

LEGAL CAPITAL: AN OUTDATED CONCEPT?

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Abstract

This paper reviews the case for and against mandatory legal capital rules. It is argued that legal capital is no longer an appropriate means of safeguarding creditors' interests. This is most clearly the case as regards mandatory rules. Moreover, it is suggested that even an 'opt in' (or default) legal capital regime is unlikely to be a useful mechanism. However, the advent of regulatory arbitrage in European corporate law will provide a way of gathering information regarding investors' preferences in relation to such rules. Those creditor protection rules that do not further the interests of adjusting creditors will become subject to competitive pressures. Legislatures will be faced with the task of designing mandatory rules to deal with the issues raised by 'non-adjusting' creditors in a proportionate and effective manner, consistent with the Gebhard formula.

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Some seven men form an Association
(If possible, all Peers and Baronets)
They start off with a public declaration
To what extent they mean to pay their debts.
That's called their capital: if they are wary
They will not quote it at a sum immense
The figure's immaterial – it may vary
From eighteen million down to eighteen pence.

I should put it rather low;
The good sense of doing so
Will be evident to any debtor.
When it's left to you to say
What amount you mean to pay,
Why the lower you can put it at, the better.¹

1. Introduction

Rules relating to 'legal capital' have received much attention in recent European company law debates (Armour, 2000; Enriques and Macey, 2001; Mülbart and Birke, 2002; Rickford *et al.*, 2004; Schön, 2004; Ferran, 2005). The core concept is that legal restrictions are imposed on corporate activity by reference to the shareholders' capital investment, as shown on the balance sheet. This is instantiated in various ways in different company law systems, which typically harness the concept to perform one or both of the following functions: (i) prescribing a minimum level of equity capital which must be invested in a trading company, and (ii) restricting transfers of assets to shareholders where the net assets fall below the value of the equity capital invested.

Whilst legal capital rules have fallen out of favour as a means of protecting creditors in common law jurisdictions,² the principles for which they stand continue to be taken seriously in continental European countries. Until very recently, it was possible to dismiss these differences as simply matters of domestic legal preference, with the rider that in any event divergences were likely to be ironed out in time, a significant step in this direction having been made with the Second Company Law Directive.³ Although not universally admired, it was not doubted that, in contrast to its obsolescence in North America, legal capital had a future in (continental) Europe.

However, the past few years have seen a seismic shift in the European debate. This was triggered by two things. On the one hand, the ECJ's decision in *Centros* and its progeny opened up the possibility of real regulatory choice in European company law—at least for private companies.⁴ Many continental entrepreneurs have responded by choosing to incorporate their businesses in the UK, where legal capital rules for private companies are relatively permissive (Armour, 2005: 385-386; Becht *et al.*, 2005). This controversial development pushed into the spotlight the question whether legal capital rules are useful or desirable, and many Member State legislatures appear to be questioning their former attachment to them. At the same time, the European Commission has been seeking to reform the Second Directive. The idea was first raised as part of the 'SLIM' (Simpler Legislation for the Single Market) initiative,⁵ and was subsequently added to the agenda for the Commission's High-Level Expert Group on Company Law.⁶ A Commission Proposal to simplify the Second Directive is now well-advanced,⁷ and debate continues about the possibility of further, more wide-ranging, reforms in the future.⁸

In light of these developments, this paper reviews the case for and against mandatory legal capital rules. It is argued that legal capital is no longer an appropriate conceptual apparatus to employ in safeguarding the interests of creditors. This is clearly the case as regards mandatory rules, which impose a 'one size fits all' approach that is likely to be over-regulatory. Moreover, it is suggested that even an 'opt in' (or default) legal capital regime is unlikely to be a useful mechanism. However, the advent of regulatory arbitrage in European company law means that these sorts of debates will in future come to be resolved with an eye on the preferences of firms. The future of legal capital may therefore be determined by investors rather than legislatures.

The rest of this paper is structured as follows. Section two gives a brief description of two different 'ideal types' of legal capital rule, and indicates some of the combinations in which they exist in Member States' company laws. Section three explains how these rule-types may be rationalised as creditor protection mechanisms. Section four then critiques these rationales. Section five turns to the impact of new-found opportunities for regulatory arbitrage, and section six concludes.

2. Types of legal capital rule

In this section, we will describe two 'ideal types' of rule that restrict corporate behaviour based on legal capital. As will be seen, different combinations of these rules are applied in different legal capital regimes.

2.1 Distribution rules

A rule prohibiting return of capital seeks to prevent a company from making distributions to its shareholders at any point at which the company's net assets do not exceed the stated value of its capital accounts.⁹ In the UK, the key statutory provision embodying this 'capital maintenance' rule is section 263 of the Companies Act 1985.¹⁰ 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, minus dividends paid and losses written off to capital.¹¹ As profits are necessarily defined in contradistinction to capital, this means that capital may not be returned to shareholders.

For such rules to impose a genuine restriction on companies' ability to make payments to shareholders, the ban on distributions must be truly 'watertight'. Hence the rules must also cover other forms of transaction whereby assets are directly or indirectly transferred to shareholders for less than market value—including share repurchases,¹² the giving of financial assistance by a company for the acquisition of its own shares,¹³ and undervalue transactions between a company and its members.¹⁴

It follows that reforms which permit capital to be returned to shareholders by any route will tend to relax the system's constraints generally: rather than being a restriction on corporate action, they become a means for channelling actions into particular forms. In the UK, for example, it is already permissible for private companies to return capital to shareholders by means of a share repurchase, contingent on the directors' ability to declare that the company will remain solvent for 12 months.¹⁵ Pending reforms will permit any reduction of capital through such a declaration of solvency.¹⁶ As a result, whilst the formal framework of legal capital will remain in place, the effective constraint on private companies' ability to distribute to shareholders will be based upon solvency, as opposed to the capital 'yardstick'.¹⁷

2.2 Minimum capital rules

A minimum capital rule requires that those incorporating a business place assets of at least the specified minimum value into the corporate asset pool. For public companies, a harmonised rule is imposed by the Second Company Law Directive, mandating a minimum share capital of at least 25,000 Euros.¹⁸ On the other hand, the existence and scope of any minimum capital requirement for private companies is left to Member States, and widely differing stances are taken. In contrast to the position in many continental European jurisdictions, English company law imposes no minimum capital requirement for private companies.¹⁹

Minimum capital rules can be of little real significance unless coupled with anti-avoidance provisions designed to ensure that assets to the required minimum value are in fact contributed. That is, some sort of independent report on the value of non-cash consideration is required,²⁰ lest those conducting initial transactions on the company's behalf be minded to value such assets optimistically. It also may be thought desirable to include rules subordinating shareholder 'loans', particularly of a secured variety, which when coupled with non-cash consideration can be used to place any capital contributed beyond the reach of the creditors (Gelter, 2005).²¹

3. The economic case(s) for legal capital rules

By virtue of the Second Directive, both distribution restrictions and a minimum capital requirement apply to public companies throughout Europe. However, in respect of private companies, some jurisdictions—such as the UK—apply only distribution restrictions but do not impose a minimum capital. It seems likely that in the future some jurisdictions will abolish these rules entirely. Unsurprisingly, given this diversity, the appropriate degree to which creditors should be protected by legal capital rules is a contentious matter. Just as it is undesirable to offer creditors too little protection, it may be equally undesirable to mandate too much protection: that is, to emphasise creditors' interests at the expense of other constituencies. This section considers the economic rationale(s) for various combinations of legal capital rules. How persuasive these rationales are will be considered in the next section.

In understanding the way in which the legal capital operate, it is helpful, analytically, to distinguish between those creditors who are able to change the terms on which they lend to reflect the associated risks of default, and those who are not so able—sometimes termed 'adjusting' and 'non-adjusting' creditors respectively.²² Adjusting creditors are those voluntarily advancing a sufficiently large sum of money to be willing to incur the transaction costs—gathering information, negotiation and the like—necessary to adjust the terms upon which credit is extended so as to compensate them appropriately for the risk they are bearing. A paradigm adjusting creditor might be a bank, which would be able to capture economies of scale in gather information and setting terms for debtors. Non-adjusting creditors are those who do not alter the terms on which they extend credit in response to a debtor's riskiness. Tort victims are the most intuitive example of a non-adjusting creditor, but the category is often also said to include others, such as the state in right of tax and environmental claims, and voluntary creditors—e.g. consumers, employees and trade creditors—who may lack the economies of scale to be able to adjust their terms easily to respond to the individual characteristics of each borrower.

3.1 Distribution rules

A restriction on the return of capital to shareholders can be understood as protecting creditors against the risk of opportunistic behaviour by the shareholders. Distributions to shareholders reduce a company's net assets, making it more exposed to the risk of default. Creditors' interests can be harmed even if the company does not actually become insolvent.²³ Such a transfer will still decrease the expected value of their claims,²⁴ whilst commensurately enhancing the combined value of shareholders' private wealth and their stake in the firm. A restriction on distributions can prevent this from happening.

However, for non-adjusting creditors, a restriction on the return of capital to shareholders is by itself of little assistance. This is because, if creditors are non-adjusting, the optimal level of capitalisation by shareholders is zero.²⁵ Thus it is a truism that those carrying on hazardous enterprises—which are likely to result in tort claims—have a tendency to structure their affairs using thinly-capitalised subsidiaries.²⁶

A distribution restriction can, however, be understood as protecting adjusting creditors against the risk of opportunistic behaviour by the shareholders. If lenders' loans were priced on the basis of pre-existing levels of net assets, then a transfer of assets to shareholders will decrease the expected value of creditors' claims,²⁷ whilst commensurately enhancing the combined value of shareholders' private wealth and their stake in the firm. Creditors' interests will be harmed even if the company does not actually become insolvent,²⁸ because by reduce a company's net assets, distributions make it more exposed to the risk of default. A restriction on distributions can prevent this sort of wealth transfer from happening.

It might initially be thought odd that such restrictions should benefit adjusting creditors: surely, if they are able to adjust, then they have no need of such protection? The answer is that such restrictions can deter *ex post* actions by shareholders (or, more accurately, directors acting on their behalf),²⁹ which will be inefficient, in the sense of failing to maximise the expected value of the corporate assets, and which are taken with the view of transferring wealth, in an expected value sense, from creditors to shareholders (Jensen and Meckling, 1976). This sort of action will result in social losses *ex post* if assets are withdrawn from valuable projects in order to fund such distributions. This would be priced into the interest rate by adjusting creditors; hence it is in shareholders' interests to commit not to do it *ex ante* (Bradley and Roberts, 2004). Moreover, because there are limits to the interest rates it is feasible to charge,³⁰ the possibility of such distributions being paid may deter creditors

from lending at all ex ante. The result either way would be underinvestment in good projects (Myers, 1977). Moreover, either way, shareholders too would prefer such restrictions to be imposed ex ante.

It might be thought that a straightforward solution 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 poured into an underperforming project. The problem in this case is the flipside of that where no restriction obtains (Megginson, 1997: 377-380).

One technique for balancing these concerns is to use a conditional restriction. The maintenance of capital doctrine can be understood as providing restriction of this sort: a company is only permitted to make payments to its shareholders at a time when its net assets exceed its capital accounts (Armour, 2000: 367-368). Adjusting creditors, in advancing funds to the company, can take into account the figure at which the constraint will become binding, and price their loans on that basis.

Many creditors in fact contract for protection—in the form of loan covenants—from the perverse investment incentives which limited liability can, under certain circumstances, give to shareholders and those acting on their behalf (Smith and Warner, 1979; Bratton, 2006). Distribution restrictions based on earnings are a commonly used covenant in US loan agreements drafted by sophisticated creditors, in an institutional environment in which there are few mandatory restrictions on distributions in company law.³¹ Making a dividend restriction condition on cumulative net profits, as opposed simply to a given financial ratio or cash flow target, encourages shareholders to take into account the expected impact of liabilities generated by the firm's operations, as well as simply financial creditors, in making investment decisions (Leuz, 1998; Gjesdal and Antle, 2001). A cumulative profits test requires provisions made for expected future liabilities to be taken into account today.³²

A prohibition on return of capital can thus be understood as saving creditors the cost of writing such a term into their loan contracts—a sort of implied covenant (Miller, 1995; Cheffins, 1997: 521-524). 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.³³ Their application will be determined by the size of a company's share capital and share premium account, which—in

the absence of a minimum capital requirement—the shareholders are free to set.

3.2 Minimum capital rules

Minimum capital rules, coupled with anti-avoidance requirements, can be understood as providing a sort of guarantee to creditors that those using the corporate form will at the very least have a certain amount of their own money at stake. As such, they are sometimes described as ‘the entry price for limited liability’ (Prentice, 1998). Clearly, it is unnecessary for adjusting creditors to have such a mandatory guarantee: should it be efficient for such protection to be taken, they can contract for it: provided that distribution restrictions are in place, this can be achieved simply by requiring the desired level of capitalisation. Thus, the justification for these rules must be sought in relation to non-adjusting creditors.³⁴ Provided that a minimum capital rule is coupled with a restriction on distributions, it makes it more difficult to carry on hazardous business through a thinly-capitalised subsidiary. Such a rule can thereby serve to ameliorate the perverse incentives which might otherwise accompany undercapitalised companies in relation to non-adjusting creditors.

4. Are these rationales persuasive?

We now consider whether the rationales considered in the previous section are persuasive. The enquiry is structured by considering the size of the likely benefits yielded by these forms of creditor protection, and comparing these in each case with the likely costs of mandatory rules. Where appropriate, consideration will also be paid to alternative regulatory strategies.

4.1 Distribution rules

It was noted that rules prohibiting returns of capital impose restrictions on transactions which might harm creditors’ interests. However, restrictions of the sort these rules create might alternatively be generated through loan covenants. Thus the ‘benefits’ of the legislation are not the costs which the prohibited transactions would impose on creditors, but rather savings in contracting costs which might otherwise be incurred.

Sophisticated (i.e., ‘adjusting’) creditors do in fact frequently include loan covenants that restrict debtors’ ability to engage in transactions harmful to lenders’ interests (Smith and Warner, 1979; Bradlye and Roberts, 2005; Bratton, 2006). Thus there are potentially significant savings to be made through company law providing ‘creditor terms’ which restrict such transactions. Commercial parties could thereby be spared the costs of writing such terms themselves.

Nevertheless, it seems most unlikely that a distribution restriction conditioned on legal capital would succeed in capturing these benefits (Manning, 1982: 33-34). Whilst there may clearly be benefits to imposing dividend constraints based on net asset values, it is hard to understand why it would make sense to calibrate those restrictions by reference to historic contributions by shareholders, as opposed to the state of the balance sheet at the time the loan is advanced (Armour, 2000: 373-374). The utility of capital as a yardstick will diminish over time, as the value of the company's assets bears less and less resemblance to the amount of the shareholders' capital claims. If this is the case, then any 'savings' in terms of drafting costs will tend to diminish as the age of the debtor company increases.

Moreover, it should be appreciated that the appropriateness of distribution restrictions—and hence the preferences of commercial parties—will differ depending on the debtor company. This point is relevant to consideration both of the benefits and costs of a mandatory rule: where a distribution rule is appropriate, it creates a benefit, and where inappropriate, a cost. In theory, a distribution restriction is likely to be particularly useful for companies which have a large proportion of their value tied up in growth opportunities (Myers, 1977). Where the exploitation of such opportunities must be financed with equity (as, for example, if they are based on 'soft' assets upon which security cannot be taken) then there is likely to be an underinvestment problem: advances of further funds to exploit the opportunities will transfer wealth from shareholders to existing creditors. Thus shareholders will be deterred from making such investments. A distribution restriction can, for such firms, force shareholders to retain equity in the firm and therefore reduce this problem. This theory predicts that the appropriateness of distribution restrictions will vary with the degree of growth opportunities. Empirical evidence suggests that, in the US, where these matters are left to contract, there is a significant difference in the use of contractual distribution restrictions depending on the level of growth opportunities.³⁵ This tends to confirm our intuition that one size probably does not fit all, and that a mandatory set of rules implied into all contracts with creditors may generate mismatch costs in many cases.

4.2 Formation rules

As we have seen, a minimum capital requirement imposes an 'entry price' for limited liability. The effect of such a restriction is most likely to be felt on small firms. For such firms, which are typically owner-managed (Cosh and Hughes, 2003: 10), limited liability is not used to reduce risk-bearing costs by permitting shareholders to diversify, as it is for listed companies (Easterbrook and Fischel, 1991: 40-62).³⁶ Rather, the principal benefit brought by limited liability is probably the reduction in risk it offers to entrepreneurs. The willingness of

marginal individuals to engage in entrepreneurial activity does appear to be affected by the actual or perceived riskiness of such endeavour. For example, more lenient personal insolvency laws are associated with higher levels of self-employment (Fan and White, 2003; Armour and Cumming, 2005), plausibly because by reducing harshness of the consequences of failure, they make entrepreneurial activity more appealing to risk-averse individuals. A similar effect could be expected to be associated with the ease of obtaining limited liability.³⁷ That is, inability to gain access to limited liability (because of lack of sufficient resources to meet a minimum capital requirement) might deter individuals from engaging in entrepreneurial activity.³⁸ Consistently with this, one study finds a negative correlation between size of minimum capital requirements (scaled for GDP) and self-employment—a common proxy for entrepreneurship—in European countries during the 1990s (Armour and Cumming, 2005: 20).³⁹

To be sure, facilitating access to limited liability may be expected to result in would-be entrepreneurs coming forward with more marginal projects, in terms of quality. Whether or not these will be funded (in the absence of a minimum capital requirement) depends on the ability of private creditors to discriminate in terms of project quality. A greater demand for credit (associated with no minimum capital requirement) can be expected to spur the development of information intermediaries in private credit markets, who can assist financial creditors in distinguishing good from bad projects (Djankov *et al.*, 2005). Moreover, there is nothing to stop an entrepreneur credibly signalling the quality of his or her project in the absence of a minimum capital requirement, either by committing personal funds to the corporate enterprise or by agreeing to stand guarantor for its debts. Thus, provided adjusting creditors are able to distinguish project quality, or require shareholders to give a personal guarantee (by way of signal), then a minimum capital requirement will impose a social cost, through preventing some entrepreneurial projects from being undertaken.⁴⁰

We have on the other hand hypothesised that a minimum capital regime may yield social benefits, through the amelioration of the position of non-adjusting creditors. Whilst adjusting creditors may be able to screen out the more marginal projects associated with ready access to limited liability, non-adjusting creditors cannot. The existence and extent of any benefits for such creditors through the imposition of a minimum capital regime therefore merits careful scrutiny.

The analysis is complicated by the fact that the social welfare implications of the treatment of non-adjusting creditors depend not on the fact that they are unable to adjust, but rather on the reasons for which they become creditors.

Consider first tort victims. In economic terms, tortious liability is imposed on those conducting hazardous activity in order to encourage them to internalise the social costs of their actions (Calabresi, 1971; Shavell, 2004). Yet the amount necessary to capitalise a business adequately so as to internalise the risks of hazardous activities will depend on the nature of the business, and a unitary minimum capital requirement is likely to be a very haphazard means of achieving this. Moreover, there are more precise means of achieving the same goal. One is to regulate hazardous activity and to require that firms carry insurance commensurate with their potential risk.⁴¹ The pricing of insurance premia would be a more precise internalisation mechanism than a ‘fixed-rate’ minimum capital requirement, not least because the insurance company would act as an ongoing monitor for the firm’s activities.⁴²

A second category of creditor commonly classified as ‘non-adjusting’ is the state, in right of tax claims. However, a minimum capital rule is also inapposite in this context. Consider that no company is able to finance its commencement of operations solely on unpaid tax claims. This is because tax claims do not arise until taxable events take place in the course of operating a business. The initial finance for such business will need to come from adjusting creditors. Thus at the outset, the state may free-ride on the screening activity of others. Where tax claims are commonly used to ‘finance’ a business is not on start-up, but at the point where financial difficulties emerge. Here, adjusting creditors tend to press for payment and what commonly happens is that the unpaid tax monies are typically used to finance the continuation of the business beyond the point at which it should be closed. A minimum capital requirement on formation is therefore irrelevant to the state as tax creditor: by definition, equity capital will have been lost by this point. Moreover, although the state cannot typically levy differential interest on tax claims, it does have considerable economies of scale in both gathering information and organising enforcement. Through varying the alacrity of enforcement depending on the creditworthiness of the debtor, it is able to some extent to adjust its position.

A third category of supposedly ‘non-adjusting’ creditor consists of trade creditors. It is argued by some that trade creditors’ adjustment may only be partial, because of relatively information and transaction costs relative to the amount at stake. Indeed, empirical studies confirm that trade creditors tend to offer the same terms to all ‘borrowers’ (that is, customers who purchase on credit) (Ng *et al.*, 1999). Some suggest that the use of such a ‘blended’ term in the face of asymmetric information about borrower quality may result in good-quality borrowers being over-charged and poor-quality borrowers being under-charged, implying an inefficient ‘subsidy’ (Bebchuk and Fried, 1996: 885-886). Yet empirical studies also report that the amount of trade credit

granted is a function of the borrower's creditworthiness and of the scope for misbehaviour by the debtor (Petersen and Rajan, 1997: 678-679; Burkart *et al.*, 2004). This implies that trade creditors do in fact adjust across the margin of amount of credit extended as opposed to variations in terms.

It appears, therefore, that it is hard to find a category of non-adjusting creditors for whom minimum capital rules offer useful protection.

4.3 A future for 'creditor terms'?

The foregoing points imply that the costs of mandatory rules based on legal capital are likely to outweigh their benefits. One issue arising consequently is whether a case may nevertheless be made out for default rules (Armour, 2000: 375-377; Schön, 2004: 438-442). Whilst such a reformulation is obviously not available as regards minimum capital rules on formation, distribution rules could be recast as frameworks to which companies opt in or opt out on formation. On this analysis, these rules are viewed as equivalent to collective terms in loan contracts, and are enforceable by a liquidator on behalf of creditors, should the company go into insolvency.⁴³

As opposed to leaving the matter solely to individual contracting between companies and their creditors, default creditor terms might be thought to yield potential benefits. By reducing the need for creditors to bargain for individual protection, they could economise on negotiation costs. By permitting a company's obligations to be centrally specified, it would at the same time render them more transparent and more tractable. Default terms might also assist in reducing 'free-rider' problems in the provision of creditor protection. These arise because adjusting creditors do not capture the whole benefit of their expenditure in negotiating loan covenants—as some of it is conferred on non-adjusting creditors—and consequently may be expected to invest suboptimally in negotiating loan covenants and monitoring the same for breach.

Yet there are two serious difficulties with this justification for default rules as 'collective creditor terms'. The first is the well-aided point that there is likely to be considerable heterogeneity of demand amongst creditors, implying that the range of terms for which it might be possible for the state to capture economies of scale are very limited.⁴⁴ The second less straightforward. As we have seen, the utility of loan covenants depends crucially upon the level at which they are set. Too lax, and they permit the debtor to harm creditors' interests; too strict, and they stifle valuable projects. Over time, what is optimal may change. Thus in negotiating loan covenants private parties face a trade-off between the costs of debtor misbehaviour and the costs of renegotiating the covenants should they cease to be appropriately set. Loan covenants tend on average to be less

stringent where the costs of renegotiation are expected to be higher. That is, public debt contains less covenants than private debt.⁴⁵ A ‘collective covenant’ included in the corporate constitution would in principle be with all a company’s creditors—adjusting and non-adjusting. It follows that there would need to be some input from non-adjusting creditors in order to vary its terms, should circumstances change.⁴⁶ Hence it would be appropriate to set the level of constraint it imposed at one lower than that which would be desired by most adjusting creditors, were they contracting privately. In turn, many adjusting creditors would therefore find themselves dissatisfied with such a term, and seek to include more stringent provisions in their loan agreements. This could easily result in a net increase in contracting costs as compared with a regime relying solely on private contracting.⁴⁷

These theoretical difficulties may be substantiated by reference to English law. It is technically possible for an English company to insert a collective term into its constitution which would restrict distributions on the basis of a condition that is more effective than the legal capital rules. Such a ‘creditor term’ could be made unalterable by inserting it into the memorandum of association.⁴⁸ However, such provisions are not encountered in practice, presumably because it is considered too risky to include an unalterable provision lest changed circumstances render it a hindrance.

5. The impact of Regulatory Competition

5.1. The ECJ’s jurisprudence

Until recently, it was thought that there were insuperable legal obstacles to regulatory arbitrage in company law within the EU (Cheffins, 1997: 426-431). The conflicts of law rules of most Member States made use of the ‘real seat’ theory in determining the existence and proper law of a company. In contrast to the ‘incorporation theory’ used in the UK and the US, the ‘real seat’ theory applies the law of the place where the company has its main place of business. When combined with rules on the recognition of the existence of corporate persons, it effectively prevented any regulatory arbitrage in company law.⁴⁹

However, matters have changed dramatically following the ECJ decisions in *Centros*, *Überseering* and *Inspire Art*.⁵⁰ These cases relate to company law arbitrage at the point of formation (Wymeersch, 2000; Siems, 2002; Kersting and Schindler, 2003; Rammello, 2004; Lowry, 2004). Each of the decisions concerned the treatment by Member State B (the ‘host state’) of a company doing business exclusively in—and thereby having its ‘real seat’ in—that Member State, but being incorporated under the laws of, and having its registered office in, Member State A (the ‘home state’). The ECJ considered that the application of the real seat theory so as to deny recognition of the

existence of the company in Member State B because it was not validly incorporated there amounted to an interference with the company's freedom of establishment. Essentially, the Court ruled that as a matter of EC law, a company, once validly formed under the laws of any Member State, becomes a 'person' and is consequently entitled to exercise the Treaty Freedoms.⁵¹ As a consequence, any laws of Member State B which have the effect of making the exercise of that freedom less attractive to companies incorporated in Member State A may be struck down by the Court unless they satisfy the four-stage criteria set out in Gebhard:⁵² that is, they are (i) applied in a non-discriminatory manner; (ii) are justified by imperative requirements of the public interest; (iii) secure the attainment of their objective; and (iv) are not disproportionate in their effect.

5.2 Do legal capital rules pass the Gebhard test?

The rule in question in the Centros decision was of course the Danish minimum capital provision, which Mr and Mrs Bryde, both Danish nationals resident in Denmark, had sought to avoid by incorporating their company in the UK. In response to the Danish government's argument that the minimum capital requirements were justified in the overriding public interest for the protection of non-adjusting creditors, the Court ruled that they were neither necessary nor proportionate to achieve that goal.⁵³ Similarly, in Inspire Art, the court concluded that, for adjusting creditors, a minimum capital was simply unnecessary, as they would be put on notice, by the fact that the company was incorporated in the UK, that English company law's protections were applicable.⁵⁴

It remains to be seen whether a requirement that 'formally foreign' companies be subjected to domestic distribution restrictions would similarly fall foul of the Treaty. The case is rather less clear-cut than minimum capital rules, as it is not beyond argument that distribution rules would even constitute a hindrance to the exercise of corporate free movement. The better view, however, is that they do. Consider a company, incorporated under the law of Member State A, which has under that law considerable distributable profits. Assume that the company moves the entirety of its business operation to Member State B. If Member State B imposes stringent restrictions on distributions, both by domestically incorporated companies and by 'formally foreign' companies, then it is possible that such a stringent restriction would constitute a hindrance to the company's exercise of its freedom of establishment in Member State B. If so, then the arguments put in the previous section would imply that it would be appropriate for the Court to find such restrictions to be unnecessary and disproportionate.

5.3 Is the boundary between company and insolvency law significant?

It has been argued by some that the impact of the ECJ's jurisprudence is limited to the appropriate rules for choice of company law. Hence, the argument goes, if a rule is properly characterised as one of insolvency law, as opposed to company law, then the Centros line of authorities is not relevant Kersting and Schindler, 2003: 1290; Koller, 2004: 341-343; Rammeloo, 2004: 403-406). This argument is said to draw support from fact that jurisdiction and choice of law in European insolvency proceedings is governed by sui generis legislation, the European Insolvency Regulation ('EIR').⁵⁵ The EIR is widely thought to be based upon connecting factors that bear more in common with the 'real seat' theory than the incorporation theory.

If correct, this argument would imply that were legal capital rules to be framed by lawmakers so that they could plausibly be characterised as part of corporate insolvency law, as opposed to company law, then they would be outwith the ambit of the ECJ's jurisprudence. However, the ECJ's judgment in Inspire Art is framed not in terms of connecting factors in company law, but of legal provisions that impede corporate freedom of establishment. Why should this apply any differently to rules formally characterised as 'corporate insolvency law' than to rules of 'company law'? The existence of the EIR, which does not purport to govern the content of insolvency laws, but merely the connecting factor for choice of jurisdiction and choice of law, provides no justification for saying that the rules selected by its procedures should not be compatible with Treaty Freedoms (Armour, 2005: 405-406).

5.4 Regulatory competition and creditor protection

The ECJ's recent caselaw is having two related effects on legal capital rules in Member States company laws. First, for practical purposes, it resolves the issue whether legal capital rules are a meaningful way of responding to the policy problems concerning non-adjusting creditors. By ruling that they are not, the ECJ has, in essence, unleashed a process of 'negative harmonisation'. This is because following the three recent cases, there has been large-scale regulatory arbitrage over company formation.⁵⁶ This is most clearly evidenced in a recent study (Becht *et al.*, 2005) showing that since 2003, approximately 6,000 private companies per annum have been formed under English law by entrepreneurs living and trading in Germany (see also Armour, 2005: 386). Similar results are expected for other European countries. Anecdotal evidence from the websites of company formation agents is strongly suggestive that the driver of regulatory arbitrage by entrepreneurs is clearly the restrictive capital adequacy and maintenance requirements of many continental jurisdictions.⁵⁷ The result of this arbitrage has been to provoke a spate of 'defensive' regulatory competition, as continental European lawmakers respond to the threat of large-scale arbitrage.

Some, such as France and Spain, have already relaxed their capital maintenance regimes (Simon, 2004; Kieninger, 2005); others, such as Germany, are planning to do so shortly (Rammeloo, 2004: 409).

Although these developments are being driven by a desire to avoid regulatory compliance, this is not a ‘race for the bottom’. Concomitantly with this relaxation of minimum capital requirements, policymakers must reconsider the treatment of non-adjusting creditors, to see whether the issues to which they give rise can be addressed using more proportionate measures which will satisfy the Gebhard formula. To the extent that such measures—several of which have been canvassed in this paper—are able to achieve effective and targeted solutions to the problems, then their succession to the minimum capital regimes is to be warmly welcomed.

The second effect of Centros is that, so far as adjusting creditors are concerned, regulatory arbitrage will result in a ‘race to the top’. The impact of choice of company law will be priced by such creditors into their lending agreements, making it worth entrepreneurs’ while to select laws which are efficient. The previous section considered whether distribution rules could usefully play a role as default rules, rather than mandatory rules. The advent of regulatory competition will, it seems, have the effect of rendering their status closer to default rules in any event. Moreover, Member States wishing to attract incorporations will have incentives to offer such creditor protection mechanisms (if any) as adjusting creditors will find valuable in reducing their costs of contracting.

6. Conclusions

It has been argued that legal capital has no future as a body of mandatory rules of European private company law. Legal capital rules are a form of primitive regulatory technology which, as a matter of theory, is likely to generate more costs than benefits. This is particularly the case for minimum capital rules, which impede entrepreneurs’ ability to gain access to limited liability. However this paper has argued that other mandatory rules based on legal capital are also likely to be over-regulatory. On the one hand, the restrictions imposed by such rules are unlikely to be appropriate for all companies; on the other hand, it is hard to see how rules that condition distributions on historic capital contributions could be useful constraints even for companies for which such restrictions are appropriate. Moreover, it is arguable that even in relation to those companies for which distribution restrictions would be appropriate, their inclusion as ‘collective creditor terms’ in corporate constitutions are likely to be less effective than having them written into loan covenants. In any event, the advent of regulatory competition in European corporate law means that those

creditor protection rules that do not further the interests of adjusting creditors will become subject to competitive pressures. Legislatures will be faced with the task of designing mandatory rules to deal with the issues raised by non-adjusting creditors in a proportionate and effective manner, consistent with the Gebhard formula. At the same time, regulatory arbitrage will provide a way of gathering information regarding adjusting investors' preferences in relation to such rules.

Notes

¹ Gilbert and Sullivan (1893).

² For example, in most US states, legal capital rules have either been abolished outright or simply withered into marcescence: Manning (1982). In the UK, pending reforms will considerably relax the application of legal capital rules to private companies: see *infra*, text to nn 15-17.

³ Second Council Directive of 13 December 1976, 77/91/EEC [1977] OJ L26/1 (Formation of Public Companies and Maintenance and Alteration of Capital).

⁴ Case C-212/97, *Centros Ltd v. Erhvervs-og Selskabssyrelsen* [1999] ECR I-1459, [2000] Ch 446; Case C-208/00, *Überseering BV v. Nordic Construction Company Baumanagement GmbH (NCC)* [2002] ECR I-9919; Case C-167/01, *Kamel van Koophandel en Fabrieken voor Amsterdam v. Inspire Art Ltd* [2003] ECR I-10155.

⁵ European Commission, *Simpler Legislation for the Single Market (SLIM): Extension to a Fourth Phase*, SEC (1998) 1944 (Brussels, 16.11.1998), 3.

⁶ High Level Group of Company Law Experts, *Report on a Modern Regulatory Framework For Company Law in Europe* (Brussels, 4 November 2002), 86-93.

⁷ European Commission, *Proposal for a Directive of the European Parliament and the Council amending Council Directive 77/91/EEC as Regards the Formation of Public Limited Liability Companies and the Maintenance and Alteration of their Capital*, COM (2004) final, Brussels 21.09.2004.

⁸ European Commission, *Modernising Company Law and Enhancing Corporate Governance in the European Union - A Plan to Move Forward*, COM (2003) 284 final, Brussels 21.05.2003, 17-18. See generally, Rickford *et al.* (2004); Ferran (2005).

⁹ See, e.g., for public companies, 77/91/EEC Art 15 (1).

¹⁰ The notion of ‘maintenance of capital’ refers not to the assets contributed to the company, but the subordinated status of the shareholders’ capital claim. See Armour (2000: 365-66).

¹¹ A public company must also demonstrate that its net assets exceed the sum of its capital accounts plus its cumulated net unrealised profits by at least the amount of the proposed distribution: Companies Act 1985 s 264.

¹² 77/91/EEC, Arts 19(1)(c), 39; Companies Act 1985 ss 159-170, 263(2)(b).

¹³ 77/91/EEC, Art 23; Companies Act 1985 ss 151-158.

¹⁴ *Re Halt Garage (1964) Ltd* [1982] 3 All ER 1016; *Aveling Barford Ltd v Perion Ltd* (1989) 5 BCC 677; *Clydebank Football Club Ltd v Steedman* (2002) SLT 109 at 124. See generally Ferran (1999: 426-429); Armour (2003: 295-300).

¹⁵ Companies Act 1985 ss 171-177.

¹⁶ Company Law Reform Bill 2005, cl 562.

¹⁷ The law regarding fraudulent conveyances—in English law, now known as ‘transactions at an undervalue’ and ‘transactions defrauding creditors’ (Insolvency Act 1986 ss 238 and 423, respectively)—would strike down a transaction under which the company receives significantly less consideration than it gives and which takes place within two years of its entering corporate insolvency proceedings, provided that it was unable to pay its debts at the time of the transaction, or became so as a result. A distribution to shareholders is viewed in English law as a gratuitous transaction (*Associated British Engineering Ltd v IRC* [1941] 1 KB 15; *Wigan Coal and Iron Co Ltd v IRC* [1945] 1 All ER 392). Hence if the distribution were such as to cause the company to become unable to pay its debts, it would be open to avoidance by a liquidator, in the same way as a return of capital failing the solvency test.

¹⁸ 77/91/EEC Art 6(1). That said, only 25% of this need actually be paid up on formation: Art 9(1).

¹⁹ Companies Act 1985 ss 11, 118 (minimum capital requirement stated to apply only to public companies).

²⁰ See, e.g., 77/91/EEC Art. 10.

²¹ English law has never restricted this practice: see, eg, *Salomon v A Salomon & Co Ltd* [1897] AC 22.

²² The terminology is derived from Bebchuk and Freid (1996: 881-890).

²³ If such a transfer renders the company insolvent, then other legal provisions protect creditors. A liquidator or administrator could seek to recover the payments as a transaction at an undervalue (Insolvency Act 1986 s 238). Alternatively, the distribution may constitute a transaction defrauding creditors (ss 423-425).

²⁴ In other words, the ‘best current market estimate’ of their worth. This will be their face value, discounted for the time value of money and discounted further for the risk of default. Even if the debtor does not become insolvent, creditors are still prejudiced if the risk of default increases above that at which they had priced it, and if the value of their debt claim matters to them as an asset. 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.

²⁵ See, e.g., the quotation from Gilbert and Sullivan (1893), *supra* text to n 1.

²⁶ For an instance well-known to English lawyers, see *Adams v Cape Industries Ltd* [1990] Ch 433. For empirical evidence that this is a general phenomenon,

see Ringleb and Wiggins (1990) (increases in liability risk in US industries during 1967-80 correlated with decrease in capitalisation of firms in that industry).

²⁷ In other words, the ‘best current market estimate’ of their worth. This will be their face value, discounted for the time value of money and discounted further for the risk of default. Even if the debtor does not become insolvent, creditors are still prejudiced if the risk of default increases above that at which they had priced it, and if the value of their debt claim matters to them as an asset. 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.

²⁸ If such a transfer does in fact render the company insolvent, then other provisions protect creditors in any event. See above, n 17.

²⁹ For the purposes of this discussion, it will be assumed for simplicity that directors act in the interests of shareholders. The key point for present purposes is simply that directors’ interests are more closely aligned with those of shareholders (who appoint and remove them) than with creditors.

³⁰ Such constraints may arise (i) from legal restrictions on high interest rates—e.g. (Insolvency Act 1986 s 244, rendering ‘extortionate’ credit transactions unenforceable in the debtor’s insolvency); (ii) from ‘adverse selection’ problems in markets for corporate credit: very high interest rates tend to be least unattractive to those who do not intend to repay (Stiglitz and Weiss, 1981).

³¹ US studies from the early 1980s found a high incidence of dividend restrictions in covenants granted by randomly-selected samples of firms. See, e.g., Kalay (1982: 214-216) (100 per cent of sample of bond indentures). More recent studies find that dividend restrictions (and covenants generally) are less commonly found, and less restrictive, in bonds than in bank debt: compare Nash *et al.*, (2003: 218) (39.7% of 1989 sample and 20.8% of 1998 sample of bond indentures), with Bradley and Roberts (2005: Table V) (87% of sample of bank loans over 1993-2001).

³² In an oblique sense, this ‘protects’ the involuntary creditors: see Schön (2004: 441); Kershaw (2005). However, the extent of such protection depends on adjusting creditors permitting non-adjusting creditors to free ride. If there are significant levels of non-adjusting creditors (e.g. because of a hazardous line of business), then both shareholders and adjusting creditors will be better off by arranging for the hazardous business to be carried on by a thinly capitalised subsidiary, or (the inverse) for non-adjusting creditors to be structurally subordinated by transferring ‘safe’ assets to a finance subsidiary, to which entity adjusting creditors then lend. See also *supra*, text to nn 25-26.

³³ This does not, however, render the application of the distribution rules anything other than mandatory, because companies are unable to choose to raise equity capital without their operation (Ferran, 2005: 10-13; cf Schön, 2004: 438-439).

³⁴ See Case 212/97 *Centros Ltd v Erhvervs-og Selskabsstyrelsen* [1999] 2 CMLR 551, 586-587, in which the Danish government sought to justify their country's minimum capital laws on the basis, inter alia, that they protected involuntary claimants.

³⁵ See Bradley and Roberts (2005: 27) (high-growth firms significantly more likely to use dividend restriction in private debt agreements); Nash *et al.* (2003: 218 (high investment-opportunity firms significantly less likely to include dividend restriction in public debt agreements)). This disparity probably reflects the fact that high-growth firms face particular uncertainty. In these circumstances, a covenant that might be readily triggered would be a useful lever of control for creditors who can renegotiate easily: private lenders set covenants tightly to use them as 'trip wires' (Dichev and Skinner, 2002). However, such a covenant would be a hostage to fortune for dispersed creditors (public debt) who cannot renegotiate easily.

³⁶ The benefits of limited liability for the financing of listed firms are well-known: namely, that it: (i) permits share prices to be independent of the purchaser's wealth and thereby to reflect information about the value of the firm; (ii) allows for diversification by shareholders, reducing the cost of risk-bearing; (iii) makes passive investment a rational strategy, allowing for specialisation in the management and risk-bearing functions; and (iv) lowers monitoring costs, both for creditors and shareholders, who no longer need to check on shareholders' wealth levels.

³⁷ Of course, the true extent of its impact will depend on a combination of factors, including the severity of the consequences of personal insolvency, and the extent to which corporate creditors demand personal guarantees from those setting up private companies.

³⁸ It is worth noting that an individual's endowment of wealth has been shown to affect propensity to entrepreneurship (see, e.g., Blanchflower and Oswald, 1997). The most plausible interpretation of this result turns on risk aversion. Because of the declining marginal utility of money, a wealthier individual will suffer a lower decrease in utility for any given loss than will a poorer individual. Thus a wealthier individual will exhibit less aversion to bearing a risk of losing a sum of money.

³⁹ This result, using data on minimum capital requirements from the World Bank's 'Doing Business' survey (www.doingbusiness.org), is however only for a univariate correlation.

⁴⁰ The grant of a personal guarantee does of course undermine the benefit of risk-reduction for the entrepreneur. In the UK, such guarantees, whilst common, are not ubiquitous: see Freedman and Godwin (1994: 246) (53.6% of sample of owner-managers had given personal guarantees). And for those entrepreneurs that do not give personal guarantees, limited liability brings meaningful risk reduction.

⁴¹ The strategy is indeed adopted in Germany: see Schön (2004: 438). In the UK, The Third Parties (Rights Against Insurers) Act 1930 transfers liability insurance claims against an insurer of an insolvent firm from the firm to the party to whom it has incurred the liability, ensuring that tort victims need not share their recoveries with the debtor's other creditors.

⁴² Other strategies include imposing pro rata unlimited liability on shareholders for corporate torts (Hansmann and Kraakman, 1991) and granting priority in insolvency to tort creditors (Leebron, 1991).

⁴³ Alternatively enforcement could be effected by a regulatory agency.

⁴⁴ This could occur both within firms—creditors having differing time horizons, priorities, and repayment schedules—and between firms—creditors' requirements varying with the debtor's business and size—and means that a single term is unlikely to suit all. See Kanda (1992); Kahan (1995).

⁴⁵ See *supra*, nn 31 and 35.

⁴⁶ Most jurisdictions provide a general mechanism for renegotiating creditor contracts external to the constitution by means of a composition, whereby a majority of creditors can bind a dissenting minority. Nevertheless it is usually the case that all creditors must at least be notified.

⁴⁷ These problems may be illustrated obliquely by reference to the difficulties caused by an earlier form of 'collective term'—that is, the corporate objects clause. Originally conceived as a means of protecting investors, the mechanism was abandoned in the twentieth century, essentially because its costs exceeded its benefits: see Cheffins (1997: 527-531).

⁴⁸ Companies Act 1985 s 17. The better view is that breach of such a restriction would render the distribution void: see *EIC Services Ltd v Phipps* [2004] EWCA Civ 1069 (protection for third parties for acts in excess of company's powers provided by First Directive does not extend to shareholders in their capacity as such).

⁴⁹ For example, if a company incorporated in Member State A (which applied the incorporation theory) then carried on business in Member State B (which applied the real seat theory), the courts of Member State B would reason that the company's proper law would be that of Member State B, and consequently, because it was not incorporated under that law, it was not validly formed at all.

⁵⁰ *Supra*, n 4.

⁵¹ Moreover, the mere fact that the company was incorporated in Member State A solely to avoid laws which would otherwise apply, were it incorporated in Member State B, does not constitute an 'abuse' of that freedom: *Centros*, *supra* n 4, at [27]-[29]; *Inspire Art*, *supra* n 4, at [96].

⁵² Case C-55/94, *Gebhard v. Consiglio dell'Ordine degli Avvocati e Procuratori di Milano* [1995] ECR I-4165.

⁵³ *Centros*, *supra* n 4, at [35]-[37].

⁵⁴ *Inspire Art*, *supra* n 4, at [135].

⁵⁵ EC Council Regulation 1346/2000 [2000] OJ L160/1. Jurisdiction over insolvency proceedings was specifically excluded from the Brussels Convention (now consolidated as EC Council Regulation 44/2001 [2001] OJ L12/1: see Art. 1(2)(b)).

⁵⁶ In addition, the adoption on 25 October 2005 of the Tenth Company Law Directive on Cross-Border Mergers (2005/56/EC, [2005] OJ L310/1) will now facilitate regulatory arbitrage for established companies.

⁵⁷ A typical example of many such agents found by a Google search is Coddan CPM UK, which offers, via the internet, same-day incorporation of a UK private company for a fee of £42. The website has versions, explaining arbitrage opportunities, in Spanish and German. See www.ukincorp.co.uk.

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