SHARE CAPITAL AND CREDITOR PROTECTION: EFFICIENT RULES FOR A MODERN COMPANY LAW?

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Abstract

This paper examines the economic case for rules of company law which regulate the raising and maintenance of share capital by companies. The enquiry has practical relevance because the content of company law is currently under review, and the rules relating to share capital have been singled out for particular attention. The existing rules apply to all companies and are commonly rationalised as a means of protecting corporate creditors. The paper asks whether such rules can be understood as an efficient response to failure(s) in markets for corporate credit. It argues that whilst the current rules are unlikely to enhance the efficiency of the markets which they regulate, a tentative case may be made for a framework in which companies 'opt in' to rules which restrict dealings in share capital.

Keywords: corporate law, default rules, creditor protection, share capital

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1. Introduction

The recent *Strategic Framework* paper published by the Company Law Review's Steering Committee is, to an extent that is striking, suffused with the normative language of welfare economics. The paper expresses a commitment to 'competitiveness' and 'efficiency', the latter defined as 'maximum output and contribution to prosperity at minimum cost' [DTI (1999: 8)]. It goes on to promise reforms which will 'maximise wealth and welfare as a whole' (p.9). This approach seems to offer answers to a number of troublesome normative questions. Lawyers may, however, be forgiven for questioning the ease with which these answers will be given.

One such troublesome question is the extent to which creditors should be provided with general protection by company law. The idea that creditors require some form of protection against the abuse of limited liability is almost ubiquitous, and is used to explain a wide range of corporate and insolvency law doctrines. Yet a norm of 'creditor protection' *per se* is inadequate to delineate the *extent* to which such rules are required. Such a norm could be used to rationalise any rule that tends to protect creditors—regardless of the consequences for other groups, or the economy more generally.[1] Economic efficiency seems to offer answers to such questions through the reduction of all social costs and benefits to one calculus. Applied to this particular question, it would assert that the law should protect creditors only insofar as the social benefits of such protection exceed the social costs.[2]

The rules of company law that relate to share capital are commonly rationalised as being an attempt to protect corporate creditors.[3] This area of law has been identified by the Steering Committee as a 'key issue' for reform [DTI (1998a: 6), (1999: 81-91)]. The relevant

provisions are generally thought to be unduly complex,[4] and to lack coherence.[5] Some have argued that their very existence is unjustified [Manning (1981); Cheffins (1997: 528-533)]. These rules therefore provide a good subject for an experimental application of the *Strategic Framework*'s evaluative methodology. This paper therefore addresses the following question: can economic efficiency tell us the appropriate extent to which such rules should seek to protect creditors?

2. The goals of a modern company law

The *Strategic Framework* paper sets out 'guiding principles' for the reform of company law [DTI (1999: 15-17)]. The first of these is entitled 'facilitation of transactions', and intones that a key role for law in the corporate arena is the support and enhancement of market-led contractual solutions. The Review adopts a 'presumption against prescription', suggesting that the merit of regulation must henceforth be demonstrated in terms of its 'costs and benefits' (p.12). The second guiding principle is entitled 'accessibility: ease of use and identification of the law'. Its aim is that the law should entail, 'minimum complexity and maximum accessibility.' The third guiding principle suggests that the allocation of responsibility for enforcement of a particular rule be chosen with sensitivity (p.17).[6]

The guiding principles are presumably intended to provide a basic methodology for the assessment of current company law and the development of reforms. The first of these principles seems to be the most fundamental. It is concerned with the justification of the very *existence* of legal rules in a particular context, whilst the second and third are concerned with their *form*. The *Strategic Framework* document contemplates that the 'presumption against prescription' may be rebutted by showing that:

> 'markets and informal pressures combined with transparency cannot be expected to work; this may happen because the

participants lack the market power, skill or resources to contract effectively' [DTI (1999: 17)].

Working under the guidance of this principle, it would seem that an analysis of the (dys)functioning of markets is called for, and the ways in which state intervention through the corporate law system might enhance them. A rebuttal of the presumption necessitates a dual finding: that market transactions in some way be inadequate, *and that legal rules can reduce their failings*. If and only if such analysis demonstrates a role for law, then the second and third guiding principles come into play: the presentation of legal rules should be as simple as is possible to achieve their stated objective, and responsibility for their enforcement should be allocated accordingly.

The first guiding principle begs a further question: on what basis is the 'adequacy' of a market to be measured? A standard technique employed by economists is to compare the system under consideration with an environment of 'perfect competition'. In the context of corporate creditors, we might begin by imagining a world of perfect capital markets, in which *inter alia* all parties have perfect information and contracting is costless [Modigliani and Miller (1958)].[7] Under these conditions, creditors need no legal protection, because their contracts will provide them with interest rate returns perfectly correlated to the risks that they bear. Moreover, shareholders could never benefit at creditors' expense by undercapitalising a company. A world of perfect capital markets is of course not the real world.[8] Yet as a thought-experiment it is a useful means of identifying the weaknesses of contracting in *real* markets. State intervention—in the form of legal rules or otherwise—may be able to help parties to overcome these 'market failures'.

A well-known problem with an argument for intervention of the foregoing form is that it implicitly assumes 'perfect regulation' in the same way as the market benchmark assumes perfect competition. A critic voicing this objection would assert that simply to diagnose that

markets do not meet a hypothetical standard of perfection is insufficient to justify prescribing legal intervention as the remedy. The critic would demand that it be demonstrated that a real market, with the addition of the proposed rule, would be superior to such a market left to its own devices [see, e.g., Stigler (1975: 103-113)].[9]

Such a critique carries its own difficulties, principal amongst which is the location of the burden of proof. Where empirical evidence is inconclusive, the burden of proof assumes undue importance, and such arguments can lead to reflex advocacy of unregulated markets.[10] Surely, if a law cannot be shown to advance or detract from the efficiency of a market environment without the law, then we have reached the operational limits of an efficiency norm?[11] In such circumstances, it would seem that other lights must be followed. One of the questions pursued in this paper will therefore be the extent to which such operational difficulties are likely to inhibit the Review.

3. (When) Might law assist in facilitating transactions with corporate creditors?

As we have seen, in an environment of perfectly competitive capital markets, creditors would require no legal protection. The next step in the analysis is to consider the factors which detract from the perfection of real markets for corporate credit, and to ask—at a fairly high level of abstraction—whether general legal 'protection' of corporate creditors *might* be able to advance efficiency. This section surveys a number of problems for real-world contracting, and their potential for amelioration by legal rules.

3.1. 'Creditors' who do not contract

The problem of 'involuntary' creditors is by now well-known [see Halpern *et al* (1980: 144-147); Easterbrook and Fischel (1985: 107-108); Hansmann and Kraakman (1991); Leebron (1991); Pettet (1995: 152-157); Cheffins (1997: 506); Goddard (1998: 32-40)]. The basic

idea is that since these parties are unable to adjust the terms on which credit is extended, shareholders may be able to profit at their expense by, for example, undercapitalising a firm or its subsidiaries. The implications for efficiency depend not on the involuntary nature of the obligation, but on the economic rationale behind imposing it on the firm. One such basis is the control of externalities. At its simplest, the idea of an 'externality' encompasses any welfare effect felt by one party as a result of another actor's production or consumption decisions that is not mediated via the price system.[12] Economic actors can be encouraged by the state to 'internalise' the social cost by awarding liability claims to those affected by their activities.[13] However, the incentives are dulled where a firm's assets are worth less than the expected value of an obligation which might be imposed upon it by tort or environmental law, and its managers will maximise shareholder value by reducing expenditure on precaution against causing harm [Hansmann and Kraakman (1991: 1882-1884)]. Limited liability readily facilitates such 'judgment proofing' : each hazardous activity is simply carried on by a separate company, with limited assets, and the costs of any harm it generates are thereby insulated from all other assets.[14] It may be that general rules designed to prevent such 'judgment proofing' and thereby protect 'involuntary' creditors might enhance efficiency.

3.2. Market power

The *Strategic Framework* document alludes to the problems caused for contracting parties by market power [DTI (1999: 15)]. Where one party has market power, the other has limited freedom in contracting. Wealth will be systematically transferred to the 'stronger' party. Furthermore, the terms of trade will not be efficient—a monopolist, for example, will tend to under-produce. Some creditors may enjoy a degree of market power—for example, banks are commonly alleged to be in such a position vis-à-vis small firms. However, in other cases, a firm enjoys market power as against some of its creditors: e.g. trade suppliers, who rely on a firm for a large proportion of their business.

And in many cases, there will be no market power either way. Hence it seems unlikely that the regulation of market power in credit markets would be an appropriate objective for general company law rules.[15]

3.3. Precontractual information asymmetries

One pervasive imperfection of real credit markets is thought to be the asymmetric distribution of information. This can give a party with superior information an opportunity to redistribute wealth from a less-informed party to themselves. Unless it is costless to acquire information about borrowers, there will be a class of creditors who remain 'rationally ignorant' of relevant information. Such creditors will under-price some loans, but we would expect the costs of this to be passed on to other borrowers through pricing according to *average* borrower risk. However, this will make the rate seem unattractively high to borrowers with good financial prospects [Akerlof (1970)].[16] An 'adverse selection' effect will be generated if the result is that these borrowers decide not to enter the market for loans. The only borrowers who remain will be those with poor financial prospects.

These problems may be mitigated by market-based mechanisms, such as 'signalling'. A signal is something that a high-quality party can do cheaply, but is costly for a low quality party to do.[17] Hence signalling behaviour can convey positive information to uninformed parties. Borrowers with good financial prospects have an incentive to signal this where the costs of signalling are less than the difference in price that they can secure as a result. Legal rules may also have a role to play: the law relating to fraud and misrepresentation is one instance. An example specific to the market for corporate loans is the mandatory disclosure of financial information, coupled with scrutiny by an independent third party. This will tend to lower the cost of acquiring information about potential borrowers, thus reducing the size of the category of 'rationally ignorant' creditors. Whether or not rules mandating disclosure are efficient is a different question, however. For this to be the case, it must be shown that the social

savings in information costs are greater than the total costs of compliance with the provisions [Cheffins (1997: 512-521)].

3.4. Incomplete contracts and postcontractual opportunism

Economists use the notion of a 'complete' contract to denote one which describes every possible contingency which is relevant to the performance of the contract, and specifies what parties must do under each circumstance so as to maximise their joint returns.[18] Real contracts are incomplete because specification of contingencies is costly,[19] and beyond a certain point the costs of specification outweigh the expected benefits.[20] Similarly, where one party is better informed about the circumstances relevant to his performance, and it is costly for the other party to observe what has happened or been done—or to verify this information to a third party such as a court—it may not be worth parties' while to include terms which depend on that information [Schwartz (1992), (1998a)]. Contractual incompleteness and postcontractual information asymmetries can be exploited opportunistically by one party taking actions that favour him and impose a cost on the other party.

In the context of corporate credit markets, the managers of debtor firms are likely to know more than creditors and courts about the circumstances relevant to their business. There are also a number of activities in which such managers may engage which enhance the interests of shareholders at the expense of creditors.[21] A classic example is the so-called 'asset substitution' problem. If creditors are able to price loans accurately on the basis of the riskiness of a borrower's business projects, then shareholders may benefit at creditors' expense by subsequently switching to higher-risk projects with the possibility of higher returns. This increases what shareholders can expect to gain if the project succeeds, but—because of limited liability—does not affect what they stand to lose if it fails.[22] Conversely, its only effect on creditors' interests is to increase their losses if the project fails [Jensen and Meckling (1976: 333-343)].

This sort of activity may result in net social losses. First, debtors' investment decisions may be skewed: they may choose projects on the basis of their potential for transferring wealth from creditors, rather than their potential to generate new wealth. Second, the supply of credit may become restricted. As the creditors' perceived risks increase, the necessary risk premium required to compensate them in advance rises sharply. Lenders would start to ration credit beyond a certain level of risk,[23] with less aggregate credit being offered in the market for corporate loans. If companies have restricted access to equity finance, then this would lead to a social cost: good business projects would go unfunded.[24]

It is therefore rational for the parties to spend money writing contractual prohibitions on wealth-reducing activities, coupled with monitoring by the creditor to observe the borrower's actions. As well as the all-important terms relating to duration and repayment, lenders in fact frequently contract for 'loan covenants' that impose restraints on the borrower's investment and financing policies [Citron (1992), (1995); Day and Taylor (1995), (1996)]. Economists suggest that these can be explained as the parties' best efforts to reduce the costs of lender-borrower conflicts of interest, or agency costs [see, e.g., Smith and Warner (1979)]. This is supported by studies of loan covenants that show that they tend to be most prevalent—and restrictive—in lending relationships where the expected costs of such opportunism are highest.[25] The losses which are still incurred, notwithstanding parties' efforts, are sometimes referred to as 'financial agency costs' [e.g. Triantis (1994: 2158)].

The ability of parties to neutralise financial agency costs by contract will depend on a variety of factors. One is the cost of contractual specification.[26] It is obviously impossible to specify in advance all the actions to be taken under all possible contingencies [Baird and Jackson (1985: 838)]. Given this difficulty, there is a risk not only that prohibitions will be under-inclusive, but also that they may be

inadvertently over-inclusive. Hence managers may find that the firm is precluded from taking steps which would have been efficient under the circumstances that eventuate.[27]

It might be thought that statutory rules could assist parties in reducing the costs of contractual specification. The state could supply 'terms' to the parties' bargains. Since the state need only write the terms once, this could generate considerable savings if it gives parties better-specified contracts. A fundamental problem for this idea is that 'terms' may end up being *imposed* on parties, which restrict their activities in an unproductive way. Valuable business opportunities might be missed as a result. Hence a strong normative theme in the law-and-economics literature is that the state should supply 'default' rather than 'mandatory' rules, the former applying only insofar as the parties have not specified otherwise.

One way in which default rules can be supplied is through the provision of 'off the rack' terms which apply in a particular context unless parties specify otherwise [Easterbrook and Fischel (1991: 15)]. The problem for the state in supplying general default rules into *creditor* contracts is twofold. First, creditors are heterogeneous in their preferences. They have differing time horizons and risk/return structures depending on their priority.[28] Hence it is unlikely that a single term will cater for them all, or even for a majority. Second, it will be expensive for parties to 'contract out' if an implied term is inappropriate. To see this, imagine that a particular default covenant is implied into the terms of corporate loans, e.g. that the debtor company shall not substantially change its line of business. If the rule is inappropriately restrictive for a firm, then it will need to persuade each and every creditor to 'waive' the term. Since creditors are a continually changing group, this will prove expensive. The *a priori* case for the supply by the state of such default rules therefore seems weak.

3.5. Collective action problems

A typical firm will borrow from numerous creditors. This may give rise to 'collective action' problems, whereby the individually-rational behaviour of creditors is inconsistent with their interests as a group. These can further reduce the ability of private contracting to neutralise financial agency costs. Two well-known examples will give a flavour of the issues.

The first is the so-called 'free rider' problem, which may be illustrated in the context of monitoring expenditure [Levmore (1982: 53-54)]. If one creditor expends money to observe what the debtor firm does, then others might save money by observing simply what that creditor does, rather than the debtor itself. Hence total investment in monitoring will be less than would be justified by the benefits it would bring to the creditors as a group. This is because each creditor captures only part of the benefits of his expenditure, but bears the entire cost. Smaller firms tend to raise a large part of their external finance from only one creditor, usually a bank, which will reduce this problem. However the frequent use of 'cross-default' clauses, which define 'default' to include a breach of any other loan covenant, suggest that creditors of larger firms may indeed attempt to free-ride off each other's monitoring activities [see Day and Taylor (1996: 323); Wood (1996: 52)].

A second variety of collective action problem is so-called 'hold out' behaviour, which can be illustrated by reference to renegotiation of loan covenants. It may be that renegotiation is in the interests of the creditors as a group, but because each creditor has a discrete contract with the firm, unanimous consent will be required. Some creditors may demand a payment, greater than their share of the collective benefits from renegotiation, simply as the price of their consent [Roe (1987: 236-239)]. For a solvent firm, the threat to withhold consent is not credible, because the creditor can simply be paid off.[29] Yet where the firm is unable to do so, the resulting costs can be so significant as

to put creditors into a 'prisoners' dilemma' situation, forcing liquidation even where this is not warranted [Jackson (1986)]. These costs may justify some form of collective procedure – whether as to the voting to ratify a change in terms, or the staying of creditors' individual enforcement efforts against the firm – or both.[30]

The free rider effect is likely to be pervasive in creditors' interactions with a debtor firm. It will apply not just to monitoring, but also to expenditure on contractual specification. It may strengthen the arguments for legal rules designed to assist parties in overcoming these underlying contracting costs. The hold-out problem is of a much greater order of magnitude, but only becomes relevant when a firm is unable to repay its creditors. It may justify legal regulation designed to create collective procedures for the resolution of financial distress.

4. The Legal Framework of Share Capital Regulation

The term 'share capital' refers to the long-term investment made in a company by its shareholders. The relevant statutory provisions are structured in two tiers. At a basic level are rules which are applicable to all companies, and which originate in nineteenth-century case law.[31] Superimposed on these is a set of more restrictive provisions derived from the Second EC Directive on Company Law.[32] This second tier of rules applies only to public companies, leaving the basic regime largely untouched in respect of private companies.[33] Three different types of rule will be discussed in this section:[34] (i) those which govern the manner in which capital is raised; (ii) the doctrine of 'capital maintenance', which restricts its depletion; and (iii) certain 'threshold' requirements dealing with the level of capital in respect of public companies.[35]

Two preliminary observations should be made. The first is that this section follows the discussion of share capital in the *Strategic Framework* in focusing on the 'creditor protection' aspect of these rules. Whilst some of the provisions applicable to share capital have at

various times been rationalised as protecting the interests of shareholders,[36] or even the general public,[37] such matters are beyond the scope of the current enquiry.[38] The second is that the provisions discussed in this section give rise to two parallel, but distinct, versions of 'capital maintenance'. As will be seen, the key to the distinction lies in what it is that is being 'maintained': net assets, or the subordination of the shareholders' claim?

4.1. Raising capital

A number of rules apply to transactions whereby a company raises capital by allotting shares. The basic common law rule, now reflected in section 100 of the Companies Act 1985, is that shares may not be issued at a discount to their par value.[39] The 'par value' is a notional capital amount associated with each share. It need bear no resemblance to their market value. An issue of shares is recorded in a company's accounts by entering a figure of 'issued capital' equal to the number of shares, multiplied by their par value. Any amount by which the issue price exceeds par must be entered as 'share premium'.[40] Together, these are represented on the 'right hand side' of the corporate balance sheet, as part of the shareholders' funds.[41]

Paradoxically in the light of the insistence on the minimum issue price, if shares in private companies are allotted for *non-cash* consideration, then no serious attempt is made to ensure that the assets supplied are in fact worth the par value of the shares.[42] In the case of public companies, the value of non-cash consideration must be subjected to an independent expert's valuation.[43] However, there is no requirement that shares in any company be issued at their full market price, where this is greater than par.[44]

The rules governing the raising of share capital can be rationalised as providing creditors with protection against a form of misrepresentation. The company's capital is recorded in its public documents.[45] Would-be creditors may view these documents and be misled if the assets have never actually been contributed to the company. Considerations of this sort are clearly apparent in the reasoning of at least some members of the House of Lords in *Ooregum (Gold Mines of India) Ltd v Roper*.[46] In laying down the rule that a company may not allot shares for less than par, Lord Halsbury stated:[47]

> 'The capital is fixed and certain, and every creditor of the company is entitled to look to that capital as his security.'

An internal weakness with this rationale the ease with which the provisions may be side-stepped through the use of non-cash consideration. The rules introduced to comply with the Second Directive can be seen as a means of plugging this gap, at least in relation to public companies.

4.2. Capital maintenance

The *Oxford English Dictionary* defines the verb 'to maintain' as:

> 'to keep up, preserve, cause to continue in being … to keep vigorous, effective or unimpaired, to guard from loss or derogation' [Simpson and Weiner (1989: Vol IX, 223)].

Following this, we might expect the doctrine of capital maintenance to require the preservation of the value of the company's net assets at the level initially subscribed by the shareholders - what might be termed 'net asset value maintenance'. Yet the classical capital maintenance doctrine, as developed by the courts and now reflected in the Companies Act 1985, does nothing of the kind.[48] Its core is rather that only *profits* may be paid by a trading company to its shareholders. As

profits are necessarily defined in contradistinction to capital—which for these purposes includes any share premia,[49] this means that capital may not be *returned to shareholders* [Mathias (1995)]. The capital may nonetheless be used in the course of business as the directors see fit.

The key statutory provision embodying the capital maintenance rule is section 263 of the Companies Act 1985. This prohibits any form of distribution of corporate assets to shareholders except where the value of the distribution is less than that of the profits available for distribution. Distributable profits are defined as the company's cumulated net realised profits,[50] minus dividends paid and losses written off to capital.[51] The definition of 'distribution' is very broad, including for example the redemption or repurchase of shares.[52] The definition probably extends to any form of transaction whereby assets are directly or indirectly transferred to shareholders for less than market value.[53] In addition, the provisions of the Companies Act 1985 that prohibit companies from giving financial assistance to purchasers of their shares can be seen as providing an further restriction on 'indirect' transfers of capital.[54] However, their scope is much broader than is necessary to implement the maintenance of capital principle, covering transactions that do not transfer any value to shareholders - e.g. loans to fund purchases of shares [Ferran (1999)].

A breach of the capital maintenance rules gives creditors no direct rights of action against the company, so enforcement on their behalf can only occur indirectly through a liquidator.[55] Section 277(1) of the Companies Act 1985 provides that distributions received by shareholders in breach of the statutory provisions are recoverable by the company if the shareholder knew or ought reasonably to have known that it was unlawful. The section is expressly without prejudice to other obligations that might be imposed on the shareholder,[56] and an interesting question is whether recovery might be had against 'innocent' shareholders. Such distributions have been described as 'ultra vires', but the meaning of that phrase in this

context is difficult to stabilise.[57] Whilst the conventional wisdom seems to suggest that such an action could not be maintained, the matter should not be regarded as closed.[58] It is nonetheless clear that an alternative remedy exists against directors who negligently or disloyally authorised such payments.[59]

The capital maintenance rules also allow for the adjustment of the restrictions they impose on companies. A company may increase its share capital either through a fresh issue of shares,[60] or by capitalising retained earnings with a bonus issue.[61] Capital may be decreased, in response to a long-term drop in the firm's net assets, by reducing the value of shares through a reduction of capital pursuant to section 135 of the Companies Act 1985. This requires the court's approval, but because it does not involve any direct transfer of assets to the shareholders, the creditors do not usually have any right to object.[62]

Alternatively, the capital maintenance principle may be bypassed altogether. One route by which this may be done is through a return of surplus capital under section 135, in which case the court is concerned to ensure that creditors' interests are protected.[63] This can usually be done by the company providing the court with evidence of a bank guarantee for all existing debts.[64] The principle may also be bypassed by private companies through a repurchase of shares out of capital.[65]

The capital maintenance principle was clearly viewed by the nineteenth century judges who developed it as a means of protecting corporate creditors against the 'extra' risks associated with limited shareholder liability. In a famous early judgment, Jessel, M.R., put the matter in the following way:[66]

> 'The creditor, therefore, I may say, gives credit to th[e] capital, gives credit to the company on the faith of the representation that the capital shall be applied only for the purposes of the business, and he therefore has a right to say that the corporation shall keep its capital and not return it to the shareholders…'

This envisages protecting creditors from the risk that shareholders would subsequently withdraw their capital investment. Naturally, this would increase the company's gearing and consequently the risk of default.[67] Conversely, the risk that the capital would be lost in ordinary business activities was one which the creditor had to bear, as is made clear by Lord Watson's classic exposition:[68]

> 'Paid-up capital may be diminished or lost in the course of the company's trading; that is a result which no legislation can prevent; but persons who deal with, and give credit to a limited company … are entitled to assume that no part of the capital which has been paid into the coffers of the company has subsequently been paid out, except in the legitimate course of its business.'

With this in mind, it is perhaps most meaningful to think of the traditional principle of capital maintenance as maintaining no more than the *subordination* of the shareholders' claim to capital. In return for a contribution of capital, an ordinary shareholder is granted the following rights to returns: whilst the company is a going concern, (i) to such dividends as may from time to time be declared by the directors; and should the company be wound up, (ii) to a *pro rata* share of capital and surplus, insofar as these exceed the company's liabilities.[69] As capital is not repayable by a going concern, it is possible to think of it as an indefinitely deferred *claim* which is payable only in winding-up.[70] As such, it is subordinate to the claims of the company's creditors. The capital maintenance doctrine ensures that it remains that way.

4.3. Threshold requirements

The provisions discussed so far leave corporate creditors with much of the responsibility for their own protection. In contrast, the Second EC Company Law Directive offers more interventionist protection in

the form of two 'threshold' rules, which are triggered by reference to the net asset value of public companies. First, a public company may not commence trading unless it has a minimum issued capital of £50,000.[71] Second, if such a company's net assets fall below one-half of its called-up share capital, then the company is required to convene a shareholders' meeting 'for the purposes of considering whether any, and if so what, steps should be taken to deal with the situation'.[72]

The law relating to share capital can therefore be seen as embodying two different systems of creditor protection. On the one hand, there are rules that derive in large part from the home-grown capital maintenance doctrine. These seek to ensure that a company's public documents contain a true *representation* of the value that has at some stage been invested in the company by shareholders, and a *promise* that the capital claim which shareholders have been accorded in return will remain subordinated to creditors' claims. On the other hand, the 'threshold' requirements of the Second Directive seek to ensure that companies are set up with a minimum capital. In this system the rules relating to raising capital act to ensure that the minimum value actually reaches the company, and the second 'threshold' rule triggers consequences if a substantial part of that value is subsequently lost. The first system is no more than the maintenance of *shareholder subordination*; the second makes steps towards a full-blown *net asset value* maintenance regime.

5. Are the Share Capital Rules Efficient?

The next stage in the analysis is to ask whether or not the share capital rules are an appropriate response to identifiable market failures.

5.1. 'Creditors' who do not contract

It might be possible to rationalise the 'threshold' requirements in relation to public company share capital as an attempt to prevent limited liability being used to facilitate 'judgment proofing' against

involuntary creditors.[73] If this is the policy goal, then it is poorly implemented by the current law. First, the rules apply only to public companies, yet there is no evidence that these are more likely to have involuntary creditors than private companies. Second, the rules do not go so far as to create a *true* net asset value maintenance regime. Hence any protection is seriously weakened by the fact that there is no guarantee that the assets will not be depleted through trading losses.[74] Before dismissing minimum capital, it is nevertheless worth considering whether there is a case for saying that the law *should* be interpreted as serving this function, and arguing hence for a strengthening of the law. It is certainly possible to point to other European corporate codes that offer more vigorous minimum capital regimes.[75]

It is unlikely that a more strongly implemented minimum share capital regime would be efficient. Whilst it might reduce the extent to which limited liability can be used for judgment proofing against involuntary creditors, any benefits would be modest. One reason for this is that the amount necessary to internalise the risk of hazardous activity will depend on the activity in question. A universal minimum share capital is unlikely to achieve an appropriate level of deterrence in many cases [Prentice (1998: 102)]. Furthermore, little of any minimum share capital is ever likely to be received by involuntary claimants. Such parties rank as unsecured creditors in a winding-up and share with consensually unsecured creditors whatever is left of the company's liquidation value after secured and preferential creditors have been paid. Typically this will be very little.[76] A regime requiring companies to maintain a minimum level of net assets would also generate considerable costs. Firms unable to raise the minimum amount of equity finance could not be structured as limited companies [Easterbrook and Fischel (1991: 114)]. This would be so, regardless of whether their business activity carried any risks of tortious or environmental liability. It therefore seems unlikely that minimum capital provisions are justifiable by this rationale.[77]

5.2. Precontractual information asymmetries

The rules governing the raising of capital might be understood as a response to an adverse selection problem in corporate credit markets. The rules make it easier for investors to find out how much capital has been subscribed to the company. This is most clear in the case of the expert valuation of non-cash consideration for issues of shares in public companies. An investor can be sure that the value stated in the company's accounts has actually been contributed by the allottee. The par value rule can be seen as a primitive approximation towards the same goal, albeit subject to its well-known defects.[78]

The fact that the regulation of allotments of shares can be understood as a means of reducing information asymmetries between investors and firms does not mean that the rules are efficient. For that to be the case, the gains that such rules generate - as compared with a system without such rules - must be greater than the costs which compliance imposes on firms. The costs of compliance with the par value rule, although once significant, are now fairly modest.[79] The expert valuation rule is likely to generate more significant costs, requiring firms to retain professional valuers each time an issue of shares is made. This should be compared to the expected benefits. These are simply the fact that the markets for corporate shares and credit will be more informationally efficient. The extent of the benefit this will generate depends on how useful the information is to investors.

A number of empirical studies have investigated the information taken into account by sophisticated creditors and equity investors in making lending decisions. None to the author's knowledge have found that share capital is considered a significant variable.[80] These findings are readily explicable. Share capital is an indication of value contributed to a firm by its shareholders at some time in the past. Yet since that value has been put into the firm, it may well have been dissipated [Cheffins (1997: 532)]. Since the information seems to be of little use to investors, these rules are likely to be inefficient.

5.3. Incomplete contracts and postcontractual opportunism

The maintenance of capital doctrine restricts shareholders' ability to withdraw their capital investment from the firm. Compliance with its dictates involves firms incurring professional fees on capital restructurings. This may mean that some value-enhancing transactions are frustrated because of the fees involved. Are these expenses outweighed by a commensurate social benefit?

A restriction on distributions to shareholders is likely to benefit creditors. To be sure, there are several other background rules which will catch asset transfers that leave a company insolvent, such as the provisions which restrict transactions defrauding creditors,[81] and transactions at an undervalue by an insolvent corporate entity.[82] Notwithstanding these, asset outflows to shareholders can harm creditors' interests even if the company is not rendered insolvent. The net assets of the business are reduced, making it more exposed to the risk of default. If lenders' loans were priced on the basis of the pre-existing levels of net assets, then this will decrease the expected value of their claims,[83] whilst commensurately enhancing the combined value of shareholders' private wealth and their stake in the firm. This sort of activity by shareholders may result in a net social loss, as well as a redistribution from creditors.[84]

It might be thought that a straightforward solution to these problems would simply be to ban all asset transfers to shareholders. However, there may be circumstances in which such transfers are efficient. Where a firm has surplus cash and no good projects in which to invest, it is efficient for the money to be returned to shareholders for investment elsewhere, rather than be ploughed into an underperforming project [Megginson (1997: 377-380)]. Hence an efficient restriction would prohibit some but not all such payments. The difficulty, of course, lies in specifying that only *inefficient* transfers will be prohibited.

One technique is to use a conditional restriction. In other words, provided the firm is able to meet a certain minimum financial condition, shareholders are free to make payments to themselves. The level at which the minimum is set will affect the degree of risk borne by the creditors. So long as they are aware at the time of lending what the minimum is, they can price their loans accordingly. Because creditors have fixed 'upside' returns, the value of their loans cannot increase if the firm *exceeds* the minimum. However, their value can decrease if the firm's condition falls below it. Their interests are therefore protected by a restriction that binds only in the latter circumstances. The appropriate choice of minimum financial condition will depend on a number of variables. Too low, and it will force lenders to incorporate excessive risk premia into their loans, making borrowing very expensive. Too high, and it may force shareholders to retain funds in the firm unnecessarily.

The maintenance of capital doctrine can be understood as providing a conditional restriction of this sort. The statutory framework can be understood as writing a 'creditor protection' term into the corporate constitution. Whilst incorporators are not free to say whether or not they want this framework to apply to their firm, they do have considerable flexibility in setting the conditions under which the maintenance of capital rules will restrict distributions. Their application will be determined by the size of a company's share capital and share premium account, which the shareholders are free to set. Seeing the rules in this light allows us to *explain* a number of their features. First, it shows us why all distributions to shareholders are restricted, rather than just dividends. Second, it allows us to see why gratuitous transfers of assets to parties other than shareholders are not restricted, provided the company is solvent.[85] The interest that is depleted or enhanced by such a transaction is the shareholders'.[86] Third, it explains why distributions are allowed if the condition relating to distributable profits is satisfied. Fourth, it explains the existence and nature of the reduction of capital procedure. Where

capital is paid out to shareholders, this acts as a mechanism whereby the firm *prospectively* changes the terms on which it contracts with creditors to reflect changing circumstances.

To say that we have an explanation of the purpose of the doctrine does not necessarily imply that it is efficient. Why can the matter not simply be left to contract? One argument in favour of general company law rules is that the supply by the state of such rules saves creditors the costs of writing terms for themselves. For this to generate benefits, the rule supplied must be one that at least a majority of parties would prefer. It was suggested earlier that the supply of particular terms into creditor contracts was unlikely to be efficient, because of the heterogeneity of creditor requirements.

Indeed, several commentators go further, suggesting that a capital maintenance rule it is unlikely to be a term which *any* creditor would choose for themselves [Grinyer and Symon (1980: 408); Egginton (1980: 14); Manning (1981: 33-34); Lewis and Pendrill (1996: 60-70); Cheffins (1997: 531-532)]. Share capital is based on historic valuations ascribed to assets transferred to the firm, and its 'maintenance' in balance sheet terms will not necessarily correlate to a reduction in the risk of default. In particular, as time goes on, it will become less and less appropriate as a 'minimum financial condition' on which to base conditional distribution restrictions. It is suggested that instead, tests which restrict shareholder asset transfers on the basis of gearing (ratio of debt to equity) or liquidity (ability to realise cash for assets) would be more appropriate. Hence the statutory rules may impose only a net social cost, by preventing efficient transactions from taking place [Kanda (1992: 447); Kahan (1995: 610)].

The empirical evidence provides some support for this position. Lenders in the UK and the US commonly demand covenants based on gearing and other financial ratios.[87] Lenders in the UK do not often demand covenants from corporate borrowers that restrict distributions to shareholders on the basis of capital and/or profits.[88] In the US,

where the statutory restrictions on distributions under the laws of most states are far weaker than the Companies Act 1985,[89] conditional restrictions on distributions to shareholders based on retained profits are amongst the most common form of loan covenant.[90] Some might conjecture that the differences in legal rules explain why UK loan covenants do not contain such provisions [Leuz *et al* (1998)], with the normative implication being that the capital maintenance rules enhance efficiency by saving specification costs. There are good reasons for doubting this conclusion.

First, the common form of these covenants in the US ties them to profits since the loan is made, rather than since the firm has been incorporated. This supports the assertion that the tying of share capital rules to the historical value of assets paid into the company by shareholders means that the rules are not relevant to creditors' needs. Second, such reasoning would require a fairly strong assumption that the pattern of loan covenant contracting is explicable by reference to differences in company law and not in other social and institutional factors. Third, the evidence – discussed earlier – that UK creditors do not investigate a firm's share capital before lending suggests that capital maintenance rules do not cause creditors to avoid writing conditional restrictions on distributions. If this were the case, they would surely check to see at what point the capital maintenance rules would become binding. However, the evidence on contracting practices does not rule out *a* role for law in assisting parties in writing loan covenants. It shows that considerable amounts of money must be spent on professional fees in negotiating and monitoring loan covenants. It may be that appropriately-structured company law rules can assist parties in reducing these costs.

5.4. Creditor terms and regulatory strategy

As they stand, the capital maintenance rules seem to be more restrictive than they are facilitative of market transactions. How might company law rules be designed so as to offer parties savings on

shareholder-creditor conflicts? A starting point might be to avoid the *weaknesses* of the current system. First, it has a strong mandatory flavour. To be sure, it is possible for shareholders to avoid capital maintenance rules, but only by undercapitalising their companies initially.[91] It would be better if incorporators might *choose* whether or not the capital maintenance regime should apply to their company. Second, it offers only one set of rules, which are likely to be inappropriate for most creditors.

In pondering these issues, regard should also be had to the *strengths* of the capital maintenance doctrine. One advantage is that, as a part of the corporate constitution, it is possible to have remedies against shareholders. These would not be available to a creditor simply taking a loan covenant from the company. The fact that shareholders might be liable to repay unlawful distributions *ex post* would reduce their incentive – or that of managers acting in their interests – to take or make such payments in the first place. This may allow for savings where monitoring costs, for example, are high.[92] Of course, personal guarantees of this nature might be taken by creditors from shareholders. But where the numbers of shareholders are large, as with a typical public company, then the costs of doing so are likely to be prohibitive. The point is not to suggest that the availability of remedies against shareholders makes capital maintenance, as it stands, efficient. Rather, it is an illustration of the *potential* advantages of the inclusion of a 'creditor term' in the corporate constitution.

This may point the way to a possible role for company law in the protection of voluntary creditors. This could be effected through the provision of a mechanism for enforcing 'creditor terms', if written into the corporate constitution by incorporators. We might imagine that some parties would want particular covenant-like restrictions, perhaps offering remedies against shareholders or directors. Others would wish to leave the matter solely to market contracting with their creditors. The specific terms could be left to the parties to decide – or perhaps offered in a 'menu' format, to allow bodies of precedent to

develop and facilitate their use. Others have advocated this approach in the context of corporate insolvency [Rasmussen (1992); Schwartz (1998b)]. Provided that it is made clear to persons dealing with the company what sort of restrictions it is subject to, then those setting it up have appropriate incentives to decide whether such restrictions are efficient.[93] The role of company law would merely be to facilitate their doing so. Any case for such a mechanism is of course tentative, the claim here merely being that it *might* be able to enhance efficiency, and as such is deserving of further enquiry.

Other roles exist for general company law (and related areas) in providing mandatory 'creditor terms'. Examples include disclosure laws and insolvency law.[94] However, in an environment where the majority of creditors are at least to some extent, able to price transactions according to risk, then general rules – such as minimum capital requirements – designed to protect involuntary creditors are likely to be inefficient. This is not to say that law cannot assist in reducing externality problems, but rather that the relevant rules should be more specifically targeted at the groups in question.

6. Conclusion

What conclusions can be drawn about creditor protection, share capital, and efficiency? This paper has sought to make two points about the legal regulation of share capital. First, it can be said with reasonable certainty that the rules relating to share capital, as they stand, are not efficient. Second, and more tentatively, there could be *a* role for general company law rules in facilitating the protection of voluntary creditors, but – disclosure provisions and insolvency apart– parties should have far more freedom in selecting the terms by which they are bound. A subsidiary point is that there might also be a role for law in protecting involuntary creditors, but this is probably best not done through general *company* law rules.

These conclusions lend support to the evaluative methodology of the Company Law Review, as set out in the *Strategic Framework* document. They suggest that the first guiding principle may be able to offer meaningful indications about the direction that should be taken in reforming company law, at least in the area of capital maintenance. Of course, there is much room for debate. Important questions remain as to how far this methodology may be taken in dealing with areas that appear to raise broader political questions.

The *Strategic Framework* document's preliminary recommendations for capital maintenance are probably a step in the right direction. The document suggests the abolition of the par value rule, subject to this being possible within the confines of the Second Directive [DTI (1999: 88-90)]. This seems entirely welcome. It also recommends replacing the court's role in the reduction of capital procedure under section 135 with a guarantee provided by the directors (pp. 82-83). This would reduce the restrictiveness of the capital maintenance rules, and as such is also likely to be an efficient move.

Whilst the proposed reforms would improve things at the margin, they fall a long way short of applying a 'presumption against prescription'. The scope of possible reform of the law relating to share capital is, of course, severely limited by the Second Directive.[95] However, it would be a pity if the opportunity could not be seized to stake out a position.

Notes

1. A measure as draconian as an outright ban on corporate borrowing might be rationalised on the basis that it tended to protect (would-be) creditors from abuse of limited liability.

2. Or more precisely, up to the point when the marginal benefits of additional protection are equal to the marginal costs.

3. Companies Act 1985 ('CA 1985'), Parts IV, V & VIII.

4. See, e.g., Sealy (1984: 8-16); Farrar *et al.* (1992: 176): ('[I]t will be apparent that the statutory provisions are of a type which has become common in English company law, i.e. they seek to cover every eventuality and in the process submerge the basic principles beneath a welter of detail').

5. Harman J gave the following memorable expression of judicial frustration, 'If there appeared a clear policy in the sections of the Act of 1985 concerning share capital I would be greatly assisted... Unhappily for me the Act does not, in my judgment, show any clear policy in this part of the field of company law.' (*Re Scandinavian Bank Group plc* [1988] Ch 87, 101B-C).

6. The third principle is accorded considerably less detailed treatment than the first two.

7. For discussions, see Barnea *et al.* (1985: 6-24); Brealey and Myers (1996); Megginson (1997: 316-323).

8. A leading corporate finance textbook warns students that they may find the perfect capital market assumptions 'almost laughably unrealistic' when they first encounter them [Megginson (1997: 316)].

9. Indeed, Stigler goes further and demands that it must also be shown that the rules which are to be compared are not those which we would ideally like to implement, but those which a *real political process* is *capable* of implementing [Stigler (1975: 114-141)]. See also Ogus (1994: 30); Viscusi *et al.* (1995: 10-11).

10. Analytically, it is of course equally possible to reverse the burden of proof, and make it necessary to demonstrate the *inferiority* of regulated to unregulated markets [Stigler (1975: 38-57)]. Most would agree that this step does not constitute an *a priori* advancement of the enquiry.

11. It should be noted that 'economic efficiency' can take on a variety of different meanings [see Deakin and Hughes (1999: 2-10)]. In this paper, it is used to refer to *allocative* efficiency, making use of the so-called 'Kaldor-Hicks' criterion. According to this, states of society are compared, and if the total social wealth in state A is greater than in state B, then A is more efficient [see Coleman (1980: 512-520)]. The states being compared in this paper's analysis are therefore 'the world without the legal rule in question' against 'the world with the legal rule'.

12. See, e.g., Laffont (1987: 112).

13. Other techniques include direct regulation and taxation according to social cost. See Coase (1960: 1); Kaplow and Shavell (1999: 21-24).

14. It should be noted that this problem is not unique to corporate entities. Individuals may be judgment proof too [(see Hansmann and Kraakman (1991: 1885-1886); LoPucki (1996); Kaplow and Shavell (1999: 12)]. However, the problem is likely to be most significant in respect of companies because it is much easier to

arrange for a corporate entity to have minimal assets than for a human being. No body to kick means no mouth to feed, after all.

15. This is not to say that market power should not be regulated, but rather that general company law rules are an inappropriate mechanism for doing so.

16. See generally Wilson (1987: 31-34).

17. See Schwartz (1981: 14-15); Triantis (1992: 250). See generally Spence (1974); Riley (1987).

18. Hart (1995: 21-24); Salanié (1997: 175-177); Kaplow and Shavell (1999: 27-28).

19. This can be taken to include not only the cost of writing a term, but the cost of quantifying the probability of the contingency's occurrence and determining the appropriate courses of action. In this sense, specification costs merge into what are sometimes known as 'symmetric information imperfections' [see, e.g., Trebilcock (1993: 127-130); Cheffins (1997: 128)].

20. It should be noted that saying a contract is 'incomplete' in this sense does not mean that there are gaps in a *legal* sense. One might think of legal completeness in at least two ways. Failing to specify key terms can lead a court to characterise a contract as being too uncertain to enforce, as in *May & Butcher v The King* ([1934] 2 KB 17n), and one might speak of a contract being 'enforceable' complete accordingly. In addition, some scholars make use of a concept of 'obligational' completeness [Ayres and Gertner (1992: 730-731)]. According to this usage, a contract is obligationally complete if it specifies *what each party is to do* in every state of the world, even if this is not the optimal action to take under some circumstances.

21. Jensen and Meckling (1976); Myers (1977); Smith and Warner (1979); Barnea *et al* (1985: 33-38). For accessible reviews of the literature see Triantis (1992: 234-241); Rasmussen (1994: 1167-1173).

22. The analysis assumes that corporate managers act in the interests of shareholders. This is most obviously true for owner-managed businesses. In public firms, an additional dimension is added by managers' private interests (e.g. in increased leisure time, building empires, or family pride, a.k.a. nepotism) that they may prefer over those of outside investors, be they debt or equity. The costs generated by such self-serving behaviour are borne in the first instance by shareholders. Paradoxically, however, the better the incentive mechanisms– executive option schemes and the like – for resolving this 'problem' and ensuring that managers act in shareholders' interests, the stronger will be their incentives to transfer wealth to the latter from creditors (see, e.g., 'Share and Share Unalike', *The Economist*, 7 August 1999).

23. For example, under section 244 of the Insolvency Act 1986, 'extortionate' credit transactions are rendered unenforceable in the borrower's insolvency. This places a cap on the effective interest rate that a lender will be willing to charge.

24. A third social cost would be that if creditors are risk averse, then an increase in the level of risk they bear will cost them more than the shareholders benefit. However, this in itself does not imply that restrictions on debtor conduct would be efficient. It might be cheaper for the risk-averse creditor to diversify, or to obtain credit insurance.

25. First, consider that the expected financial agency costs will increase with the debtor's ratio of debt to equity ('gearing'), since this will intensify the incentives to expropriate creditors. Studies of US practices have found the number, and in some

cases the restrictiveness, of loan covenants, to be statistically correlated to borrower gearing [Duke and Hunt (1990); Press and Weintrop (1990)]. Similar findings are reported from qualitative studies in the UK [Citron (1992: 326); Day and Taylor (1995: 397)]. Second, financial agency costs may be expected to increase with the size of the loan, since this increases the potential for expropriation. UK studies suggest that size of loan is positively correlated to the incidence of loan covenants (*ibid.*).

26. Another will be the ability of creditors to *observe* whether or not debtors have complied with any restrictions. Mandatory disclosure rules may be able to assist parties in reducing the costs of such monitoring activity. The issue is similar to that discussed in the context of precontractual information asymmetries. See text to nn 16-17 above.

27. These sorts of difficulties are described by Jensen and Meckling as 'bonding costs' (1976: 308).

28. Kanda (1992: 440); Kahan (1995: 609-610); Schwartz (1998: 279).

29. The concept of 'solvency' may need a degree of attenuation: liquidity and time constraints may be more relevant than balance sheet solvency in determining a firm's ability to 'cash out' an obstructive creditor.

30. Empirical studies of financially distressed US firms show that the number of creditors and the heterogeneity of their claims are related to whether a firm is more likely to go into Chapter 11 bankruptcy than restructure its debt privately, suggesting that these are determinants of renegotiation costs [Gilson *et al* (1990); Franks and Torous (1994)].

31. The English doctrine was at first a judicial construct, introduced as an explanation of certain provisions of the Companies Act 1862. It later served to inspire legislative modification of the share capital rules. See generally Yamey (1941); French (1977).

32. Second Council Directive of 13 December 1976 (77/91/EEC) [1977] OJ L26/1 (Formation of Public Companies and Maintenance and Alteration of Capital). It was implemented by the Companies Act 1980, now consolidated into the Companies Act 1985. See generally Prentice (1980).

33. The rules relating to distributions were, however, tightened in relation to private companies. See text to note 48 below.

34. On the first two of these, see Farrar *et al* (1998: 172). See generally Manning (1981), (1985).

35. The *Strategic Framework* document does not consider all of these in its section on capital maintenance [DTI (1999: 81-90)].

36. See, e.g., the preamble to the Second Company Law Directive [1977] OJ L26/1.

37. First, the rules restricting repurchases of shares are said to ensure that 'market rigging' does not occur, thereby protecting 'others interested in the company' [Gower (1980: paras 5, 16)]. Second, the rules prohibiting the giving by a company of financial assistance can be also be partially rationalised as a means of protecting market integrity [Ferran (1999)]. Third, it was at one time thought that the court in confirming a reduction of capital was required to ensure that it was in accordance with the interests of the 'general public', in addition to those of the shareholders and creditors. These rationales seem largely unpersuasive in the light of other more sophisticated modern regulation of financial markets [Ferran (1999)].

38. Hence provisions relating to share capital which can only be rationalised as protecting shareholders – such as pre-emption rights, provisions relating to class rights, and procedural requirements for shareholder resolutions on share repurchases or reductions, are excluded.

39. *ibid.* The allottee remains liable to the company for the difference (CA 1985 s 100(2)).

40. CA 1985 s 130.

41. CA 1985 Sch 4.

42. *Re Wragg* [1897] 1 Ch 796 (CA) is the *locus classicus* of the doctrine that, 'The value paid to the company is measured by the price at which the company agrees to buy what it thinks it worth its while to acquire.' (*per* Lindley LJ at 831). The incoherence of taking this position alongside the par value rule was noted as long ago as 1918 by the Wrenbury Committee, who stated, '[T]he courts have - if it be not a contradiction in terms - adhered to the [*Ooregum*] principle but not maintained it' [Company Law Amendment Committee (1918: 41)]. The doctrine does not apply where the transaction is a sham or colourable (*Re Wragg* at 830) or where it is clear from the terms of the contract that the consideration bears no resemblance to the par value of the shares (*Hong Kong Gas Company v Glen* [1914] 1 Ch 527).

43. CA 1985 ss 103, 108. The allottee remains liable to transfer the agreed consideration to the company (s 115), subject to discretionary relief from the court (s 113). The regime also prohibits outright the giving of services as consideration for an allotment of shares (s 99(2)), or any arrangement which *may* take more than five years to perform (s 102)).

44. *Hilder v Dexter* [1902] AC 474.

45. Most obviously, in its accounts. The nominal or authorised capital must also be stated in its memorandum (CA 1985 s 2(5)(a)).

46. [1892] AC 125.

47. *ibid*, 133. See also *ibid*, 137 *per* Lord Watson, 140-141, *per* Lord Herschell. The same rules can also be seen as protecting outside shareholders in a similar fashion. See *ibid*, 134 *per* Lord Halsbury LC.

48. For most practical purposes, the common law principle has been surpassed by the statutory rules introduced in 1980.

49. CA 1985 s 130(3). It also includes capital redemption reserve, if any (s 170(4)). There are limited exceptions: share premia may be used to offset the expenses of an issue of shares or a company's preliminary expenses (s 130(2)).

50. The ICAEW have recently issued draft guidance on the meaning of 'realised profits' in this context, a matter that for many years remained notoriously unclear [ICAEW (1999)].

51. A public company must additionally demonstrate that its net assets exceed the sum of its capital accounts plus its cumulated net *un*realised profits by at least the amount of the proposed distribution (CA 1985 s 264). However, unrealised profits and losses are rare and hence this is unlikely to be significantly different to the result under s 263 [Lewis and Pendrill (1996: 63)].

52. See CA 1985 s 263(2)(b). Repurchases or redemptions are permitted where these do not reduce share capital. First, a repurchase or redemption of shares must be funded by distributable profits (s 160(1)). Second, because the repurchase or redemption of shares will result in their cancellation and equivalent reduction of the issued capital (s.160(4)), an equivalent amount must be accredited to the 'capital redemption reserve' which is treated subsequently as capital (s 170).

53. *Re Halt Garage (1964) Ltd* [1982] 3 All ER 1016; *Aveling Barford Ltd v Perion Ltd* (1989) 5 BCC 677; *Barclays Bank plc v British & Commonwealth Holdings plc* [1996] 1 BCLC 1.

54. CA 1985 ss 151-155; See Company Law Committee (1962: para 173).

55. *Mills v Northern Rly of Buenos Ayres* (1870) 5 Ch App 621. See Furey (1996: 176-179).

56. It is clear that shareholders who have knowledge of the relevant facts may be liable as constructive trustees (*Precision Dippings Limited v Precision Dippings Marketing Ltd* (1985) 1 BCC 99, 539*; Aveling Barford*, n 53 above).

57. Amongst the authorities, some passages may be read as characterising the issue as one of corporate capacity (see, e.g., *Aveling Barford*, n 53 above, 682), whereas others appear to view it as a matter of illegality (*Barclays Bank v British & Commonwealth Holdings*, n 53 above, 26-29). Some commentators view it as both [see, e.g., Boyle *et al* (1986-1999: 3.001 n3) ('ultra vires and illegal')]. One reason why the correct characterisation of the issue matters is that recovery on restitutionary principles may not be possible from an innocent recipient under an *illegal* transaction, because of the maxim *ex turpi causa non orit actio* [Grantham (1999: 311-313)].

58. The pre-1980 case law provides tentative support for a 'knowledge' requirement (see *Re Denham & Co* (1883) 25 ChD 752 (director/shareholder without understanding of the circumstances held not liable); *Moxham v Grant* [1900] 1 QB 88 (shareholders who had knowledge of the relevant circumstances held liable)). However, *dicta* of Collins LJ in *Moxham v Grant* (at 94) suggest that an action for money had and received might be brought against an innocent shareholder, provided that the funds received were identifiable in his hands.

59. *Re Exchange Banking Co, Flitcroft's Case* (1882) 21 ChD 519; *Dovey v Corey* [1901] AC 477.

60. The authorised share capital may be increased by an ordinary resolution of the general meeting (CA 1985 s 121).

61. *ibid* s 263(2)(a); Table A art 110. An issue of bonus shares may also be funded from the share premium account or the capital redemption reserve (ss 130(2), 170(4)). However, this does not increase the level of the capital yardstick, merely recycling it from one account to another.

62. *ibid* s 136(2); *Re Meux' Brewery* [1919] 1 Ch 28. This is commonly justified on the theory that in lending to the company, they bear the risk that losses will be made in trading (see, e.g., *Guinness v Land Corporation of Ireland* (1882) 22 ChD 349, 375 *per* Cotton LJ). The court must, however, be satisfied that the loss is *permanent*. If there is a possibility that it may only be temporary, then it may require the company to promise to create a capital reserve account if the loss is recovered (*Re Jupiter House Investments Ltd* [1985] 1 WLR 975; *Re Grosvenor Press plc* [1985] 1 WLR 980).

63. CA 1985 ss 136-137.

64. The statute prescribes a lengthy procedure whereby creditors must be informed of the proposed reduction and either consent to it or be paid off (s 136). However the court has a discretion to waive the procedure where satisfied that the 'special circumstances of the case' demonstrate that the interests of creditors are otherwise protected (s 136(6)). It is possible for the company to satisfy the court in this fashion by obtaining a bank guarantee of all its outstanding debts [see Atkin *et al* (1995: 204-205)]. This practice is almost universally followed so as to avoid the expense of the full procedure [Boyle *et al* (1986-1999: 13.012)].

65. The requisite procedure (CA 1985 ss 171-177) involves providing current creditors with what is in effect a one-year statutory guarantee made by the firm's directors and auditors (s 173), and backed by the purchasers of the shares (Insolvency Act 1986 s 76).

66. *Re Exchange Banking Company, Flitcroft's Case* (1882) 21 ChD 518, 533-534.

67. See further text to nn 83-84 below.

68. *Trevor v Whitworth* (1887) 12 App Cas 409, 423-424.

69. Insolvency Act 1986 s 74(2)(f); *Soden v British & Commonwealth Holdings plc* [1997] 3 WLR 840; [1997] BCC 249.

70. See *Re Northern Engineering Ltd* [1994] 2 BCLC 704, 712g-h *per* Millett LJ.

71. CA 1985 ss 11, 118. However, only one-quarter of this need actually be paid-up (*ibid* s 101(1)). See Ferran (1999).

72. CA 1985 s 142.

73. As was argued by the Danish government in *Centros* (Case C-212/97 *Centros Ltd v Erhvervs- og Selskabsstyrelsen*, Judgment 9 March 1999 (http://curia.eu.int/en/jurisp/index.htm), paras 32-33). The Court's response constitutes a major set-back for this view.

74. CA 1985 s 142 requires that a general meeting be called to decide what should be done if a public company loses more than half its called-up share capital. However, there is no *obligation* for anything to be done, and the decision is given to shareholders, whose interests are likely to conflict with those of creditors [Prentice (1998: 103)].

75. Swedish law is an example. If the net assets of a Swedish company fall below half its share capital, then the shareholders must either inject fresh equity to restore the net asset level, or liquidate the company [Norberg (1998)].

76. A recent study suggests that creditors proving in liquidation typically receive 12.6% of the face value of their claims [Society of Practitioners of Insolvency (1999: 17, Fig 33)].

77. Superior methods of protecting 'involuntary creditors' exist. One is to regulate hazardous activity directly, requiring firms to carry insurance commensurate with their potential risk. The pricing of insurance premia would be a more precise internalisation mechanism than a 'fixed-rate' minimum capital requirement, and the Third Parties (Rights Against Insurers) Act 1930 would help to ensure that insurance payments actually reached the victims. Other techniques include granting tort and environmental claimants priority over other claimants in corporate insolvencies [Leebron (1991); Bebchuk and Fried

(1996)], or imposing *pro rata* unlimited liability on shareholders for corporate torts [Hansmann and Kraakman (1991)]. These would cause voluntary creditors or shareholders respectively to increase the firm's cost of finance in proportion with the level of hazardous activity in which it is engaged. Any of these techniques would be likely to be more efficient than the use of a minimum capital regime.

78. Text to nn 41-43 above.

79. Historically, if a company's share price fell below par, then it was rendered unable to raise equity finance. This might prove disastrous if a fresh injection of funds was required to save a financially distressed firm. However, the matter can now be dealt with by splitting shares into multiples with a smaller par value, provided that the total share capital is not reduced (CA 1985 s 121).

80. See Day (1986) (interviews with 15 stockbrokers suggesting that share capital plays a very minor role in the evaluation of company reports, and no role in forecasting company performance); Berry *et al.* (1993); Deakins and Hussain (1994) (interviews with bank lending officers indicating criteria for assessing creditworthiness of small business - share capital not amongst them).

81. IA 1986 ss 423-425.

82. IA 1986 s 238.

83. To say that the 'expected value' of the creditors' loans decreases does not imply that the debtor firm subsequently enters insolvency. This may never happen, but creditors can still be prejudiced if the *risk* of insolvency increases above that at which they had priced it, and if the value of the expected repayment as

an *asset* matters to them. This would be the case if they wished to realise the value of the loan before maturity, as with bonds, secondary markets for syndicated loans, factoring of book debts, etc.

84. See text to nn 21-24, above.

85. Subject of course to directors' duty to ensure that such payments are made *bona fide* in the interests of the company.

86. Their recourse against gratuitous transactions which do not advance their welfare is through firing the directors (CA 1985 s 303), or through an unfair prejudice petition if the directors are backed by the majority shareholder (CA 1985 s 459).

87. For evidence on the UK position, see Citron (1992b: 23-24); Day and Taylor (1995: 397). On the US, see Kalay (1982).

88. Citron (1992b) found no dividend restrictions in a sample of 22 loan contracts. Day and Taylor, (1995: 398) interviewed bankers who suggested that dividend restrictions were only used in lending agreements with private companies or MBO vehicles. Day and Taylor (1996: 321) conducted 44 interviews with corporate treasurers. Only four (9%) stated that their company's loan contracts contained explicit dividend restrictions.

89. Many states have adopted various incarnations of the Model Business Corporations Act (MBCA). The post-1979 version of this Act, and its successor the Revised MBCA, have entirely abolished the remnants of the maintenance of capital doctrine [Manning (1981: 164-180); RMBCA §§ 6.21, 6.40]. The pre-1979 MBCA, which is still the model used by many state corporate codes, whilst formally restricting dividend payments, allows for (a) payments out of what is called 'share premium' in the UK; and (b) reductions of capital by shareholder resolution

[Manning (1981: 59-76); Cox *et al* (1995: § 21.16)]. Delaware has not adopted either the MBCA or the RMBCA. However, the Delaware General Corporate Law's dividend provisions have the same gaps apparent in the pre-1979 MBCA with the addition of permitting 'nimble dividends' (Del Gen Corp Law §§ 154, 170).

90. A number of studies have reported a high incidence of dividend restrictions in covenants granted by randomly-selected samples of firms. See, e.g., Kalay (1982: 214-216) (100% of sample); Duke and Hunt (1990: 55-56) (55.1% of sample); Press and Weintrop (1990: 74) (61% of sample). One study investigated the terms of such contracts and found that the same formula, taken from a well-known 'boilerplate' provision, was used to specify the restriction used in almost all cases [Kalay (1982: 216, fn.9)]. This provision restricts the firm's ability to engage in transactions which result in distributions to shareholders: dividends, share repurchases and other gratuitous transfers. It allows some dividends to be paid - basically the profits which the firm has made since a particular loan was advanced.

91. Many companies in fact choose to carry very little share capital. As of 31 March 1998, 67.2% of all registered companies had an issued share capital of less than £100 [DTI (1998b: Table A7)]. Of these, only 1% were public companies (*ibid* Table A2). The percentage of new incorporations with share capital below £100 is even higher, in 1997-98 being 91% (*ibid* Table B3). These figures are somewhat misleading as to the true extent of application of the share capital exit rules because they do not state the extent to which share premia or capital redemption reserves exist.

92. Nor does such a rule impose a risk of unlimited liability on shareholders.

93. The subscribers, seeking to maximise the value of their firm, would be well-advised to use such provisions only where they consider the expected benefits to outweigh the costs.

94. The rationales for these have been touched on only in passing, and this is not the place to debate them in full.

95. The recent *Centros* case (n 73 above) may be a glimmer of hope that the policies underlying the Second Directive may not be set in stone.

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