

Creditors Versus Capital Formation: The Case against the European Legal Capital Rules

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Luca Enriques and Jonathan R. Macey, *Creditors Versus Capital Formation: The Case against the European Legal Capital Rules*, 86 Cornell L. Rev. 1165 (2001)
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CREDITORS VERSUS CAPITAL FORMATION: THE CASE AGAINST THE EUROPEAN LEGAL CAPITAL RULES

Luca Enriques[†] & *Jonathan R. Macey*^{††}

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This Article presents a critical economic analysis of the European Union's legal capital rules as codified by the Second Directive. Professors Enriques and Macey explore the fundamental differences between United States and European Union approaches to the conflict between fixed and equity claimants and argue that the European Union should abandon its inefficient approach. The costs associated with the European legal capital rules—particularly costs to shareholders, creditors, and society as a whole—significantly outweigh any benefits accrued by creditors. The authors suggest that a public-choice theory best explains the existence of the European legal capital rules, in that certain influential interest groups benefit from the rules despite their inefficiency. In conclusion, this Article advocates that the European Union should abandon its current legal capital rules in favor of more flexible, contractarian rules in order to facilitate entrepreneurship and business development in European markets.

INTRODUCTION

A fundamental lesson of corporate finance is that the interests of the various claimants on a business's cash flow inevitably come into conflict. In particular, the interests of fixed claimants conflict with the interests of equity claimants whenever a firm makes a decision about how to allocate capital. For example, interests conflict when the firm makes investments, pays dividends, or effects other kinds of distributions (such as share repurchases or recapitalizations). Europe (or the European Union) and the United States have radically different approaches to the rules governing legal capital. These rules provide the basic framework for allocating power between creditors and other claimants, particularly equity claimants.

In this Article we seek to make two important points about these legal capital rules. First, we observe that the differences between American and European legal capital rules are fundamental and definitional. They reflect a deep, philosophical divide between Europe and the United States concerning how society should regulate corporations. Second, we argue that these differences also have profound implications for the structure of the economies of the United States and Europe. Specifically, the differences between legal capital rules in the United States and Europe explain why U.S. capital markets are significantly more robust than European capital markets and why banks dominate corporate governance in Europe. Most importantly, these differences help explain why the United States is better able to provide financing to the high-risk (be it high-tech, biotech, or dot-com) firms that have been responsible for the superior economic per-

formance of the United States relative to Europe over the past decade.¹

This Article shows that the European Union's legal capital rules are not justifiable on efficiency grounds² and argues that the best way to reform this area³ of European Union law would be to repeal the legal capital rules altogether.⁴ We show that the benefits of such rules are, to say the least, doubtful, and that their costs are certain, if not substantial. Furthermore, these costs may not only burden shareholders (that is, entrepreneurs and investors), but also, in some cases, the same creditors that these rules supposedly protect. We also argue that if legal capital rules conferred substantial benefits, market participants would adopt them spontaneously, obviating the need for mandatory legislation. Finally, the analysis will show that if a Member State or the European Union itself were to introduce more stringent legal capital rules to strengthen creditor protection, we would observe an increase in the costs of these rules with no offsetting increase in their benefits. Thus, until the European Union repeals the Second Council Directive of December 13, 1976 ("Second Directive"),⁵ Member States should

¹ See Bernard S. Black & Ronald J. Gilson, *Venture Capital and the Structure of Capital Markets: Banks Versus Stock Markets*, 47 J. FIN. ECON. 243, 244-45 (1998).

² We will focus on the legal capital rules aimed at protecting creditors. Another analysis has shown that the European Community rules on increases in capital, which supposedly protect shareholders, are also unjustifiable from an economic viewpoint. See Eilfs Ferran, *Legal Capital Rules Under the Pressure of the Securities Markets—The Case for Reform, as Illustrated by the UK Equity Markets passim* (2000) (unpublished manuscript, on file with author).

³ The more general and very intriguing question of whether the European Union's harmonization of Member States' company laws is *itself* desirable is outside the scope of this Article.

⁴ In October of 1998 the European Commission announced that its *Simpler Legislation for the Internal Market (SLIM)* initiative, launched in May of 1996 to identify ways to simplify European Union law, would cover company law. See EDDY WYMEERSCH, *EUROPEAN COMPANY LAW: THE "SIMPLER LEGISLATION FOR THE INTERNAL MARKET" (SLIM) INITIATIVE OF THE EU COMMISSION 1* (Fin. Law Inst., Working Paper No. 2000-09, 2000), available at <http://www.law.rug.ac.be/fli/WP/wp2000-09.pdf>. The Commission identified the Second Company Law Directive as a subject of this "deregulation exercise." COMPANY LAW SLIM WORKING GROUP ON THE SIMPLIFICATION OF THE FIRST AND SECOND COMPANY LAW DIRECTIVES, EXPLANATORY MEMORANDUM WITH REGARD TO THE RECOMMENDATIONS 1 (Oct. 1999), available at <http://www.law.rug.ac.be/fli/WP/SLIM.pdf> [hereinafter EXPLANATORY MEMORANDUM]. The Commission established a Working Group chaired by Professor Eddy Wymeersch in 1998, and submitted proposals for simplification to the Commission in October of 1999. See *id.* The Commission later endorsed these proposals. See Company Law SLIM Working Group, *Report from the Commission—Results of the Fourth Phase of SLIM 56* (Jul. 2000) (unpublished manuscript, on file with author). This Article describes these proposals in more detail below. See *infra* notes 50, 52, 69, 74, 90. The Commission is now reviewing them to determine its future course of action. See EXPLANATORY MEMORANDUM, *supra*, at 1. Notably, neither the Commission nor the Working Group have raised any doubts as to the overall functionality of the legal capital doctrine. See *id.* (proposing to simplify the legislation, not eliminate it).

⁵ Second Council Directive 77/91 of 13 December 1976 on Coordination of Safeguards Which, for the Protection of the Interests of Members and Others, are Required by

not impose more stringent legal capital rules, as most of them do today in one form or another. Furthermore, they should not impose any legal capital rules on companies not covered by the Second Directive.

This Article proceeds as follows. Part I briefly sketches the basic conflict of interest between creditors and corporate debtors (that is, shareholders), and the fundamental difference between the U.S. and European Union approaches to this conflict. Part II first describes the Second Directive, which provides the basic framework for the European approach.⁶ It then describes an important legal capital statute some Member States have adopted—we term this kind of statute a “recapitalize or liquidate” rule.

Part III contains the core of the Article. It provides an economic analysis of the Second Directive’s legal capital rules. We show that these rules benefit only a subset of creditors, and provide only insignificant benefits to that subset. We also show that the high social costs associated with these rules outweigh their benefit to creditors. Finally, we show that the costs associated with legal capital rules more stringent than the Second Directive’s (such as rules imposing a higher initial capital requirement or those requiring recapitalization or liquidation) would still be higher than the benefits.

In our conclusion, we suggest that a public-choice perspective can best explain the European legal capital rules as a mechanism for transferring wealth from equity investors to fixed claimants and other special interest groups. We conclude that Europe should reformulate its law in this important area in order to facilitate entrepreneurship, business development, and the investment in high-risk, start-up companies that hold the best promise for future economic growth.

I

THE CONFLICTS BETWEEN FIXED AND EQUITY CLAIMANTS

A. Interests and Incentives

Shareholders of companies with debt have strong incentives to act opportunistically at the expense of existing creditors in a wide variety of ways.⁷ First, shareholders can engage in asset diversion. They

Member States of Companies Within the Meaning of the Second Paragraph of Article 58 of the Treaty, in Respect of the Formation of Public Limited Liability Companies and the Maintenance and Alteration of Their Capital, with a View to Making Such Safeguards Equivalent, 1977 O.J. (L 26) 1 [hereinafter Second Directive].

⁶ *Id.*

⁷ See, e.g., Clifford W. Smith, Jr. & Jerold B. Warner, *On Financial Contracting: An Analysis of Bond Covenants*, 7 J. FIN. ECON. 117, 118-19 (1979) (outlining four major sources of bondholder-stockholder conflict—dividend payments, claim dilution, asset substitution, and underinvestment).

can make distributions to themselves in the form of dividend payments, share buy-backs, and excessive salaries. All of these distributions reduce the equity cushion upon which creditors depend when they extend credit to a company.⁸ Second, shareholders can engage in claim dilution. They can do so by issuing additional debt of the same or higher priority, thereby eliminating the advantage of existing creditors' claims on a company's assets if the company becomes insolvent.⁹ Higher leverage might, of course, also increase the value of the outstanding equity claims.¹⁰ Additionally, shareholders can profit at the expense of creditors by abandoning projects with a positive net present value if the only benefit from accepting the project accrues to the creditors.¹¹

Finally, and perhaps most importantly, shareholders can transfer wealth from fixed claimants to themselves by pursuing investment projects that are riskier than the creditors had contemplated when they extended credit. This, too, increases the value of equity at the expense of creditors.¹² A simple example will help to illustrate this conflict. Suppose that a firm owes \$80 in principal and interest on bank debt and has 20 shares of stock outstanding. This firm has the following options: it may select Investment A, which has a 100% chance of returning \$100; or it may select Investment B, which has a 50% chance of returning \$50 and a 50% chance of returning \$150. The expected value of both investments is \$100, as the following equations illustrate:

Investment A: $100\% \times \$100 = \text{Expected Return of } \100

Investment B: $50\% \times \$50 + 50\% \times \$150 = \text{Expected Return of } \100

Under Investment A, the bank has a 100% chance of receiving \$80, and the shareholders have a 100% chance of receiving \$20. Under Investment B, the bank has a 50% chance of receiving \$50 and a 50% chance of receiving \$80. Thus, the total expected value of Investment B for the bank is \$65. The shareholders have a 50% chance of receiv-

⁸ See, e.g., Saul Levmore, *Monitors and Freeriders in Commercial and Corporate Settings*, 92 YALE L.J. 49, 51-52 (1982).

⁹ Such actions do not damage new creditors because they will be aware of the company's new financial situation, and will accordingly charge a higher interest rate.

¹⁰ See, e.g., Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 333-34 (1976) (supposing that managers might borrow money and use the money to invest in risky projects that benefit shareholders at the expense of creditors).

¹¹ See Stewart C. Myers, *Determinants of Corporate Borrowing*, 5 J. FIN. ECON. 147, 149-53 (1977).

¹² See Levmore, *supra* note 8, at 52; see also Laura Lin, *Shift of Fiduciary Duty upon Corporate Insolvency: Proper Scope of Directors' Duty to Creditors*, 46 VAND. L. REV. 1485, 1489-91 (1993) (providing an illustration of the difference in risk preference between shareholders and creditors when the corporation is insolvent).

ing nothing and a 50% chance of receiving \$70. Thus, the total expected value of Investment B for the shareholders is \$35.

Thus, creditors prefer Investment A while shareholders prefer Investment B. Creditors prefer Investment A because, from their perspective, Investment A has an expected value of \$80, while Investment B has an expected value of only \$65. Shareholders prefer Investment B because from their perspective, Investment A has an expected value of \$20, while Investment B has an expected value of \$35.

B. Factors Mitigating Opportunistic Shareholder Behavior

Although shareholders can benefit themselves at the expense of creditors by engaging in the types of behavior described above, creditors can also benefit themselves at the expense of the shareholders by engaging in similar behavior.¹³ For example, to the extent that fixed claimants control or exert a controlling influence over the firms to which they have loaned money, such claimants can divert assets by forcing the company to prepay loans or decline to pay dividends. Fixed claimants can also engage in equity claim dilution by forcing indebted companies to issue additional equity in order to pad their equity cushion. Fixed claimants can require the firm to pursue less risky projects than the shareholders had envisioned when they invested, thereby increasing the value of the fixed claims at the expense of the shareholders' claims. Finally, when creditors have too much control, they can force companies to reject projects that have a positive present value if the benefit from accepting such projects accrues only to the shareholders.

Furthermore, however plausible it may be that shareholders will benefit themselves at the expense of creditors in theory, in practice that risk is far less significant.¹⁴ Borrowing is a repeat game in the life of a company, and companies are unlikely to fool creditors more than once. If a corporation were to engage in behavior that systematically harmed creditors, future creditors would refuse to extend credit to the company at competitive rates. Shareholders considering whether to act opportunistically would have to trade off the present gains stemming from such opportunistic behavior with the higher interest rates

¹³ See Frank H. Easterbrook, *Two Agency-Cost Explanations of Dividends*, 74 AM. ECON. REV. 650, 653 (1984) (discussing creditors' efforts to control managers' risk-taking through bond indentures and interest rate adjustments).

¹⁴ Practicing lawyers (and even academics, who in continental Europe often engage in the practice of law) may perceive this risk to be more common than it really is because of their litigation experience in business and company law. Due to the absence of derivative suits and contingency fees, such litigation often involves bankruptcies in which shareholders or managers engaged in the kinds of behavior set forth above. Because of this perspective, European lawyers naturally might perceive these pathological cases to be more common than they truly are.

they would have to pay in the future.¹⁵ This argument applies with particular force to the problems of asset diversion and claim dilution because creditors can most easily detect these kinds of wrongdoings.¹⁶ The easier it is to detect wrongdoing, the more probable it is that ex post settling-up will take place, and the lower the expected value of that action will be to shareholders.

The risk of opportunistic behavior by corporate debtors looms large primarily during some sort of end period, such as when a company is near insolvency.¹⁷ However, even when a firm is on the verge of insolvency, the problem of opportunistic behavior by shareholders is not as grave as it might first appear. This is because professional managers run public corporations. These managers are unlikely to try "gambling the company back to success."¹⁸ It is more likely that the managers will decide "to avoid scrupulously any hint of wrongdoing for fear of inflicting irrevocable damage on their reputational capital in the managerial job market."¹⁹

This is also true for smaller companies that typically have few shareholders—shareholders who manage the company. While these shareholders' "financial wealth may be shielded from responsibility for wrongdoing, their reputational assets (esteem, stature in the community) may not be."²⁰ Furthermore, although community sanctions are "not a perfect answer to shareholder opportunism, [they] will increase the costs to shareholders of corporate wrongdoing."²¹

The possibility of ex post settling-up and the concern of managers and shareholders for their reputations are not the only factors preventing wrongdoing against corporate creditors. The very first way for creditors to protect their own interests is by contract. At the outset of their relationship with the company, creditors can contract for an

¹⁵ See Richard A. Posner, *The Rights of Creditors of Affiliated Corporations*, 43 U. CHI. L. REV. 499, 504 n.14 (1976); cf. Ross Grantham, *The Judicial Extension of Directors' Duties to Creditors*, 1991 J. BUS. L. 1, 3 (noting that Judge Posner's argument is premised upon the continuation of the company, "such that the short-term gain from high-risk activity is more than offset by the long-term loss of lender confidence").

¹⁶ See Smith & Warner, *supra* note 7, at 153 (concluding that stockholder use of "dividend policy and financing policy" to the detriment of creditors is "readily observable").

¹⁷ See, e.g., Posner, *supra* note 15, at 504 n.14.

¹⁸ Ronald J. Daniels, *Must Boards Go Overboard? An Economic Analysis of the Effects of Burgeoning Statutory Liability on the Role of Directors in Corporate Governance*, in CURRENT DEVELOPMENTS IN INTERNATIONAL AND COMPARATIVE CORPORATE INSOLVENCY LAW 547, 557 (Jacob S. Ziegel ed., 1994).

¹⁹ *Id.*

²⁰ *Id.* at 553.

²¹ *Id.*

adequate interest rate²² and, possibly, for control rights on the company.²³

The interest rate that lenders charge is also compensation for the risk that borrowers will misbehave.²⁴ A borrower may obtain a lower interest rate by accepting restrictions on its freedom to manage corporate business—restrictions which one often finds in loan agreements and bond indentures.²⁵ These covenants frequently restrict the freedom of corporate borrowers to distribute assets to the shareholders.²⁶ They also do so, as we will see, in a more sophisticated and comprehensive way than legal capital provisions do.²⁷

A frequent objection to this line of reasoning is that only one category of creditors—sophisticated creditors (usually financial creditors)—do in fact contract for control rights and higher interest rates. Other creditors, including some trade creditors, employees, and especially involuntary creditors such as tort victims and the state as tax collector, are not able to contract for themselves.²⁸ We address this objection later and show that it does not justify legal capital provisions.²⁹ In addition, these “weak” or involuntary creditors can free-ride on the contracts of sophisticated creditors. Weak creditors can take advantage of lenders who impose a restriction on distributions to shareholders and who monitor the borrower to ensure compliance; the decrease in the company’s risk of insolvency will benefit all of the creditors. Hence, even if only one sophisticated creditor has imposed such covenants on a corporate debtor, all of that company’s creditors will gain protection from wrongdoing.³⁰

²² See Posner, *supra* note 15, at 501 (making the “fundamental point that the interest rate on a loan is payment not only for renting capital but also for the risk that the borrower will fail to return it”).

²³ See, e.g., G. Mitu Gulati et al., *Connected Contracts*, 47 UCLA L. REV. 887, 908-18 (2000).

²⁴ See Posner, *supra* note 15, at 501-03.

²⁵ See Smith & Warner, *supra* note 7, at 119 (describing a variety of debt covenants).

²⁶ See *id.* at 131-35. Smith & Warner note that in a 1979 study of 150 randomly selected firms, each firm had a dividend restriction in at least one of its debt instruments. *Id.* at 131 n.28.

²⁷ See *infra* text accompanying notes 112-13.

²⁸ See Phillip I. Blumberg, *Limited Liability and Corporate Groups*, 11 J. CORP. L. 573, 618-19 (1986); Jonathan M. Landers, *Another Word on Parents, Subsidiaries and Affiliates in Bankruptcy*, 43 U. CHI. L. REV. 527, 529 (1976).

²⁹ See *infra* notes 116-38 and accompanying text.

³⁰ In closely held companies, the financial creditors may prefer to protect their interests by asking for a personal guarantee from the shareholders or a lien on the company’s assets. In either case, financial creditors will engage in monitoring to a certain degree. In the former case, this is because it might be more expensive for creditors to pursue the assets of individual shareholders. In the latter case, this is because creditors want to prevent the sale or dispersion of collateral. Other creditors will take advantage of such monitoring activity. See Levmore, *supra* note 8, at 53-54. Practicing lawyers are less inclined to believe that such conduct is likely because they have more experience with cases in which

C. Contrasting Approaches to the Shareholder-Creditor Conflict of Interest

The disintegration of the Soviet Union and the collapse of communism effectively ended the debate about the relative merits of the market and the state in allocating capital within an economy.³¹ Nevertheless, while we no longer argue much about the virtues of capitalism as compared to the virtues of communism, the disagreement now focuses on the proper roles of fixed claimants (creditors) and equity claimants (shareholders) within a market system.

Europe and the United States have each wagered their prosperity on the soundness of their legal capital rules. A deep fissure exists between European and American theories concerning treatment of fixed claimants and equity claimants. In Europe, fixed claimants play an integral role in corporate governance, and European legal capital rules exist to protect fixed claimants from opportunistic behavior by residual claimants.³² The fundamental purpose of corporate law in Europe is to protect creditors. Law, not contract, protects creditors in Europe.³³

In the United States, the reverse is true. Fixed claimants participate in corporate governance at their peril, and society has designed legal capital rules to provide maximum flexibility to shareholders.³⁴ The fundamental purpose of corporate law in the United States is to provide maximum flexibility for private ordering within a structure that seeks to maximize value for shareholders. In the United States, creditors who wish to protect themselves from shareholders behaving opportunistically must do so by contract.³⁵

The basic justification for European-style legal capital rules aimed at protecting creditors is that compliance with such rules is the price that firms must pay to obtain the benefits of limited liability. Under this view, limited liability is a "privilege" which benefits shareholders but hurts fixed claimants. To obtain this benefit, under a typical European legal capital regime, shareholders must make contributions of a minimum value (capital) to the company, and the company may not return these contributions to the shareholders during the company's

the company has gone bankrupt and monitoring has not taken place or has been ineffective. *See supra* note 14.

³¹ *See, e.g.*, PETER KOSLOWSKI, *THE SOCIAL MARKET ECONOMY: THEORY AND ETHICS OF THE ECONOMIC ORDER* (1998).

³² *Cf.* Jonathan R. Macey & Geoffrey P. Miller, *Corporate Governance and Commercial Banking: A Comparative Examination of Germany, Japan, and the United States*, 48 *STAN. L. REV.* 73, 81 (1996) (describing the German model of corporate governance).

³³ *See infra* Part II.

³⁴ *See infra* Part III.A.2.

³⁵ *See* FRANK H. EASTERBROOK & DANIEL K. FISCHEL, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* 17-35 (1991).

life.³⁶ This traditional view remains very popular among the majority of European legal scholars. Within the last decade, however, those European legal scholars most sensitive to the developments of American law have begun to question the soundness of this traditional view.³⁷

One development in particular, however, has hampered change in the legal capital rules. Although individual European Union Member States once devised their own legal capital regimes, the European Union's codification through directives essentially locked the legal capital doctrine into place. The resulting petrification effect is typical of many European Union efforts,³⁸ and here operates to "place[] the national legislations in a straitjacket and prevent[] any kind of experimentation."³⁹

II

LEGAL CAPITAL DOCTRINE IN THE EUROPEAN UNION: AN OVERVIEW

All of the European Union Member States adhere to the legal capital doctrine.⁴⁰ In part, the European Union has imposed this doctrine⁴¹ by adopting the Second Directive. The Second Directive imposes limits on minimum capital, contributions, distributions to shareholders, and increases or reductions in capital. However, many Member States go beyond the Second Directive's legal capital rules, providing for a stricter regime intended to better protect creditors. In

³⁶ See, e.g., SABINE DANA-DÉMARET, *LE CAPITAL SOCIAL* 253 (1989).

³⁷ See MARKUS BAUER, *GLÄUBIGERSCHUTZ DURCH EINE FORMELLE NENNKAPITALZIFFER—KAPITALGESELLSCHAFTSRECHTLICHE NOTWENDIGKEIT ODER ÜBERHOLTES KONZEPT?* 329-40 (1995); FRIEDRICH KÜBLER, *AKTIE, UNTERNEHMENSFINANZIERUNG UND KAPITALMARKT* (1989); Eilís Ferrán, *Creditors' Interests and "Core" Company Law*, 20 *COMPANY LAW* 314, 316-21 (1999); see also COMPANY LAW AND INVESTIGATIONS DIRECTORATE, BRITISH DEP'T OF TRADE AND INDUS., *MODERN COMPANY LAW FOR A COMPETITIVE ECONOMY* 6-7 (1998), available at <http://www.dti.gov.uk/cld/comlaw/comlaw.pdf> (criticizing the British legal capital rules and proposing alternative ones); COMPANY LAW REVIEW STEERING GROUP, BRITISH DEP'T OF TRADE AND INDUS., *COMPANY FORMATION AND CAPITAL MAINTENANCE*, at vi-ix (1999), available at <http://www.dti.gov.uk/cld/1843cptl.pdf> (criticizing the British legal capital rules and proposing alternative ones). Notably, the Model Business Corporation Act dropped the legal capital concept in 1980. See generally BAYLESS MANNING & JAMES J. HANKS, JR., *LEGAL CAPITAL* 176-92 (3d ed. 1990) (providing a detailed exposition of the Revised Model Business Corporation Act's provisions on shareholder contribution and distribution).

³⁸ See RICHARD M. BUXBAUM & KLAUS J. HOPT, *LEGAL HARMONIZATION AND THE BUSINESS ENTERPRISE* 243 (Mauro Cappelletti et al. eds., *Integration Through Law Series*, vol. 4, 1988) ("Because [European] Community directives require a long process of negotiation and compromise, there is a great danger that once a directive is enacted it will be practically impossible to amend or rescind.").

³⁹ André Tunc, *Corporate Law*, in *EUROPEAN BUSINESS LAW* 199, 208 (Richard M. Buxbaum et al. eds., 1991).

⁴⁰ See Second Directive, *supra* note 5, art. 1, at 2.

⁴¹ See *supra* note 38 and accompanying text.

this Part, after describing the Second Directive, we will also briefly describe the most important of these additional state-imposed legal capital rules—the “recapitalize or liquidate” rule.

The Second Directive applies only to publicly traded companies, those limited-liability companies that issue shares and other securities to the public under the laws of the Member States in which they are located.⁴² There is a purely political explanation for this limitation on the Second Directive’s applicability.⁴³ Some Member States, most notably the United Kingdom and Ireland, opposed extending the legal capital rules to closely held companies because investors in those companies benefit from their very flexible legal regime.⁴⁴

A. Minimum Capital Rules

One set of the European Union’s legal capital rules deals with minimum capital. This set of provisions obligates Member States to pass laws requiring companies to have a minimum capital of at least €25,000 before they can commence business,⁴⁵ and this capital may

⁴² See Second Directive, *supra* note 5, art. 1, at 2 (naming covered types of companies under the laws of each Member State). For the sake of brevity, we shall refer to limited-liability companies other than those covered by the Directive as “private limited-liability companies.”

⁴³ In fact, the official explanation of the motivation for Second Directive makes little sense. See *id.* recitals, at 1 (stating that the coordination of national company laws “is especially important in relation to public limited liability companies, because their activities predominate in the economy of the Member States and frequently extend beyond their national boundaries”). As Professor Timmermans has noted, “[a]t least in Member States like the United Kingdom, Germany and the Netherlands, the private company is a much more common vehicle for doing business than the public company, and is certainly not limited to the smaller businesses alone.” Christian Timmermans, *Methods and Tools for Integration, in EUROPEAN BUSINESS LAW, supra* note 39, at 129, 131. Professor Timmermans goes on to point out that, “[f]rom the point of view of cross-border trade in goods and services, . . . private companies are anything but a negligible factor or of minor interest only to the functioning of the Common Market.” *Id.*

⁴⁴ See VANESSA EDWARDS, *EC COMPANY LAW 53* (1999) (speaking of the “resistance from the United Kingdom and Ireland” to extending these rules to private companies). Ms. Edwards also recounts a proposal for extending the Second Directive to private companies. See *id.* at 54-55.

⁴⁵ Second Directive, *supra* note 5, art. 6(I), at 3. Article 6(3) provides:

Every five years the Council, acting on a proposal from the Commission, shall examine and, if need be, revise the amounts [of €25,000] in the light of economic and monetary trends in the Community and of the tendency towards allowing only large and medium-sized undertakings to opt for the [public limited-liability company].

Id. art. 6(3), at 4. The Council has never made use of its powers under this Article. Cf. EDWARDS, *supra* note 44, at 60 (providing an updated description of the Second Directive’s provisions, which does not include an increase in the minimum capital requirement). The company laws of most Member States do, however, impose a higher minimum capital requirement. For instance, Italy imposes a minimum capital requirement of €100,000, see CODICE CIVILE [art 2327 (Italy)]. England requires £50,000, see Companies Act, 1985, c. 6, § 118 (Eng.), and Germany requires €50,000, see § 7 Aktiengesetz v. 6.9.1965 (BUNDESGESETZBLATT, I Teil I [S.] 1089) (F.R.G.). €1.00 is currently worth \$.85, and £1.00

only consist of "assets capable of economic assessment."⁴⁶ Furthermore, Article 7 of the Second Directive goes on to specify that "an undertaking to perform work or supply services may not form part of these assets."⁴⁷ At least one-quarter of the subscribed capital must be paid up at the time of incorporation or authorization to commence business.⁴⁸ Additionally, Article 9(2) requires that shares issued for consideration other than cash "must be transferred in full within five years."⁴⁹

Interestingly, when the consideration comes in some form other than cash, the Second Directive requires "one or more independent experts appointed or approved by an administrative or judicial authority" to create a report.⁵⁰ The report, which the company must publish in accordance with Article 3 of the First Company Law Directive,⁵¹ must describe the assets and the methods of valuation, and indicate whether the resulting valuations "correspond at least to the number and nominal value, or where there is no nominal value, to the accountable par and, where appropriate, to the premium on the shares to be issued for them."⁵²

is currently worth \$1.39. See CNN, *Markets: Currencies*, at <http://cnfnfnn.com/markets/currencies> (last visited June 13, 2001).

⁴⁶ Second Directive, *supra* note 5, art. 7, at 4.

⁴⁷ *Id.*

⁴⁸ *Id.* art. 9(1), at 4.

⁴⁹ *Id.* art. 9(2), at 4.

⁵⁰ *Id.* art. 10(1), at 4. In practice, however, the requirement of independence is not particularly severe. For example, English company law implementing this part of the Second Directive allows a company to appoint its current auditor as expert. See, e.g., EILTS FERRAN, *COMPANY LAW AND CORPORATE FINANCE* 298-99 (1999). In Italy, a judge (the president of the local tribunal) appoints the expert. C.C. art. 2343 (Italy). In practice, however, the judge will usually appoint the person the shareholder has informally requested.

Article 10(4) contains a very narrow exception to the requirements of Article 10(1), designed to cater to certain intra-group issues and corporate reorganizations involving the creation of a subsidiary. See *id.* art. 10(4); see also EDWARDS, *supra* note 44, at 62-63 (describing Article 10(4) in greater detail). The Third Council Directive provides for a further exception for "the formation of a new company" to acquire an existing company or companies by a merger. Third Council Directive 78/855, art. 23(4), 1978 O.J. (L 295) 41; see also EDWARDS, *supra* note 44, at 63 (describing this exception). The SLIM Working Group has proposed that the European Union extend this exception. See COMPANY LAW SLIM WORKING GROUP, *RECOMMENDATIONS ON THE SIMPLIFICATION OF THE FIRST AND SECOND COMPANY LAW DIRECTIVES 3-4* (1999), available at <http://www.law.rug.ac.be/fli/WP/SLIM.pdf> [hereinafter RECOMMENDATIONS]. The Working Group has proposed further exceptions for situations in which an independent expert has recently valued the company's assets, and for situations involving the contribution of securities traded on a regulated market. *Id.* The Working Group has also called for further "harmonisation as to the rules to be followed for the conversion of debts in capital." *Id.* at 4.

⁵¹ Second Directive, *supra* note 5, art. 10(3), at 4.

⁵² *Id.* art. 10(2), at 4. The Second Directive does not permit "pure" no-par-value shares. See, e.g., EXPLANATORY MEMORANDUM, *supra* note 4, at 5-6. The Working Group leaves open the issue of whether a company may introduce true no-par-value shares. See RECOMMENDATIONS, *supra* note 50, at 4 ("There is subject for further investigation and research whether the present notions of nominal value and accountable par should be inain-

The provisions requiring a report in situations involving non-cash consideration also apply when a company acquires any asset belonging to one of the company's founders for consideration of more than one-tenth of the company's subscribed capital.⁵³ In addition, these provisions apply to any acquisition that occurs within two years of a company's incorporation or receipt of authorization to start its business.⁵⁴ Furthermore, they also apply "in the event of the conversion of another type of company into a public limited liability company."⁵⁵

To ensure that a company receives full consideration for its subscribed capital, the Second Directive states that "[s]hares may not be issued at a price lower than their nominal value, or, where there is no nominal value, their accountable par."⁵⁶ It also specifies that, "[s]ubject to the provisions relating to the reduction of subscribed capital, the shareholders may not be released from the obligation to pay up their contributions."⁵⁷ Moreover, the Second Directive prohibits the subscription of shares by the same issuing company.⁵⁸

B. Dividend Payment and Share Repurchase Restrictions

A second set of provisions in the Second Directive regulates distributions to shareholders.⁵⁹ These provisions impose a balance-sheet test that does not allow distributions to shareholders "when on the closing date of the last financial year the net assets . . . are, or following such a distribution would become, lower than the amount of the

tained, or whether a simplification would result from the use of shares that merely represent a fraction of the company.")

⁵³ See Second Directive, *supra* note 5, art. 11(1), at 5. Article 11(2) specifies that this provision "shall not apply to acquisitions effected in the normal course of the company's business, to acquisitions effected at the instance or under the supervision of an administrative or judicial authority, or to stock exchange acquisitions." *Id.* art. 11(2), at 5.

⁵⁴ *Id.* art. 11(1), at 5.

⁵⁵ *Id.* art. 13, at 5.

⁵⁶ *Id.* art. 8(1), at 4. Article 8(2) provides an exception to this rule for underwriters. *Id.* art. 8(2), at 4.

⁵⁷ *Id.* art. 12, at 5.

⁵⁸ *Id.* art. 18(1), at 6.

⁵⁹ The Second Directive does not define the term "distribution," unlike the Revised Model Business Corporation Act. See REVISED MODEL BUS. CORP. ACT § 1.40(6) (1998) (defining "distribution" as "a direct or indirect transfer of money or other property (except its own shares) or incurrence of indebtedness by a corporation to or for the benefit of its shareholders" and further stating that "[a] distribution may be in the form of a deduction or payment of a dividend; a purchase, redemption, or other acquisition of shares; a distribution of indebtedness; or otherwise"). Article 15(1)(d) of the Second Directive specifies only that this term "includes in particular the payment of dividends and of interest relating to shares." Second Directive, *supra* note 5, art. 15(1)(d), at 5. This formulation leaves it for the courts to determine the scope of Article 15's provisions. Commentators generally assume that the term "distribution" encompasses all transfers of money and indebtedness of the corporation or other property to a shareholder in respect of the corporation's shares. See Ferran, *supra* note 2, at 321-22 (citing and discussing English cases that adopt a broad definition of the term "distribution").

subscribed capital plus those reserves which may not be distributed under the law or the statutes."⁶⁰ The test does not apply in "cases of reductions of subscribed capital."⁶¹

The Second Directive subjects a company's acquisition of its own shares not only to the above limit,⁶² but also to a number of additional restrictions.⁶³ In stark contrast with U.S. law,⁶⁴ companies in European Union Member States cannot repurchase their own shares unless the shareholders have authorized the share repurchase at a general meeting.⁶⁵ Shareholders must vote to authorize the specific number of shares that the company may acquire, as well as the maximum and minimum consideration the company may pay for the shares.⁶⁶ Neither the company nor any of its subsidiaries may hold more than ten percent of the company's subscribed capital⁶⁷ at the same time,⁶⁸ and the company may acquire only fully paid-up shares.⁶⁹

⁶⁰ Second Directive, *supra* note 5, art. 15(1)(a), at 5. The Second Directive allows Member States to provide an exception for investment companies with fixed capital. *Id.* art. 15(4), at 6. Article 15(1)(c) adds that "[t]he amount of a distribution . . . may not exceed the amount of the profits . . . plus any profits brought forward and sums drawn from reserves available for this purpose, less any losses brought forward and sums placed to reserve in accordance with the law or the statutes." *Id.* art. 15(1)(c), at 5. Article 15(2) introduces similar limitations for interim dividends. *See id.* art. 15(2), at 5.

⁶¹ *Id.* art. 15(1)(a), at 5.

⁶² *Id.* art. 19(1)(c), at 7. One may question why the Second Directive treats share buy-backs differently than distributions. It is our guess that the lawyers who drafted the Second Directive failed to understand the functional equivalence between payment of dividends and share buy-backs.

⁶³ *See id.* art. 19, at 6-7. There are exceptions to these provisions, but the exceptions are very narrow. *See id.* arts. 19(2), 19(3), 20, at 7.

⁶⁴ *See* REVISED MODEL BUS. CORP. ACT § 6.31(a) (1998) (noting that "a corporation may acquire its own shares").

⁶⁵ Second Directive, *supra* note 5, art. 19(1)(a), at 6.

⁶⁶ *Id.* The shareholders also have a time limit of eighteen months to authorize the acquisition. *Id.*

⁶⁷ Due to the rigidity of rules on decreases of capital, companies in Europe have traditionally kept their own shares as treasury shares instead of canceling them. Article 22 contains the Second Directive's rules applicable to treasury shares. *See id.* art. 22, at 8 (applying to "the holding of . . . shares" by a company, as opposed to the cancellation of those shares).

⁶⁸ A new Directive has extended "Articles 18 to 24 of the Second Directive to the subscription, acquisition or holding of shares in a public company effected by another company under the public company's control." EDWARDS, *supra* note 44, at 76-77 (referring to Council Directive 92/101, art. 24a(5), 1992 O.J. (L 347) 64) (providing greater detail on this Directive). This calculation also includes shares that the company has accepted as security. *See* Second Directive, *supra* note 5, art. 24(1), at 8.

⁶⁹ Second Directive, *supra* note 5, art. 19(1)(d), at 7. With respect to the acquisition of a company's own shares, the SLIM Working Group made three proposals. First, it proposed that the ten-percent limit "should be replaced by a limitation of the acquisition to the amount of the distributable net assets." RECOMMENDATIONS, *supra* note 50, at 4. Second, with respect to companies listed on stock exchanges, the Working Group proposed that "the articles may provide the general meeting to authorise, upon a simple majority and within the limits of the distributable net assets, the board of directors to acquire [the company's] shares at the market price, provided that there is sufficient continuous and

By contrast, U.S. law treats share repurchases exactly the same as it treats dividend payments.⁷⁰ The U.S. approach makes sense because share repurchases are, from an economic perspective, identical to dividend repayments. A simple example illustrates this point. Suppose that a corporation has 500 shares of stock outstanding. The corporation has two shareholders, each of whom owns 250 shares of stock. The corporation has assets with a present value of \$1000 and debt of \$500. Therefore, the corporation has \$500 in equity, and each share is worth \$1.00. Furthermore, the value of each shareholder's investment is \$250. The firm's balance sheet looks like this:

BALANCE SHEET	
ASSETS \$1000	LIABILITIES \$500
	EQUITY \$500

If the corporation repurchases a total of 250 shares (125 from each shareholder) for \$1.00 per share, its balance sheet would then look like this:

BALANCE SHEET	
ASSETS \$750	LIABILITIES \$500
	EQUITY \$250

After the share repurchase, each shareholder would then have 125 shares of stock worth \$1.00 each, for a total of \$125 in stock. Each shareholder also would have \$125 in cash from the sale of his shares. The total value of the shareholders' investment after the share repurchase would be \$250.

If the corporation pays a dividend of \$.50 per share on the 500 shares, its balance sheet would look like this:

BALANCE SHEET	
ASSETS \$750	LIABILITIES \$500
	EQUITY \$250

After the dividend payment, each shareholder would have 250 shares of stock worth \$.50 each, for a total of \$125 in stock. Each

periodic disclosure." *Id.* Finally, the Group proposed that the European Union extend the time period for shareholders to authorize a company to acquire its own shares to five years. *Id.*

⁷⁰ See REVISED MODEL BUS. CORP. ACT § 1.40(b) (1998).

shareholder would also have \$125 in cash from the dividend of \$.50 per share. The total value of the shareholders' investment after dividend would be \$250.

From this simple example, we can make the following observations. Share repurchases are exactly like dividend payments from the point of view of the corporation's balance sheet. Proportional, pro-rata share repurchases, like the one in the example above in which the corporation purchased the same number of shares from all shareholders at the same price, are like dividend payments from the shareholders' point of view as well.

Public policy issues arise when a company does not repurchase shares equally from all shareholders. This is the problem of dilution. To illustrate this problem, suppose that the corporation purchases all 250 of the shares belonging to one shareholder for \$1.20 each. The firm's balance sheet after the repurchase would then look like this:

BALANCE SHEET	
ASSETS \$700	LIABILITIES \$500
	EQUITY \$200

The shareholder who had sold her shares would realize \$300 ($\1.20×250 shares). The other shareholder, however, would see the value of his shares decline from \$250 to \$200, or from \$1.00 per share to \$.80 per share ($\$200$ in equity / 250 shares = \$.80 per share). In this situation, the share repurchase is dilutive because it dilutes the value of the remaining equity.

Dilution can be a problem, and U.S. law imposes restrictions on share buy-backs.⁷¹ This concern does not, however, justify buy-back rules as strict as the Second Directive's. In fact, in some situations such rules prevent companies from taking actions that benefit their shareholders.

For example, suppose the balance sheet looks like this:

BALANCE SHEET	
ASSETS \$1000	LIABILITIES \$500
	EQUITY \$500

⁷¹ See, e.g., DEL. CODE ANN. tit. 8, § 160(a)(1) (1983) (providing, in relevant part, that a "corporation may purchase, redeem, receive, take or otherwise acquire, own and hold, sell, lend, exchange, transfer . . . and otherwise deal in and with its own shares" except where so doing would impair the corporation's capital); REVISED MODEL BUS. CORP. ACT § 6.31(a), 6.40(c) (1998) ("[a] corporation may acquire its own shares except where so doing would render the firm insolvent").

Suppose further that our two shareholders have different (or "heterogeneous") views about this valuation. Recall that each shareholder owns 250 shares. Suppose that one shareholder thinks that the present value of the firm's assets is really \$1250, so that each share is really worth \$1.50 instead of \$1.00. In addition, suppose that the other shareholder thinks that the present value of the assets is really only \$750, so that the value of each share is only \$.50 rather than \$1.00. In such a situation, a repurchase would benefit both shareholders. Where such heterogeneous views of the present value of the firm exist, a share repurchase at some price greater than \$1.00 and less than \$1.50 will make each shareholder better off. That is because the shareholder who values her shares at \$.50 will tender them, while a shareholder who values them at \$1.50 will not. A dividend payment cannot accomplish this result because a corporation must make payments of dividends on a pro-rata basis.

C. Additional Restrictions in the Second Directive

Article 23 of the Second Directive contains a sweeping prohibition against firms providing financial assistance to those who might want to acquire their shares.⁷² A company "may not advance funds, nor make loans, nor provide security, with a view to the acquisition of its shares by a third party,"⁷³ regardless of the conditions attached to these loans or the creditworthiness of the third party.⁷⁴ This prohibition is so broad that it bans some leveraged buy-outs because the assets of the acquired company would be, in fact, the security for the acquisition.⁷⁵

Article 26 provides that shares issued for consideration "must be paid up to at least 25% of their nominal value or, in the absence of a

⁷² Second Directive, *supra* note 5, art. 23(1), at 8.

⁷³ *Id.* Article 23(2) provides that the prohibition "shall not apply to transactions concluded by banks and other financial institutions in the normal course of business, nor to transactions effected with a view to the acquisition of shares by or for the company's employees or the employees of an associate company." *Id.* art. 23(2), at 8. It also provides, however, that "these transactions may not have the effect of reducing the net assets below the amount specified in Article 15(1)(a)." *Id.*

⁷⁴ The SLIM Working Group recommended that the European Union reduce the prohibition on financial assistance "to a practical minimum" by limiting it either "to the amount of the distributable net assets" or "to the assistance for the subscription of newly issued shares." RECOMMENDATIONS, *supra* note 50, at 5.

⁷⁵ See Roberto Weigmann, *L'Interpretazione del Diritto Societario Armonizzato nella Unione Europea*, in *CONTRATTO E IMPRESA / EUROPA* 487, 500-01 (1996); see also WYMEERSCH, *supra* note 4, at 4 ("The regulation, as it now stands, prevents useful [management buy-outs from being] realized."). Lumsden provides an illustration of the English law on this subject. See C.G.M. Lumsden, *Financial Assistance Problems in Management Buy-Outs*, 1987 J. BUS. L. 111, *passim* (1987). In fact, the original rationale for the prohibition of financial assistance in England was "the prevention of 'asset-stripping' takeovers," or leveraged buy-outs. See John Armour, *Share Capital and Creditor Protection: Efficient Rules for a Modern Company Law*, 63 *MOD. L. REV.* 355, 368 (2000).

nominal value, of their accountable par."⁷⁶ It goes on to specify that "[w]here provision is made for an issue premium, it must be paid in full."⁷⁷ Article 27 regulates capital increases when a company issues shares for consideration other than cash, providing that "the consideration must be transferred in full within a period of five years from the decision to increase the subscribed capital."⁷⁸ It also requires an independent expert report under the same rules that apply to initial contributions.⁷⁹

Article 32 provides that in the event of a reduction in subscribed capital, "at least the creditors whose claims antedate the publication of the decision to make the reduction shall be entitled at least to have the right to obtain security for claims which have not fallen due by the date of that publication."⁸⁰ It goes on to specify that "[t]he laws of a Member State . . . may not set aside such right unless the creditor has adequate safeguards, or unless the latter are not necessary in view of the assets of the company."⁸¹ Furthermore, the Second Directive requires the laws of the Member States to "stipulate at least that the reduction shall be void or that no payment may be made for the benefit of the shareholders, until the creditors have obtained satisfaction or a court has decided that their application should not be acceded to."⁸² Article 33 specifies that "Member States need not apply Article 32 to a reduction in the subscribed capital whose purpose is to offset losses incurred,"⁸³ provided that the Member States adopt "the measures necessary to ensure that the amounts deriving from the reduction of subscribed capital may not be used for making payments or distributions to shareholders or discharging shareholders from the obligation to make their contributions."⁸⁴

Hence, companies that do not reduce their capital to offset losses may find such reductions cumbersome. This is because any creditor,

⁷⁶ Second Directive, *supra* note 5, art. 26, at 8-9.

⁷⁷ *Id.*

⁷⁸ *Id.* art. 27(1), at 9.

⁷⁹ *Id.* art. 27(2), at 9; *see also supra* notes 50-55 and accompanying text (detailing the independent report requirement in the context of initial contributions). The Article allows exception to the report requirement "in the event of an increase in subscribed capital made . . . to give effect to a merger or a public offer for the purchase or exchange of shares and to pay the shareholders of the company which is being absorbed or which is the object of the public offer." *Id.* art. 27(3), at 9. Article 27, *id.* art. 27(4), at 9, also contains an exemption similar to the one in Article 10(4), *see supra* note 50.

⁸⁰ Second Directive, *supra* note 5, art. 32(1), at 10. The decision to make the reduction must be published in accordance with Article 3 of the First Directive. *Id.* art. 30, at 10.

⁸¹ *Id.*

⁸² *Id.* art. 32(2), at 10.

⁸³ *Id.* art. 33(1), at 10. The same paragraph also exempts reductions of capital when a company establishes a reserve no greater than ten percent of the reduced capital, and only if it does not distribute the reductions to shareholders. *Id.*

⁸⁴ *Id.* art. 33(2), at 10.

however small, may veto the transaction.⁸⁵ Furthermore, this veto threat may continue until the company pays the creditor or a court validates the reduction in capital after being satisfied that there are adequate safeguards for the opposing creditors.

Article 34 provides that “[t]he subscribed capital may not be reduced to an amount less than the minimum capital laid down in accordance with Article 6.”⁸⁶ However, this rule only forbids formal capital reduction below that threshold. It does not mean that if net assets fall below the subscribed capital, companies must recapitalize, liquidate, or transform themselves into another type of company (as certain Member States require).⁸⁷ When a company suffers “a serious loss of the subscribed capital,” the Second Directive only requires that “a general meeting of shareholders must be called within the period laid down by the laws of the Member States, to consider whether the company should be wound up or any other measures taken.”⁸⁸ This provision clearly does not require a company either to wind itself up or to take other measures. Rather, the only requirement is that the company let shareholders discuss the possible alternatives, including the possibility of not taking any action. This provision also applies, of course, when losses put the company below the statutory minimum capital requirement. Because this “fatuous”⁸⁹ provision clearly aims at protecting shareholders instead of creditors, we shall dedicate no further attention to it.

Article 15(1)’s distribution limits and Article 32’s safeguards for creditors also apply in the peculiar transactions described in Articles 35, 36, 37, and 39 leading to a reduction of subscribed capital. It is unnecessary to go into the details of these transactions here.⁹⁰

D. The “Recapitalize or Liquidate” Rule

In addition, a number of European Union Member States (including France, Italy, Sweden, and Spain) have legal capital rules that go beyond even the strict rules generally applicable in the European Union. In particular, these states require that whenever losses cause a firm’s net assets to fall below some specified minimum level, the firm

⁸⁵ See *id.* art. 32(2), at 10.

⁸⁶ *Id.* art. 34, at 10.

⁸⁷ See *infra* note 91 and accompanying text.

⁸⁸ Second Directive, *supra* note 5, art. 17(1), at 6. The Second Directive specifies that a Member State may not set the amount of a loss that is “serious” at more than half of a company’s subscribed capital. *Id.* art. 17(2), at 6.

⁸⁹ See PAUL L. DAVIES, *GOWER’S PRINCIPLES OF MODERN COMPANY LAW* 248 (6th ed. 1997) (disparaging this requirement because “the general meeting is not compelled to take any steps and is given no greater powers than it would otherwise have”).

⁹⁰ The SLIM Working Group proposed a modification of Article 36’s rules on withdrawal of shares to make squeeze-out transactions easier. See RECOMMENDATIONS, *supra* note 50, at 4.

must either recapitalize or reorganize into a type of company with a legal capital requirement no greater than the remaining net assets.⁹¹ Furthermore, if a firm does not carry out such a reorganization or recapitalization in a timely manner, these rules either require the company to wind up, or they impose personal liability on the directors.⁹² This is one of the most extreme examples of how European company laws place fixed claimants first on their priority list.

Thus, in order to protect the creditors of public limited-liability companies, the Member States of the European Union rely on several provisions. The Second Directive contains provisions against watered stock. It provides limitations on distributions to shareholders in the form of a balance-sheet test, and sets similar limits to share buy-backs. It broadly prohibits financial assistance. It grants veto powers to all creditors with regard to reductions of capital not aimed at offsetting losses. Finally, individual Member States have adopted a "recapitalize or liquidate" rule.

III

THE LEGAL CAPITAL DOCTRINE: A COSTLY AND INEFFICIENT WAY TO PROTECT CREDITORS

In this Part, by highlighting specific shortcomings of the legal capital doctrine, we will show that the legal capital laws of the European Union and its Member States are not justified. First, the legal capital doctrine unjustifiably burdens companies (and hence investors and the efficient functioning of the entire equity market) by making their financial structures inflexible, burdening them with cumber-

⁹¹ The Italian Civil Code provides for dissolution if a company experiences losses greater than the minimum statutory capital, unless the company recapitalizes or converts into another kind of company with a lesser or nonexistent capital requirement. C.C. arts. 2447, 2448(4) (Italy). The French Commercial Code provides for dissolution if a company experiences losses greater than half of the subscribed capital, unless the company reduces its capital correspondingly within two financial years and the resulting capital is higher than the minimum statutory capital. See CODE DE COMMERCE [C. COM.] art. L225-248 (Fr.). In other words, French law does not require dissolution if the company recapitalizes itself so as to reach this amount in case of higher losses. See *id.* A company may also avoid dissolution by converting into another kind of company. See *id.* Professor Yves Guyon provides further details on the French rule. See Yves Guyon, *La Mise en Harmonie du Droit Français des Sociétés avec la Directive des Communautés Européennes sur le Capital Social*, 1982 LA SEMAINE JURIDIQUE 3067 paras. 19-20. Spain imposes dissolution when a company experiences losses that are higher than half of its subscribed capital, unless the company reduces its capital requirement or increases its capital on-hand sufficiently within two months by a general meeting of its stockholders. See Corporation Law arts. 260(I), 262 (BOLETÍN OFICIAL DEL ESTADO [B.O.E.], 1989, 310) (Spain); see also RODRIGO URÍA, CURSO DE DERECHO MERCANTIL § XXI, at 327-36 (4th ed. 1964) (discussing Spanish Corporation Law dissolution provisions). Sweden has a similar rule. See Armour, *supra* note 75, at 371 ("[I]f the net assets of a Swedish company fall below half its share capital, then the shareholders must either inject fresh equity to restore the net asset level, or liquidate the company.").

⁹² See discussion *supra* note 91.

some procedures, and forcing them to pay for useless expert reports and legal advice. It also burdens society with the out-of-pocket expenses and opportunity costs of having judges enforce this complex set of rules. In addition, the legal capital laws of the European Union and its Member States do not significantly benefit creditors, and in certain cases, may even harm certain creditors. Creditors have more efficient means of protecting their interests. Voluntary creditors, however weak they may be, can contract to protect themselves against asset diversion. Furthermore, society can find more efficient and less costly ways to protect involuntary creditors—such as piercing the veil of misbehaving close corporations. This Part will also show that the recapitalize or liquidate rule, which has been adopted by several Member States, is an inefficient alternative to the legal capital doctrine.

The purpose of this Article is not to demonstrate that the European Union should abandon company laws protecting creditors entirely. Rather, our point is that the European Union should jettison its current legal regime, which is based on antiquated notions of legal capital, in favor of an alternative regime based on the U.S. Revised Model Business Corporation Act and liability rules such as veil-piercing.⁹³

A. Specific Shortcomings of the Legal Capital Doctrine

1. *The Legal Capital Doctrine Does Not Protect Creditors*

The Second Directive's minimum initial capital requirement provides no meaningful protection for creditors.⁹⁴ The amount required, €25,000, is trivial.⁹⁵ It is also meaningless because it is unrelated to

⁹³ Under the Model Act, distributions to shareholders are legal as long as a company is not insolvent in a balance-sheet sense, and as long as a company would still be able to pay its debts as they became due in the ordinary course of business (the "equity insolvency" test). REVISED MODEL BUS. CORP. ACT § 6.40(c) (1998). Such a regime would be far superior to the European Union's current one.

California has adopted an alternative test for limiting distributions to shareholders, which allows distributions if the company satisfies two financial ratios (a current ratio and a leverage ratio). See CAL. CORP. CODE § 500 (West 1990). As Professor Cheffins notes, "it is doubtful whether [California's] laws are a helpful precedent for a jurisdiction seeking to develop laws based on what parties would bargain for under ideal circumstances." BRIAN R. CHEFFINS, *COMPANY LAW* 535 (1977) (reasoning that, "[s]ince each corporation governed by a statute is different, the provisions may be too technical and restrictive for many purposes and too primitive for others"); MANNING & HANKS, *supra* note 37, at 176 n.3 ("One must maintain a certain skepticism as to whether indenture-like ratio provisions are warranted in a general corporation statute or will prove administrable.").

⁹⁴ Cf. Dan D. Prentice, *Veil Piercing and Successor Liability in the United Kingdom*, 10 FLA. J. INT'L L. 469, 470 n.7 (1996) (characterizing the £50,000 that the 1985 Companies Act requires U.K. companies to have as minimum paid-up capital as "insignificant").

⁹⁵ E.g., EDWARDS, *supra* note 44, at 60-61 ("The figure is unquestionably on the small side if the purpose is to ensure that the company's capital is a genuine guarantee for third parties . . .").

the debt that a company may incur⁹⁶ and to the sorts of business activities that a company may pursue.⁹⁷ Clearly, it makes no sense for a highly leveraged company that transports radioactive waste to have the same minimum capital requirement as a company with little leverage that designs software.

The legal capital doctrine assumes, falsely, that the fixed amount of a firm's legal capital informs current and potential creditors of the resources that a firm possesses and may not freely distribute to its shareholders.⁹⁸ In the real world, however, creditors (and potential creditors) care neither about these resources nor about the legal capital rules that are supposed to signal these resources.⁹⁹

The primary reason that creditors do not give significant weight to legal capital is that as soon as a firm starts to operate, it can use its capital to purchase assets that decline in value.¹⁰⁰ Because a firm may immediately begin to incur losses, either merely in the normal course of business or by entering into one of the many kinds of unfair transactions that Article 11 of the Second Directive does not cover, the

⁹⁶ See FERRAN, *supra* note 50, at 312; Bernhard Walter, *Gesetzliches Garantiekapital und Kreditentscheidung der Banken*, 1998 AKTIENGESELLSCHAFT 370, 371.

⁹⁷ See ROBERT CHARLES CLARK, *CORPORATE LAW* § 2.4, at 77-78 (1986); Paul Davies, *Legal Capital in Private Companies in Great Britain*, 1998 AKTIENGESELLSCHAFT 346, 349.

⁹⁸ In the traditional view, legal capital provisions protect potential creditors against deceit by restraining companies from misrepresenting their real capital. See FERRAN, *supra* note 50, at 283. However, the law provides general remedies against misrepresentation. *Id.* at 284. Moreover, the possibility that a company will mislead creditors as to its real capital depends on the existing legal regime. If a state adopts harsh legal capital rules, creditors will have a reason to believe that shareholders indeed contributed a specific amount of capital. If a state has not adopted such rules, creditors will not rely on the legal capital figures. They will allow for the higher probability that shareholders have not in fact made contributions of that amount, and behave accordingly by further investigating the availability of a satisfactory equity cushion. In other words, this kind of rationale may be useful to explain all of the specific, technical rules within the legal capital doctrine. However, it cannot justify the legal capital doctrine itself. In any case, as we shall see, it is far from clear why creditors should care whether shareholders contributed more or less at the beginning of the venture. See MANNING & HANKS, *supra* note 37, at 92.

⁹⁹ See, e.g., ROBERT R. PENNINGTON, *COMPANY LAW* 187 (7th ed. 1995) ("A creditor who enquires into the company's resources before allowing it to become indebted to him does not in practice rely on the amount of the company's capital, paid or unpaid, in assessing its creditworthiness."); see also COMPANY LAW REVIEW STEERING GROUP, *supra* note 37, § 3.5, at 23-24 ("The view of a substantial number of consultees . . . was that a company's share capital is nowadays relatively unimportant as a measure of its ability to repay credit."); KÜBLER, *supra* note 37, at 31; MANNING & HANKS, *supra* note 37, at 92 ("A corporation's 'legal capital' is a wholly arbitrary number, unrelated in any way to any economic facts that are relevant to a creditor.").

¹⁰⁰ See, e.g., DANA-DÉMARET, *supra* note 36, at 96-97, 258; KÜBLER, *supra* note 37, at 30; cf. Terence L. Blackburn, *The Unification of Corporate Laws: The United States, the European Community and the Race to Laxity*, 3 GEO. MASON INDEP. L. REV. 1, 81 (1994) ("The par value, stated capital, and earned surplus of a company express only historical facts concerning the company and do not give any significant indication of the current financial condition of the company.").

initial paid-in capital is a meaningless amount.¹⁰¹ In other words, creditors willing to inform themselves about a firm's existing equity cushion must examine its entire balance sheet.¹⁰² Moreover, creditors must consider the current value of the firm's assets, not the value of such assets at the time of purchase. The legal capital entry on the right-hand side of a corporation's balance sheet thus provides no useful information to creditors.¹⁰³ Even if it did, creditors could just choose to deny credit to firms without satisfactory amounts of paid-in capital.

Even assuming that creditors care about how much equity shareholders really injected into a venture at its outset, requiring an expert report on contributions in kind is of little benefit to them. First, evaluation techniques leave experts with a very wide range of discretion.¹⁰⁴ This is true even when the expert must explicitly state "the methods of valuation used," as the Second Directive requires.¹⁰⁵ Second, experts can never really be "independent." Even when a third party (like a judge) chooses the expert, that expert will be a professional offering her accounting and valuation services on the market. Normally, she will derive more profits from her normal services than from her Article 9 valuation activities. Furthermore, she must constantly attract and retain clients for these normal services.¹⁰⁶ Hence, she will not risk losing her current or prospective clients by acting too independently in the valuation of non-cash consideration.¹⁰⁷ Because of motivating professional interests, experts will tend to approve any

¹⁰¹ See *supra* notes 96-97 and accompanying text. Companies can so easily circumvent Article 11, due to its narrow scope, that it does not provide significant protection for creditors. See Marco Saverio Spolidoro, *Modificazioni alla Disciplina Delle Società di Capitali e Cooperative*, in NUOVE LEGGI CIVILI COMMENTATE 1, 51-52 (Piergaetano Marchetti ed., 1988). Additionally, this Article has shown the ineffectiveness of the independent-report requirement. See *supra* notes 50-52 and accompanying text; *infra* notes 104-06 and accompanying text.

¹⁰² The First Company Law Directive requires all limited-liability companies to disclose their balance sheets by depositing them in a public register. First Council Directive 68/151, art. 2(f), 1968 O.J. (L 065) 43.

¹⁰³ A more reliable (and increasingly available) way to get information about a company's solvency is to obtain processed data from those firms that specialize in such information, credit rating agencies. See Friedrich Kübler, *The Rules on Capital Under the Pressure of the Securities Markets 13* (2000) (unpublished manuscript, on file with author) ("By providing more transparency at lower costs[,] rating allows [creditors] to refine the pricing of risk in a way which is superior to the traditional mechanism of legal capital; this is another reason why rules on capital become increasingly obsolete.").

¹⁰⁴ See BAUER, *supra* note 37, at 171-74; Lucian Arye Bebchuk & Marcel Kahan, *Fairness Opinions: How Fair Are They and What Can Be Done About It?*, 1989 DUKE L.J. 27, 29-37 (evaluating the problem of discretion in fairness opinions).

¹⁰⁵ Second Directive, *supra* note 5, art. 10(2), at 4.

¹⁰⁶ See, e.g., Bebchuk & Kahan, *supra* note 104, at 41 (noting that investment banks must take into account future business when issuing fairness opinions).

¹⁰⁷ See *id.* at 41-42 ("[F]airness opinions are unlikely to serve as an effective independent check . . .").

contribution in kind that is not so outrageously overvalued that a non-expert could surmise that the company had watered its stock.

2. *Independent Means of Creditor Protection*

Creditors concerned prospectively with the risk that a company might divert assets have several options. They may charge a higher interest rate that compensates them for this risk.¹⁰⁸ They may insist upon collateral of some kind.¹⁰⁹ In addition, they may negotiate for direct or indirect restrictions on shareholder distributions. In the case of closely held companies, creditors may negotiate for a personal guarantee by shareholders.¹¹⁰ Compared to such contractual means of creditor protection, the Second Directive's protections are less effective. They are often less restrictive, and by necessity they are not tailored to the specific financial and industrial characteristics of the company involved.¹¹¹

Creditors can require a firm to comply with a specific financial ratio, like a debt-to-equity ratio or a current ratio.¹¹² In addition, they may define the funds available for dividend payments in such a way as to prohibit distributions "financed by issuing debt or by the sale of the firm's existing assets, either of which would reduce the coverage on . . . the debt."¹¹³

Even legal scholars who support the validity of the legal capital regime generally concede that many creditors, particularly sophisticated financial creditors, have no use for the doctrine because they can protect themselves by contract.¹¹⁴ These scholars, however, justify the legal capital provisions as mechanisms that protect "weak" credi-

¹⁰⁸ See *supra* text accompanying notes 24-27.

¹⁰⁹ MANNING & HANKS, *supra* note 37, at 101; KÜBLER, *supra* note 37, at 32. A security interest is functionally equivalent to an asset-specific contractual restriction on distributions, see *infra* text accompanying note 113.

¹¹⁰ See, e.g., KÜBLER, *supra* note 37, at 31-32.

¹¹¹ Perhaps even more significantly, the Second Directive's protections are not tailored to the legal rules of each individual European Union Member State. The Second Directive's protections do not necessarily match the effectiveness of each state's bankruptcy laws, its judicial systems, its ethical standards, and so on. Cf. Rafael La Porta et al., *Law and Finance*, 106 J. POL. ECON. 1113, 1145-51 (1998) (providing data showing that different countries within Europe provide a different degree of protection to creditors, and that this difference depends on the laws in place and, more broadly, on the legal and ethical environment within each country).

¹¹² CHEFFINS, *supra* note 93, at 533-34.

¹¹³ Smith & Warner, *supra* note 7, at 132.

¹¹⁴ See, e.g., Jeff Keustermans, *Countertrends in Financial Provisions for the Protection of Corporate Creditors: The Model Business Corporation Act and the E.E.C. Corporate Directives*, 14 DENV. J. INT'L L. & POL'Y 275, 289 (1986) ("While most financial or institutional creditors can protect themselves against insolvent debtors, general trade creditors cannot, as a practical matter, similarly protect themselves."); Marco Saverio Spolidoro, *Il Capitale Sociale*, in *IL DIRITTO DELLE SOCIETÀ PER AZIONI: PROBLEMI, ESPERIENZE, PROGETTI* 59, 67-68 (1993).

tors who are unable to protect themselves by contract, such as trade creditors, employees, and involuntary creditors.¹¹⁵

First, not all trade creditors and employees are weak in the sense that they lack the bargaining power necessary to obtain compensation for the risk of non-payment due to asset diversion—a risk that the legal capital rules supposedly reduce. Some trade creditors, such as suppliers of goods with some market power and large customers, are certainly not weak. These creditors may well seek a personal guarantee from shareholders, collateral from the company, higher prices for their goods, or higher interest rates for delayed payments.¹¹⁶ Furthermore, they may simply refuse to deal with the company.¹¹⁷

Many creditors, particularly trade creditors, also have very short time-horizons. Because they are concerned about the business's ability to keep its accounts current on a day-to-day basis, these creditors do not care about the capital on a firm's balance sheet:

[The general trade creditor's] real concerns are at very close range and in an immediate time frame. . . . The trade creditor measures his world in days and hours; his concern with ancient business history is minimal; his regard for subtleties of balance sheet accounting is almost nonexistent. He wants cash, he wants it promptly, he cares little where else the debtor's earlier-held cash may have gone, and he will act immediately in one institutional way or another if he is not paid.¹¹⁸

After having extended credit, the trade creditor who wishes to protect himself simply "stays alert."¹¹⁹

[The general trade creditor's] main protection is to stay close to the situation, to know his debtor, to spot the slow-downs in payment, the main telltale sign of drying up of working capital, to put prudent limits on the amount of credit extended to each trade purchaser, to clear checks immediately, to take instantaneous action, perhaps legal action, when a delinquency is spotted, to badger and cajole the delinquent debtor tirelessly, to see to it that when the next payment is made it does not go to other creditors, etc.¹²⁰

Similarly, employees with readily available alternative job opportunities have enough bargaining power to obtain compensation in the

¹¹⁵ See, e.g., Marcus Lutter, *Gesetzliches Garantichapital als Problem Europäischer und Drutscher Rechtspolitik*, 1998 *AKTIENGESELLSCHAFT* 375, 376.

¹¹⁶ See MANNING & HANKS, *supra* note 37, at 101-02 (describing institutional arrangements available to protect the trade creditor).

¹¹⁷ Cf. Justin J. Mannolini, *Creditors' Interests in the Corporate Contract: A Case for the Reform of Our Insolvent Trading Provisions*, 6 *AUSTL. J. CORP. L.* 14, 24 (1996) ("Put simply, debtors with a history of either default or high-risk conduct will find it difficult or expensive to obtain suitable credit.").

¹¹⁸ MANNING & HANKS, *supra* note 37, at 100.

¹¹⁹ *Id.* at 98.

¹²⁰ *Id.*

form of higher salaries for any perceived risk of insolvency.¹²¹ Such employees can also simply refuse to accept employment with firms that they view as risky. Thus, employees often will be the first to abandon a company when it becomes insolvent or even financially unstable. Similarly, organized workers can obtain compensation for the higher risks associated with working for a financially troubled firm.¹²²

Having said this, we do not deny that there are some weak trade creditors and employees lacking adequate bargaining power. For such creditors and workers, however, the European rules requiring initial minimum capital of €25,000 and prohibiting watered stock are of very little, if any, help. On the other hand, at first glance, the legal capital rules limiting corporate distributions appear to reduce the risks of asset diversion borne by creditors with marginal bargaining power. Closer inspection, however, reveals that this is not the case.

Workers and small-stakes trade creditors do not benefit from Article 15's limits on distributions because these limitations are based on balance-sheet data that may bear no relationship to the true economic condition of the firm.¹²³ Management has virtually unfettered discretion to determine whether there are profits available for distribution.¹²⁴ Even more importantly, management may pursue one of several alternatives if it wishes to distribute assets to shareholders without having such distributions appear as distributions on the firm's balance sheet. In particular, distributions can take the form of transactions with shareholders, or of excessive compensation for shareholders who are also directors or employees of the firm.

¹²¹ See, e.g., Posner, *supra* note 15, at 506 ("[T]he wage rate can adjust to compensate the worker for the risk of nonpayment of any compensation claim that he may some day have against his employer.").

¹²² Cf. EASTERBROOK & FISCHER, *supra* note 35, at 51 (arguing that unions will understand a firm's risk and, by implication, bargain appropriately even if individual workers do not).

¹²³ See *supra* notes 101-03 and accompanying text.

¹²⁴ See MANNING & HANKS, *supra* note 37, at 37 ("[E]very accounting-literate person will agree that economic verity and the accountant's depiction are often unrecognizably dissimilar."). Manning and Hanks go on to observe that "[a] stated capital/surplus figure . . . is the product of dozens of judgmental accounting decisions." *Id.* at 91. This is no less true for companies within the European Union. It is well known that the Fourth Council Directive, Council Directive 78/660, 1978 O.J. (L 222) 11, leaves a number of options open both to Member States and to individual companies to avoid balance-sheet recognition of a company's true capital position. Cf. EDWARDS, *supra* note 44, at 117 (acknowledging that "the existence and number of options mean that accounts prepared in compliance with the [Fourth] Directive can appear very different"); Yoav Ben-Dror, *An Empirical Study of Distribution Rules Under California Corporations Code § 500: Are Creditors Adequately Protected?*, 16 U.C. DAVIS L. REV. 375, 392-412 (1983) (providing an empirical analysis showing that even California's more sophisticated test for determining whether distributions are lawful allowed many companies that became insolvent shortly after distributions to make those distributions, while forbidding many companies who did not go bankrupt later to make distributions).

It is therefore highly probable that, even under legal capital rules, weak creditors will only detect unlawful distributions upon bankruptcy. In the bankruptcy context, furthermore, such distributions are also unlawful under the Model Business Corporations Act's equity-insolvency test, which we view as a superior alternative to the rigid and antiquated European legal capital regime.¹²⁵

At first glance, Article 32's conditioning of capital reductions upon each creditor's consent appears to offer much more effective protection for "really weak" creditors.¹²⁶ Because such creditors are indeed weak, however, we must accept the fact that they have no bargaining power. Consequently, they will be unable to exercise the veto power that the Second Directive grants them.¹²⁷ In other words, there is no reason to think that those suppliers, customers, and employees who had no bargaining power at the outset of their relationship with the company will be able to exercise bargaining power later on in the form of a veto on the reduction of the company's capital.

Moreover, it is quite unlikely that a company will distribute assets to shareholders by way of a capital reduction when the company is approaching insolvency because the rules on such distributions are very strict. If a company decides that it must distribute assets to shareholders, it will endeavor to distribute them in other ways, such as by entering into self-dealing transactions with favored shareholders.

Even if we assume, *arguendo*, that legal capital rules do significantly benefit weaker creditors, there is no reason for legislatures to adopt such rules because if this proposition were accurate, the market would adopt them spontaneously. A company would spontaneously grant such protection even to its weakest creditors, as long as these creditors value the benefits of such protection more than its cost to the company. In other words, a company would spontaneously grant such protection if it were efficient to have this protection in place.

In order to illustrate this point, let us take an extreme example.¹²⁸ Tiny Supplier Co. (TS) is a small business that produces components for Big Producer PLC (BP). BP is a monopsonist with regard

¹²⁵ See *supra* note 93 and accompanying text.

¹²⁶ See Second Directive, *supra* note 5, art. 32(2), at 10; *supra* notes 80-84 and accompanying text (discussing Article 32).

¹²⁷ See Second Directive, *supra* note 5, art. 32(2), at 10 (creating creditor veto power).

¹²⁸ In the context of the employment relationship, Professor Stewart Schwab has constructed similar examples that inspired this one. See Stewart J. Schwab, *The Law and Economics Approach to Workplace Regulation*, in GOVERNMENT REGULATION OF THE EMPLOYMENT RELATIONSHIP 91, 112-13 (Bruce E. Kaufman ed., 1997); see also Ian Ayres & Stewart Schwab, *The Employment Contract*, 8 KAN. J.L. & PUB. POL'Y 71, 76-77 (1999) ("[I]f workers prefer working with a slicing machine that has a hand guard on it that costs employers an extra 50 a year, a monopsonist employer will provide the hand guard so long as workers are willing to accept a wage deduction greater than 50."). Professor Schwab, in turn, drew inspiration from Professor Duncan Kennedy. See Duncan Kennedy, *Distributive and Pater-*

to those components.¹²⁹ Suppose that it would be very costly for TS to switch production to other goods. Suppose further that there are no legal capital rules in place and that TS sells the components to BP for €200 million a year, paying in two, six-month tranches. Finally, suppose that TS values legal capital protection at €10 million a year (because such protection would lower the risk that BP might default on its current debt to TS), and that such legal capital protection would cost BP €5 million a year. Assuming that BP attempts to maximize its profits, BP will voluntarily offer legal capital protection to TS in exchange for a lower price for the components. BP may buy the components for any price between €190.1 million and €194.9 million a year, making a profit of between €4.9 million and €0.1 million. Thanks to its strong bargaining power, BP may well go home with a price of €190.1 million. However, even if the outcome of the negotiations were at this end of the bargaining range, TS still will be better off because it will gain €0.1 million.¹³⁰

Thus, in the absence of rules like the Second Directive's, even the weakest creditors will obtain legal capital protection by contract whenever the borrower's cost of providing such protection is lower than the benefit the creditor obtains from it. In other words, as long as restrictions like the Second Directive's create value, rational firms will adopt them voluntarily because doing so produces gains from trade, like in the above example of TS and BP. When such restrictions do not create value, their adoption is not in anyone's interest.

One might argue that mandatory legal rules are necessary in this context because transaction costs might prevent parties from bargaining to an efficient outcome. However, it is difficult to imagine examples of transaction costs that might prevent parties from reaching a mutually beneficial agreement. In particular, we note that there are no information asymmetries. Because the parties are already in contractual privity, moreover, the marginal cost of adding some readily available terms would appear to be negligible.

One could also argue that legal capital rules are market-mimicking devices that save parties from incurring transaction costs. Bargaining for protection is, in fact, costly. Even so, these rules are inefficient because not all firms benefit from them. The rules are also unfair

nalist Motives in Contract and Tort Law, with Special Reference to Compulsory Terms and Unequal Bargaining Power, 41 MD. L. REV. 563, 607-08 (1982).

¹²⁹ A monopsonist is a person who is the only buyer of a particular good. Cf. RANDOM HOUSE WEBSTER'S UNABRIDGED DICTIONARY 1245 (2d ed. 1998) (defining "monopsony" as "the market condition that exists when there is one buyer").

¹³⁰ In fact, thanks to the contractual capital protection, TS will now be richer by €10 million minus €9.9 million (the reduction in the sale price of the components), or €0.1 million. How the parties divide up the gains from trade among themselves is obviously irrelevant from an efficiency point of view.

because they transfer wealth to benefiting firms from all of the non-benefiting firms. Legal capital rules do mimic the market outcome of a situation like the above example, but as we show below, it is far from clear that such situations are very common. The demand for legal capital rules is certainly not strong enough to justify such rules on the grounds that they are market-mimicking.¹³¹ Even if we could justify the rules on this ground, there still would be no reason to make them mandatory instead of permissive—legal capital rules could contain an opt-out provision. One could also argue that in some debtor-creditor relationships, the costs of explicitly negotiating for particular rules regarding distributions would be too high in relation to the small stakes involved.¹³² In these situations, however, creditors could free-ride on the legal capital protections that a company gives to those creditors unwilling to bear the risk of asset-diverting behavior in exchange for a higher interest rate.¹³³

Finally, one may argue that weak creditors are simply unable to evaluate the benefits they derive from legal capital rules. Under this view, in the example above, TS would be unable to figure out that the value of insisting upon legal capital protections is €10 million. This inability might be due to excessive optimism or to any other bound on TS's rationality. The legislature, so the argument goes, is in a better position than the weak creditor to determine that strong legal capital protection is in that creditor's best interests. This paternalistic argument is difficult to dismiss.¹³⁴ However, it is highly doubtful that legal capital rules are the least costly way for a paternalistic legislature to protect even the weakest voluntary corporate creditors against the risk of default from losses caused by shareholder asset diversion.

The case of involuntary creditors is slightly different. Of course, because they become creditors unwillingly, involuntary creditors do not rely on legal capital *ex ante*. They do not consider the amount of the legal capital of their prospective (and, of course, yet unknown) debtor, nor do they adjust their behavior accordingly.

Once they become creditors, the company is either still solvent notwithstanding the liability incurred, or it is not. In the latter case, it is too late for legal capital rules to play any role. To be sure, one may argue that rules restricting distributions to shareholders decrease ex

¹³¹ Cf. Armour, *supra* note 75, at 63 (discussing efficiency); Kübler, *supra* note 103, at 9-10 (same).

¹³² Cf. Posner, *supra* note 15, at 506 (hypothesizing that an employee who faces only a slight probability of being seriously injured on the job might not have sufficient interests to warrant negotiating inclusion of an express contract term to cover the probability).

¹³³ *Supra* text accompanying note 28.

¹³⁴ See Christine Jolls et al., *A Behavioral Approach to Law and Economics*, 50 STAN. L. REV. 1471, 1545 (1998) ("[I]ssues of paternalism are to a significant degree empirical questions, not questions to be answered on an *a priori* basis.").

ante the risk that a company will ever go bankrupt. It is doubtful, however that rules on legal capital reduce this risk much, if at all. It is true that this is an empirical question but there is certainly no evidence that bankruptcies or business failures are more likely in the United States than in Europe.¹³⁵

In any case, the legal capital rules do not require a company to maintain capital matching its possible tort liability multiplied by the probability that it will cause the tort.¹³⁶ If a company is still solvent after involuntary creditors come into existence, then (as this Article already noted above in its discussion of weak voluntary creditors)¹³⁷ the company may well have other sophisticated creditors who might have already restricted its ability to make shareholder distributions. Involuntary creditors, like weak creditors, may free-ride on sophisticated creditors' monitoring and contractual self-protection. A fortiori, this would be so if, as some legal scholars have suggested, legal systems would provide involuntary creditors with a super-priority in bankruptcy.¹³⁸

If contract creditors do not impose contractual restrictions on distributions to shareholders, then some involuntary creditors might be worse off in a regime without legal capital protection than in one with such protection. We are not arguing, however, that the European Union should abandon such protections altogether. Rather, we are arguing that the restrictions imposed by U.S. rules such as the equity-insolvency test are superior to the restrictions imposed by the Second Directive. Because unlawful distributions will not take the form of illegal dividend payments, even the most stringent legal capital rules and restrictions on distributions will not prevent companies from making distributions unless someone (presumably a creditor) monitors their compliance.¹³⁹ Finally, in situations without sophisticated creditors to protect the interests of potential involuntary creditors, European-style legal capital rules do not protect involuntary

¹³⁵ See THE 2000 BANKRUPTCY YEARBOOK & ALMANAC 332-33 (Christopher M. McHugh ed., 2000) (comparing the United States with eleven other countries including Denmark, France, Germany, the Netherlands, and Sweden and finding that the United States has the lowest rate of business bankruptcies per capita).

¹³⁶ Cf. *United States v. Carroll Towing Co.* 159 F.2d 169, 173 (2d Cir. 1947) (Hand, J.) (setting forth the famous Hand negligence formula that "if the probability be called P; the injury, L; and the burden, B; liability depends upon whether B is less than L multiplied by P: i.e., whether $B < PL$ "); Robert Charles Clark, *The Duties of the Corporate Debtor to Its Creditors*, 90 HARV. L. REV. 505, 545 n.107 (1977) (discussing Hand's "famous" formula for determining whether a defendant behaved reasonably in a negligence case).

¹³⁷ See *supra* text accompanying note 28.

¹³⁸ See David W. Leeborn, *Limited Liability, Tort Victims, and Creditors*, 91 COLUM. L. REV. 1565, 1643-46 (1991).

¹³⁹ Cf. Myers, *supra* note 11, at 160 (arguing that there are monitoring costs involved in enforcing restrictive covenants on dividends).

creditors better than the simpler, more flexible U.S. equity-insolvency test.

3. *The Legal Capital Doctrine Imposes Costs on Companies*

Legal capital rules are costly in terms of time and money. This is particularly obvious when they require shareholders to make contributions in kind in exchange for stock.¹⁴⁰ The European rules are costly in that they delay company formation and increases of capital through the issuance of new shares and require that companies pay for an independent expert report.¹⁴¹

In addition, it is companies going public that must follow and bear the costs of the procedures for contributions in kind.¹⁴² Most of the company laws of Member States are much more flexible for private limited-liability companies than they are for companies covered by the Second Directive. This means that new ventures have great advantages in incorporating as private companies, and usually do so. In the case of Member States (like the United Kingdom) that do not impose legal capital rules on non-public companies, the Second Directive indirectly imposes an additional burden on any business that attempts to raise capital from public markets. This is because such companies must undergo the valuation procedure and bear its costs (however little these costs compare to the total cost of going public) in order to convert into a public limited-liability company with the ability to issue securities to the public.

Similarly, the Second Directive's prohibition against issuing stock in exchange for future services¹⁴³ also "generates obvious problems for the financing of high-tech start-up companies."¹⁴⁴ In the "new economy," ideas are increasingly worth much more than physical assets¹⁴⁵ and competitors strive to retain the best minds;¹⁴⁶ this prohibition unduly curtails the ability of existing companies to customize compensation packages to recruit and retain talented employees.¹⁴⁷

¹⁴⁰ See Kübler, *supra* note 103, at 6.

¹⁴¹ See *id.*

¹⁴² See Second Directive, *supra* note 5, art. 1, at 2; *supra* text accompanying note 42.

¹⁴³ Second Directive, *supra* note 5, art. 7, at 4.

¹⁴⁴ Kübler, *supra* note 103, at 12.

¹⁴⁵ See Peter Coy, *The Creative Economy*, *BUS. WK.*, Aug. 28, 2000, at 77, 79; Luigi Zingales, *In Search of New Foundations*, 55 *J. FIN.* 1623, 1642 (2000).

¹⁴⁶ Cf. John A. Byrne, *Management by Web*, *BUS. WK.*, Aug. 28, 2000, at 84, 88 (commenting that it is crucial for businesses to "attract and retain the best thinkers" in order "to succeed in this new era").

¹⁴⁷ The only way to circumvent the prohibition in this case would be to create a new company between the existing one and the employee. Forming a new company, of course, will not always be convenient or possible (there might simply be no independent business to which the key employee is contributing).

Notably, the Revised Model Business Corporation Act allows corporations to issue shares for consideration consisting of "intangible property or benefit[s]," "services per-

If companies could issue stock in exchange for future services, start-up companies would benefit most. This is because in the first years of operation, such companies usually have little cash but a great need for the services of lawyers, accountants, and management consultants on an ongoing basis.¹⁴⁸

The European-style balance-sheet test is an inefficient way to discriminate between lawful and unlawful distributions because it is based on historical book values. The typical ratio of market capitalization (a reliable estimate of the "true" value of a company) to book value is much higher today than in the past, because ideas now account for profitability more than real assets do.¹⁴⁹ Consequently, the balance-sheet test for distributions imposes a heavy burden on modern companies. This, in turn, means that it is more likely that European companies will not be able to distribute dividends even when they have no positive-net-present-value projects in which to invest.¹⁵⁰

The Second Directive's constraints on dividends also inhibit the signaling function of dividend policy.¹⁵¹ Dividend policy is an efficient signal that management can use to convey inside information about the firm's expected cash flows.¹⁵² The Second Directive limits the freedom of managers to declare (or propose) dividends. This limitation reduces the ability of the market to process information on dividend policy, and has a negative effect on the equity market's efficiency and consequently on the liquidity of European shares.

This silencing effect is stronger in light of the possibility that managers may decide to forego distributions to shareholders in situations in which it would be perfectly legal to do so, for fear that a judge

formed," and "contracts for services to be performed." REVISED MODEL BUS. CORP. ACT § 6.21(b) (1998).

¹⁴⁸ Again, these companies face a choice: they can either incorporate as public limited-liability companies and renounce the possibility of paying for services with their own shares, or they can incorporate as private companies. In the latter case (provided that Member States do not extend the prohibition against issuing stock in exchange for services to these companies as well), these companies have the option of paying for services with their own shares. However, shares in private limited-liability companies are, by necessity, less liquid. Consequently, it is less convenient for private companies to use shares instead of cash. Moreover, the company will have to bear the costs of converting to a public limited-liability company when it decides to issue securities to the public.

¹⁴⁹ See Coy, *supra* note 145, at 82 (providing market-capitalization-to-book-value ratio data for several American companies).

¹⁵⁰ Covenant restrictions on dividends have a possible overinvestment effect. See, e.g., Avner Kalay, *Stockholder-Bondholder Conflict and Dividend Constraints*, 10 J. FIN. ECON. 211, 226-27 (1982); Smith & Warner, *supra* note 7, at 134.

¹⁵¹ For the proposition that changes in dividend policy perform an effective signaling function, see Daniel R. Fischel, *The Law and Economics of Dividend Policy*, 67 VA. L. REV. 699, 708-09 (1981).

¹⁵² See *id.*; see also FERRAN, *supra* note 50, at 410-11 ("Dividends can perform an information function . . . [by indicating that] management has confidence in the business and its prospects.").

might erroneously determine such distributions to be illegal.¹⁵³ Due to the complexity of accounting issues and to the wide discretion accounting principles and rules leave to decision makers, the possibility of courts making errors in judgments is more than sufficient to deter risk-averse managers from making distributions.

The limitations on share repurchases may raise the costs of disputes among shareholders.¹⁵⁴ In some cases, this prohibition will prevent a company from purchasing the stock of a dissenting shareholder, making it more difficult to overcome deadlock or disharmony which may negatively affect the company's operations.¹⁵⁵ More generally, this limit to share repurchases makes equity investments less liquid, and hence less attractive *ex ante* because reselling shares to the company may often be the only way for shareholders in the company to liquidate their investment.¹⁵⁶

To be sure, companies can always make larger distributions to shareholders than those that Article 15¹⁵⁷ allows in the form of a reduction in capital, as long as such reductions are within the limits of the minimum statutory capital. The transaction costs of such voluntary reductions of capital are high, however, because each creditor has a sort of veto power. This veto power allows creditors to engage in strategic behavior—they can hold out for side payments in exchange for agreeing to reductions in capital. Moreover, if the real net worth of a company is much higher than its book value, then even the statutory minimum capital sets too high a limit on distributions to shareholders.

The very broad prohibition on financial assistance for the purchase of a company's shares unduly restricts shareholders' and directors' freedom to manage companies. On the one hand, the prohibition's benefits are doubtful because it "can only endanger the interests of creditors in a situation of potential insolvency, when the directors' duties and the provisions on fraudulent and wrongful trading are likely to be relevant."¹⁵⁸ On the other hand, the doubts this provision raises on the legality of leveraged buy-outs¹⁵⁹ may have a

¹⁵³ Cf. Richard O. Kummert, *State Statutory Restrictions on Financial Distributions by Corporations to Shareholders*, 59 WASH. L. REV. 185, 203-09 (1984) (arguing that Model Act corporations often forego paying dividends to avoid incurring the cost of determining whether the distribution can be made without violating relevant provisions).

¹⁵⁴ See *supra* text accompanying note 71.

¹⁵⁵ Cf. Kummert, *supra* note 153, at 207-08 (observing that if a company chooses not to repurchase shares from a shareholder who wishes to leave the company, conflict may later develop between management and that shareholder).

¹⁵⁶ See Davies, *supra* note 97, at 348.

¹⁵⁷ See Second Directive, *supra* note 5, art. 15, at 5.

¹⁵⁸ COMPANY LAW REVIEW STEERING GROUP, *supra* note 37, at 39.

¹⁵⁹ See *supra* note 75 and accompanying text.

negative effect on the functioning of the market for corporate control.¹⁶⁰

Finally, rules requiring shares to have a par value are an obstacle to companies increasing their capital when their shares are trading below par.¹⁶¹ In cases like this, companies will first have to reduce the par value of the shares by reducing their capital for losses, and only then proceed to the capital increase. This two-step procedure will entail higher administrative costs than would a system that permitted "pure" no par value shares.

4. *The Legal Capital Doctrine Imposes Costs on Some Creditors*

Legal capital rules may well end up hurting weak creditors the most. We have just seen that legal capital rules burden shareholders unnecessarily.¹⁶² However, if a company has market power in any of the relevant input or output markets, then it will be able to pass on some or all of those costs to its counter-parties. In particular, if a company is a monopolist in the market for its products, then shareholders will be able to pass the costs of legal capital rules on to consumers. We have also seen that supporters of the legal capital doctrine believe that it is useful in order to protect the weakest creditors, those with little or no bargaining power vis-à-vis their public limited-liability company counterparts. In other words, these supporters believe that the purpose of the doctrine is to protect the creditors who have no market power.¹⁶³ However, if it is true that (1) these creditors, as we tried to show before, gain little or no benefit from legal capital rules; (2) these rules impose costs on companies; and (3) companies are able to pass on these costs to counter-parties with whom they have greater bargaining power, then it is precisely the creditors that the legal capital doctrine supposedly protects who will bear its costs.

The legal capital doctrine is also likely to damage sophisticated, risk-preferring creditors. These creditors will lend money at a rate that compensates them for the risks they bear.¹⁶⁴ Some creditors, however, would prefer to bear a higher risk of default in exchange for a higher return on their investment. Thus, the legal capital rules benefit risk-averse lenders (like banks) that prefer low-risk and lower-return investments, not risk-preferring capital providers (like finance

¹⁶⁰ See GUIDO FERRARINI, SHAREHOLDER VALUE AND THE MODERNISATION OF EUROPEAN CORPORATE LAW 35-36 (Centro di Diritto e Finanza, Working Paper, 2000), available at <http://www.cedif.org/WP%203-2000%20-%20G.%20Ferrarini.pdf>.

¹⁶¹ See, e.g., FERRAN, *supra* note 50, at 285; see also KÜBLER, *supra* note 37, at 33.

¹⁶² See discussion *supra* Part III.A.1-3.

¹⁶³ See discussion *supra* Part III.A.2.

¹⁶⁴ Cf. Kübler, *supra* note 103, at 13 ("[R]ules on capital operate as a restriction of the freedom to contract, as they burden all creditors with risk-reducing costs which at least some creditors would prefer to avoid in order to bargain for a higher return.").

companies, private equity investors, or venture capitalists) that prefer higher-risk investments because of the higher returns associated with such investments. To be sure, it is highly doubtful that the Second Directive's legal capital rules effectively reduce the risk of public limited-liability companies going bankrupt. Even those who believe that the rules do reduce the risk cannot avoid the conclusion that the legal capital rules will have a cost not only for shareholders but also for risk-preferring creditors.

B. The Legal Capital Doctrine: A Losing Proposition

The preceding analysis has shown that legal capital rules aimed at assuring that shareholders contribute a certain amount of money or assets to the company provide no benefits either to creditors or to society. The Second Directive's rules on distributions, which are based on antiquated concepts of legal capital, are less accurate than the contractual restrictions that sophisticated creditors normally impose on corporate borrowers. The Second Directive's legal capital restrictions burden shareholders, creditors, and society as a whole because they reduce flexibility and discourage investment in high-risk companies.

It is difficult to imagine how the European Union could strengthen or improve the existing legal capital rules. One intractable problem is that each firm has unique needs. Each firm has its own unique entrepreneurial, organizational, and financial characteristics. Therefore, increasing the initial capital requirements to protect creditors would be especially unwise,¹⁶⁵ because there can be no standard measure of the minimum equity contribution by shareholders.¹⁶⁶ Moreover, any initial decision about legal capital is doomed to quickly become obsolete as business, financial, and technological conditions inevitably and rapidly evolve.

Second, because the Second Directive does not require a firm to maintain its initial capital in the face of losses during the life of the company, those who become creditors after the company has formed are unable to rely on initial minimum capital requirements for protection. Thus, they must protect themselves in some other way. Because this is the case, one must ask the following question: Why are those who become creditors at the time of formation or immediately thereafter not able to protect themselves in some other way as well?¹⁶⁷

¹⁶⁵ See, e.g., Davies, *supra* note 97, at 353.

¹⁶⁶ See CLARK, *supra* note 97, § 2.4, at 77-78.

¹⁶⁷ Robert C. Downs has asked the same question. See Robert C. Downs, *Piercing the Corporate Veil—Do Corporations Provide Limited Personal Liability?*, 53 UMKC L. REV. 174, 187 (1985).

Furthermore, any meaningful initial capital requirement would constitute an unjustifiable entrance fee to the securities markets.¹⁶⁸ Whenever the minimum capital required is higher than the amount of equity that grants an adequate rate of return for any company's shareholders, the legal capital rules have simply impeded that company from entering those markets even though a public issue of securities might be the cheapest way to raise money.¹⁶⁹ Moreover, a high minimum capital requirement would make it more costly for new businesses to enter into various product markets, and thereby increases the monopolistic power of incumbents.¹⁷⁰

Finally, in a wide variety of situations, high initial capital requirements for public companies would have a very negative impact on financing decisions. Suppose that a private limited-liability company with a very low legal capital has issued convertible bonds to some angel investors. Suppose furthermore that the company is in financial distress, and that these angel investors want to liquidate their investment. One possible way would be for the angels to sell the bonds to the public. However, if the company must have a high initial capital in order to go public, shareholders or someone else would have to inject significant amounts of money into the company in order for investors to liquidate their stakes. Most probably, existing shareholders will have already contributed their entire wealth to the venture, or will find it unattractive to put more money into what is now a very risky investment. Furthermore, finding new investors for a company in financial distress will be extremely difficult.¹⁷¹ In short, the prospect of being unable to liquidate one's investment in a firm via a public offering will affect investor behavior at the outset of the firm-investor relationship. Angel investors and venture capitalists will require a higher return on their investment to compensate them for the higher risk they bear due to the increased illiquidity that a high initial capital requirement would cause.

¹⁶⁸ See Ferran, *supra* note 37, at 317; Dan Prentice, *Corporate Personality, Limited Liability and the Protection of Creditors*, in *CORPORATE PERSONALITY IN THE 20TH CENTURY*, at 99, 102 n.23 (Charles E.F. Rickett & Ross B. Grantham eds., 1998). In fact, some continental European legal scholars believe that the function of a minimum legal capital requirement should be to allow only "big" businesses to adopt the public company form. See, e.g., Angel Rojo & Emilio Beltrán, *El Capital Social Mínimo*, 1988 *REVISTA DE DERECHO MERCANTIL* 149, 152-53.

¹⁶⁹ See Downs, *supra* note 167, at 187.

¹⁷⁰ See EASTERBROOK & FISCHER, *supra* note 35, at 60; Davies, *supra* note 97, at 353. Tullio Ascarelli had already made this point. Tullio Ascarelli, *Disciplina delle Società per Azioni e Legge Antimonopolistica*, 9 *RIVISTA TRIMESTRALE DI DIRITTO E PROCEDURA CIVILE* 273, 295 (1955).

¹⁷¹ See Downs, *supra* note 167, at 188.

C. The "Recapitalize or Liquidate" Rule: An Inefficient Alternative

The "recapitalize or liquidate" rules of individual European Union Member States¹⁷² are undeniably much more effective at protecting creditors than the other legal capital rules, at least so long as such rules are easily enforceable.¹⁷³ However, because these rules penalize risk-taking, they are highly inefficient and severely retard the growth of equity markets.

First of all, from a more formalistic point of view, such rules are inconsistent with the very concept of limited liability.¹⁷⁴ In a hypothetical world in which every single company abided by these rules, no company would ever become insolvent because every company would either liquidate or reorganize before that. This, in turn, would mean that there would be no operational role for limited liability.

Second, rules requiring a company to liquidate or recapitalize when the value of the company's net assets falls below some preordained minimum level create the potential for opportunistic shareholder behavior. Shareholders can, in fact, take advantage of such provisions in disputes with other shareholders.¹⁷⁵

Third, majority shareholders may use such rules in order to get rid of financially constrained minority shareholders. If the company's capital falls to zero, a shareholder who is unable or unwilling to contribute more money to the venture will lose her shareholder status.¹⁷⁶

Another reason why these rules are inappropriate is because they are based on unreliable balance-sheet data. The relevant legal inquiry is whether the value of a firm's net assets as shown on its balance sheet has fallen below the requisite statutory minimum. A company with a real economic value significantly higher than the minimum legal capital amount will nonetheless have to undergo the radical restructuring that these rules require because its balance sheet does not reflect the true economic value of its assets. In order to avoid liquidation, such a company will either have to transform itself into a private limited-li-

¹⁷² See *supra* note 91 and accompanying text.

¹⁷³ See Geoffrey P. Miller, *Das Kapital: Solvency Regulation of the American Business Enterprise*, in CHICAGO LECTURES IN LAW AND ECONOMICS 65, 69-70 (Eric A. Posner ed., 2000) (1994).

¹⁷⁴ See BAUER, *supra* note 37, at 128; Downs, *supra* note 167, at 189; Miller, *supra* note 173, at 70.

¹⁷⁵ Rock and Wachter argue, from a team production theory perspective, that rules providing shareholders with an easy exit may be, *ex ante*, contrary to shareholders' interests. Edward B. Rock & Michael L. Wachter, *Waiting for the Omelet to Set: Match-Specific Assets and Minority Oppression in Close Corporations*, 24 J. CORP. L. 913, 920 (1999). That is, in the first years of a venture, when it has not yet developed the project for which it was formed, it is better for each of the coventurers to be able to rely on the others' commitment to the venture than to permit dissolution or withdrawal. *Id.*

¹⁷⁶ See, e.g., DANA-DÉMARET, *supra* note 36, at 304-08.

bility company (thereby losing the opportunity to access outside financing) or issue more equity.

If the company in question really does face financial risks, then the cost of equity financing will be very high. Controlling shareholders may not have sufficient funds to contribute, and will face a Hobson's choice of either liquidating the company or diluting their control positions by finding other investors willing to subscribe to the new issue. *Ex ante*, the prospect of having to choose between contributing more funds to a company in distress and diluting one's own control will be a disincentive for people to found new companies.¹⁷⁷

Finally (needless to say), if liquidation is the only result of this rule, then creditors as well as shareholders will suffer. After all, the assets of the company will, *ipso facto*, devalue in liquidation.¹⁷⁸

CONCLUSION

This Article has shown that the Second Directive's legal capital rules provide little or no benefit to corporate creditors. Furthermore, the rules create extra costs for shareholders, certain creditors, and society as a whole. In light of our analysis, the obvious question is why these rules remain in force on the European continent, long after the United States has repealed them. We believe the answer is that certain interest groups with more influence in Europe than in the United States benefit significantly from the legal capital rules, despite their inefficiency.

One interest group that benefits from the legal capital regime is incumbent management. In Europe, incumbent managers tend also to be either aligned with controlling shareholders, or as is more usually the case in continental Europe, major blockholders themselves.¹⁷⁹ Management benefits from a system that limits dividend payments and share repurchases; these limitations give management more freedom to reinvest the company's profits, even when there are no available positive-net-present-value investment projects. Management will make such inefficient investments as long as the opportunity cost of capital is offset by the higher private benefits derived from controlling a larger company. The higher the legal limitations on distributions, the more opportunity this interest group has to make inefficient investments.

Two other interest groups that clearly benefit from the Second Directive's status quo are accountants (who provide the required valu-

¹⁷⁷ See Downs, *supra* note 167, at 188.

¹⁷⁸ *Id.* at 188-89.

¹⁷⁹ See, e.g., Mario Becht & Colin Mayer, *Corporate Control in Europe*, in *THE WORLD'S NEW FINANCIAL LANDSCAPE: CHALLENGES FOR ECONOMIC POLICIES* (Horst Siebert ed., forthcoming 2001).

ation services) and lawyers (who must guide managers through the labyrinth of needlessly complicated legal capital rules). Lawyers, who play a critical role in influencing the shape of the European company law directives, and benefit from them professionally, defend European legal capital rules. They do so both because it is in their self-interest and because they often lack sophistication in finance and economics and may honestly but erroneously believe that the legal capital rules are an efficient tool for creditor protection. Furthermore, most European corporate lawyers have invested significant human capital in becoming familiar with the legal capital rules. Repealing these rules would destroy the value of that human capital.

Additionally, incumbents in the various product markets, and especially those in the most mature markets, benefit from the Second Directive's legal capital rules. This is because these rules make it more difficult for new competitors to enter the market. As legal capital rules create obstacles to capital formation, they are especially costly for start-up companies.¹⁸⁰

Finally, legal capital rules benefit banks. Banks take advantage of the fact that legal capital rules reduce the risk that their corporate borrowers will go bankrupt.¹⁸¹ More importantly, however, banks have an interest in preserving rules, like the legal capital doctrine, which negatively affect equity markets and thereby protect bank market power in the European financial markets.

Professor Kübler has correctly observed that developments "in financial markets [are] pressing for changes in the traditional legal capital regime."¹⁸² Within the global marketplace, the importance of European equity markets is increasing, and the Second Directive's negative impact on the efficiency of those markets will become even less defensible over time. As the importance of venture capital and other forms of modern finance increases, the pressure to eliminate rules which burden investors with inflexibility will increase as well.

Our view is that the European Union should repeal the Second Directive¹⁸³ and replace it with flexible, contractarian rules modeled

¹⁸⁰ See discussion *supra* Part III.A.3.

¹⁸¹ As we tried to show, the "recapitalize or liquidate" rule may be the only legal capital rule that actually has such an effect. See *supra* notes 172-73 and accompanying text.

¹⁸² Kübler, *supra* note 103, at 11; see also FERRARINI, *supra* note 160, at 33-35 (reporting recent (1998) French and German reforms liberalizing share buy-back rules).

¹⁸³ Many Commonwealth countries, as well as Israel, have abandoned or at least scaled back their legal capital rules. See Ferran, *supra* note 37, at 319 (providing an account of reforms in Canada and Australia); Uriel Procaccia, *Crafting a Corporate Code from Scratch*, 17 CARDOZO L. REV. 629, 633 (1996) (reporting that Israel has abandoned the par-value doctrine). By contrast, it is true that several Eastern European legal systems have adopted the legal capital doctrine in the last twelve years. See GIUSEPPE B. PORTALE, *CAPITALE SOCIALE E SOCIETÀ PER AZIONI SOTTOCAPITALIZZATA* 28 n.51 (1991). However, this fact does not provide significant support for the doctrine. This is because most of those countries are candi-

after modern statutes like the Model Business Corporation Act.¹⁸⁴ In the meantime, Member States should dismantle all legal capital protections that the Second Directive does not require.

dates for membership in the European Union, and consequently they have a strong incentive to adapt their company laws to match European Union directives.

¹⁸⁴ In addition, the European Union would do well to adopt some form of ex post regulation like veil piercing for the protection of involuntary creditors. See Davies, *supra* note 97, at 353-54. But see Lutter, *supra* note 115, at 377 (arguing that businesspeople would prefer the certainty of legal capital rules to the inevitable indeterminacy of judges applying liability standards ex post facto). Legal capital rules, however, also rely on standards (such as accounting standards); thus, the certainty they provide is relative. Furthermore, one could argue that most European legal systems already provide for liability rules to supplement the weak protection that legal capital rules give creditors although these rules are generally unclear and not enforced.