. The Guidelines were produced in response to fears about the impact of IFRS, including their potential to introduce volatility into institutions' financial statements and regulatory own funds in ways which were not indicative of the economic substance of institutions' financial positions. CEBS analysis of the operation of the Guidelines is that they neutralise the negative impact on credit institutions' regulatory own funds that IAS/IFRS were observed to have at transition: Committee of European Banking Supervisors, *The impact of IAS/IFRS on banks' regulatory capital and main balance sheet items*, 14 February 2006, at http://www.c-ebs.org/press/14022006.pdf (accessed February 2006).

[110] Day, Ormrod and Taylor, 'Implications for Lending Decisions', n. 24 supra, 475 – 486.

[111] Ibid.

effect in certain circumstances.[112] For example, in early 2005 Rentokil plc, a UK listed company, announced that it was to implement a scheme of arrangement to create distributable reserves.[113] The company stated that the scheme was necessary to ensure its ability to pay dividends in the medium and long term because the move to IFRS would result in the level of its distributable reserves being reduced. This was due in particular to IAS 19, which required Rentokil to recognise its pension deficit as a liability.

That a company could have lower profits available for distribution to its shareholders even though its underlying economic position is unchanged is a development that justifies bringing the rules that appear to mandate such a result to the foreground of policy attention.[114] The Commission's Accounting Regulatory Committee has commenced a study specifically to examine the warnings about the impact of IFRS on dividends.[115] This is a very welcome development because it suggests an acceptance of the need for new regulatory policy choices to be evidence-based rather than formed on the impressions of policy-makers who are distant from market practice and of real-life concerns. Should the dire warning about the adverse impact of IFRS on dividends prove to be overstated, the urgency of the case for making reform of the 2nd Directive a policy priority is arguably diminished.[116]

Is there fundamental incompatibility between the 2nd Directive and accounting trends?

The modern approach to accounting, as exemplified by the *IASB Framework*, is oriented towards the needs of the capital markets but the legal capital regime is creditor oriented. This raises concerns about incompatibility and prompts a fundamental question: if the corporate sector is increasingly moving towards a system of accounting that serves the needs of the capital markets rather than creditors, is it not then time to consider breaking the link between accounts and creditor protection and to address creditors' interests, to the extent that it is appropriate to do so within company law, in a more conceptually coherent way? In principle the argument that accounting developments will one day necessitate a re-assessment of the legal capital regime seems unassailable. Whilst some Member States have decided to permit or require companies to continue to use older, national accounting systems for their individual accounts, this approach has the feel of being a stopgap solution that merely postpones the day when issues of incompatibility between the accounting framework and the distribution rules have finally to be confronted, especially in view of the project to converge national accounting systems towards IFRS.

In some respects it is possible to view the transition to IFRS as already effecting a creeping relaxation of the legal capital regime in the 2nd Directive. We have seen this already to the extent that fair value accounting may lead to a more inclusive category of realised profits. However, this line of analysis can be taken further, even to the

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112 Rickford (ed), 'Reforming Capital', n. 46 supra, 958 – 965 (discussing the accounting treatment of pension fund deficits and its impact on distributable profits).

113 http://www.rentokil-initial.com/rentokil-frameset.htm?PHPSESSID=909d52d63d7300418689c6d475ca5d0f (accessed May 2005).

114 *Financial Times* (London), 23rd May 2005, Editorial Comment, p. 16.

115 'Commission to Probe Threat to Dividends from IFRS', *Financial Times*, 23rd May 2005, p. 19.

116 See Part D infra.

point of suggesting that the concept of 'realisation' – which is that dividends can only be paid out of net realised profits – which in Britain at least has long been regarded as a fundamental pillar of the European legal capital regime, falls away under IFRS. At first sight, it is a startling argument that by switching to IFRS as the basis for its individual accounts (which are the accounts that the 2nd Directive requires to be used for the determination of reserves available for distribution) a company could escape the stricture that dividends must come from realised profits. It is therefore worthwhile to consider this argument in some detail.

Article 15.1(c) of the 2nd Directive, which limits distributions to net accumulated profits, does not explicitly refer to profits having to be 'made' or 'realised'. It is only in Article 15.2, which establishes the conditions for the payment of interim dividends, that we find any reference to profits that have been 'made' but the concept is not further elaborated in the Directive.[117] The 4th Company Law Directive provides the elaboration and makes it generally applicable to annual accounts: under Article 31 of the 4th Directive, valuation for the purposes of annual individual accounts must be made on a prudent basis and in particular only profits made at the balance sheet date may be included. [118] The concept of 'prudence', as traditionally understood, means the recognition of profits only when realised but provision for all known liabilities. By way of derogation, Article 33 of the 4th Directive allows for unrealised profits, such as those arising on the revaluation of fixed assets, to be included in accounts but makes it plain that such reserves cannot be distributed until they are actually realised.

It is thus by reading the 4th Directive and the 2nd Directive in conjunction with each other that we arrive at the conclusion that only profits that have been realised can be counted towards distributable reserves.[119] Where a company, in accordance with an option or a requirement under its national law, draws up its individual accounts in accordance with IFRS, national provisions derived from the 4th Directive do not apply to the extent that they are displaced by IFRS.[120] Under the *IASB Framework,* prudence is understood to be 'the inclusion of a degree of caution in the exercise of the judgements needed in making the estimates required under conditions of uncertainty, such that assets or income are not overstated and liabilities or expenses

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[117] When the 2nd Directive was first proposed and adopted, EC law was silent on the method of determining assets and profits and losses and these were thus matters of national law: V. Edwards, *EC Company Law* (Oxford, OUP, 1999) 69.

[118] The 4th Company Law Directive filled some of the gaps but there were still some uncertainties about the concept of realisation that were left to be resolved at national level. For additional guidance in the UK, see TECH 7/03 *Guidance on the Determination of Realised Profits and Losses in the Context of Distributions under Companies Act 1985* (Institute of Chartered Accountants in England and Wales) http://www.icaew.co.uk/index.cfm?AUB=TB2I_49110,MNXI_49110 (accessed June 2005); and most recently, TECH 21/05, *Distributable Profits: Implications of IFRS* (Institute of Chartered Accountants in England and Wales, and Institute of Chartered Accountants Scotland, 2005 (draft)).

[119] Rickford, 'Legal Approaches to Restricting Distributions to Shareholders', n. 109 supra, goes further. He suggests that the interpretation of the 4th Directive outlined in the text may have been an example of British over-implementation and that Article 31 does not have the effect of preventing the distribution of unrealised profits.

[120] European Commission, *Comments concerning certain Articles of the Regulation (EC) No 1606/2002 of the European Parliament and of the Council of 19 July 2002 on the application of international accounting standards and the Fourth Council Directive 78/660/EEC of 25 July 1978 and the Seventh Council Directive 83/349/EEC of 13 June 1983 on accounting* (Brussels, November 2003) http://europa.eu.int/comm/internal_market/accounting/docs/ias/200311-comments/ias-200311-comments_en.pdf (accessed May 2005)

are not understated'. [121] Although 'prudence' is not irrelevant to IFRS accounting, its significance is downgraded.[122] Furthermore, the notion of 'realisation' is not mentioned at all in the *IASB Framework* as a criterion for income recognition. The European Commission has acknowledged that in principle this means that the *IASB Framework* enables the recognition of fair-value based unrealised revaluations as income.[123] Can they then be regarded as counting towards distributable reserves for the purposes of 2nd Directive? The only provision of the 2nd Directive that appears problematic in this respect is Article 15.2 on interim accounts. Article 15.1, which is the principal constraint on payouts, does not on its face seem to require that profits be realised. Thus we appear to arrive at the conclusion that shifting to IFRS could enable a company to escape the requirements for profits to be realised before they can be distributed. To be clear, this does not mean that switching to IFRS will necessarily increase a company's dividend-paying capacity because other elements of the regime could be less favourable. Certainly the thrust of much of recent debate on IFRS has been to the effect that it could impair rather than improve companies' ability to pay dividends. However, it does mean that there could be an improvement, and a corresponding erosion of creditor protection, in some circumstances.

The same analysis can also be applied in relation to the Fair Value Directive. This Directive provides a derogation to the 4th Directive principles and requirements for prudent valuation and in particular recognition only of realised profits so as to enable Member States to permit or require fair value accounting within their national accounting rules. Under national regimes that move in this direction, again the possibility will arise that unrealised profits could count towards distributable reserves for the purposes of the 2nd Directive.

If it is true that European law now allows the possibility of the distribution of profits that have been recognised in accounts drawn up under IFRS without imposing the further requirement that those profits be realised, it would be possible for Member States to reflect the new position in their national law by repealing more restrictive national rules. That would amount to some relaxation of the formal elements of the legal capital regime – though, since the requirement for distributions to come from profits would still remain, companies would not necessarily have more room for manoeuvre because this would depend on an overall accounting assessment of income and liabilities. However, this analysis of the impact of IFRS and similar accounting systems is put forward only tentatively because of unease that a supposed fundamental pillar of creditor protection, namely the requirement for distributable profits to be realised, could be blown away by what feels like a side wind.[124] It may be that, contrary to the argument outlined here, an ingenious legal argument can be devised to support the conclusion that the 2nd Directive does still require profits to be paid only from realised profits even where the relevant accounts have been drawn up under IFRS or a similar national system. On this point, at least, there is a strong case for urgent clarification to remove uncertainty about the new legal environment within

[121] *IASB Framwork,* para. 37 See also Ernst & Young, *International GAAP 2005*, pp. 93-94.
[122] Ernst & Young, *International GAAP 2005*, p. 91.
[123] European Commission, *Examination of the Implications of the new EU-Accounting Regime on Profit Distributions* MARKT/CLEG/F2 and F3/D (20050 4785C.
[124] But for a more trenchant view on misplaced assumptions about the centrality of 'realisation' to the 2nd Directive's regime for limiting distributions, see further Rickford, 'Legal Approaches to Restricting Distributions to Shareholders', n. 109 supra.

which corporate accounts have to be drawn up so that affected parties can make properly-informed choices and also to promote pan-European consistency in the interpretation and application of the legal requirements.

D. A way forward for Europe

Previous parts of this paper have argued that the justification for retaining the 2nd Directive on the ground that it reflects creditors' preferences and thus avoids the need for costly contractual negotiations is weak. Nor does the 2nd Directive appear to justify itself on the basis of providing meaningful protection to weaker creditors who would otherwise be vulnerable to abuse of the corporate form and limited liability. Since there are costs associated with the 2nd Directive, this suggests that the 2nd Directive is not worth keeping because its costs are disproportionate to its benefits.

The evidence presented in this paper suggests that the option of simply dismantling the 2nd Directive merits serious consideration. Repealing the 2nd Directive, putting nothing in its place at EU level and leaving it to Member States to address creditors' interests as they thought fit in national company laws could be vulnerable to the charge that this is liable to promote a race to the bottom in the market for incorporations that has sprung up post-*Centros* and the market for reincorporations that may eventually emerge. However, the deficiencies of the 2nd Directive mean that it is hard to make this charge stick: since the 2nd Directive fails to provide meaningful protection to creditors, its repeal could not easily be characterised as a lowering of standards.

If the option of radical deregulation is a political non-starter, it is important to bring into the discussion an awareness of the costs relative to the benefits that might be associated with abandoning the 2nd Directive and putting something else in its place at EU level. Some adaptation costs are inevitable when a new legal regime is introduced. However, for the purposes of this discussion it is more relevant to focus on the potential ongoing costs of any new regime than on the transitional costs associated with its introduction. Reforming the 2nd Directive would be a largely futile exercise if the new laws also involved disproportionate costs.

European policy-makers are currently considering an optional alternative to the 2nd Directive rather than its outright abandonment in favour of a new approach. This is helpful to the extent that it facilitates market testing: Member States or companies (depending on where the optionality lies) will be able to judge for themselves where the net balance of advantage lies with regard to the costs of compliance with the 2nd Directive or with the optional alternative. However, this strategy also impoverishes the debate about whether, to what extent, or in what way creditors' interests should be addressed within modern European company law. The lack of a full debate is not merely a theoretical concern for two reasons. First, framing the reform debate in a way that potentially excludes some of the fundamental issues could undermine the chances of successful legislative change. It is well-known that legislative processes at EU level are vulnerable to political distortions rooted in national protectionism. Although the Commission's Company Law Action Plan appears to move the Community's orientation in this field towards facilitation rather than protection, it is not clear that this new approach coincides with the views of influential opinion-formers in all Member States. A wide-ranging debate led by the European

Commission could help untangle some of the confusion. It could make EU policy and law-makers better equipped to make rational, conceptually-defensible, evidence-based choices that are in tune with market conditions Secondly, whilst in principle the adoption of an optional alternative to the 2nd Directive would not exclude the possibility of more fundamental change thereafter (including the radical option of not specifically addressing creditors' interests in company law at EU level), it is only realistic to doubt the willingness of EU policy and law-makers to keep returning to this aspect of company law on a regular basis. The possibility of being stuck with an alternative regime that is no better, and possibly even worse, than the 2nd Directive should give pause for thought.

Of course concern about making poor legislative choices would recede if it can be shown that the costs of compliance with the 2nd Directive are so disproportionate as to make any alternative, even an inadequately thought-though one, look like a bargain. It is for this reason that it is especially important, and welcome, that the European Commission and the Accounting Regulatory Committee have decided to focus attention on the costs associated with the transition towards IFRS. But for this consideration, which could certainly tip the balance if the suggestions that IFRS has significant adverse implications for companies' ability to make distributions prove to be well-founded, arguably the 2nd Directive is not so bad as to make any new approach, however imperfect, seem better. In this regard it is pertinent that the High Level Group itself noted that the peculiarities of the European legal capital regime in the 2nd Directive were generally not considered to put European companies at a competitive disadvantage internationally.[125] Although the Group acknowledged the need for further examination of the issues and the significance of the potential problems associated with IFRS may not have been fully appreciated at the time when it reported, the Group's preliminary conclusion tends to support the view that it is correct to doubt the need for reform of the 2nd Directive to be a policy priority.

Some reasons for being sceptical about the case for reform of the 2nd Directive to be a policy priority but for IFRS-related concerns follow.

Regulatory divergence as a policy concern

Some years ago, Hansmann and Kraakman provocatively announced the 'end of history' in corporate law.[126] By this they meant that most of corporate law in developed market jurisdictions had already achieved a high degree of uniformity and that continuing convergence toward a single, standard model was likely. They predicted that the ideological and competitive attractions of convergence would become indisputable, even among legal academics, as equity markets evolved in Europe and throughout the developed world.

Convergence between the company law systems of the US and Europe still seems to have some way to go in the realm of creditor protection, although, as we have seen, debt financiers' reliance on contractual covenants, an aspect of market practice that is well-developed in the UK and Ireland and now growing in importance in Continental

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[125] High Level Group, *A Modern Regulatory Framework*, n. 5 supra, p. 78.

[126] H. Hansmann and R. Kraakman, 'The End of History For Corporate Law' (2001) 89 *Georgetown Law Journal* 439.

Europe, means that the gap is narrower than a glance at company law statute books might appear to suggest. Yet, even if the legal regimes are still some way apart, we can justifiably ask: so what? Merely because the approach in one region is different to that adopted elsewhere does not constitute a sufficient reason to change it. Theories of regulatory competition inform us that there are good reasons for allowing countries and regions to adopt legal requirements that suit their particular needs rather than forcing them into the straitjacket of a single, homogeneous international model. Something more than merely being different is needed to make diversity worthy of policy-makers' attention.

Diversity matters if it results in the delivery of different levels of creditor protection. In a globalised competitive financial marketplace, low-cost capital can be expected to flow to where the interests of its providers are best protected. So if a country or region has inferior standards of creditor protection this may result in its businesses not having access to the capital they need to innovate and grow.

Diversity is a source of complexity. This matters in an international marketplace because understanding unfamiliar foreign laws that look very different to those at home can be costly for internationally mobile providers of capital and they will transmit these costs onto their corporate borrowers, thereby increasing the cost of capital for the corporate sector. Diversity also matters if it means that certain economically worthwhile transactions are possible in some jurisdictions or regions but not in others because of legal impediments or if such transactions are more costly to execute because navigating the legal maze is a more complex task.

Where the general economic well-being of society is losing out because of differences in regulatory strategies, policy-makers need to pay attention.

It is difficult to measure conclusively whether the level of creditor protection is intrinsically higher under one or other strategy.

Merkt has said that it is impossible to estimate accurately whether a standards-based strategy for creditor protection is, viewed holistically, better than a rule-based strategy.[127] He puts forward compelling arguments for why it is difficult to compare the quality of one system against the other: the systems are very different, they work with different legal instruments, and they reflect different underlying deep-rooted assumptions about the role that company law should play in protecting interests other than those of shareholders.

However, not all have been daunted by this task. Law and finance scholars have sought to measure and compare the quality of different legal families and to show linkages between the quality of laws and the size and extent of financial markets. The growing body of data tends to suggest that German-based legal systems provide weaker creditor protections than common law systems and that both rank ahead of French civil law systems in the strength of their creditor rights.[128]

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[127] Merkt, 'Creditor Protection', n. 23 supra, 1052.

[128] R. La Porta, F. Lopez-de-Silanes, A. Shleifer and R.W. Vishny, 'Legal Determinants of External Finance' (1997) 52 *Journal of Finance* 1131. For more recent work building on this foundation, see S. Djankov, C. McLiesh and A. Shleifer, 'Private Credit in 129 Countries', available at SSRN: http: ssrn.com/abstract=637301.

The 2nd Directive is not a stand-alone system so it does not easily lend itself to this sort of measurement anyway

A central problem in trying to measure the value of the 2nd Directive's approach to creditor protection is that it is generally a 'minimum harmonisation' measure. Member States are free to bolster it with additional creditor protection provisions under their domestic law. It does not apply at all to private companies, though Member States are free to extend its approach in their direction. So to see how well a lender to the European corporate sector is protected by the general company law, it is necessary to look at the 2nd Directive, as implemented into the applicable Member State's national law, in combination with additional creditor protection provisions of that national law. The fact that European creditor protection is actually a hybrid of Community and domestic law means that it is fanciful to think of there being some general pan-European level of creditor protection derived from the 2nd Directive that can be compared to the level of creditor protection available elsewhere. Thus, even if reservations about the persuasiveness of comparative, quantitative assessments of the quality of different legal systems are put on one side, one is still left with the conclusion that this would be a meaningless exercise to attempt in relation to the 2nd Directive because of the way in which it actually operates. Its effect is obscured by too many other variables from which it would be impossible to disentangle it.

Notwithstanding diversity in the legal strategies, the degree of functional convergence in the overall level of creditor protection in major market economies may be significant.

Studies suggest that in broad terms the demands of the European corporate sector for debt finance are being met. To the extent that quality of law and market growth are interlinked, it is possible to draw from this the modest conclusion that the European approach to creditor protection is not a complete turn-off: the environment is not so unattractive as to lead lenders to direct their capital elsewhere into markets where they feel that their interests are more protected. However, this much established, one then has to face the harsh reality that the attractiveness of the European corporate sector to potential debt financiers may actually have little to do with the applicable general legal regime, of which the 2nd Directive is a significant element.

Hertig and Kanda doubt whether creditors are significantly better off in some jurisdictions than in others.[129] One reason they give for this is that creditors in major jurisdictions rely more on contract and market institutions for their protection than they do on legal strategies.[130] From this perspective differences in legal strategies thus recede in importance because contractual and market mechanisms lead to, in effect, functional convergence. The arguments presented in this paper are consistent with this analysis. From a creditor-oriented perspective, the 2nd Directive looks very much like a curious relic with little remaining contemporary relevance; as such, its continued existence may be of no more than marginal interest.

[129] Hertig and Kanda, 'Creditor Protection' n. 3 supra, p. 98.
[130] Ibid.

Why diversity matters in this context.

The reason why diversity may matter in this context, and therefore why policy-makers should pay attention to it, is thus not because the European approach embodied in the 2nd Directive comes out poorly in some abstract measurement of its intrinsic quality. Rather, the problems with the 2nd Directive lie in the costs associated with complying with it. The urgency of the case for reform is thus intimately entwined with the magnitude of those costs as compared to its benefits and also the costs that may be associated with any other regime.

E. The current reform agenda: brief reflections

There is scope for national governments to look again at their implementation of the 2nd Directive so as to remove requirements that over-implement or 'gold-plate' the Directive. The treatment of share premiums under English and German national company laws is a case in point. So too is the extension to private companies of the ban on the giving of financial assistance, something which will finally be eradicated from English law by the Company Law Reform Bill published in March 2005. If it is correct to say that the 2nd Directive does not in fact require profits to be realised, national laws to that effect could be repealed. Those steps taken, one might then conclude that the prudent stance is to relegate reform of the 2nd Directive more to the sidelines of policy concern until the company policy- and law-makers at EU level are better-equipped to make rational, conceptually-defensible, evidence-based choices and at responding to market developments.[131] The European corporate debt market has flourished notwithstanding the 2nd Directive and, whilst there are costs associated with it, it should not be overlooked that what might replace or serve as an alternative to the 2nd Directive could be even more costly.

Despite this conclusion there would be a gap in this paper if it did not comment briefly on the proposal that has been made for an alternative regime to the 2nd Directive, which is to deliver levels of protection at least as good as those of the 2nd Directive. There is undoubtedly a momentum behind the case for reform of the 2nd Directive. The Simpler Legislation for the Single Market project on the 2nd Directive led the way. The fact that the ECJ in its famous *Centros* decision[132] saw no unique value in legal capital rules as a creditor protection device added ballast, as did the powerful support of the High Level Group.

An alternative regime based on solvency

The core element of the proposed new alternative regime is a solvency test for any payment of dividends or other distributions. This is an attractive idea in principle. In efficiency-oriented systems of company law around the world, it is increasingly recognised that the maintenance of the balance between creditors and shareholders

[131] The propensity of legal systems to innovate has been suggested as a basis for assessing the quality of corporate law: K. Pistor, Y. Keinan, J. Kleinheisterkamp and M.D. West, 'Innovation in Corporate Law' (2003) 31 *Journal of Comparative Economics* 676.

[132] *Centros Ltd v Erhvervs- og Selskabsstyrelsen*. Case C-212/97. The pro-freedom of establishment approach established in this breakthrough decision has been followed in a number of subsequent ECJ decisions: *Überseering BV v Nordic Construction Company Baumanagement GmbH (NCC).* Case C-208/00; *Kamer van Koophandel en Fabrieken voor Amsterdam v. Inspire Art Ltd.* Case 167/01.

requires that company law should at least give effect to the basic bargain that creditors make when they lend to companies, namely, that their interests should rank ahead of those of equity providers. This minimum is achieved by a solvency rule. An EU-wide rule that has a prohibition on solvency-threatening distributions at its core would bring the EU into line with the trend in other industrialised economies and thus would enable the EU corporate sector to reap benefits flowing from international legal consistency. Such a rule could be expressed in a precise way so as to minimise the scope for interpretative variations between Member States. This might imply a case for its legal form to be by way of a directly-applicable Regulation.

The High Level Group suggested that the solvency test should be determined by reference both to liquidity and also balance sheet measurements. This is an aspect of the debate that needs to be further discussed. One concern is that a balance sheet test might import into the alternative regime the same kind of incompatibility problems between accounting systems and creditors' interests that are now afflicting the 2nd Directive.

Should the new European model extend beyond this into the complex territory of unwinding dispositions and directors' liabilities? This, arguably, is where real difficulties arise, certainly if what is being contemplated is anything more specific than generally-worded provisions requiring Member States to bolster EU rules with domestic civil law sanctions.[133]

Consider, for instance, the question of unwinding a distribution to shareholders that has been made in breach of solvency requirements. Setting out exactly how such a mechanism would work would require the lawmaker to work carefully through a range of complex issues arising from company law, property law, contract and restitution before arriving at a statutory code. This would be a hard enough challenge for a national lawmaker working entirely within the confines of its domestic law. It would surely be nigh on impossible to draw up a detailed EU-wide mechanism that could be made to work effectively within 25 different national legal systems. Something worded in very general terms is all that is practically feasible. The current Article 16 of the 2nd Directive, which provides for the return of unlawful distributions by shareholders who know of the irregularity or could not in the circumstances have been unaware of it, indicates what might be done. However, at least in English law the statutory provision that implements Article 16 has proved to be a less effective mechanism for the recovery of unlawful dividends than case law-based equitable principles that run alongside it. This example can perhaps be viewed as illustrating the wisdom of leaving it to Member States to determine within the parameters of their domestic law the most effective sanctions for breach of EU rules.

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[133] For example, Prospectus Directive (2003/71/EC) art. 6.2 which requires declarations as to the accuracy of prospectus information to be underpinned by the Member States' civil law. Article 10 EC requires Member States to take all measures necessary to guarantee the application and effectiveness of Community law. Where the choice of penalties remains within their discretion, they must ensure that infringements of Community law are penalised in conditions, both procedural and substantive, which are analogous to those applicable to infringements of national law of a similar nature and importance and which make the penalty effective, proportionate and dissuasive: Case 68/88 *Commission* v *Greece* [1989] ECR 2965, paragraphs 23 and 24; Case C-326/88 *Hansen* [1990] ECR I-2911, paragraph 17; Case C-36/94 *Siesse* [1995] ECR I-3573, paragraph 20, and Case C-177/95 *Ebony Maritime and Loten Navigation* [1997] ECR I-1111, paragraph 35.

With regard to sanctions more generally, an idea that is gaining ground in policy circles is that an EU-wide wrongful trading regime is a desirable element of creditor protection. It is premature to speculate on how such a provision might be worded save to say that in order to achieve its desired effect it would need to contain quite general language requiring directors to refrain from conduct that is harmful to creditors' interests. Difficult issues, such as the point in time from which potential liability should start to run, the standard of liability, the measure of recovery, the range of potential claimants, and the scope for contribution between defaulting directors, would all need to be addressed but in a manner that left room for the standard to remain flexible and capable of adapting to changing circumstances.

There is good reason to be cautious about placing much faith in generally-worded standards as a technique for effective EU-wide lawmaking. EU laws are liable to be implemented into national laws in different ways and thereafter interpreted and applied differently because they are seen through different cultural lenses in each Member State. This can happen even with rules that leave relatively little room for uncertainty because they are drafted in a quite precise form. For example, one study of the application of the financial assistance provision in the 2nd Directive across Europe indicated widely diverging approaches to implementation and enforcement.[134] The Rickford Report provides another example by highlighting differences in Member States' approach to the regulation of share premiums. A later paper by Jonath Rickford highlights the way in which accounting trends have increased the variety of bases for determining whether the balance sheet test is met, with very diverse results in terms of the impact on the financing capacity of companies.[135] The risk of regulatory divergence is magnified where the rules that national authorities are called upon to interpret and apply have been deliberately designed as open-textured measures that can be moulded to fit a wide range of circumstances.

Experience in the securities field reinforces the concern that generally-worded EU wide rules are likely to fail to achieve the desired effect. The new Prospectus Directive and the secondary Prospectus Regulation together impose a regime on prospectus content requirements that is very detailed and which does not allow deviation by Member States. The shift to this 'maximum harmonisation' approach was driven by the perceived failings of the predecessor regime, prominent amongst which were the varying interpretations of the law across Europe.

Divergence in national practice is sometimes used as an argument against retention of the 2nd Directive on the ground that this calls into question the value of harmonisation.[136] This is a good argument but it has also to be applied to whatever might replace the 2nd Directive or serve as an alternative to it. An open-textured wrongful trading regime would be received into the pre-established legal system of each Member State and the legal practitioners, judges and academics there could not help but be influenced by the techniques and approaches of their local legal environment in how they interpret and apply it.[137] Until these aspects of national legal culture have converged to a point where a reasonably consistent approach is likely,

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[134] E Wymeersch, 'Art 23 of the Second Company Law Directive' in J. Basedow and others (eds) *Festschrift für Ulrich Drobnig* (Hamburg 1999). Wymeersch.
[135] Rickford, 'Legal Approaches to Restricting Distributions to Shareholders', n. 109 supra.
[136] Rickford (ed), 'Reforming Capital', n. 46 supra, 927.
[137] T. Bachner, *After Centros*, n 76 supra.

the reality of harmonisation would fall far short of its appearance. As such, this prompts the question: why bother? Might it not be more straightforward, clearer and more in line with reality simply to require Member States to apply an appropriate range of sanctions to support a solvency-based regime and leave it to Member States themselves to fill in the details?

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