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Legal Capital, Creditor Protection & Efficiency?

An Analysis of the European Legal Capital Regime in the Light of Recent Developments & Debates

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ABSTRACT

This thesis examines the rules of European company law which regulate the interest conflict between shareholders and creditors, i.e. the legal capital rules relating to the raising and the maintenance of contributed share capital. This area of company law is at present highly relevant and frequently discussed as a result of recent developments. Primarily, the rules on capital have come to be questioned and even undermined, as a consequence of the Centros case permitting national rules on capital to be circumvented. Although it has been over six years since the ruling of the case, the enquiry of legal capital rules is most relevant today. Criticism of the rules is constantly being put forward based on arguments of both the Centros case, EU goals of a Common Market and the fact that the current regime is held not to accomplish the objectives set out for it. In recent years, the debate has flared up even more as a consequence of the content of company law and legal capital currently is being under review.

As a result of the current European development and debate, this paper asks whether legal capital rules can be understood as an efficient instrument to balance the shareholder-creditor conflict. Moreover, it asks whether such rules can be objectively justified in the light of the freedom of establishment and the realization of an Internal Market. It argues that the current regime is unlikely to provide the protection which it has the objective to do, and moreover that it not enhances the efficiency of the economic markets. In accordance with the recommendations made by the Winter Group to the European Commission, this thesis furthermore argues that a new regime is needed if Europe will be able to provide sufficient protection of company creditors and sustain the development of the Common EU Market, however, not without acknowledging the difficulties that to such changes would imply.

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ABBREVIATIONS

AG	Aktiegesellschaft
AktG	Aktiengesetz of 1965
CA	Companies Act of 1985
ECJ	European Court of Justice
EU	European Union
EC	European Community
GmbH	Gesellschaften mit beschänkter Haftung
GmbHG	Gestez betreffend die Gesellschaften mit beschänkter Haftung of 1994
Ltd	Limited
SLIM	Simpler Legislation for the Common Market
UK	United Kingdom
US	United States of America

CHAPTER 1 INTRODUCTION

1.1 Presentation of Subject Matter

Legal capital rules as an instrument of protecting creditors from shareholder misconduct of a company's capital, emerged in Europe already in the second half of the nineteenth century. Ever since, rules consisting of capital formation requirements and shareholder distribution limitations have been characteristic elements of continental European legislation. It has even been held that the fundamental purpose of corporate law in Europe is to protect company creditors. This objective is clearly evinced by the fact that most European national legislations comprise of comprehensive and detailed statutory regulations on company capital.

During recent years, however, these cornerstone rules of European company law have come to be challenged, questioned and harshly criticised from several directions. First of all, the legal capital doctrine has been challenged as a consequence the development of the Common Market within the EU. More precise, the doctrine has come to be questioned as a consequence of some resent rulings from the ECJ in its dealing with companies' freedom of establishment within the Common Market. Although the Court did not directly express its opinion regarding legal capital rules and their ability to protect creditors, the consequences of the holdings have been held to be devastating with regards to the legal capital doctrine. As a result of the ECJ rulings, a debate has started within the Union, asking whether legal capital rules are in conformity with the goals of the European Union and whether such rules may still be justified with respect to the present development within the Union.

Bearing in mind the ECJ rulings, various scholars and corporate actors have furthermore expressed harsh criticism of the legal capital regime, referring to *"Anglo-American wisdom"* and modern economic theory. In accordance with these references, the critics claim that legal capital regulations no longer can be justified with regards to either creditor protection or business promotion. Some scholars even speak of a "petrification effect", signifying that market developments may turn out to be stronger than statutory requirements and hence overrule these rules.

Furthermore, in a recent presented examination report, only 25 % of the respondents firmly believed in the current regime, while 73 % considered that the same objectives that are accomplished through the current system, could be achieved by other means. Based on the findings from these consultations, the European Commission last year adopted an action plan on modernising European company law, comprising of rather remarkable changes on the area. Thus, the current debate has made the issue of legal capital rules highly interesting at the moment, and has come to place European company law international in focus. The issue whether the cornerstones of European company law are under pressure to change and where Europe should go in the future is currently discussed, not only in Europe, but in the entire world.

1.2 Objective & Delimitations

As stated, legal capital rules are some of the most fundamental and characteristic corporate rules in continental European legislation. The objectives of this thesis are primarily four. *First*, the objective is to present the legal capital doctrine and clarify why we have rules on capital and how our European rules differ from the important US regulations. Bearing in mind these rules, my *second* objective is moreover to study recent and present development of European company law, primarily with regards to some controversial rulings from the ECJ. The consequences of these judgments have been held to have devastating consequences with respect to national legal capital rules; why is that, and what exactly are the effects of the rulings? Considering the effects of these rulings, is it possible that rules on capital are not compatible with the goals of the European Union?

Taking into consideration the effects of the ECJ rulings above, my *third* objective is furthermore to analyse whether there is a pressure of changing the current regulations. Hence, my ambition is to scrutinize the criticism put forward towards the current legal capital regime and see if the regime can still be justified, both from the perspective of the recent ECJ rulings, but also from a creditor protection and business effectiveness point of view. Accomplishing this objective, it is additionally my *fourth* and last ambition to look ahead and see where the ongoing development will take European rules. What role will rules on legal capital play in the future, do they even have a future? Where will and where should Europe go in the future?

This thesis will merely consider the legal capital rules relating to *capital formation* and *shareholder distributions*. Under rules on capital formation, aspects of minimum capital requirements and contributions in kind will be covered. However, rules relating to post-formation acquisition and the legal reserve etc. will be disregarded in this thesis. With respect to shareholder distributions, merely dividend distributions will be comprised. It must nevertheless be noticed, that except from capital formation and shareholder distribution rules the legal capital regime comprise of numerous more regulations For instance, rules regarding acquisitions of own shares, disbursements in respect of reductions of share capital and even liquidation rules. These rules will accordingly fall outside the scope of this essay.

When the material legal capital legislations are presented under chapter three only the national legislations of Germany and the UK will be presented. The reason for presenting these two Member States is that they represent the two prevailing theories on capital regulation within the EU, which the remaining states have based their national rules on.

With respect to the ECJ case law, only two rulings will be presented; The Centros and Inspire Art case. There are, however, several rulings which also concern the subject matter dealt with, but these will due to the page limit have to be disregarded under the scope of this thesis. Furthermore, the cases presented will merely be dealt with from the perspective of legal capital rules. The decisions have in contemporary legal writing been extensively analysed from the perspective of conflicting national company regulation, i.e. the conflict between the real seat principle and the incorporation principle. This aspect will, however, not be considered in this thesis.

1.3 Method & Material

This thesis is a traditional desk study where descriptive and analytical, as well as comparative method has been used. The basic understanding of the subject has been received by primarily reading technical books dealing with legal capital rules in Europe from several perspectives. Based on this received knowledge a traditional source of law description method has been used when presenting the material rules. The additional and deeper understanding with respect to the present development and its implications has further been attained through the study of various European and American articles, and furthermore material from the European Commission concerning the current development and present ongoing debate. Based on this

understanding and knowledge I have focused on describing, analysing and scrutinizing the specific problems that are the objective and ambitions of this thesis.

The descriptive part of the material rules aim at being as comprehensive as the page limit provide for, and hereby supplying the reader with a sufficient ground for the following analytical parts. Mainly, an argumentative approach has been applied when writing, but in various parts also a more critical approach has been applied. The analytic parts contain legal as well as economic arguments. Furthermore, the analysis contains comparisons with Anglo-American Common Law, focused on US regulations. The objective of this comparison is dual; first, they will illustrate the main differences between the European and the US system and thereby provide the reader a deeper understanding of the current European regime, and its benefits and possible shortcomings. Second, the comparison will serve as a reference system when considering potential developments of the current European model.

Since legal capital regulations are cornerstones in European corporate legislation there is hence much material with regards to material regulations. To present the essence of these material regulations, professional literature, national statutes, EU Directives and various EU publications have been studied. The material scrutinized derived from both European and American legislations and have moreover been authored by various well-reputed scholars.

Concerning the more specific issues seeking to problemize the issues analysed with respect to legal capital rules, mostly legal writing in articles and reports have been studied. Moreover, also rulings from the ECJ have been studied. To explain these decisions, and also to analyse the consequences of the outcomes, various articles commenting on the rulings have been examined. The final chapter regarding the future of the European legal capital regime is principally founded on material from the European Commission. This material has almost exclusively been received from the website of the European Commission, see the list of references.

Hence, this thesis is principally based on material achieved after extensive research in various databases. This material primarily consists of articles and presentations written by various authors, lawyers and company law experts. All material that has been used is up to date and published by respected legal scholars in respected law journals and journals from prominent universities, see the list of references.

1.4 Outline

This thesis is implicitly divided into two parts. The first part comprises of chapter 2-4 and is mainly descriptive. Chapter **two** starts of with presenting the underlying conflict which this thesis is based on, the conflict between shareholders and creditors within a company. This chapter is meant to provide the fundamental understanding of why there are rules on capital and moreover to illustrate how legal cultures reflect values and priorities within a society. Based on this understanding, chapter **three** will thereafter present the material regulations of Europe and the EU with regards to capital formation and capital maintenance rules. Following this chapter, chapter **four** will provide a brief overview of the Common Law tradition, illustrated by American regulations. This chapter only comprises the main features of the relevant US rules, and will mainly serve a comparative function to contrast the European regulations to the American ones in balancing the shareholder-creditor conflict.

The second part, chapter five, six and seven, comprise the analytical part of the thesis and is based on the previous descriptive chapters. Chapter **five** can be held to be the central chapter, and deals with the European legal capital rules in the perspective of the EU's goal of a Common Market. The chapter will display how two recent rulings from the European Court of Justice, the Centros and the Inspire Art case, have come to challenge and question the whole legal capital regime. Initially, the two cases will be presented and hereafter a discussion will follow of the consequences of these rulings. From the perspective of the Centros and Inspire Art cases, the following chapter, chapter **six**, asks whether the European legal Capital regime may still be justified considering the previous rulings, and the harsh critique put forward towards the current system. The chapter focuses on criticism regarding rules on capital formation, shareholder distribution through a balance-sheet test, protection of involuntary creditors and criticism based on efficiency and abuse arguments. Bearing in mind the harsh critique presented, chapter **seven** hereafter considers the future of the legal capital regime in Europe. The chapter is mainly based on a recent report from a respected group of company law experts, which by direction of the European Commission have presented several recommendations for a modernising company law in Europe. These recommendations will be scrutinized and commented on. Finally, a vision of the future will conclude the chapter by considering where Europe will and should Europe go. Last, the thesis will be rounded off in chapter **eight** with a conclusion and some final remarks.

CHAPTER 2 CONFLICTING INTERESTS & LEGAL CULTURE

2.1 The conflict between shareholders and creditors

Within a corporation there are many groups of actors, as for example, majority shareholders, minority shareholders, management, employees and creditors. These groups all have various interests in a corporation's cash flow, and these interests inevitably come into conflict. [1] This thesis is based on one of these conflicts, the conflict between shareholders and creditors.

The origin of the shareholder–creditor conflict arises as a consequence of the fact that shareholders in corporations are not held personally responsible for the debts of the company. The members and the investors in a corporation are not liable for more money than the amount they invested in the company.[2] Consequently, all persons that may have claims on a company's capital, the *creditors*, are restricted to the assets of the company.[3] This characteristic is usually justified by the fact that ordinary persons would not be willing to start up companies if they risked being personally responsible for debts that the corporation may incur. Notwithstanding the advantage of corporations for society, the benefit of limited liability does not eliminate the risk of business failure. Limited liability simply shifts the risk from the shareholders to the creditors[4]. While shareholders have an interest in obtaining yield of the money they have invested in the company, creditors have an interest in the corporation having enough capital to pay its debts. Accordingly, there is a conflict between shareholders and creditors regarding the usage of a company's capital.[5]

2.2 Interests and Incentives; the Reason for Legislating

A limited liability corporation is based on the notion of making profit to its shareholders. However, since shareholders are not held personal liable for debts of the company, shareholders in companies with heavy debts often have strong incentives to act opportunistically. These opportunistically actions regularly occur at the expense of existing

[1] *Bergström*– Aktiebolagets grundproblem, p.28-29.
[2] *Werlauff* – EC Company Law, p. 23.
[3] *Bergström*– Aktiebolagets grundproblem, p.188
[4] *Van der Elst*– Economic Analysis of Corporate Law in Europe: an Introduction, p.7
[5] *Enriques* & *Mecey* - Creditors versus Capital Formation: the Case against the European Legal Capital Rules, p. 4-5.

creditors since the result is that company assets are reduced.[6] The temptation of making more profit is moreover held to increase the risk-taking. If there is a slight chance of increasing the value of equity, the chance will often be taken, often at the risk and the expense of the creditors.[7] The result is thus that the limited liability may create incentives for shareholders to, for example, invest in projects that are riskier than planed when the creditors extended the credit.[8]

Furthermore, shareholders interest in obtaining profit may create incentives to engage in asset diversion from the creditors to themselves.[9] This diversion may, for example, take place in forms of dividend payments to the shareholders, payment of expensive salaries etc. All of these distributions will, naturally, reduce the capital upon which creditors depend when they extend credit to a company.[10] Furthermore, shareholders, or managers, may engage in claim dilution and in this way affect the financial stability of the company. This situation may, for example, arise if the shareholders increase debt leverage by taking another loan at the same or a higher priority than the old debts. Creditors may also be affected negatively by shareholder behaviour if assets are purchased which is connected to a better safety right. The result is the elimination of the advantage that the existing creditors have connected to their claims, if the company becomes insolvent.[11] The reason for having legislations on the area is accordingly to prevent misconduct and create a balance in these presented situations.

2.3 Contractual Creditors & Involuntary Creditors

Creditors as a group comprise of a wide range of actors and may primarily be divided into contractual creditors and non-contractual creditors. Contractual creditors are those creditors who contract with company and in this way their claim towards the company arises. The major contract creditors are banks and other finance houses, but also different suppliers extend credit when supplying products, rents and electricity.[12]

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[6] *Bergström* – Aktiebolagets grundproblem, p.190
[7] *Bergström* – Aktiebolagets grundproblem, s.191
[8] *Enriques* & *Mecey* – Creditors versus Capital Formation: The Case against the European Legal Capital Rules, p. 2-3
[9] *Bergström* – Aktiebolagets grundproblem, p.191.
[10] *Enriques* & *Mecey* – Creditors versus Capital Formation: The Case against the European Legal Capital Rules, p. 2.
[11] *Bergström* – Aktiebolagets grundproblem, p.192 and *Enriques* & *Mecey* - Creditors versus Capital Formation: The Case against the European Legal Capital Rules, p. 2
[12] *Rhode* – Aktiebolagsrätt, p. 21

Non-contractual, or involuntary, creditors on the other hand, do not have the possibility of contracting with the company. One examples constitute of tort victims, who receive claims towards the company after being hurt by the company in any way and thus has the right to damages, for instance under environmental law.[13] Other involuntary creditors are employees and the public as tax and VAT collector. All these creditors have no possibility of protecting their interests alone and they are therefore dependent on other mechanisms that will secure that the company covers their claim.[14]

2.4 Interests of Protection

As illustrated in the previous paragraphs, the opposite interests in the present conflict are, on one side, shareholders´ freedom of action regarding the company capital, and on the other side, creditors' interest of keeping the same capital in the company. Which of these actors and interests that is regarded more meriting protecting, have been regarded differently in different legislations. In other words, the extent to which creditors are protected by law varies among national legal systems, and reflects the values and exceptionalisms of each society.

2.4.1 The European "Civil Law" Legal Culture

Under European Civil Law tradition, creditors have always been benefices of a strong legislative protection from shareholders interests. The interest of protecting creditors in company law goes back a long time and is by now deeply rooted in the European culture.[15] Some scholars have even held that one of the fundamental purposes of corporate law in Europe is to protect creditors.[16] The reason for this position has always been the fear that creditors would not invest in companies if they were not protected by shareholder misconduct and guaranteed a certain amount of assets if the company went bankrupt.[17] Thus, the security of creditors is held to be equal to the capital of the company, and therefore the European starting-point is that the company capital must be controlled. As a result, shareholders´ freedom of action will be restricted with several rules aiming to protect the company capital.

[13] *Kübler*, – The Rule on Capital under the Pressure of the Securities Markets, p. 9.
[14] *Rhode* – Aktiebolagsrätt, p. 21
[15] *Hopt* – Modern Company Law problems; A European Perspective, Keynote speech, p. 6 and *Kübler*, – The Rule on Capital under the Pressure of the Securities markets, p. 1.
[16] *Enriques & Mecey* - Creditors versus Capital Formation: the Case against the European Legal Capital Rules, p. 4-5.
[17] *Rodhe* – Aktiebolagsrätt, p. 21.

These rues are called *legal capital rules,* and the compliance with these rules can be seen as the trade off for shareholders to obtain the benefits of limited liability.[18] Consequently, legal capital rules are the protectors of both contractual and involuntary creditors in Europe.[19] Some national European legislations, and also EU regulations, based on this tradition will be presented under chapter 3.

From the heading of this subsection it was stated that the legal culture presented concerns European Civil Law countries. However, with regards to the UK which de facto is a European state, the situation is more complex. Britain namely has a Common Law tradition and as a result the British legal tradition differs widely from the rest of Europe.[20] Hence, what is stated in the next subsection will in many aspects be more correct concerning the UK tradition. This "dual" position of the UK will be further illustrated under part 3.3.2 and 3.4.2 where the material rules of the country are presented.

2.4.2 The Anglo-American "Common Law" Legal Culture

The legal culture in Common Law systems, as for example the US and to a certain extent in the UK, is nearly the opposite compared to the European tradition of statutory creditor protection. The Anglo-American system is instead based on values of individualism, equal rights and opportunities are upheld, not equal results or conditions. As a result market forces are often let to run freely with merely a modest involvement of government and legislation.[21] The fundamental purpose of existing corporate law is accordingly to provide the utmost flexibility for private ordering within a structure that seeks to maximize value for shareholders.[22] Creditors are seen as individuals, and not a homogenous group, resulting in that creditors who wish to protect themselves from shareholders behaving opportunistically, must do so by contract based on credit references etc.[23] The starting-point under Anglo-American Common Law tradition, is thus that creditors participate in corporate governance at their peril.[24]

[18] *Kübler*, – The Rule on Capital under the Pressure of the Securities Markets, p. 1.
[19] *Rodhe* – Aktiebolagsrätt, p. 21 and *Enriques & Mecey* - Creditors versus Capital Formation: the Case against the European Legal Capital Rules, p. 4-5.
[20] *Kübler*, – The Rule on Capital under the Pressure of the Securities Markets, p. 3.
[21] *Chase* – American "Exceptionalism" and Comparative Procedure, p. 1.
[22] *Enriques & Mecey* - Creditors versus Capital Formation: the Case against the European Legal Capital Rules, p. 5.
[23] *Enriques & Mecey* – Creditors versus Capital Formation: The Case against the European Legal Capital Rules, p. 5.
[24] *Enriques & Mecey* – Creditors versus Capital Formation: The Case against the European Legal Capital Rules, p. 4-5.

Also with regards to involuntary creditors, statutory legal capital rules are rejected. The argument is that such rules do not consider the individual situation of each company in relation to its business activity; hence they cannot provide any meaningful protection to creditors.[25] However, because involuntary creditors are not able to create protection through contracts, other means of protection have been created. First of all, there is a system of disregarding the corporate entity and the limited liability, and thereby raise claims directly against the shareholders under what is called the doctrine of "*piercing the corporate veil*".[26] Second, corporations are also obliged to take out mandatory insurances that will cover the claims of these creditors.[27]

This chapter has pointed out the conflict between shareholders and creditors, and two ways of balancing the interests within the conflict has been presented. In Civil Law Europe the side is clearly taken for creditors and comprehensive sets of rules have been developed to protect these actors as a group. In Common Law systems as the US, on the other hand, focus lies on individual flexibility for both shareholders and creditors. Bearing in mind this chapter as a background, the next two chapters will look further into, mainly the European, material regulations that are based on these legal traditions and values.

CHAPTER 3 LEGAL CAPITAL DOCTRINE IN EUROPE

Rules on capital of companies emerged in Europe in the 2nd half of the 19th century and are, as been stated, generally viewed as a reaction to the separation of liability.[28] Today all of the EU Member States, more or less, adhere to the legal capital doctrine. In most states the rules on capital are considered cornerstones and various company and closely related regulations are built up around these rules. However, in a few states rules on capital have no tradition, but have been imposed by the EU through its endeavour of harmonising national company legislation within the Member States. The objective of this chapter is thus to present and explain the legal capital rules in Europe and how it has been affected by the EU

[25] *Kübler* - The Rules on Capital under the Pressure of the Securities Markets, p. 3-4.
[26] *Miller* – Piercing the Corporate Veil among Affiliated Companies in the European Community and in the US: A Comparative Analysis of US, German and UK Veilpiercing Approaches, p.3.
[27] *Kübler* - The Rules on Capital under the Pressure of the Securities Markets, p. 8.
[28] *Kübler* - The Rules on Capital under the Pressure of the Securities Markets, p. 1.

harmonisation work. Before beginning with this presentation, an important distinction of company forms must be made.

3.1 Publicly and Privately Held Companies.

Within most states of the EU there are two forms of limited-liability companies, one *public* form[29] and one *private* form[30]. The main difference between the two is that only the public form may issue shares to the public for procurement of capital.[31] Moreover, and irrespective of this difference, the distinction between the two forms is highly important since only *publicly* held companies are comprised by the harmonization work of the EU, see part 3.1. As a result, all publicly held European companies are regulated by similar national regulations since they all are subject under the same minimum regulations.[32]

Contrarily, with respect to *privately* held companies, there are no EU rules, or any other guidelines for that matter, that Member States must oblige to. Regulations concerning privately held companies are thus entirely the task of each national Parliament. As a consequence, European private corporate legislations have been divided into two camps or models; one model which may be considered traditional European with the origin in German legislation, and one model based British legislation and tradition. To display this division of Europe, which will be of importance later in this thesis, the German legal capital legislation (representing states as for example France, Italy, Spain, Austria, and the Scandinavian countries), and the UK capital legislation (representing mostly Ireland) will be presented with regards to both public and private companies, see part 3.3 and 3.4.

3.2 Harmonization and the Second Company Law Directive

Already in the 1960´s, a harmonization work started within the EU which over the years has become more and more comprehensive. The harmonization of national company law has been accomplished through Directives which oblige the Member States to adjust their national

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[29] Examples of public company forms are: *Germany*- the Aktiengesellschaft (AG), *the UK* – public Ltd, *France* – Societ e´ Anonyme (SA), *Italy* –Societ a´ per azioni (spa), *Spain* Sociedad Anonima (SA).
[30] Examples of private company forms are: *Germany*- the Gesellschaft mit beschänker Haftung (GmbH), *the UK* – private Ltd, *France* – Societ a´ Responsabilité Limitée (SARL), *Italy* –Societ a´ responsebilita limitata (srl), *Spain* Sociedad Limitada.
[31] *Rodhe* – Aktiebolagsrätt, p. 22.
[32] See Article 1, Second Company Law Directive.

legislation to the requirements of these directives.[33] At this point, ten Company Law Directives have been adopted[34], and one of those is the Second Company Law Directive (77/91/EEG) adopted on the 13th December 1976. This directive, which is called "*The Capital Directive*", deals with the formation of public[35] limited liability companies and the maintenance and alteration of their capital.[36]

The Directive is clearly characterised by traditional Civil Law tradition and values. The preamble, for example, states that the provisions of legal capital regulation in the Directive should be adopted for the maintenance of a company's capital since this capital constitutes creditors' security.[37] In accordance with this objective, the material regulations of the Second Directive are built up around *two tiers* and the rules may thus be distinguished by their purpose relating to these tiers; either they relate to (1) the *raising of capital* which will guarantee that a certain capital is contributed to the corporation before the company is incorporated, see part 3.1, or (2) the rules have been enacted in order to ensure that *capital is maintained* in the company after incorporation, see part 3.2. This second tier thus complete the first tier, by providing regulations that will prohibit return of the initial contributions to the shareholder during the company's life.[38] Accordingly, the underlying thought of these rules is, in conformity with the European culture, that there always should be a "*cushion*" in the company[39] which will protect both contractual creditors and involuntary creditors.[40]

The following presentation of, both public and private, European legal capital regulations will follow the above division and the regulations of the Second Directive.

3.3 Capital Formation Rules in the European Union

With regards to public companies, the first tier of the Second Directive deals with the raising of company capital through a minimum share capital requirement. Article 6 of the Directive

[33] SOU 1997:168, p. 49 The legal base for harmonization is Article 44 (2) g, Treaty of Rome. Fourteen Directives have been issues of which however four (the 5th Directive concerning corporate governance, 9th Directive regarding groups of companies, the 10th Directive on mergers or the 14th Directive on transfer of the registered seat while retaining the legal personality) have not been adopted yet.
[34] *Werlauff* – EC Company Law, p. 46.
[35] Article 1 (1) Second Directive. Whether a company is public or not, must be evident from the name of such company.
[36] *Edward* – EC Company Law (1999), p. 51-52.
[37] See the preamble of the Second Company Law Directive.
[38] *Enriques & Mecey* – Creditors versus Capital Formation: The Case against the European Legal Capital Rules, p. 5.
[39] *Bergström* – Aktiebolagets grundproblem, p.190
[40] *Andersson* – Kapitalskyddet i Aktiebolag, s. 9

thus obliges Member States to pass laws requiring public companies to have a minimum share capital of at least 25,000 European Units, i.e. euro, before they may commence business.[41] In addition, Article 7 moreover states that this subscribed capital only may consist of "assets capable of economic assessment".[42]

Furthermore, it is possible for shareholders to pay their shares by other means than cash. This type of payment is called *contribution* (or payment) *in kind* and may constitute of for example real property, single pieces of machinery, a patent or a complete undertaking.[43] In these situations, it has been regarded important to guarantee that the assets contributed have the value that has been assigned to them, since an overvaluation clearly would be a disadvantage of the creditors, and moreover that these assets indeed are assigned to the company. As a result, Article 10 of the Second Directive prescribes that in cases where contributions are made in kind, an *independent exert*[44] appointed or approved by an administrative or judicial authority, must prepare a special report which will be subject to disclosure.[45] At minimum the expert's report must (1) describe the asset, (2) describe the valuation method and (3) state whether the value of the assets corresponds to the value of the shares that the shareholder receives.[46] As a consequence of this strictly formal procedure, Member States may not permit undertakings to perform work or supply services to form part of assets constituting contributions in kind.[47] Moreover, Article 9, prescribe that shares issued for a consideration must be paid up at the time the company is incorporated, by not less than 25 % of their nominal value.[48]

3.3.1 Capital Formation Rules in Germany

As been stated, most European legal capital legislations have their origin in German corporate tradition. In general, the German, and the continental European, corporate legislation is characterized by detailed and mandatory provisions with a long tradition of protecting creditors. In Germany this tradition is based on the idea that a company is "something more"

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[41] The amount of the minimum capital shall moreover be revised every five years by the Council, with regards to the economic and monetary trends in the Community see Article 6 (2) of the Second Company Law Directive. See also *Dorresteijn* – European Corporate Law (1995), p. 41 and *Edwards* – EC Company Law, p. 60.
[42] *Dorresteijn*– European Corporate Law (1995), p. 41.
[43] *Werlauff* – EC Company Law, p. 114 and *Edwards*– EC Company Law, p. 62-64.
[44] Persons who act as independent experts can be either natural or legal persons, according to the provisions of each Member State.
[45] *Edwards* – EC Company Law, p. 62.
[46] *Werlauff* – EC Company Law, p. 114.
[47] See Article 7 second sentence.
[48] *Edwards* – EC Company Law, p. 61.

than just a contract between the shareholders. Companies are regarded to have a responsibility towards the society and everyone that engages in the company's activity which, for example, is reflected in the fact that major creditors as banks have seats in the supervisory board, *Aufsichtrat*.[49]

The German public limited liability company, *Aktiengesellschaft* (AG)[50], is subject to the Second Directive and is thus required to have a minimum start capital of 25,000 euro. Article 7 of the Stock Corporation Act (Aktiegesetz: AktG), however, prescribe that the double amount, at least 50,000 euro must be submitted.[51] Furthermore, the amount of the share capital must always be stipulated in the articles of association. Prior to registration all shares must be subscribed to, and at least one-fourth, 25 per cent, of the nominal value amount of the cash contributions must have been paid-in.[52]

In addition to traditional cash payment shareholders may also pay their part of the share capital with other means. In accordance with Article 10 of the Second Directive it is therefore, it is also possible under Article 27 § AktG to make contributions in kind, as long as the assets contributed comprise of assets which have an "ascertainable economic value".[53] This economic value must moreover be certified in an independent expert report made by independent experts, which in Germany is appointed by the court.[54] Moreover, according to Article 36a AktG, all contributions in kind must be made *in full* prior to registration which thus is a stricter provision than what is required by the Directive.[55] However, if the contributions in kind consist of an obligation to transfer assets to the company, such obligation must be capable of being fulfilled within five years after registration in the company register. In accordance with the Second Directive, undertakings to provide services are explicitly prohibited.[56]

Turning to the regulations of the *private* limited liability companies, there are, as been said, no requirements for the Member States to oblige to. Generally, private companies in Europe

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[49] *Hopt* – Modern Company Law problems; a European Perspective, Keynote Speech, p. 6.
[50] The public company *Aktiengesellschaft* (AG) is regulated in the Aktiengesetz (AktG). In total there are about 3000 AG in Germany, see SOU 1997:168 p.51.
[51] *Dorresteijn* – European Corporate Law, p. 72.
[52] *Maitland-Walker*– Guide to European Company Laws, p. 158 and *Dorresteijn*– European Corporate Law, p. 73.
[53] *Dorresteijn* – European Corporate Law, p. 72-73. The authors of the book state that only in rare cases the contributions take the form of cash and that in most cases the issue of shares is based on non-cash contributions such as the conversion of an existing business.
[54] Article 33 paragraph 3 AktG, see also *Kübler* – The Rule on Capital under the Pressure of the Securities Markets, p. 1.
[55] *Maitland-Walker* – Guide to European Company Laws, p. 158.
[56] *Dorresteijn* – European Corporate Law, p. 72.

offer more flexibility and rules which may be considered more lax with respect to legal capital. However, all Member States except the UK and Ireland, see below, require a minimum capital before incorporating. The German private limited-liability company, *Gesellschaft mit beschänker Haftung* (GmbH)[57], for example, require a minimum share capital to be submitted of at least 25,000 euro. Furthermore, the amount of the original contribution of each shareholder must be at least 100 euro in total, according to Article 5 (1) GmbHG, and at least one-quarter of each original contribution must be paid in before registration.[58]

When contributions are to be made in kind, the assets comprising the contributions, and the amount of the original contribution that they are to cover, must be stated in the articles of association, see Article 5 (4) GmbHG.[59] Shareholders must moreover set out in a report, the major considerations supporting the appropriateness of the valuation of the non-cash contributions which has to be reviewed by the local court of registration[60]. In situations when a business is transferred to the company, the results of this business activity of at least two financial years must be stated in the report. If, at the time of the application for registration, the value of a contribution in kind does not equal the amount of the original contribution subscribed for, the shareholder must make cash contribution in the amount of the shortfall, according to Article 9 GmbHG.[61]

3.3.2 Capital Formation Rules in the UK

Following a Common Law culture, Britain has a tradition of viewing the corporation as merely a "*network of contracts*" [62]. This metaphor signifies that all a company is regarded to be, is a system of different contracts. Accordingly, a company is not considered to have any further responsibility towards the society, as in Germany. The sole purpose of a company is instead to make profit to its shareholders. In accordance with Common Law tradition, the role of the legislator is to involve as little as possible, and hence the traditional British view of corporate law drastically differs from the traditional European view.

As a consequence of the British Common Law tradition, the UK was the Member State that had to change its corporate legislation most in adapting its regulations to the Second

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[57]The GmbH is regulated in GmbHgesetz (GmbHG) and there are about 500 000 GmbH in Germany, see SOU 1997:168 p.51.

[58] *Dorresteijn* – European Corporate Law, p. 71. *Maitland-Walker* – Guide to European Company Laws, p. 173.

[59] *Maitland-Walker* – Guide to European Company Laws, p. 174.

[60] "Local court" is signified in relation to the registered office.

[61] *Maitland-Walker* – Guide to European Company Laws, p. 175. *Dorresteijn* – European Corporate Law, p. 71.

[62] *Kübler* - The Rules on Capital under the Pressure of the Securities markets, p. 7.

Company Law Directive. Before the EU entry, there was, for example, no requirement of minimum share capital. Due to this background the UK, and also Ireland, loudly opposed the extending of legal capital rules to private companies which the countries, as known, succeeded in.[63] As a result, the regulations regarding public and private companies diverge to a great extent in the UK, though the two companies are regulated in the same statue, the Companies Act (CA).

British legislation does not only differ with regards to culture and tradition, but also the terms used are different. The British capital regulation system is, first of all, based upon a distinction between what is called *authorised* and *issued* share capital. The authorised share capital must be stated in the memorandum of association and represents the maximum amount of share capital that a company can issue at any given time[64]. This capital operates as a limit on a company's ability to raise new finance through share issues, but it does not indicate how much finance has previously been raised by shares issues.[65] The issued share capital, on the other hand, is the amount of share capital that has been allotted by a company at any time. [66]

As been stated, there was no legal requirement of either a minimum authorised, or a minimum issued, share capital under previous UK regulations. However, due to the Second Directive, publicly held companies today must have an authorised share capital of at least £ 50,000 (about 72,700 euro) according to Article 118 of the *Companies Act* (CA). Furthermore, the share capital must be stated in the Memorandum.[67] The amount paid up in respect of nominal amount of shares represents a company's *paid-up share capital.* The paid-up share capital regarding *public* companies is regulated in Article 101 CA. According to the Article a public company must have a paid-up share capital of at least one quarter of the nominal value of the shares. Based on the minimum share capital of £ 50,000, this implies that at least £ 12,500 must be paid up before the company starts trading.[68]

As states under part 3.3.1, the shareholders of a British *privately* held company, have the unique position of deciding by themselves what the share capital shall be.[69] It should also be noted, that even when the shareholders decide to have a share capital, there is no regulation of the amount which a company must raise before incorporating. Many private companies do in

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[63] *Enriques & Mecey*– Creditors versus Capital Formation: The Case against the European Legal Capital Rules, p. 5.
[64] Companies Act 1985, Article 2 (5)(a)
[65] *Ferran* - Company Law and Corporate Finance, p. 44.
[66] *Ferran* - Company Law and Corporate Finance, p. 45.
[67] *Maitland-Walker*– Guide to European Company Laws, p. 453, *Dorresteijn*– European Corporate Law, p. 82.
[68] *Ferran* - Company Law and Corporate Finance, p. 46
[69] SOU 1997:168, p. 56 and *Andersson* – Om Vinstutdelning från Aktiebolag, p. 94.

fact operate with a token amount of share capital £ 100 or less. Of about 1.25 million registered UK companies, 1.1 million had an issued share capital of less than £ 1000 and, of these, 80 per cent had £ 100 or less. [70]

Except for shares issued for cash, shares may also be issued in kind in both public and private companies. In contrast to Germany, however, shares in private companies may be issued both in return for assets and also in return for services.[71] Notable is also, that there is no general obligation for private corporations to obtain a formal valuation of either the assets, or the services contributed. The result may therefore be that shares are actually issued at a discount, something that is prohibited under Article 100.[72] Concerning public companies, however, Article 103 CA, in accordance with Second Company Law Directive, now requires public companies to value assets transferred as consideration in an independent expert's report.[73]

3.3.3 Final Remarks on European Capital Formation Rules

In the two European legislative models presented, the German model represents the main part of the European states, whereas the UK model more must be seen as an exception in European legislations. Both systems are however important and influential for European company law, and the rules on capital formation can be summarized as follow:

	Share Capital	**Contributions in kind**
2nd Directive	*25,000 euro*	*assets of economic value*
Germany		
Public AG	50,000 euro	assets of economic value
Private Gmb	25,000 euro	assets of economic value
The UK		
Public Ltd	£ 50,000	assets of economic value
Private Ltd	-------	assets & undertakings to perform services

National regulations concerning European publicly held companies have been harmonized through the Second Company Law Directive. Therefore, although legislations may have differed with regards to minimum share capital amount and submission of this capital

[70] *Ferran*- Company Law and Corporate Finance, p. 46
[71] *Dorresteijn* – European Corporate Law, p. 83.
[72] For a closer understanding see the leading case Re Wragg Ltd, see *Hicks* & *Goo* – Company Law, p. 278.
[73] *Hicks* & *Goo* – Company Law, p. 279-280.

previous, legislations within the EU today are more or less similar. One observation made, however, was that both Germany and the UK require the double share capital amount than required by the Directive.

The differences between legislations concerning private companies are, however, both numerous and contrasting. As stated, all private company forms in Europe require a minimum share capital before incorporating, except in the UK and in Ireland where companies may start trading with a capital of just £ 1. Moreover, there are differences with regards to contributions made in kind. In the UK both assets and undertakings to perform services are valid as contributions without any expert's valuation report to be required. These lax rules are thus significantly diverse from German and other continental European regulations which require strict valuation procedures. To sum up, it is accordingly much more inexpensive, and less bureaucratic, to start up a private company in the UK or Ireland, compared to other EU Member States. As a consequence, creditors in these countries sustain considerably less protection by law.

3.4 Capital Maintenance Regulations

Since corporations aim to generate profit to shareholders, the regulations on capital formation would be rather meaningless as creditor protection if there were not complementary regulation of how the paid-up capital may be distributed from a company.[74] The *second* tier of the Second Directive therefore deals with the maintenance of the share capital contributed. To prevent capital from being distributed from the company, Article 15 of the Directive hence limits the amount that the company may distribute to its shareholders. The term *distribution*[75] in this thesis concern dividend distributions in forms of either money or other property to the shareholders. Both *open distributions*, i.e. distributions where the decision of making distributions have been taken at the ordinary shareholders meeting, or by other authorized decision making organ as for example the board of directors, as well as *colourable transaction,* i.e. where no such formal decision has been taken, are comprised by the Second Directive.

Article 15 is based on the distinction between *restricted* and *non-restricted* equity. In conformity with the first-tier-rules, the paid-up share capital is considered restricted equity of

[74] *Andersson* – Om Vinstutdelning från Aktiebolag, p.271and *Edwards* – EC Company Law, p. 68.
[75] The English term "distribution" corresponds to the German term "ausschüttong".

the company, together with the premium fund[76], legally required reserves that are not distributable, the revaluation reserve and other reserves that are not distributable according to the articles of association.[77] For the protection of creditors, the restricted equity may never be distributed back to the shareholders. Contrarily, a company may distribute other means, i.e. non-restricted equity. As a consequence of this principle on protection of the restricted equity, a *balance-sheet test* must be made before any distributions are made, ensuring that the distribution will not trespass the restricted equity.[78]

Nevertheless, it must be noticed that even when a cushion of restricted equity is built up in the company, this capital is not kept in a box or in an account reserved for the creditors. This capital may be used in the business of the company and may accordingly decrease as the company starts trading. All assets may be lost legally if the company conducts loss-making business activity, this situation cannot be prevented by the legislator.[79] The legal principle is, however, that the members may not plunder the company of the capital that they have paid in. As a consequence, the shareholders may not freely dispose over the company assets.[80]

A further security for the creditors is provided by Article 16. The Article prescribes that any distribution made contrary to Article 15, always must be returned by the shareholder who received it, if the company proves that the shareholder knew of the irregularity of the distributions made to him, or could not in view of the circumstances have been unaware of it.[81]

3.4.1 Distribution to Shareholders in Germany

It has been held that the German legal capital rules are representative for the most states in Europe. With regards to distribution to shareholders, however, the German rules on public companies stand out as both strict and comprehensive in a European comparison.[82] The decision to make dividend distribution must always be taken by the shareholders meeting, Article 174 AktG. Moreover, the fundamental rules of shareholder distributions are found in Article 57 and in Article 58, fifth paragraph, AktG. Article 57 is the most central for the protection of creditors and prescribes an *unconditional prohibition* of distributions to

[76] This fund consists of the premiums that arise when to company issues new shares, see also Article 9 and 10 of the Fourth Company Law Directive.
[77] *Andersson*– Om Vinstutdelning från Aktiebolag, p. 76-77.
[78] *Edwards*– EC Company Law p. 70
[79] *Hicks & Goo* – Company Law, p. 274.
[80] *Bergström* – Aktiebolagets grundproblem, s.170
[81] *Edwards* – EC Company Law, p. 70.
[82] *Andersson* – Om Vinstutdelning från Aktiebolag, p. 82.

shareholders other then according to the regulations in the AktG.[83] The prohibition accordingly does not only imply a protection of the restricted equity, which is what the Second Directive requires. Instead, there is a prohibition with regards to *all* distributions to shareholders which are not made in accordance with the AktG. All payments to the shareholders must be in entirety compliance with the regulations of the statue. This implies, for example, that colourable transactions are not allowed under any circumstances in an AG.[84] Accordingly, to be a legal transaction the decision of distribution must always be taken by the shareholders meeting, see Article 174 AktG.[85]

In accordance with Article 16 of the Second Directive, an illegal distribution of the company's assets is accompanied by a duty of restitution to the company for benefits received, under Article 62 AktG. Moreover, transactions in contrast to the AktG are as a principle always invalid under Article 134 of the German Civil Code BGB.[86]

In Germany, the regulations concerning distributions to shareholders in *private* corporations, the GmbH, are considerably more liberal than compared to the AG regulations. Under Article 30 GmbHG, the part owners of the company are not entitled to either fully or partly distribute assets that will fall below debts and the share capital. Accordingly, the principle is that distributions are permissible as long as they do not trespass the share capital.[87] This principle applies independently of whether all part owners have given approval or not. Accordingly, contrary what is stated regarding the AG, the statement in Article 30 GmbHG is not a distribution prohibition, but a distribution restriction. Colourable transactions are hence permissible as long as the distribution does not trespass the restricted equity.[88]

If a distribution is made in contrast to Article 30 GmbHG a duty of restitution to the company is stated in Article 31 GmbHG. Moreover, illegal distributions may furthermore be invalid under certain provisions under Article 134 BGB.[89]

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[83] *Andersson* – Om Vinstutdelning från Aktiebolag, p. 83
[84] *Andersson*– Om Vinstutdelning från Aktiebolag, p. 82-83.
[85] It should however be noted that the shareholders may not dispose over the non-restricted equity as they wish. The management board, Vorstand, may make allocations to free funds with up to 50% of the annual financial results according to Article 58 (2) AktG. In addition to this, it should also be noted that the company it required to set of means to a legal fund, according to Article 150 AktG, something that is not required in UK companies.
[86] *Andersson* – Om Vinstutdelning från Aktiebolag, p. 83.
[87] *Dorresteijn* – European Corporate Law, p. 88.
[88] Note, however, that a colourable transaction may be illegal with respect to competence exceeding of the corporate executives, be in conflict with the duty of loyalty or the principle of equality.
[89] *Andersson* – Om Vinstutdelning från Aktiebolag, p. 87.

3.4.2 Distribution to Shareholders in the UK

Traditionally, the regulations regarding distribution of dividends have been extremely liberal in Britain compared to the rest of Europe. The principle rule has been that companies were able to make distributions to the shareholders as long as the company at the time of the distribution was not, or as a consequence of the distribution would become, insolvent. [90] However, also in this area the regulations became more stringent as the UK adjusted to the requirements of the Second Company Law Directive.[91] Today, Article 263 to 281 CA therefore limits distributions to be made legally. The regulations are mandatory and the stated Articles include "*every description of distribution of a company's assets to its members, whether in cash or otherwise*"[92].

If something else has not been stated in the articles of association, the decision regarding distribution of dividends is taken by the shareholders meeting. If, however, the company uses the standard articles of association, Table A, the shareholders meeting may decide to distribute assets amounting to maximum what has been suggested by the board of directors.[93] Thus, the power of the shareholders meeting may be significantly limited, compared to what applies in Germany and other continental European states.

Assets of a company available for distribution to the shareholders, are assets within the scope of the company's net profit of the year and profit brought forward from earlier years, with a reduction of accumulated losses, Article 263 (1) and (3).[94] Hence, distributions are permissible as long as they do not trespass on the share capital. Concerning *public* companies there is also a further requirement under Article 264 (1). The Article prescribe that distributions may only be made when the amount of the company's net assets is not less than the aggregate of its called up share capital and undistributable reserves. Furthermore, distributions may only be made if, and to that extent that, the distribution does not reduce the amount of those assets to less than that aggregate. Consequently, this additional requirement gives effect to Article 15 of the Second Company Law Directive and the result is that only non-restricted capital may be distributed in a public company.[95]

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[90] More about the previous British regulations see *Andersson* – Om Vinstutdelning från Aktiebolag, p. 95.
[91] SOU 1997:168, p. 56.
[92] *Ferran* - Company Law and Corporate Finance, p. 417.
[93] See Articles 102 and 103 of Table A. *Hicks* & *Goo,*– Company Law, p. 280, SOU 1997:168 p. 57 and *Andersson* – Om vinstutdelning från Aktiebolag, p.98.
[94] *Hicks* & *Goo* – Company Law, p. 280-281 and SOU 1997:168, p. 57.
[95] *Ferran* - Company Law and Corporate Finance, p. 419.

Concerning *private* companies, only Article 263 is applicable. Consequently, private companies may distribute assets as long as the distribution does not trespass the *share capital*. However, it must be noted that even though the principle is that distributions may not trespass on the share capital, the result of the provision is dramatically different whit respect to the private companies. As been states, there is no requirement of a minimum share capital in private companies. Many private companies do also in fact have a share capital of £ 100 or less, why more or less all of the company's assets may be distributed in practice.[96] Creditors of private Ltd companies are however not without all protections as it may seem. In accordance with the provisions that applied before the UK entered into the EU, there is a well-developed doctrine of "*piercing the corporate veil*", implying that creditors may put forward their claims directly towards the shareholders as these under certain circumstances may be personally liable for the company's debts.[97] See more about this doctrine under chapter four where the American regulations are briefly presented.

The consequence if distributions are made in contravention of the law is, according to Article 277, for both private and public companies, that a receiver in bad faith is liable to repay the amount to the company.[98] Furthermore, directors who authorised the illegal distribution are liable to repay the money to the company, unless they justifiably relied on the accuracy of the accounts.[99] This provision accordingly goes further than what is required under the Second Directive and may compensate poorly protected creditors in private companies to some extent.

3.4.3 Final Remarks on the Rules regarding Distribution to Shareholders

The regulations regarding distributions to shareholders in Europe may be summarized as follows:

	Non-Distributable Assets	**Consequence of Illegal Distribution**
2nd Directive	*restricted equity*	*repayment by shareholder*
Germany		
Public AG	distribution prohibition	repayment by shareholder
Private Gmb	share capital	repayment by shareholder
The UK		
Public Ltd	restricted equity	repayment by shareholder
Private Ltd	share capital	& person who took decision

[96] *Ferran* - Company Law and Corporate Finance, p. 417-419. see also *Andersson* – Om vinstutdelning från Aktiebolag, p.96.
[97] *Andersson*– Kapitalskyddet i Aktiebolag, p. 159.
[98] See also Precision Dippings Ltd v Precisions Dippings Marketing Ltd (1986) Ch 447, Chort of Appeal, *Hicks*, & *Goo* – Company Law, p. 283
[99] According to case Re Exchange Banking Co. (1882) 21 ChD 519, Court of Appeal, Flitcroft´s Case, see *Hicks* & *Goo* – Company Law, p. 282-283

Even though the area is harmonized with respect to public companies, national legislations are not identical. Most notably, there is a difference of how much assets that may be distributed. The Second Directive state that all assets except the restricted equity may be distributed which is what also apply to British public companies. In Germany on the other hand, there is a much stricter provision. For a distribution to be permitted it must always be in accordance with the law, implying that only open distribution that not trespass on the restricted equity will be permitted.

In private companies, the variation between national legislation is even wider. Though, both German and UK regulations prescribe that the share capital contributed may not be distributed, the result of the regulations differ radically as the regulations are based on the share capital contributed. As stated, the German private company GmbH requires a minimum share capital of at least 25,000 euro before registering, while there is no requirement at all with respect to the private Ltd. Accordingly most of the assets in a private Ltd may be distributed to the shareholders. In accordance with what was stated under part 3.3.3, the statutory protection provided to creditors in the UK is significantly less than compared to Germany and other European states.

To sum up this long chapter, legal capital regulations are applied in Europe to provide company creditors with a protection from shareholder misconduct. Strong interference by the legislator is a characteristic and the regulations are in general detailed. The regulations are similar in most of the European states, and their approach is represented by the German legislation in the previous presentation. Even the regulations between the two company forms, privately and publicly held companies, can be held to be similar. Although the details may vary, the construction and fundamentals of the regulations are the same. In short, the protection is created by requiring a capital at the formation of the company, and which later on may not be distributed from the company to the shareholders. Under this construction, a cushion will be built up and preserved in the company as a guarantee for both contracting and involuntary creditors´ claims.

However, as presented, there are variations also within Europe comprising of mainly the UK and Irish legislations. The regulations of public companies which are harmonised under the Second Directive are naturally similar to the rest of Europe. The regulations regarding private companies on the other hand drastically differ, mainly since there is no minimum share capital requirement. These regulations, or lack of regulations, derive from the British Common Law tradition. In the following chapter, the Common Law tradition will be further

presented when the US legislation will be briefly reviewed. The reason for presenting these regulations in a thesis concerning Europe is first and foremost to provide a deeper understanding of the European regulations by contrasting our regulations to the American ones. Furthermore, the regulations are also presented since they are internationally known, and moreover since Europe have a tendency to be influenced by our big neighbour in the West.

CHAPTER 4 AMERICAN CAPITAL RULES

Any serious discussion about legal capital rules cannot ignore to at least present an overview of the American system. As been described when presenting Common Law Legal Culture, the American view of company law differs drastically from the European. In a society based on values of individualism[100] the legislator generally stays out of interfering in market conditions as much as possible. The rules existing on companies´ capital therefore presents radically different features and plays only a limited role.[101] This situation does however not mean that there is no protection of creditors. Instead, other techniques are used, which, according to an American point of view, is held to be more effective as creditor protection than techniques applied in Europe. Even though the American regulations only will be briefly reviewed, the rules will provide an important base for further comparison in the following chapters.

In the US nearly all of the company law is state law, as the impact of Federal Government generally is minimal.[102] There is however a model act, the *Model Business Corporation Act* (RMBCA[103]), dealing with both public and closed corporations, and which has been adopted by more than half of the US states.[104] This presentation will focus on the MBCA, but references will also be made to other systems applied by influential states.

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[100] *Chase* – American "Exceptionalism" and Comparative Procedure, p. 1.
[101] Also in countries as Canada and Australia legal capital rules tend to have limited role, see *Wymeersch* – Some Recent Trends and Developments in Company Law, p. 13
[102] *Kübler*– The Rule on Capital under the Pressure of the Securities Markets, p. 3.
[103] The shortening is RMBCA since the MBCA was revised in 1984. See *Andersson* – Om Vinstutdelning från Aktiebolag, p. 107
[104] *Morrisson,* - Fundamentals of American Law p. 333.

4.1 Capital Formation & Shareholder Distributions

The American view considers requirements of minimum share capital to be arbitrary and insufficient, and thus that such capital cannot provide any meaningful protection to creditors.[105] In accordance with this theory, only a handful states have a statutory required share capital.[106] However, in the states that does prescribe a minimum share capital, the amount required considerably lower than in Europe with a maximum of $ 1000.[107] One state which still has this type of requirement is the corporately important state of Delaware, where more than half a million business entities have their legal home and which include more than 50% of all U.S. publicly-traded companies and 58% of the Fortune 500.[108] In general, however, it is extremely rare with minimum share capital requirements in the US, and the RMBCA provides no such recommendation. Instead the registration of a corporation may occur without regard to the capital contribution, and similar to an English private Ltd it is accordingly enough with merely $ 1 in share capital for a company to be incorporated.[109]

The difference between the US and Europe is even more obvious where the considerations for shares to be paid by assets other than cash. The RMBCA allows for any sort of property right, including *services* to be performed or contracts for services to be performed, which are strictly prohibited under the Second Directive, see part 3.3.[110] Moreover, under the RMBCA it is for the board of the corporation to determine if the consideration received for the shares is adequate, not an independent expert.[111]

Also regarding dividend distribution the American approach differ highly from continental European. There are two major systems[112] of which the *first* is similar to the European system and which is applied for example states as Delaware and New York. This model is based on a classical capital construction and funded on a principle of restricted equity.[113] However,

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[105] *Andersson* – Om vinstutdelning från Aktiebolag, p. 107-108.
[106] *Morrisson* - Fundamentals of American Law p. 337 and *Andersson* – Om Vinstutdelning från Aktiebolag, p. 107.
[107] *Andersson*– Om Vinstutdelning från Aktiebolag, p. 108.
[108]Since so many corporations are incorporated in the Delaware the state is accordingly leading and influential in corporate law making. For statistics see http://www.state.de.us/corp/default.shtml and also *Lucian Arye* – Federalism and the Corporation: The desirable limits on State Competition in Corporate Law, p. 1
[109] *Kübler* – The Rule on Capital under the Pressure of the Securities Markets, p. 3.
[110] *Kübler* – The Rule on Capital under the Pressure of the Securities Markets, p. 3.
[111] Article 6.21 (c) RMBCA
[112] There is also held to be a third model in the US which is applied in the state of California. See *Andersson* – Om Vinstutdelning från Aktiebolag, p. 111-112.
[113] *Andersson* – Om Vinstutdelning från Aktiebolag, p. 111.

considering what has just been stated regarding share capital amounts, the American system widely differ our system based on restricted equity in Europe.

The *second* system, which is recommended under the RMBCA, implies that distributions to the shareholders are allowed as long as the company is not, or due to the payment, will not become either insolvent or insufficient.[114] This *solvency test* system has so far not had the same impact at state level as the abolishment of the minimum share capital requirement. There is however a significant number of states that have adopted the system and the number of states are estimated to increase.[115] In sum, it should nevertheless be observed that neither in the Delaware system, nor under the RMBCA model, capital is a barrier for the distribution of dividends to shareholders.[116]

In addition to these lax rules, and in contrast to what applies in Europe, the principle rule in American corporate law is that the board of directors, and not the shareholders meeting, takes the decision of dividend distribution.[117] Accordingly, the board of the corporation has the discretion to determine how much dividend that will be paid to the shareholders. Moreover, if a distribution has been mad in contrast with the law, there is no creditor protection obliging shareholder to refund the payment. Neither is there a regulation that the directors who took the decision may have to refund the payment.[118]

4.2 Protection of Involuntary Creditors

As mentioned, the American system is built up around values of individualism and accordingly creditors wanting to participate in corporate business have to protect themselves. However, considering involuntary creditors, not all creditors have the possibility of contracting their security. Compared to the European legal capital system, there is no capital-cushion in the company since the only requirement is that the company remains solvent. Accordingly, often there will be no money to cover the claims of involuntary creditors. As a result, other mechanisms have been invented to protect these creditors, one of the most important is the doctrine of "*piercing the corporate veil*".[119] This metaphor is used to describe the judicial act of imposing personal liability on otherwise immune shareholders for the

[114] RMBCA § 6.40 (c)(1). See also *Andersson* – Om Vinstutdelning från Aktiebolag, p. 109-110.
[115] *Andersson* – Om Vinstutdelning från Aktiebolag, p. 111.
[116] *Kübler* – The Rule on Capital under the Pressure of the Securities markets, p. 4.
[117] *Andersson* – Om Vinstutdelning från Aktiebolag, p. 112
[118] *Andersson* – Om Vinstutdelning från Aktiebolag, p. 113-114.
[119] *Miller* – Piercing the Corporate Veil Among Affiliated Companies in the European Community and in the US: A Comparative Analysis of US, German and UK Veilpiercing Approaches, p.3.

corporation's wrongful acts. The doctrine is based on case law and regarded as extremely extensive and messy.[120] Hence, it is suffice to say that in protection of (involuntary) creditors, shareholders in American corporations may under certain conditions be personally liable for the debts of the corporation (the interested reader is referred to reference under footnote 121). As a Common Law country, also the UK applies this doctrine.[121]

Second, involuntary creditors are moreover protected by mandatory insurances. These insurances mainly serve as protection if, under certain conditions, the limited liability will not be restrained.

Leaving these descriptive chapters behind, the thesis will now continue with studying the recent and present development of European company law with respect to legal capital. Bearing in mind the regulations presented, the following chapters will consider factors that have come to challenge, and even question, the whole concept of a legal capital regime. The whole system of regulations presented, are namely at present facing both antagonism and harsh criticism.

CHAPTER 5 LEGAL CAPITAL RULES IN THE LIGHT OF EU GOALS, A COMMON MARKET & ECJ CASE LAW

Taking into consideration the regulations presented above, statutory creditor protection is obviously a fundamental objective in both national Member States and within the EU. The reason for harmonizing the capital area was even stated to be an increased protection of creditors in public companies, which indirectly has affected also private companies in most states. This harmonization objective is, however, only a part of a larger objective within the European Community. In a wider perspective, harmonisation is an instrument of reaching fundamental goals of the European Community. One of these fundamental goals is the realization of a *Common Market* based on free movement and free establishment of all production factors.

[120] *Miller* – Piercing the Corporate Veil Among Affiliated Companies in the European Community and in the US: A Comparative Analysis of US, German and UK Veilpiercing Approaches, p.4. See the whole article for an overview of the doctrine.
[121] *Miller* – Piercing the Corporate Veil Among Affiliated Companies in the European Community and in the US: A Comparative Analysis of US, German and UK Veilpiercing Approaches, p.3.

In recent years, the ECJ has rendered a number of controversial rulings based on the realization of this Common Market where the outcome of the judgments supported an extended freedom of establishment for companies. The effects of the decisions, however, have proven to be very controversial, and even contrary, to the traditions of European legal capital rules as presented above. Hence, the objective of this chapter is to present the development of the Common Market, to see what effects this development have had on the traditional rules on capital.

To provide a better understanding of the cases presented, and moreover an understanding of why the present regulations have come under pressure, fundamental goals of the European Community and incident regulations will be briefly reviewed.

5.1 EU Goals of a Common Market & Freedom of Establishment

In 1957, the European Economic Community (EEC) was established through the Treaty of Rome. The purpose was to lay down the foundations for "*an ever closer union among the peoples of Europe*"[122]. The Community was based on theories of economic growth through cooperation, and the main goal was to engage a closer economic relationship between the participating nations. This goal was realized through the establishment of a customs union and by the adoption of a *Single Market* based on the principle of free movement over the boarders concerning the factors of production (goods, services, labor and capital).[123] In 1986 the Community cooperation expanded even further through the adoption of the Single European Act (SEA) and through the establishment of the *Common Market.* The aim was to expand economic integration and growth even more, which was to be realized by securing free movement of the four freedoms by eliminating all barriers of establishment.

The regulations regarding the four freedoms have all been laid down in the Treaty of Rome. The Treaty moreover contains a chapter on *freedom of establishment* for both natural and legal persons. The freedom of establishment is often counted as the fifth freedom within the Common Market, but strictly speaking, it is a part within the free movement of persons.[124] The specific rules are fund within Articles 43-48 and are based on the EC fundamental

[122] Article 1, Treaty on the European Union
[123] These four freedoms are all laid down in the Rome Treaty and Article 14 expresses: "*The Common Market shall comprise an area without internal frontiers in which the free movement of goods, persons, services and capital is ensured in accordance with the provisions of this treaty*". See *Steiner & Woods – Textbook on EC Law*, p.5
[124] *Edwards* – EC Company Law, p. 336-337

principle of equivalence, stated in Article 12. This principle implies that national rules cannot discriminate on their face against non-nationals, nor can they be applied in a discriminatory way.[125]

The Articles relevant are Article 43 and Article 48 which have to be red together to be understood correctly.[126] Article 43 states that restrictions on the freedom of establishment of *nationals* of a Member State, within the territory of another Member State, shall be prohibited. The prohibition applies also to restrictions on the setting-up of agencies, branches or subsidiaries by nationals of any Member State established in the Community. Accordingly, Article 43 concerns natural persons, and the Article has been held to have direct effect.[127] Article 48 on the other hand, concerns *legal persons* and states that also companies and firms formed in accordance with the law of a Member State shall enjoy the same freedom of establishment as natural persons.[128] Consequently, both foreign citizens and companies have equal opportunities of national citizens and companies to practice economic activity.

The wording of Article 43 and 48 may appear to provide both natural and legal persons a rather extended freedom of establishment. It is however important to observe that these Articles are not a guarantee of a general right to establishment within another Member State. They merely imply that there will be *equality in establishment opportunities* between national and foreign subjects.[129]

As companies started to make use of their freedom of establishment, rather complicated issues of what were to be comprised in this freedom was raised. If a company incorporated in one Member State conducted business in other Member States, which states company law would apply? These issues have their origin in the fact that two principles of connection between a company and a state are applied within the Community, the *incorporation principle* and the *real seat principle*. The former imply that it is always the state of incorporation that have jurisdiction with regards to company law, while the latter imply that it is the state where the company has its real seat which will have jurisdiction.[130]

As the sole interpreter of the Treaty, it hence was the task of the ECJ to answer these issues. This position as interpreter has come to place the Court in a very powerful position in

[125] *Steiner & Woods* – Textbook on EC Law, p.189.
[126] *Steiner & Woods* – Textbook on EC Law, p.336-337. See also *Wymeersch* – Centros: A Landmark Decision in European Company Law, p 630 and *Wymeersch* – The Transfer of the Company's Seat in European Company Law, p.12.
[127] Case C-81/87 Daily Mail, para 15. See also *Steiner & Woods* – Textbook on EC Law, p.189.
[128] Article 48, Treaty of Rome
[129] *Edwards* – EC Company Law, p. 336-337. See also Case 81/87 Daily Mail, para 16.
[130] *Wymeersch* – The Transfer of the Company's Seat in European Company Law, p. 5-8.

determining future company law. In trying to interpret what the freedom of establishment entailed, the Court has given several important preliminary rulings, as for example, Case C 183/83 *Segers*[131], Case C-212/97 *Centros*[132], Case C-208/00 *Überseering*[133] Case C-167/01 *Inspire Art*[134] which all have had tremendous impact on European company law. However, only the Centros and the Inspire Art case directly concerned rules on capital, and will thus be re-examined and analysed below to see what impact the cases have had on legal capital rules.

5.2 The Centros Case

It has been over six years since the *Centros Ltd v. Erhvervs- og Selskapsstyrelsen* case was rendered, but in those few years the case has become almost legendary. The case has been held to be one of the most mentioned cases ever of the ECJ, and there is no doubt that this judgment belongs to the cases that have affected European company law the most.[135]

5.2.1 Facts of the case

The factual circumstances of the case were simple: A Danish married couple wanted to set up an incorporated business in Denmark. Danish law, however, required a share capital input on formation amounting to about 28 000 Euro. The couple therefore decided to set up a private Ltd in the UK which only required a starting capital of £ 100.[136] Without starting any business activity in the UK the couple applied for registration of a branch at the Danish registry office[137]. The Danish authority, however, refused to register a branch of Centros since the company, according to the authority, was in effect seeking to establish in Denmark, not a branch, but its principal establishment.[138] Moreover, the Danish authority held, the company intended by doing so to escape the application of the Danish rules on minimum capital.[139] As a consequence of the rejection, Centros filed law suit and argued in Court that the refusal of registration was incompatible with the EC rules on freedom of establishment. The Danish Court referred to the ECJ for a preliminary ruling and asked whether it was compatible with

[131] Case C-182/83 *Segers v. Bedrijfsverening*, 1984.
[132] Case C-212/97 *Centros Ltd v. Erhvervs- og Selskapsstyrelsen*, 1999.
[133] Case C-208/00, *Überseering BV v. NCC GmbH*, 5 November 2002.
[134] Case C-167/01, *Kamer van Koophandel en Fabrieken voor Amsterdam v. Inspire Art Ltd*, , 2003.
[135] *Wymeersch* – Centros: A Landmark Decision in European Company Law, p 629.
[136] Case C-212/97 Centros, para 7.
[137] Case C-212/97 Centros, para 6.
[138] *Wymeersch*– Centros: A Landmark Decision in European Company Law, p 629.
[139] Case C-212/97 Centros, para 7.

Articles 42 and 48, to refuse registration of a branch company which has its registered office in another Member State, and has been lawfully funded and exists in conformity with the legislation of that country, though the sole purpose of the establishment was to circumvent national legal capital rules.[140]

5.2.2 Court Reasoning; permission to circumvent national rules

In its answer to the national court, the ECJ started out by stating that the present situation, in which a company formed in accordance with the law of one Member State desires to set up a branch in another Member State, "*falls within the scope of Community law*"[141]. This principle applies without regards to the fact that the sole purpose of the establishment may have been to circumvent national host state regulations.[142] That is how Article 43 and Article 48 is to be interpreted.[143] The consequence of this interpretation is accordingly that companies are entitled to carry on their businesses in other Member States than where incorporated through agencies, branches or subsidiaries, however, *subject under the laws of the incorporation state*. Moreover, the Court stated, to refuse a company this right implies that the company is prevented from exercising its freedom to establishment.[144]

In an attempt to justify its acting, the Danish authorities claimed that the establishment of Centos´ branch constituted an *abuse,* as it was acknowledged that the only purpose of incorporating in the UK was to circumvent Danish national regulations. In their submission, Denmark therefore claimed that host states must be entitled to take steps to prevent such abuse by refusing to register the branch.[145] In answer to this claim, the Court held that Member States indeed do have some possibilities to take measures of preventing individuals from *improperly* or *fraudulently* taking advantage of provisions of Community law.[146] However, the Court stated, it cannot in itself constitute an abuse if a person that wishes to set

[140] Case C-212/97 Centros, para 13 + 14 and *Wymeersch* – Centros: A Landmark Decision in European Company Law, p 630.
[141] Case C-212/97 Centros, para 17 and *Wymeersch* – Centros: A Landmark Decision in European Company Law, p 633 - 634
[142] Case C-212/97 Centros, para 18. See also *Holst* – European Company Law after Centros: Is the EU on the Road to Delaware?, p. 3–4 and *Wymeersch* – Centros: A Landmark Decision in European Company Law, p 634 + 641.
[143] Case C-212/97 Centros, para 18 + 19
[144] Case C-212/97 Centros, para 20, 21 & 23, *Wymeersch* – Centros: A Landmark Decision in European Company Law, p 647 and *Holst* – European Company Law after Centros: Is the EU on the Road to Delaware?, p. 4
[145] Case C-212/97 Centros, para 31 + 32
[146] *Wymeersch*– Centros: A Landmark Decision in European Company Law, p 638-639

up a company in a Member State chooses to do so in the stat that he, or she, considers to have the least restrictive company regulations, and then set up a branch in another Member State.[147]

Accordingly, only if the circumvention of national rules would constitute *improperly* or *fraudulently abuse* host states have some possibilities to take preventive measures. With regards to this abuse, the Court moreover distinguished between circumvention of rules relating to the *formation* of companies, and rules concerning the *carrying on* of certain trades, professions, or businesses. The second category, carrying on business, was held to might have a bearing and justify preventive measure. The former category, where regulations as minimum share capital belong, has, however, no effect on the establishment of a firm. Hence, legal capital rules requiring a minimum share capital cannot be invoked to refuse access.[148]

After stating that Denmark's argument on abuse could not justify the refuse to register the branch, the Court went on to looking at if there was any other ground of justification. In case law previous Centros, the Court had establishes a doctrine implying that national legislation might be justified with reference to *imperative requirements in the general interest.*[149] The general interest claimed by the Danish authorities, was argued to be the protection of primarily public creditors, but also creditors in general. It was argued that a minimum share capital requirement was necessary since, unlike contracting creditors, public creditors cannot secure their debts by means of guarantees.[150] Moreover, a minimum capital requirement was argued to be needed to protect all creditors, as the risk of fraudulent bankruptcies, due to the insolvency of companies whose initial capitalisation was inadequate, needed to be anticipated.[151]

With reference to its previous case law, the ECJ stated that if national legislation will be justified, though hindering the exercise of the freedom of establishment, the rules must fulfill four conditions: *First*, the regulations must be applied in a non-discriminatory manner, *second* they must be justified by imperative requirements in the general interest, *third* they must be suitable for securing the attainment of the objective which they pursue and *fourth*, they must not go beyond what is necessary in order to attain it.[152]

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[147] Case C-212/97 Centros, para 23-28. See also *Bebchuck* - Federalism and the Corporation: The Desirable Limits on State Competition in Corporate Law, p. 3 and *Wymeersch* – Centros: A Landmark Decision in European Company Law, p 641.
[148] *Wymeersch* - Company Law in the 21st Century, p. 7.
[149] This doctrine or test has been named the "Gebhard test" after the principles laid down in Case C-55/94 Gebhard.
[150] Case C-212/97 Centros, para 32.
[151] Case C-212/97 Centros, para 32.
[152] *Wymeersch*– Centros: A Landmark Decision in European Company Law, p 642-644.

After lining up these prerequisites, the Court held that none of these conditions were fulfilled.[153] This statement was mainly due to the fact that Denmark, as an incorporation country, generally was prepared to allow foreign companies into its borders. If Centros had been conducting business in the UK, Danish authorities would have registered Centros branch in Denmark. This situation, the Court stated, might have proven equally risky to Danish creditors.[154] Moreover, the Court argued, since Centros held itself out to be a UK company, Danish creditors were noticed of the fact that the company was not governed by Danish law, and thereby protected.[155]

Furthermore, the Court was of the opinion that it had been possible to adopt measures which were less restrictive or which at least interfered less with the fundamental freedoms. As an example, the Court suggested that it was possible "by law" to protect public creditors to obtain necessary guarantees.[156] The Court did however not say anything about how this protection by law would be constructed. Finally, and with reference to Denmark's argument of protecting creditors in general, the also Court stated that combating fraud, could not in any event justify a practice of refusing to register a branch of a company which has its registered office in another Member State.[157]

Accordingly, the holding of the Centros ruling was that a company registered in one Member State, may establish in another Member State without conducting any business in this home state, with the sole purpose of circumventing national host states regulations.

5.2.3 Conformity between the Centros Case and European Legal Culture?

The Centros judgement was received by Member States within the Union in different ways. For states as the UK, it was of course a victory to see their lax rules prevail over what they considered to be business obstructive regulations. For most Member States, however, the ruling was received as devastating, and legal writers were clearly traumatised by the decision. For these countries the decision was no victory at all. On the contrary, the result was the

[153] Case C-212/97 Centros, para 34.
[154] Case C-212/97 Centros, para 35.
[155] Case C-212/97 Centros, para 36. For the requirement of notice, see Fourth Council Directive 78/660/EEC of 25 July 1978 based on Article 54(3)(g) of the Treaty on the annual accounts of certain types of companies and the Eleventh Council Directive 89/666/EEC of 21 December 1989 concerning disclosure requirements in respect of branches opened in a Member State by certain types of company governed by the law of another State. See also *Bebchuc*k - Federalism and the Corporation: The Desirable Limits on State Competition in Corporate Law., p.5 and *Wymeersch* – The Transfer of the Company's Seat in European Company Law, p.19.
[156] Case C-212/97 Centros, para 37.
[157] The Danish authorities also referred to Article 46 as a way of justification (public policy, public security or public health), but the Court stated that the Danish authorities could present no justifications falling within the ambit of Article 46 of the Treaty.

undermining of their legislations with respect to foreign companies establishing within their territory.

As a consequence of the Centros case, many Member States feared that the Court hade opened up for "forum shopping" possibilities.[158] This term has its origin in American corporate law and signifies the situation when companies may select state of incorporation with regards to the most favourable company legislation. Since shareholders decide where to incorporate, the most favourable legislation will be where this group has the most power to act. Considering the conflict described in chapter 2, this location will be where there is little, or no, statutory protection of creditors. Accordingly, it may be argued that the effect of the Centros case was the creation of an incentive to circumvent national legislations protecting creditors to seek more lax regulations. The way the Centros case was worded, it might even be claimed that the Court, more or less, exhorted future incorporators to register in states with lax legislation to stimulate business activity and economic integration within the Common Market.

It is, however, important to observe that the case did not deal with national (Danish) company law, it merely dealt with Community law. Nevertheless, since incentives to circumvent national regulations have been held to be created, it follows as a consequence of the ruling that to uphold national legal capital regulations will constitute an obstacle to the freedom of establishment. National protective legislations may be circumvented in favour of the freedom of establishment. In other words, what the Court argued was that national company law rules were respectable traditions, but these should surrender to the overwhelming thrust of the basic freedoms and the Common Market.

Accordingly, referring to the heading of this part, the conformity between the Centros Case and present legal capital regulations must be held to be weak. However, to say that the traditional legal capital rules are contrary to the Centros case and the economic life of the Common Market must be regarded to take conclusions too far. National rules on capital may still be upheld by Member States for domestic use. Nevertheless, even if national Member State regulations are not contrary to EU development, Centros clearly challenged and even questioned the concept of such legal capital rules.

[158] *Kersting & Schindler*– The ECJ´s Inspire Art Decision of 30 September 2003 and its effect on Practice, p. 1291 and *Birkmose-Sondergaard*– The Fear of the Delaware-effect – The American Demon?, p. 246.

After the Centros case[159], many Member States started to take countermeasures, trying to go round the Centros holding as a reaction of protecting their national interests. Whether suchlike countermeasures were permitted or not with regards to Articles 43 and 48 were recently reviewed by the ECJ in case C-167/01 Inspire Art.

5.3 The Inspire Art Case

5.3.1 Facts of the Case

Inspire Art was a *private* limited liability company, incorporated in the UK, which was dealing with objects of art. Immediately after the company formation, the company started conducting business in the Netherlands where also its sole shareholder and director was domiciled.[160] Just as in the Centros case, no business was ever meant to be conducted in the UK, the shareholder only intended to take advantage of the liberal UK company law. Hence, a branch was therefore registered in the Netherlands.[161]

However, Article 1 of the applicable Dutch law (WFBV) defined companies which did not which carry on their activities entirely or almost entirely in the Netherlands, such as Inspire Art, as *formally foreign companies.*[162] Article 2 of the same statue then required a company falling within that definition of a formally foreign company, to be registered as such in the commercial register.[163] Moreover, Article 4 WFBV required the subscribed capital of a formally foreign company to be at least equal to the minimum amount required of Netherlands limited liability companies. If this requirement was not fulfilled the directors would be jointly and severally liable.[164]

Due to some administrative error, Inspire Art was nevertheless registered in the commercial register without any indication that it was formally foreign company. Since such indication was mandatory, the Chamber of Commerce applied for an order that this fact should be added to Inspire Art's registration.[165] Inspire Art on the other hand, opposed the

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[159] See also case C-208/00 Überseering, The case both complemented and extended the freedom of establishment, stating that Member States always must recognize a company legal capacity when establishing within its territory.
[160] Case C-167/01Inspire Art, para 34.
[161] *Kersting & Schindler* – The ECJ´s Inspire Art Decision of 30 September 2003 and its effect on practice, p. 1279
[162] Case C-167/01Inspire Art, para 22.
[163] Case C-167/01Inspire Art, para 24.
[164] Case C-167/01Inspire Art, para 25+27 and *Kersting & Schindler* – The ECJ´s Inspire Art Decision of 30 September 2003 and its effect on practice, p. 1279-1280.
[165] Case C-167/01Inspire Art, para 36.

above requirements and claimed that these were contrasting with Community law. The question thus was referred to the ECJ for a preliminary ruling.[166]

5.3.2 Court Ruling; countermeasures of protection not justifiable

In its judgment, the Court referred to many of many arguments used in the Centros case. These arguments will not be presented fully again but merely be referred to.

As in Centros, the Court started out by reminding of the fact that companies may be formed in one Member State and thereafter exclusively carry on their business in another state. Moreover, reasons for which a company chooses to establish in a certain Member State, will not affect this freedom of establishment rules, except in cases of fraud, see part 4.2.1.[167] The Netherlands Government did however put forward arguments that the present provisions of the WFBV did not hinder the freedom of establishment. Primarily, since foreign companies were fully recognised in the Netherlands and they were not refused registration in the business register, and second, the Netherlands Government claimed that the provisions only resulted in administrative effects.[168] The Court did however, not accept these arguments. To the contrary, the Court stated that in cases as the present, the host state must respect the legislation of the incorporation state regarding minimum capital and directors' liability.[169] Accordingly, the countermeasures taken by the Dutch legislator trying to uphold its legal capital rules were held to constitute restrictions on the freedom of establishment as guaranteed in the Treaty. [170]

After this statement the Court went on to looking at whether there was any justification for the Dutch provisions relating to minimum capital and directors' liability.[171] Like in previous cases, the Court considered the justification grounds relating to the *public interest* and reminded of the four conditions that had to be fulfilled, part 5.2.2 above. As the Danish Government, also the Netherlands Government based their justification on grounds of creditor protection. However, the Court merely repeated its statements in Centros, see part 5.2.2.[172]

[166] Case C-167/01Inspire Art, para 39 and *Kersting* & *Schindler* – The ECJ´s Inspire Art Decision of 30 September 2003 and its effect on Practice, p. 1280
[167] Case C-167/01Inspire Art, para 95-96. See also Case C-212/97 Centros, para 18. See also *Kersting* & *Schindler* – The ECJ´s Inspire Art Decision of 30 September 2003 and its effect on Practice, p. 1281.
[168] Case C-167/01Inspire Art, para 99.
[169] Case C-167/01Inspire Art, para 100+101.
[170] Case C-167/01Inspire Art, para 101 & 105 and *Kersting* & *Schindler*– The ECJ´s Inspire Art Decision of 30 September 2003 and its effect on Practice, p. 1281.
[171] The Court first stated that there was no justification under Article 46 concerning public policies, public security and public health, see para 131. The Court moreover stated in the Centros case that the protection of creditors do not fall within ambit of Article 46.
[172] Case C-167/01Inspire Art, para 131-140.

As, Inspire Art was held out to be UK company governed by British law, creditors were put on sufficient notice of the rules regulating the company.[173] Moreover, the Court held, to the extent that the provisions concerning minimum capital were incompatible with freedom of establishment, the same necessarily applied regarding the penalties attached to non-compliance with those obligations, i.e. the personal joint and several liability of directors.[174]

Furthermore, the Netherlands Government also referred to factors as countering fraud, ensuring that tax inspections were to be effective and that business dealings were fair as grounds of public interest. None of these arguments could however justify the Dutch requirements in Dutch law. First, since to set up a business where the least restrictive rules are is not fraud, see part 4.2.2[175], and with regards to the second and third argument that the measures in question did not satisfied the criteria of efficacy, proportionality and non-discrimination.[176] Accordingly, the Dutch countermeasures taken imposing requirements on the UK Company could not be justified, and were thus not in conformity with Community law.

5.3.3 No Ways of Protecting National Legal Capital Rules?

The Inspire Art case was not received by the Member States in an equally dramatic and revolutionary way as the Centros decision was. Partly because much of what the court stated in Centros was repeated in the Inspire Art decision, and partly because the decision was more expected as a continuation of the Centros case. What the Court did in the Inspire Art case was, really, to continue and extend the development it had started in the Centros case.

Except being a continuation and repetition of the Centros decision, the Inspire Art case, however, also had an independent meaning. The Court held that it was contrary to Articles 43 EC and 48 EC for Member States to impose certain conditions in domestic company law with respect to company formation relating to minimum capital and directors' liability. Accordingly, what the Court held was that *all* attempts of countermeasures to preserve national legal capital rules will constitute obstacles to the freedom of establishment.

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[173] Case C-167/01Inspire Art, para 135.
[174] Case C-167/01Inspire Art, para 141. See also See *Kersting & Schindler* – The ECJ´s Inspire Art Decision of 30 September 2003 and its effect on practice, p. 1284, where the authors discuss whether such notice actually does make it clear to creditors that foreign law apply to the company.
[175] Case C-167/01Inspire Art, para 136-139.
[176] Case C-167/01Inspire Art, para 140. For a further analysis see *Ensig-Sorenson* - Centrso Ltd-avgorelsen og dens konsekvenser, p.100-102. This article is interesting since it deals with the present Dutch regulations already two years before the ruling of Inspire Art.

The holding of the Inspire Art case did not only affect the Netherlands, but also several states which were trying to protect their national legislations through counter-measures after Centros. For instance, Denmark enacted a new tax legislation as a reaction of the Centros case, which would make it more difficult for companies incorporating in Denmark to circumvent their legislation. The legislation was, however, even before the Inspire Art case strongly criticised by legal writers and regarded not to pass the discrimination and proportionality test. As a consequence of the Inspire Art case, it was however later evident that such countermeasure was not permissible and the regulations were abolished.[177]

The holding of the Centros and the Inspire Art case is therefore evident; The only possible way of justifying any overriding of the freedom of establishment is if such provisions pursues a legitimate aim compatible with the Treaty, is justified by pressing reasons of public interest and is of such nature as to ensure achievement of the aim in question and not go beyond what is necessary for that purpose.[178] Accordingly, as the situation is today, there is no way of protecting national interests except for cases of fraud.[179] With regards to what was stated in part 5.2.3, regarding the conformity between Centros and present European legal capital rules, the answer after the Inspire Art case is even more definite. Considering the fact that the Court permits circumvention of national rules in favour of the Common Market and dismisses all future attempts to protect these rules [180], the two rulings certainly call into question both the purpose and the existence of the rules.

5.4 Potential Developments after Centros & Inspire Art

Freedom of establishment is based on the Common Market. One way of interpreting the present judgments is therefore that the Common Market, to reach the goals of economic growth and integration, requires a European development where companies are able to freely establish and freely elect their applicable company law. As a consequence of the feared "forum shopping" presented, many scholars furthermore predicted a regulatory competition

[177] *Trefil* – European Company Law: Comments and Meta-Comments on Centros, p.7.
[178] *Baelz* & *Baldwin* - The end of The Real Seat Theory, the European Court of Justice Decision in Überseering of 5 November 2002 and its Impact on German and European Company Law, p. 8
[179] *Kersting* & *Schindler*– The ECJ´s Inspire Art Decision of 30 September 2003 and its effect on practice, p. 1284.
[180] See Case C-212/97 Centros, para 39 and Case C-167/01Inspire Art, para. 140.

between the European states, leading to *a "race to the bottom"*.[181] To prevent this development, arguments that Europe should increase its harmonization in the capital area even further was called for by several scholars.[182] However, today six years have past since the Centros decision, and so far no noticeable competition has taken place. Neither has there been a radical increase of companies incorporating in the UK trying to circumvent national regulations.[183] Thus, the by many predicted and feared race to the bottom development has demonstrated not to take place in Europe. As a consequence, arguments that Europe should extend its harmonization to prevent this development can scarcely be motivated today.

Even though no regulatory competition started in Europe, is may nevertheless be claimed that the ECJ rulings have come to call the whole legal capital doctrine into question, see part 5.2.3 and 5.3.3. It has even been claimed that the Court questions both the purpose and the existence of the regime as such. However, the Court did not directly take a position as to the usefulness of legal capital in general. Considering the consequences of the rulings, some scholars nevertheless saw the rulings as a signal of the fact that Europe had to review its, almost holy, legal capital regulations.[184] Other scholars, on the other hand, held that legal capital rules still had an important role to play in domestic company law, where the rules served as creditor protection. In response to this argument, the former scholars, however, have put further pressure of changing the current regime by presenting extensive critique and arguing that the capital doctrine does not fulfil its objective of protecting creditors. The next two chapters will therefore investigate this critique and see whether legal capital rules have a role to play in the future.

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[181]The concept of regulatory competition has its origin in the US where the American states compete to have the most attractive legislation, to attract as many companies to incorporate as possible. Some scholars have claimed that this regulatory competition will lead to a race to the bottom since legislators must adopt as flexible and management friendly regulations as possible to attract incorporaters. More on the discussion of a race to the bottom in Europe see for example *Birkmose-Sondergaars*– The Fear of the Delaware-effect – The American Demon?, *Mock* - Harmonization, Regulation and Legislative Competition in European Corporate Law and *Wymeersch* – Centros: A landmark Decision in European Company Law, p. 652.

[182] *Baelz* & *Baldwin*, The end of The Real Seat Theory, the European Court of Justice Decision in Überseering of 5 November 2002 and its Impact on German and European Company Law, p. 8 and See *Kersting* & *Schindler* – The ECJ´s Inspire Art Decision of 30 September 2003 and its effect on practice, p. 1284, where the authors discuss whether such notice actually do make it clear to creditors that foreign law apply to the company.

[183] High Level Company Law Expert's Report, p. 29

[184] *Kübler*, The Rules on Capital under the Pressure of the Securities Markets, p. 15.

CHAPTER 6 RULES ON LEGAL CAPITAL; PROTECTIVE & ECONOMICALLY EFFICIENT?

Stimulated by the previous ECJ rulings, and moreover by "*Anglo-American wisdom and modern economic theory*"[185] scholars have launched extensive and serious critic in recent legal writing, and thereby called the legal capital rules into question. It has been held that the current regime is incapable of achieving its objective of protecting creditors, and moreover, that it harms enterprisingness.[186] The objective of this chapter is hence to review the legal capital doctrine as a protector of company creditors to see whether the regime may still be justified for this purpose. Moreover, criticism related to the previous rulings and economic development within the Common Market will be scrutinized. This thesis does, however, not allow for more than a few observations.

6.1 Criticism of Rules on Capital Formation as Creditor Protection

6.1.1 Share Capital Requirements as Creditor Protection are Arbitrary & Insufficient …

The principal criticism made towards the European minimum share capital requirement, is that every requirement of a minimum capital requirement will be arbitrary.[187] The minimum requirement is unrelated to the *size* of the company, to *sort* of business activities that a company may pursue and to the *risks* related to that activity. As a consequence, the requirement imposed on companies will be unrelated to the debt that a company may incur.[188] This argument must be considered well-founded since the situation where a company that transports radioactive waste, has the same minimum share capital requirement as a company with little leverage and which designs software, has little connection with real life.[189] The

[185] *Hopt* – Modern Company Law Problems; a European Perspective, Keynote Speech, p. 6.
[186] See for example *Enriques & Mecey* – Creditors versus Capital Formation: The Case Against the European Legal Capital Rules, *Armour* – Share Capital and Creditor Protection: Efficient Rules for a Modern Company Law?, *Kübler* – The Rule on Capital under the Pressure of the Securities Markets, *Armour* – Share Capital and Creditor Protection: Efficient Rules for a Modern Company Law?.
[187] *Armour* – Share Capital and Creditor Protection: Efficient Rules for a Modern Company Law? p.19.
[188] *Kübler* – The Rule on Capital under the Pressure of the Securities Markets, p. 5.
[189] *Enriques & Mecey* – Creditors versus Capital Formation: The Case against the European Legal Capital Rules, p. 11.

European legal capital model can thus be considered to be un-dynamic and too much of a one-size-fits-all-rule oriented regime.[190]

Since the share capital is arbitrary it will also be insufficient in many situations. Therefore, criticism have moreover been put forward that the minimum capital amount required by the Second Directive and by Member States is too trivial to provide any protection.[191] As a result, the cushion in the company will be insufficient in situations of insolvency. For example, 25,000 euro in a German private GmbH, or 50,000 euro in a German public AG, will scarcely be meaningful as creditor protection, in a situation of insolvency, when sales and risk are of some significance.[192] Accordingly, it may be held that the cushion which the minimum capital requirement intends to build up as creditor protection is too small to provide any real protection in practice.

6.1.2 …and Misleading if Trusted

Since the share capital will not provide any meaningful protection for contractual creditors, minimum capital requirements are often held to be misleading as an indicator of creditor security.[193] The legal capital doctrine assumes that the fixed amount of a company's share capital informs current and potential creditors of the recourses that a company possesses and may not freely distribute to its shareholders. As been stated before, however, as soon a company starts to operate, this capital can be used to purchase assets which later may decline in value.[194] Since a company may begin to incur losses either in the normal course of business, or by entering into unfair transaction, the initial paid-in capital will be a meaningless amount. Creditors who wish to inform themselves about a company's existing equity cushion thus must examine the entire balance sheet. Accordingly, it can be held that legal capital rules will lull creditors into a false security to the extent that they believe that the legal capital legislation will protect them.[195]

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[190] *Kahan*, Legal Capital Rules and the Structure of Corporate Law: Some Observations on the Differences between European and US Approaches, p. 147.
[191] *Wymeersch*,- Some Recent Trends and Developments in Company Law, p.14.
[192] *Van der Elst* - Analysis of Corporate Law in Europe, p 8 and *Andersson* - Kapitalkrav och kapitalskydd i internationellt perspektiv – onödigt borgenärsskydd?, p. 39.
[193] *Andersson* - Kapitalkrav och kapitalskydd i internationellt perspektiv – onödigt borgenärsskydd?, p.38.
[194] *Armour* – Share Capital and Creditor Protection: Efficient Rules for a Modern Company Law?, p.18 and *Enriques & Mecey*– Creditors versus Capital Formation: The Case against the European Legal Capital Rules, p. 11.
[195] *Andersson* - Kapitalkrav och kapitalskydd i internationellt perspektiv – onödigt borgenärsskydd?, p.39.

In practice, creditors are aware of this misleading balance sheet item and hence do not give significant weight to the share capital paid-up in a company.[196] More common is instead that creditors rely on credit references and/or providing of guarantees.[197] This fact has, for example, been supported by a number of empirical studies, which have investigated the information taken into consideration by sophisticated creditors when making lending decisions. Not too astounding, none of the studies found that the share capital was a considerable variable for creditors when providing or extending credit. Consequently, as this information seem to be of little use to investors, these rules are likely to be inefficient.[198]

Even more interesting, and supportive of the argument presented above, is the fact that major banks in Germany, who for a long have been defenders of capital rules, have become more interested in securities business. Hence, even these banks tend to favour a more market-orientated corporate system today, where protection is received through contracting. Considering this development, some scholars have predicted a "petrification effect", meaning that these market developments may turn out to be stronger than the law and hereby outlive the EU Directives.[199]

6.2 Criticism of a Balance-Sheet Test as Creditor Protection concerning Shareholder Distributions

As the rules concerning maintenance of a company's capital are based on the capital formation rules, the arguments of criticism presented above concern also these rules. As it may be held that minimum share capital requirements provide no real protection of creditors, see previous part, it is difficult for the regulations protecting this cushion to provide any extended protection.

One objection in favour of the European legal capital system must, however, be made. When a company operates as a "going concern", the share capital often amount to a higher sum than what is legally required.[200] These "higher amounts" are then protected by the European principle on the protection of the restricted equity. At least in this way, the protection of creditors would be satisfied. However, this argument falls short by the fact that

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[196] *Enriques & Mecey* – Creditors versus Capital Formation: The Case against the European Legal Capital Rules, p. 11 and *Wymeersch*,- Some Recent Trends and Developments in Company Law, p.14.
[197] *Andersson* - Kapitalkrav och kapitalskydd i internationellt perspektiv – onödigt borgenärsskydd?, p.38-39.
[198] *Armour* – Share Capita and Creditor Protection: Efficient Rules for a Modern Company Law?, p.20.
[199] *Hopt* – Modern Company Law Problems; a European Perspective, Keynote speech, p. 6.
[200] *Andersson* - Kapitalkrav och kapitalskydd i internationellt perspektiv – onödigt borgenärsskydd?, p.41.

the share capital only *may* amount to a higher sum. The company *must*, however, not have a higher share capital then what is legally required. Considering that most private companies in the UK have a share capital of less than £ 100, see part 3.32, and also that the majority of the private companies in other Member States have a share capital corresponding to the minimum requirements,[201] this argument is unfortunately rather vague.

Criticism has moreover been put forward that the European system, as such, is not an efficient and satisfying model of controlling distribution of dividends to shareholders.[202] One argument considers that systems based on minimum regulations, in general tend to encourage different sorts of *circumventions* and *manipulations* of the rules.[203] Scholars have even held that it is part of the "human nature" trying to go around minimum regulations, and the classical example is taken from the taxation area where activities of planning to evade the rules are common.[204] If there is any veracity in this argument, the current European system can even be said to encourage accounting measures which are objectively incorrect. For example, there is a discussion in many Member States[205] whether the *gross method* (the market value) or the *net method* (the booked value) should be applied when valuating assets, as both methods are permissible under the Second Company Law Directive. Hence, as the net method is acceptable and used, it can be claimed that there is a contradiction in the system; on the one hand, creditor protection is meant to be guaranteed, but on the other hand, companies are allowed to underestimate its assets.[206]

6.3 Does Legal Capital Protect Involuntary Creditors?

The conclusion from the criticism presented above is that contractual creditors regard the share capital insufficient and therefore provide themselves with security through various contractual arrangements. Involuntary creditors, on the other hand, do not have this possibility of contraction, and are thus dependent on the legal capital to cover their claims in Europe.[207] However, not surprisingly, also for these creditors the legal capital rules may be held to not provide any meaningful protection[208]. First of all, as stated, the amount of the minimum

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[201] *Andersson* - Kapitalkrav och kapitalskydd i internationellt perspektiv – onödigt borgenärsskydd?, p. 42.
[202] *Enriques & Mecey* – Creditors versus Capital Formation: The Case against the European Legal Capital Rules, p. 16.
[203] *Van der Elst* - Analysis of Corporate Law in Europe, p 8.
[204] *Andersson* - Kapitalkrav och kapitalskydd i internationellt perspektiv – onödigt borgenärsskydd?, p.43.
[205] For example in Sweden.
[206] *Andersson* - Kapitalkrav och kapitalskydd i internationellt perspektiv – onödigt borgenärsskydd?, p.43.
[207] *Kübler* – The Rules on Capital under the Pressure of the Securities Markets, p. 12.
[208] *Armour* – Share Capital and Creditor Protection: Efficient Rules for a Modern Company Law?, p.18-19.

capital is both arbitrary and relatively low. Furthermore, little of any legal capital is ever likely to be received by involuntary claimants in a process of winding-up or bankruptcy. Such parties namely rank as *unsecured creditors,* and will accordingly be paid only after the secured and preferential creditors have had their parts of the company's assets.[209] As a consequence, there is typically little or nothing left to the involuntary creditors.[210]

However, it may be argued that a minimum capital requirement will provide all creditors with at least some protection with regards to the cushion kept in the company, constituting a *"marginal benefit"*[211]. This argument has, however, been considerably weakened after the Centros and the Inspire Art rulings. As mentioned previous, the Court stated that such arguments cannot justify rules hindering the freedom of establishment.[212] Instead, the Court suggested that protection could be accomplished in other ways through law, however, without clarifying what it meant. Accordingly, the European system of today cannot be held to provide any satisfying protection at all for involuntary creditors.

6.4 Criticism based on Efficiency & Abuse Arguments

6.4.1 Increased Costs on Society

It has been held above that the minimum capital requirements of the European legislations analysed are too low to provide any real security for creditors. However, if the alternative is to raise these amounts, many small corporations may be unable to raise the minimum cost and thus cannot be formed as limited liability companies.[213] For that reason it may be claimed that any meaningful initial capital requirement would constitute an obstruction in the formation and starting-up of companies. As a result, the whole economic growth would be affected negatively if we actually had an efficient share capital. For example, the risk of monopolies would increase compared to today as it would be more difficult for new competitors to enter the market.[214] Considering the aims of the EU and the Common Market, a capital regime which increases the possibilities of more monopolies being created must clearly be regarded contradictory to any market economy.

[209] *Kübler* – The Rules on Capital under the Pressure of the Securities Markets, p. 13.
[210] *Armour* – Share Capital and Creditor Protection: Efficient Rules for a Modern Company Law?, p.19.
[211] *Andersson* - Kapitalkrav och kapitalskydd i internationellt perspektiv – onödigt borgenärsskydd?, p.43.
[212] Case C-167/01Inspire Art, para 131-139 +143 and Case C-212/97 Centros, para 34-37 +39.
[213] *Armour* – Share Capital and Creditor Protection: Efficient Rules for a Modern Company Law?, p.19.
[214] *Van der Elst* - Analysis of Corporate Law in Europe, p 8.

One of the objectives of a requiring an initial capital, is also to prevent small companies from forming with a shareholder objective of abusing the limited liability. There is also some evidence that the absence of share capital will reflect a higher propensity of companies becoming insolvent.[215] In accordance with this evidence, it could thus be argued that if we were to have legal capital rules, these would be applicable to the smallest firms, and the larger firms would be exempted under this hypothesis. Interestingly, at present the Second EU Directive requires exactly the opposite.

6.4.2 Bureaucracy and Increased Costs on Companies

In addition to the criticism mentioned above, legal capital regulations have moreover been argued to impose costs on companies. First, it is often held that rules on capital formation will slow down the process of forming companies.[216] This is particularly obvious with respect to contributions in kind which must be valued by an independent expert before incorporation. Such procedure is both cumbersome and expensive for companies as it involves significant administrative costs and requires much time spent on issues that may be seen as bureaucracy.[217] Moreover, in some cases this procedure is held to not even add any value for either the incorporation process or to the creditors. [218] This is especially the case if the assets contributed have been fully and effectively valuated at regular market price, for instance when listed or regulatory trade securities are being contributed.[219] In this area there are however some changes to come in a near future, see chapter 7.

Moreover, the prohibition of the Second Directive against contributions in exchange for future services has also been claimed to reduce the flexibility of companies. In the new economy, ideas are increasingly considered to be worth more than physical assets, and competitors hence strive to retain the best minds.[220] As a consequence it may be claimed that the prohibition of services as contributions in kind, may generate problems for the start-up

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[215] *Wymeersch*- Some Recent Trends and Developments in Company Law, p.14.
[216] The process of forming a company is considerably more complicated and bureaucratic in Europe than compared to for example the US. In the US it common practice for a corporation to be formed within a single business day, see *Morrisson* - Fundamentals of American Law, p. 337, in Europe, however, requires specific conditions to be fulfilled and certain information to be complete, which will be certified in a notarial deed, see *Maitland-Walker* – Guide to European Company Laws, p. 158.
[217] *Kübler* – The Rules on Capital under the Pressure of the Securities Markets, p. 6, *Van der Elst* - Analysis of Corporate Law in Europe, p 8, *Andersson* - Kapitalkrav och kapitalskydd i internationellt perspektiv – onödigt borgenärsskydd?, p.39 and *Wymeersch*,- Some Recent Trends and Developments in Company Law, p.17.
[218] *Wymeersch*, Some Recent Trends and Developments in Company Law, p. 17.
[219] *Kübler* – The Rules on Capital under the Pressure of the Securities Markets, p. 6.
[220] *Enriques* & *Mecey*– Creditors versus Capital Formation: The Case against the European Legal Capital Rules, p. 16.

financing of, for example, high-tech companies or companies specialized in providing services. In such companies a significant part of the assets will comprise of "brain-power", which under current system is not legally regarded as assets. Thus it may be argued, that the prohibition of providing services, is a brake in the economic growth of the Common Market. These regulations may, however, be subject to change in the near future, see part 7.3.

In accordance with this flexibility argument, the present debate has also pointed at the increased flexibility that could be achieved if more convergence was to be achieved in the regulatory requirements of the world, first and foremost with respect to the US. This convergence would benefit especially larger companies since these operate over boarders more than ever today.[221]

The purpose of this chapter was of course not to demonstrate that Europe should abandon legal capital rules at once and let market forces run freely. There is nothing in this chapter advocating that Europe should adapt a US or similar system. Rather, the point was to highlight that our system is not perfect, and that we therefore have reasons to become aware of these. Only when we are aware of the disadvantages we can change these to the better. As the criticism reviles, and to a certain extent also the presented ECJ rulings, there is pressure on the current legal capital rules of adapting to the economic system and business methods predominant today.

Accordingly, what I am advocating is that Europe should jettison the regulations that are based on antiquated notions, in favour of a more efficient and up to date regime. Values and traditions are important notions that should be respected, but to base the capital regulations on such conservative arguments[222] is, according to me, not sustainable. Consequently, it can be claimed that there are more efficient ways of protecting creditors and at the same time provide more efficient rules for companies. Statements like this, however, automatically give raise to another question; how will an "efficient" and "up to date" European regime be drafted? Should we blindly follow other systems or should we seek our own ways? This issue has become more interesting than ever after the launch of a report, issued by the EU Commission, on the modernising of EU company law.

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[221] *Wymeersch*, Some Recent Trends and Developments in Company Law, p. 14.
[222] *Enriques* & *Mecey*– Creditors versus Capital Formation: The Case against the European Legal Capital Rules, p. 11.

CHAPTER 7 FUTURE DEVELOPMENT OF THE LEGAL CAPITAL REGIME IN EUROPE

As been illustrated by the previous chapters, many scholars and business actors agree that company law has not kept up with recent developments, in particular with respect to the Common EU Market which companies wish to use to the optimum. Company law must hence catch up with these developments to provide a modern regulatory framework within the EU for company law. This is, however, not to ignore that proper protection of creditors is an integral part of this development. Such protection will be necessary to reduce the risk and costs so that creditors are willing to lend money and extend credit. Under these assumptions, the EU Commission initiated an investigation to provide the EU with a modern, competitive and efficient company law.

7.1 SLIM and the High Level Group Report

In 1996 the European Commission launched a project to modernise and simplify key Common Market legislation. The program was named SLIM (*Simpler Legislation for the Common Market*) and comprised 17 different legislative key sectors.[223] One of these key sectors to analyze was the company law sector, and thus a SLIM working party was set up for this purpose.[224] The objective of the working party was to identify whether a simpler legislation could replace the existing one in the field the First and the Second Company Law Directive.[225] The working party submitted a number of proposals, of which, with regards to this essay, the most interesting was to eliminate the need for an expert's valuation report where contributions consisted of securities traded in a regulated marked. (To review the further proposals of the SLIM working party, see reference in footnote 226.[226])

Though the SLIM proposals were presented to the Commission already in 1999, no further action was taken during some years. In September 2001, however, the Commission set up a new group to continue and complete the SLIM project. This group comprised of seven

[223] European Company Law: The "Simple Legislation for the Common Market" (SLIM) Initiative of the EU Commission, p. 1.
[224] The working party was composed of officials of the state administrations, company law practioners and academics, under guidance of Chairman Eddy Wymeersch.
[225] SLIM Report, p. 1 + 4.
[226] See the complete list of the SLIM proposals at: http://europa.eu.int/comm/internal_market/en/company/company/official/6037en.pdf

company law experts[227], and worked under the name *The Group of High Level Company Law Experts* (also called the "Winter Group" after the chairman of the group Jaap Winter). The areas covered by the project were corporate governance, groups and pyramids, corporate restructuring and mobility, the European Company and capital formation and maintenance, the latter to be scrutinized here.[228]

The Winter Group was given the objective of initiating a discussion on the need for modernisation of company law in Europe, in light of the previous SLIM report.[229] For that purpose the Group in April 2002 launched a *consultation document* on possible approaches to reform company law in Europe. In the consultative document the Group invited all parties interested in, and concerned with, company law in Europe to comment on the issues discussed in the document.[230] Based on these consultations, over 2500 pages of response and comments, the High Level Group in November 2002, presented the final *"Report of the High Level Group of Company Law Experts on a Modern Regulatory Framework for Company Law in Europe"*[231] to the EU Commission. In the report the Group initiated what it believed to be the most important priorities for the EU on the short, medium and long perspective, and moreover made recommendations with respect to these priorities.[232]

7.2 Consultations Revealing Dissatisfaction of the System

As stated, the Winter Group worked on the basis of a *consultation document*, and eleven questions were consulted with respect to capital formation and maintenance rules[233]. The findings from the consultation were rather remarkable. First of all, only 25 % of the respondents firmly believed in the current legal capital system and regarded that the legal capital served a function as creditor protection. The majority, however, 68 %, of the

[227] The company law experts comprised of: Chairman Jaap Winter, Klaus J. Hopt, Jonathan Richford, Guido Rossi, Jan Schans Christensen and Joelle Simon. Rapporteur was Dominique Thienpont and Karel Van Hulle was Secretariat.
[228] "*Report of the High Level Group of Company Law Experts on a Modern Regulatory Framework for Company Law in Europe*", presented to the European Commission on the 4th November 2002, p. 27. Below called the "Report"
[229] *Andersson*– The High Level Group and the Issue of European Company Law Harmonization – Europe Stumbles Along? p. 183.
[230] *Andersson*– The High Level Group and the Issue of European Company Law Harmonization – Europe Stumbles Along? p. 184.
[231] See the Report at: http://europa.eu.int/comm/internal_market/en/company/company/modern/consult/report_en.pdf
[232] *Von Hulle* – Does the EU have a Role to Play in Company Law? p. 30.
[233] Anex 3 of the Report, p. 147.

respondents did not believe that the legal capital served this function.[234] The share capital amount stated in the articles of association was instead considered to be a primitive and inaccurate indication of a company's ability to pay its debts and there was a wide agreement that the concept of legal capital was not effective in attaining the objectives that were assigned to it.[235] Most respondents therefore held that there was room for improvement of the current regime and that a more flexible regulation was needed. As a consequence of this critique, 73% stated in their answers that they considered there to be other possibilities of reaching the same objectives by means of other techniques than legal capital. [236] Only 10 % of the respondents held that there was no need for a new approach.[237]

Three alternative approaches to reform were presented by the Group in the consultation document and subsequently considered by the interest groups participating. The *first* alternative presented was based on the previous SLIM proposals and represented the least radical change. This approach did not imply a radical departure from the current system in Europe, instead it may be seen as an evolution of the current regime to a more simplified and modern capital regime.[238] This first alternative was supported by 45 % of the respondents and is scrutinized under part 7.1.2.[239] The *second* approach was much more radical and more or less based on the experience of US jurisdictions. This approach would imply nearly revolutionary changes from the Europe perspective if it were to be implemented, and was only supported by 9% of the respondents.[240] This approach will therefore not be further discussed.

Lastly, a *third* approach was contemplated which may be considered as something in between the other two alternatives, and which was supported by 26 % of the respondents.[241] As the US approach, this alternative was also based on the elimination of the concept of legal capital, but which seek to integrate that fundamental change with some of the basic features of European company law. Accordingly, this approach would not copy a US capital regime, but

[234] Anex 3 of the Report, p. 147.
[235] Report, p. 78.
[236] Anex 3 of the Report, p. 148.
[237] Anex 3 of the Report, p. 148. Although the harsh critic of the current capital system, it is worth noticing that a small majority, 54 %, did not consider that European companies were at a disadvantage of attracting investors, compared to companies subjects under different capital systems. However, half of the negative responses came from German respondents. Of the persons that thought that European companies were at a disadvantage (46 %), blamed this on the restrictive charters and complexity of the system, in particular with regards to the regulations concerning contributions in kind and the *weak capital protection*. None of the respondents argue that European companies enjoy an advantage thanks to the legal capital regime existing within the EU. See the Report p. 78-79. and Anex 3 of the Report, p, 149.
[238] Report, p. 79-80.
[239] Anex 3 of the Report, p. 148.
[240] Report, p. 80 and Anex 3 of the Report, p. 148.
[241] Anex 3 of the Report, p. 148.

instead rebuild the regime from a European point of view, making use of some ideas coming from the US experience but also from other legal systems[242] (see part 7.1.3). Taking into consideration the consultation results, the Winter Group made two important recommendations.

7.3 *First recommendation*; Amendment of the Second Company Law Directive

The first recommendation from the Group was put forward as a matter of priority. This recommendation was based on the *first* approach mentioned in the previous paragraph, and implied that the Commission should present a number of proposals to reform the Second Company Law Directive. This reform would follow the proposals suggested by the SLIM working party, but also further modifications and supplementary proposals which were made by the Group in what was called the *SLIM-plus Report*.[243]

Under the SLIM-plus approach, the concept of legal capital was recommended to remain as the basis together with other fundamental European legal capital features. The minimum share capital requirement would remain in present form, even though the Group stated that the only function it served was to deter individuals from light-heartedly starting a public limited company.[244] However, in accordance with what the SLIM working party proposed, the Winter Group recommended the elimination of expert's valuation reports of non-cash contributions since these were regarded to be expensive and not able to offer a total guarantee of the assets´ real value. This abolition was recommended to apply when (1) contribution consists of securities traded in a regulated market and there is a market price, (2) where there is a recent evaluation and there are no new qualifying circumstances that need to be taken into account and (3) where values derive from audited accounts provided that the accounting principles used are still applicable to the assets.[245]

Furthermore, the Group examined the possibilities of allowing services as contributions in kind. In accordance with the consultation results[246], the Group regarded this institute to be decisive to, for example start-up companies, technological companies or professional companies specialised in services, see part 6.4.2. As a result, the Group commended the

[242] Report, p. 80.
[243] Report, p. 81.
[244] Report, p. 82.
[245] Report, p. 83.
[246] Anex 3 of the Report, p. 150.

Commission to review the possibility of allowing services as contribution in kind in the revision of the Second Directive.[247]

The presented consultations clearly demonstrate the fact that there is a pressure of reviewing the current legal capital regulations. This first recommendation of change can be held to be a step in the right direction of a more efficient regime, at least with regards to business activity. At the same time, the method recommended may prove to be treacherous. Basically what is recommended in this first proposal is that the traditional European legal capital system is retained while details, from mainly the US system, are being incorporated. Both regulations regarding services in kind and the notion of not requiring expert valuation reports are features of a system which not is built up around creating a cushion in the company. The consequence may therefore be that these incorporated details will be picked without consideration of their context and regulations existing to "back them up", when placed in our system. The regulations incorporated are clearly shareholder friendly, but no changes are made as to make the creditor protection more effective. (Involuntary) creditors, still only have the "insufficient" share capital to rely on. The point thus is, that to create an efficient and complete model the whole system must be coherent; every rule must be based on a previous to complete each other. However, all in all, it must be regarded that this first recommendation to the Commission will be a positive development for European company law, when implemented.

7.4 *Second recommendation*; Development of an Alternative Regime

On basis of the consultations the Group observed that the criticism directed at the current regime was both fundamental and serious. Therefore, it was considered necessary to create a new approach which abandoned the current legal capital regime, but which at the same time fit in the European company law structure.[248] A second recommendation of the Group was therefore that the Commission, at a later stage, should conduct a review into the achievability of an *alternative regime,* based on more modern solutions for creditor protection.[249] This regime would be based on the *third* approach presented in the consultation document, see part

[247] Report, p. 83. Numerous more recommendations were moreover made, for example concerning pre-emption rights, capital reduction and financial assistance. See the complete report and all recommendations made at: http://europa.eu.int/comm/internal_market/en/company/company/modern/consult/report_en.pdf
[248] Report, p. 81+86.
[249] Report, p. 86-87.

7.1.1. The idea of this alternative approach was not to replace the capital formation and maintenance rules of the Second Directive, as amended according to the SLIM-plus proposals. Rather, this new regime was suggested to be offered as an alternative option. Member States should be able to decide whether to impose the alternative regime or to retain requirements of the Second Directive.[250]

Under the recommended alternative approach, the share capital requirement would be fully abolished. Creditor protection would instead come by means of a *solvency test*, which would be applied to *all* distributions of capital.[251] The Group held that this method had all potential to be at least as effective, even superior, in achieving the objectives of creditor protection as the current regime based on legal capital.[252] As an argument, the Group stated that creditors would be better protected if an *adequate solvency test* was developed, since under the present system there are possibilities that solvent companies are unable to make distributions which clearly harm creditors. Also controversially, there are possibilities under the current system that insolvent companies are able to make distributions, which would be prevented if an adequate solvency test was developed.[253]

Considering the critique presented towards the first recommendation of the Group, this second recommendation clearly views the recommended approach as an entirety, building up the regime from the start. Though the Group does not deal with this alternative model in detail, but refers to coming investigations, it has all the potential to become a complete and coherent system. Personally, I believe that the idea of a European solvency test regime can provide both a more flexible system, and at the same time attain a better creditor protection.

First of all, with regards to contractual creditors, their way of acting would not drastically differ from today since contractual creditors already manage their own risk by insisting on contracts. Instead, the recommended approach regards creditors more individually and would accordingly conform better to the existing reality. It could of course be argued that a mandatory legal regime may save the parties from extensive contracting. This argument is, however, only persuasive as long as it can be assumed that the legal capital regime in fact is able to grant creditors satisfactory amount of certainty that they will be repaid out of corporate funds.[254] As stated in part 6.1, this is not the situation under the current system.

[250] Report, p. 87.
[251] Report, p. 87-88.
[252] Report p. 87.
[253] Report p. 87.
[254] *Kübler* – The Rule on Capital under the Pressure of the Securities Markets, p. 9.

Furthermore, this alternative regime can be seen to be in conformity with the recent development of new and more sophisticated instruments to protect creditors contractually. For example, banks constantly refine the use of receivables as collateral, and there are moreover many contractual forms – sureties, guarantees, standby letters of credit, performance bonds- which allow shifting liability back to the shareholders.[255] As been stated previous, this argument holds true even for actors whom traditionally have defended the legal capital system, for instance German banks.[256] These new opportunities have in several ways contributed to the erosion of the capital regime. Moreover, their proliferation demonstrates that creditors have lost confidence in being protected by rules on capital. At the same time they provide a better protection by enabling creditors to seek satisfaction from specific assets. This situation, however, imply that these assets are no longer available for protection of the other creditors. Accordingly, this situation obviously increases the problem for involuntary creditors as they are unable to rely on any form of contracting.[257]

Even though the issue of involuntary creditors was not directly addressed in the Report, the Group suggested two ways in which a solvency test could offer also these non-contractual creditors a stronger protection compared to, for example, the US model. First, the Group suggested that it might be considered whether there should be a certain *solvency margin,* meaning that a company distributing dividends must have assets exceeding its liabilities by at least a certain percentage.[258] Adapting such solvency margin, would, according to me, offer a proper mechanism to integrate legal and statutory reserves into a regime where there is no legal capital.

Second, and as a further protection, the Group suggests that on the basis of the solvency test recommended, the directors would have to issue a *solvency certificate,* which would contain an explicit confirmation that the proposed distributions meet the solvency test. A valid distribution could thus be made only when such certificate is issued. It was moreover suggested, that directors should be responsible for the correctness of this solvency certificate, and that Member States should impose proper sanctions if the certificate was proven to be misleading.[259] In addition to what the Winter Group has recommended, alternatives based on mandatory insurances might furthermore be regarded to avoid an extended use of the piercing of the corporate veil doctrine. Such alternative might, for example, have been what the ECJ

[255] *Kübler* – The Rule on Capital under the Pressure of the Securities Markets, p. 13.
[256] See part 6.1.2.
[257] *Kübler* – The Rule on Capital under the Pressure of the Securities Markets, p. 13.
[258] Report, p. 88.
[259] Report, p. 88.

considered in both the Centros and the Inspire Art Case when it stated that public creditors, i.e. involuntary creditors, could be protected by law, see part 5.2.2.[260]

The recommended approach was not dealt with in detail by the Group since the Group concluded that further studies had to be made in order to develop and adopt this solvency test.[261] However, in accordance with the recommendations made, the Group advised the Commission to set up an *Action Plan* to move forward with the objective of modernizing European company law.

7.5 "Action Plan to move Forward"; Where will, where should Europe Go?

In May 2003 the EU Commission gave its response to the High Level Group recommendations and presented a report on "*A Plan to Move Forward*"[262]. In this report, the Commission stated that it intends to adopt the recommendations from the High Level Group on simplifying the Second Directive on the basis of the SLIM-plus approach. Accordingly, expert valuations regarding contributions in kind will be abandoned in defined circumstances, see part 7.3, and the Commission intends to implement these recommendations as soon as possible with the deadline running out in 2005.[263]

In addition, the Commission also announced the launch of a study into the feasibility of an *alternative regime* to the legal capital regime. Exactly how this alternative regime will be drafted, and when it will come into force, is thus so far only subject of speculations. Even if an alternative regime will be drafted may be subject to speculations. The issue of changing the legal capital doctrine is namely not only changing the "black letter rules"[264], traditions must also be changed. Regards must be taken to the fact that these rules have been cornerstones in European company law for a long time. Furthermore, politics play an important role even when legal decisions are made, especially within the EU. Company law may be considered to be only one piece in a larger game. When the final decisions are taken there will be log-

[260] See Case 212/97 Centros Case para 37. See also *Kübler* – The Rule on Capital under the Pressure of the Securities Markets, p. 13.
[261] Report p. 88.
[262] "Modernising Company Law and Enhancing Corporate Governance in the European Union –A Plan to Move Forward".
[263] *Von Hulle* – Does the EU have a Role to Play in Company Law?, p. 30+34, and Modernising Company Law and Enhancing Corporate Governance in the European Union – A Plan to Move Forward, p. 18.
[264] Metaphor for the written text in a statue.

rolling and trade offs between the Member States. The important thing is, however, that initiatives are taken and that the system do not remain as is has always been just because "that is the way it has always been". If an alternative regime was adopted, not only company law would develop but also the European commercial life. Accordingly it will be interesting to follow the development to come and to see which Member States that will adopt potential new regime.

What about *private* companies? These are not subject under any harmonization requirements and the national rules regarding these companies are free for Member Sates of changing already today, or? Well, it is true that the Second Directive only concerns public companies. The development of public companies may, however, be claimed to be most relevant, even decisive, also for private companies. Since Member States are obliged to follow the Second Directive, they have also built up other statutory rules, for example bankruptcy law, around the notion of legal capital. Even in the UK, where private companies drastically differ from remaining European states, the company structure can be held to be built up around a legal capital as distributions to shareholders may not be made if these would trespass the share capital. Accordingly, also private companies will follow requirements applicable to public companies. Consequently, it may therefore be claimed that a prerequisite of changing national rules regarding private companies, is that the mandatory regulations concerning public companies are changed.

Today most limited liability companies are private companies. Considering this fact it is therefore more important than ever that EU company law is effective. As it may be held that EU company law has not kept up with recent developments in other closely related areas, see chapter 6, it is time to remedy this defect. This development is not only necessary to provide creditors satisfactory protection but also if the EU will be able to live up to its aims of stabile economic growth within the Common Market. Whatever the outcome of the discussions presented above will be, the usefulness of the legal capital itself will continue to be contested, and it will be most interesting to follow the ongoing debate and development within Europe in the nearest future.

CHAPTER 8 CONCLUSION AND FINAL COMMENTS

The European legal capital rules were adopted in the second half of the nineteenth century. Since then, the rules have become firmly rooted in European company laws, EU Directives and even in traditions. However, in roughly 150 years society changes, and along with it business conduct and conditions of running a company changes. Ever since the creation of the EU, states within the Union has been involved in an extensive economic integration. As from the adoption of the Single European Act, and the establishment of the Common Market, this development has become even more obvious as Europe has faced a rapidly growing economy. The objective of this thesis has been to illustrate how this development has come to interfere in, and challenge, traditional national and EU legal capital regulations.

Primarily this interference has been illustrated through the acknowledgement of a right for companies to freely establish within the Union. This freedom of establishment has been guaranteed in the EC Treaty as an instrument of achieving the EU goals of economic growth and integration within the Common Market. The consequence of providing such establishment, however, has been that national legal capital rules protecting creditors have been possible to circumvent. Most Member States were traumatized by this development which has come to turn national rules into non-applicable words, with respect to foreign companies establishing within their territory. To protect national rules on capital counter-measures were therefore taken, but also these were regarded to be contrasting to EU goals and could hence not be upheld. As a consequence of this development, this thesis has raised the question whether rules on capital are compatible with the goals of the EU. In response it has been argued that it would be taking conclusions too far claiming that legal capital rules are contrary to EU goals. However, it must be held that both the purpose and the existence of the current legal capital regime have been called into question.

Bearing in mind the consequences of the ECJ rulings and the development of the common Market, some scholars have regarded these circumstances as a signal of the fact that Europe should review its rules on capital. These pleaders have even further highlighted that the current regulations may not be justified as effective in achieving their objective, to protect creditors. Both legal and economic actors have thus held that the regulations are both arbitrary and insufficient, and thus also misleading instead of protecting for creditors relying on them.

Moreover, and contrasting to Common Market goals, the rules are considered inflexible and cumbersome as they impose cost on both companies and the society as a whole. As a consequence, this thesis therefore argue that Europe should review its legal capital regulations and jettison rules that are based on antiquated notions, in favour of a more efficient and up to date regime. Nevertheless, values and traditions are important factors to consider, although this thesis regards it not to be sustainable to base capital regulations on such conservative arguments.

As a consequence of the present EU development and the presented criticism, the thesis moreover examined the future of the legal capital doctrine. Primarily, the recommendations in the High Level Group of Company Law Expert's report on modernising European company law were considered. The examination report reviles that a remarkably little group of interest organizations and parties believe in the current system, merely 25 %. In addition, nearly 75 % regard that there are other ways of achieving the same objectives as under the current system. Considering these results, the thesis hence regards that the pressure of reviewing the present regulations is both evident and urgent.

The recommendations of the High Level Group, presented to the EU Commission, were primarily two with regards to legal capital regulations. *First* some amendments of the Second Directive concerning contributions in kind were made. These recommendations may be seen as a first step of adjusting the current regime to provide more efficient and enterprising regulations, in conformity with the Common Market. The amendments will be adopted by the Commission before the expiration of 2005. In its *second* recommendation the Group request the Commission to initiate an investigation to the feasibility of an "alternative regime" to the Second Directive, based on creditor protection through a solvency test. The thesis concludes that such regime would constitute a more modern and efficient approach than the current, while at the same time being in conformity with values of creditor protection and goals of a Common Market. Moreover, such alternative regime may be regarded to constitute a balanced solution, bearing in mind the status of the legal capital doctrine as deeply rooted tradition. Changing rules on capital into a solvency test approach, would in some Member States, based on the strict German regulations, imply nearly revolutionary adjustments. Through the solution of an alternative regime, however, Member States can amend their legislations when they consider them to be ready, or they do not have to change at all. Nevertheless, the

important thing is that there are other possibilities which conform better to currant economic life and development.

Summarily, the current and ongoing development within the EU clearly denotes a distinct shift from the approach taken in the Member States today with respect to legal capital rules. To fulfil EU goals, and at the same time safeguard national interest of creditor protection, new ideas should be considered. This is however not to say that Europe should adapt a shareholder perspective similar to the prevailing in the US. Contrarily, the point made is, that there are other more effective ways of protecting creditors and at the same achieving more flexible and effective regulations, all within our European values. It is necessary for Europe to open up their eyes and not blink the fact that there are new solutions when the present are not effective. However, how such system will be drafted, as an alternative regime or perhaps as a model act, only the future can answer.

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