



**UNIVERSITY OF CAMBRIDGE  
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**RECONSIDERING THE NECESSITY AND THE EFFICACY OF LEGAL CAPITAL RULES AND  
THEIR POSSIBLE REORGANISATION FOLLOWING 'BREXIT'**

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**Thesis Topic:** Reconsidering the Necessity and the Efficacy of Legal Capital Rules and Their Possible Reorganisation Following 'Brexit'

**Abstract:**

The legal capital regime is highly controversial, both in terms of its objective to protect creditors, and its "one-size-fits-all" approach in trying to do so. The mandatory nature of these rules can also be criticised. Overall, the inability of the regime to provide little or no benefit to creditors while increasing the costs for not only the shareholders, but also risk-preferring creditors, is regarded as a strong justification for repealing the rules altogether. The EU's promulgation of the legal capital regime in the Second Company Law Directive ("Directive") follows its trend towards greater regulation, whereas in US Corporate Law, the trend is more permissive and tends more towards deregulation.

This paper critically analyses the existing legal capital regime, particularly the minimum capital requirements and the distribution rules for public companies. The paper will argue in favour of a more deregulatory approach and for greater flexibility, as was sought by the UK when the Directive was under negotiation. Flexibility and deregulation were key reasons behind the significant inflow of *private* limited companies from other EU member states to the UK. A similar strategy could be now used in order to exploit a market for *public* companies in Europe.

# Table of Contents

<b>I. Introduction</b> .....	<b>1</b>
<b>II. The Legal Capital Debate</b> .....	<b>5</b>
<b>A. Legal Capital as a Strategy: Its Strengths and Weaknesses?</b> .....	<b>5</b>
1. The Conflict of Interests between Shareholders and Creditors .....	5
2. Legal Capital Regime .....	10
(a) Contractual Protection as an Alternative to Legal Capital .....	12
(b) Non-adjusting creditors .....	14
(c) Shifting Creditor Protection towards Solvency Standards and Insolvency Law .....	18
<b>B. Time for a Change?</b> .....	<b>25</b>
<b>III. Minimum Capital</b> .....	<b>26</b>
<b>A. Introduction</b> .....	<b>26</b>
<b>B. Discussion</b> .....	<b>28</b>
<b>IV. Restrictions on Dividend Distributions</b> .....	<b>31</b>
<b>A. Introduction</b> .....	<b>31</b>
<b>B. Discussion</b> .....	<b>33</b>
<b>C. Alternative</b> .....	<b>34</b>
<b>V. The Way Forward for Britain</b> .....	<b>38</b>
<b>Bibliography</b> .....	<b>40</b>

## I. Introduction

The legal capital regime is as old as limited liability itself.<sup>1</sup> It was designed to prevent the possible abuse of corporate form and limited liability.<sup>2</sup> Entrepreneurs organised their business using the corporate form, in which the enterprise became a separate legal entity, the company. By a regime of 'asset partitioning' the assets of the entrepreneur and that of the company were separated and reserved respectively for the entrepreneurs' personal creditors, and the company's creditors.<sup>3</sup> Thus, limited liability reduced the risk of failure that entrepreneurs had previously faced, by shifting the risk to their creditors.<sup>4</sup> Creditors transacting with the company would no longer have any claims against the entrepreneur-owner but only against the company itself.<sup>5</sup> This gave rise to 'an agency problem'<sup>6</sup> between the owners and the creditors of the company, in which the latter could be subject to exploitative behaviour by the former. For instance, the owners could be interested in taking the value out of the company at the expense of

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<sup>1</sup> Paul L Davies and Sarah Worthington, *Gower's Principles of Modern Company Law* (10th edn, Sweet & Maxwell 2016) 11-1.

<sup>2</sup> Eilis Ferran, 'The Place for Creditor Protection on the Agenda for Modernisation of Company Law in the European Union' (2006) 2 ECFR 179, 212.

<sup>3</sup> John Armour, Luca Enriques and others, *Anatomy of Corporate Law: A Comparative and Functional Approach* (3rd edn, OUP 2017) 8-9.

<sup>4</sup> Professor Halpern and others regards this shifting of risk from the owners to the creditors by virtue of limited liability as an implicit insurance provided by the latter against the risk of failure of the business: Paul Halpern and others, 'An Economic Analysis of Limited Liability in Corporation Law' 30 *The University of Toronto Law Journal* 117.

<sup>5</sup> Provided that, of course, they had not contracted for personal guarantees or sureties from the entrepreneur-owner himself separately.

<sup>6</sup> A conflict of interest scenario between a principal and an agent, in which the agent acting on behalf of the principal would be tempted to pursue his self-interest rather than to accommodate the interest of the principal.

the creditors, whereas the creditors would be interested in preserving the value in it until their debt has been fully paid.<sup>7</sup>

The legal capital is a legal strategy to deal with this particular agency problem. It was perceived as a *quid pro quo* for limited liability; a scheme that company law provided to creditors transacting with the corporate legal person.<sup>8</sup> It was intended to provide them with an extra ‘margin of safety’.<sup>9</sup> Initially via a ‘fixed capital’ consisting of the consideration that the owners of the company (the shareholders) were required to contribute to access the corporate form;<sup>10</sup> and subsequently by prohibiting the return of the capital back to the shareholders to ensure that it was maintained within the company. Consequently, creditors, transacting with the corporate legal person instead of the shareholders individually, could rely on the capital rather than the personal wealth of the shareholders.<sup>11</sup>

The preceding paragraph is an approximate description of what legal capital started out to be and what it ought to achieve. Accordingly, in *Wood v. Dummer*<sup>12</sup>, Story J refers to the ‘capital stock’ of the company to denote the legal capital. He perceived the capital of a company as its ‘stock’—“the root or trunk of something growing, or a basic central

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<sup>7</sup> For the discussion on the conflict of interest between shareholders and creditors, see Section II-A1(a) *infra*.

<sup>8</sup> Richard A Booth, ‘Capital Requirements in United States Corporation Law’ in Lutter (ed), *Legal Capital in Europe* (De Gruyter Recht 2006) 623.

<sup>9</sup> Paul L Davies and Sarah Worthington, *Gower’s Principles of Modern Company Law* (10th ed, Sweet & Maxwell 2016) 12-15.

<sup>10</sup> UK Company Law distinguishes between a private limited company (*ltd*) and a public limited company (*plc*) in this regard. There is no minimum capital requirement to establish an *ltd*.

<sup>11</sup> On that note, Jessel MR held that creditors extended credit to the capital of the company: *Re Exchange Banking Co (Flitcroft’s Case)* [1882] 21 Ch D 519, [533] – [534].

<sup>12</sup> 30 F. Cas. 435 (1st Cir. 1824).

supply” (using the word in its etymological Old English meaning).<sup>13</sup> The current perception of capital is, however, much changed. The legal capital of a corporation, which is the historical contribution that subscribers (shareholders) originally made, has become a random number. Manning and Hanks take this suggestion even further by asserting that it is not much different than a number “taken from a telephone directory as from a series of unconnected and irrelevant historical events”.<sup>14</sup>

Despite its randomness, however, legal capital remains an important ‘yardstick’ for testing whether some transactions of the company (such as dividend payments)<sup>15</sup> are lawful. Nevertheless, it is relatively easy to circumvent some of the rules. Any experienced corporate lawyer would be able to work round some of the rules and the top legal representation of public companies could even make the whole legal capital ‘problem’ disappear.<sup>16</sup> A telling example is the ban on financial assistance<sup>17</sup>, which prohibits companies from ‘smoothen[ing] the path’ for persons to acquire shares in the company.<sup>18</sup> Whilst the ban was intended to render leveraged buy-out activity illegal in Europe, in reality it has been avoided due to the elaborate arrangements employed by lawyers leading to the creation of a significant LBO market developed in Europe.<sup>19</sup>

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<sup>13</sup> Bayless Manning and James J Hanks Jr., *Legal Capital* (3rd edn, The Foundation Press 1990) 30-33.

<sup>14</sup> *Ibid*, 92.

<sup>15</sup> For a discussion of the legal capital rules restricting dividend distributions, see Section IV *infra*.

<sup>16</sup> *Ibid*, 94; E Ferran, ‘The Place for Creditor Protection on the Agenda for Modernisation of Company Law in the European Union’ (2006) 2 ECFR 179, 190-191.

<sup>17</sup> *Companies Act* 2006, ss 677-683. For a critique, see Eilis Ferran, ‘Corporate Transactions and Financial Assistance: Shifting Policy Perception But Static Law (2004) 63 Cambridge LJ 225.

<sup>18</sup> *Chaston v SWP Group Plc* [2003] 1 BCLC 675 (CA) 38 (Arden LJ).

<sup>19</sup> Luca Enriques, ‘EC Company Law Directives and Regulations: How Trivial Are They?’ (2006) 27 UPaInt’l EconL 1, 39-40.

Many jurisdictions in the economically developed world have responded to the breakdown of legal capital by moving away from the rigid system of rules to a more flexible 'standards-based' system.<sup>20</sup> In contrast, in Europe, the rudimentary rules remain an important part of company law. The Second Company Law Directive<sup>21</sup> currently mandates public limited companies of twenty-eight EU member states and three EEA countries to abide by a system of legal capital. In addition, Switzerland, Turkey and Russia that have adopted the same system through bilateral relations with the EU.<sup>22</sup> The system came under attack by the Rickford Group, which proposed abolishing it and repealing the Second Company Law Directive altogether.<sup>23</sup> This proposal was taken up by, the UK government, which demanded at the least the revision to the Second Directive, however, the European Commission has, in the main, kept on this front.<sup>24</sup> This debate has also revealed that there was a significant divergence of views within Europe concerning whether company law or insolvency law should accommodate the interests of the creditors. Thus, the issue of 'how' became a matter of 'when'. Following the UK's vote to leave the European Union in June 2016, the time is ripe to reopen the debate on legal capital and address the issues of 'how' and 'when' for the future of public companies in the UK.

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<sup>20</sup> Ellis Ferran and Look C Ho, *Principles of Corporate Finance Law* (2nd edn, OUP 2014) 155.

<sup>21</sup> Directive of the European Parliament and of the Council 2012/30/EU of 25 October 2012 on coordination of safeguards which, for the protection of the interests of members and others, are required by Member States of companies within the meaning of the second paragraph of Article 54 of the Treaty on the Functioning of the European Union, 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 [2012] OJ L315/74 (Second Company Law Directive).

<sup>22</sup> Marcus Lutter, 'Legal Capital of Public Companies in Europe' in Lutter (ed), *Legal Capital in Europe* (De Gruyter Recht 2006) 1-2.

<sup>23</sup> Jonathan Rickford, 'Reforming Capital, Report of the Interdisciplinary Group on Capital Maintenance' (2004) EBLR 919.

<sup>24</sup> Ellis Ferran and Look C Ho, *Principles of Corporate Finance Law* (2nd edn, OUP 2014) 159.

The paper will focus on the position of public limited companies in the UK. The UK still has an obligation under the Second Company Law Directive to implement the legal capital regime for public limited companies. Section II will observe the debate on legal capital in general. It will set out first the conflict of interest between shareholders and creditors and subsequently consider the strengths and the weaknesses of the legal capital regime in addressing this conflict of interest, ultimately testing the feasibility of an alternative. Sections III and IV, will break down the discussion to the specific rules of the regime, respectively the rule on minimum capital and the restrictions on dividend distributions. Section V will consider the way forward for Britain as it leaves the EU. This paper will argue for dismantling the existing legal capital regime and replacing it with a more enabling alternative based on solvency to set free the British *plc* to possibly improve the global competitiveness of Britain as a destination for international businesses.

## **II. The Legal Capital Debate**

### **A. Legal Capital as a Strategy: Its Strengths and Weaknesses?**

#### ***1. The Conflict of Interests between Shareholders and Creditors***

There are three principal actors under the umbrella of a company: the shareholders, the management (including managers, directors, and majority shareholders, otherwise referred to as the ‘insiders’) and the creditors (including lenders, employees, tort victims

*et cetera*, otherwise referred to as the 'outsiders') of the company.<sup>25</sup> Each actor interacts with the company by contributing to corporate activities (in either financing or the running of the business) and therefore can influence corporate decision-making.<sup>26</sup> The specifics of the interaction between an actor and the company determine the potential for conflicts of interest among them.<sup>27</sup>

There are three common conflicts of interest in the company, in the form of agency problems. The first is that the managers, who are appointed or hired by the shareholders, could pursue their own personal interests at the expense of the shareholders. Second, there could be an agency problem among the shareholders whenever some of them have the means to assert control over the company affecting the interests of their class as a whole.<sup>28</sup> The problem is most evident in the conflict of interest between majority and minority shareholders, as the former may be able to exploit the latter in corporate decision-making<sup>29</sup> because the *Companies Act 2006*

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<sup>25</sup> John Armour, Luca Enriques and others, *Anatomy of Corporate Law: A Comparative and Functional Approach* (3rd edn, OUP 2017) 29-31; For a more detailed analysis of 'key participants in companies', see Brian Cheffins, *Company Law: Theory, Structure and Operation* (Clarendon Press 1997) ch 2.

<sup>26</sup> Brian Cheffins, *Company Law: Theory, Structure and Operation* (Clarendon Press 1997) 47.

<sup>27</sup> Professor Cheffins employs 'duration', 'return', 'risk' and 'control' as factors to determine the possible conflicts of interest among the actors in the company and explain the dynamics of bargaining regarding these conflicts: Brian Cheffins, *Company Law: Theory, Structure and Operation* (Clarendon Press 1997) 41-46.

<sup>28</sup> John Armour, Luca Enriques and others, *Anatomy of Corporate Law: A Comparative and Functional Approach* (3rd edn, OUP 2017) 30.

<sup>29</sup> The essence of this problem would change, indeed, where minority shareholders hold positive or negative control rights, such as a right to appoint a director or veto rights against some important decisions.

provides, by default, decisions in a company to be taken by ordinary resolution, which requires a simple majority.<sup>30</sup>

The final problem could be a possible conflict between the creditors and the shareholders.<sup>31</sup> The severity of this conflict depends particularly on the financial position of the company. It may be solvent, or it may be in financial distress—nearing insolvency—or ultimately it may be insolvent. While the company is a profitable going concern, the shareholders' interests dominate, and there is a lesser regard for the creditors<sup>32</sup>. In fact shareholders are commonly described as being the 'residual claimants', in other words, they are entitled to the risks and rewards involved with the running of the company.<sup>33</sup> Shareholders are, indeed, mainly interested in rewards, in the form of returns. They would like the company to generate profits and to share in such profits, commonly by way of dividends or share buybacks.<sup>34</sup> In exchange, they bear the risk on a winding up; being the residual claimants, they may not get paid at all.

Creditors, on the other hand, have fixed claims such that their claims do not depend on other variables, in particular, the profits of the company<sup>35</sup>. They are likely to be indifferent to whether the company is making profits provided that the company is and

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<sup>30</sup> Ss 281-282.

<sup>31</sup> For the analysis of this particular problem; it is assumed that the interests of the shareholders and the insiders of the company are aligned.

<sup>32</sup> The able creditors are likely to bargain for protection to accommodate the less regard for their interests by monitoring corporate activities.

<sup>33</sup> Louise Gullifer and Jennifer Payne, *Corporate Finance Law: Principles and Policy* (Hart Publishing 2014) 57ff.

<sup>34</sup> Brian Cheffins, *Company Law: Theory, Structure and Operation* (Clarendon Press 1997) 54.

<sup>35</sup> Louise Gullifer and Jennifer Payne, *Corporate Finance Law: Principles and Policy* (Hart Publishing 2014) 58.

remains able to pay its debt. Therefore, it is the creditors, who bear the risk of failure while the company is solvent. In insolvency, however, they rank ahead of the shareholders in the order of payment and thus the risk shifts to shareholders.<sup>36</sup> Accordingly, as a company nears insolvency, the misalignment of interests between the two constituents becomes more and more prone to conflict as the creditors' interests begin to dominate.<sup>37</sup>

This conflict of interest may come about in various ways;<sup>38</sup> however, it commonly presents itself in two specific forms. First and foremost, shareholders could engage in conduct, referred to as 'asset substitution' in which the shareholders increase the riskiness of the company by employing low-risk assets in high-risk activities.<sup>39</sup> When the company is solvent, the conflict presents itself in a divergence of preferences between the constituents. Shareholders tend to favour projects with higher returns even if they bear greater risks, as they would share in the profits proportionately, however, in the event of failure, their liability would be limited to the equity they hold.

The creditors, in contrast, would prefer modest projects with stable returns—or even no projects at all—to ensure that the company will be able to pay its debts as they fall due and make sure the company could in principle turn to the creditor for new credit going

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<sup>36</sup> For order of payment in insolvency, see Louise Gullifer and Jennifer Payne, *Corporate Finance Law: Principles and Policy* (Hart Publishing 2014) 89-98.

<sup>37</sup> Louise Gullifer and Jennifer Payne, *Corporate Finance Law: Principles and Policy* (Hart Publishing 2014) 54-55.

<sup>38</sup> Robert C Clark, 'The Duties of the Corporate Debtor to Its Creditors' (1977) 90 HLR 505, 507-513.

<sup>39</sup> John Armour, Luca Enriques and others, *Anatomy of Corporate Law: A Comparative and Functional Approach* (3rd edn, OUP 2017) 111ff.

forward.<sup>40</sup> “An apt analogy is the way one would play poker on money borrowed at a fixed interest rate, with one’s own liability limited to some very small stake”.<sup>41</sup> Furthermore, as the company nears insolvency the stake stays the same, but the rewards of turning things around get higher and higher. Consequently, in a sense, there is a significant risk for creditors that shareholders could be ‘gambling’ their funds away.<sup>42</sup>

Another problem would be ‘asset dilution’ or ‘asset diversion’ whereby the shareholders transfer the value in the company to themselves, increasing their personal wealth while reducing the amount available to pay the creditors any outstanding debt.<sup>43</sup> The problem is strongly linked to the shift of the positions of creditors and shareholders when the company enters the twilight zone. Shareholders, however, have information regarding the financial outlook of the business that could be superior to that of the creditors. The fact that they may not get paid in insolvency could motivate them to extract value from the company while their interests still dominate, and more importantly, before creditor interests take over; therefore leaving creditors with less or even no funds when the dust settles.

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<sup>40</sup> Louise Gullifer and Jennifer Payne, *Corporate Finance Law: Principles and Policy* (Hart Publishing 2014) 73ff.

<sup>41</sup> Michael C Jensen and William H Meckling, ‘The Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure (1976) 3 J Fin Econ 305, 346.

<sup>42</sup> Brian Cheffins, *Company Law: Theory, Structure and Operation* (Clarendon Press 1997) 80.

<sup>43</sup> John Armour, Luca Enriques and others, *Anatomy of Corporate Law: A Comparative and Functional Approach* (3rd edn, OUP 2017) 111ff.

## 2. Legal Capital Regime

The agency problems mentioned in the previous section can be mitigated by legal intervention to constrain the agent.<sup>44</sup> Applying the terminology of Professor Armour and others,<sup>45</sup> the legal capital regime is a ‘rules-based strategy’, which *ex ante* prescribes specific conduct for the company, to resolve the conflict of interest between the shareholders and the creditors in favour of the latter.<sup>46</sup> The regime mainly covers three aspects of corporate finance: (1) requiring a minimum amount of contribution in equity by the shareholders, (2) restricting the return of the equity capital back to the shareholders, and finally (3) prescribing actions to be taken following a serious loss of capital.<sup>47</sup> Thus, shareholders are prevented from exploiting the creditors by betting their funds in a so-called “heads we win, tails creditors lose” manner.<sup>48</sup>

Proponents of the regime claim that the legal capital regime provides preventative protection. It demands the founders of a company to make a statement about their enterprise by requiring them to put up a minimum of equity capital, which is then disclosed to the public to evidence their seriousness.<sup>49</sup> Furthermore, creditors face high transaction costs to contract for the protection of their claims in the form of

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<sup>44</sup> For an economic analysis of state intervention in general, see Brian Cheffins, *Company Law: Theory, Structure and Operation* (Clarendon Press 1997) chs 3 and 4.

<sup>45</sup> John Armour, Luca Enriques and others, *Anatomy of Corporate Law: A Comparative and Functional Approach* (3rd edn, OUP 2017) 31ff.

<sup>46</sup> John Armour, ‘Legal Capital: An Outdated Concept’, (2006) 7 EBOR 1, 5.

<sup>47</sup> *Ibid*, 124ff.

<sup>48</sup> Brian Cheffins, *Company Law: Theory, Structure and Operation* (Clarendon Press 1997) 80.

<sup>49</sup> Marcus Lutter, ‘Legal Capital of Public Companies in Europe’ in Lutter (ed), *Legal Capital in Europe* (De Gruyter Recht 2006) 4.

covenants.<sup>50</sup> The regime effectively reduces the costs for all creditors, and as opposed to covenants that are typically negotiated by the able creditors, who tend to look out for themselves; it also ensures that other creditors are not left unprotected.<sup>51</sup> Overall, proponents of the legal capital regime take the view that the rules have become an important part of the legal culture in Europe, and they should not be dismantled, because this would cause considerable uncertainty.<sup>52</sup>

Opponents of the regime, on the other hand, point out the fact that it is a 'crude mechanism' which fails to provide protection to any creditors. It imposes costs on companies by compelling them to seek professional advice to find a way round the rules, which clever legal and financial professionals can achieve with ease.<sup>53</sup> A worrying example is that over £20 million annually is spent by companies on obtaining legal advice to ensure that proposed transactions do not get caught out by the ban on financial assistance.<sup>54</sup> Besides, in some areas, the rules apply regardless and thereby prevent otherwise economically worthwhile transactions no matter how elaborate the advice.<sup>55</sup>

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<sup>50</sup> For a detailed analysis of the Costly-Contracting Hypothesis, see Clifford W Smith, Jr. and Jerold B Warner, 'On Financial Contracting: An Analysis of Bond Covenants' (1979) 7 J Fin Econ 117.

<sup>51</sup> Peter Mankowski, 'Does Contract Suffice to Protect the Creditors of a Company and Their Interests' in Lutter (ed), *Legal Capital in Europe* (De Gruyter Recht 2006) 409ff.

<sup>52</sup> Marcus Lutter, 'Legal Capital of Public Companies in Europe' in Lutter (ed), *Legal Capital in Europe* (De Gruyter Recht 2006) 6.

<sup>53</sup> Eilis Ferran and Look C Ho, *Principles of Corporate Finance Law* (2nd edn, OUP 2014) 157.

<sup>54</sup> Len Sealy and Sarah Worthington, *Sealy and Worthington's Cases and Materials on Company Law* (10th ed, OUP 2013) 534-535.

<sup>55</sup> An example is the 'no issue at a discount rule': Jonathan Rickford, 'Reforming Capital, Report of the Interdisciplinary Group on Capital Maintenance' (2004) EBLR 919, 933-934. For other examples, see also Eilis Ferran, 'The Place for Creditor Protection on the Agenda for Modernisation of Company Law in the European Union' (2006) 2 ECFR 179, 189-191.

The question, then, becomes whether the benefits of having the rules outweigh the costs involved. The opponents of the regime answer this question negatively because most creditors can protect themselves by contracting regardless of the mandatory rules of company laws.<sup>56</sup> The mandatory rules also do not offer the unable creditors any significant protection.<sup>57</sup> The opponents, therefore, suggest that a better approach to creditor protection, which would allow tackle the issue under insolvency law thereby providing companies with more flexibility in their management.<sup>58</sup>

The debate revolves around three main issues. (A) Whether the legal capital regime could reduce the transaction costs for the able creditors who can bargain for their protection; (B) whether it offers protection to the unable creditors who are generally not in a position to negotiate the terms on how they extend credit to company; and consequently (C) whether as an alternative, protection to creditors could be provided under insolvency law through the use of solvency based standards along with a regime of directors' liability.

#### (a) Contractual Protection as an Alternative to Legal Capital

The legal capital regime is claimed to be a 'market-mimicking' device that provides creditors with default protection that they would have to contract for otherwise.<sup>59</sup>

Taking into account the high transaction costs involved with rigorous contractual

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<sup>56</sup> For the discussion on the issue, see II-A2(a) *infra*.

<sup>57</sup> For the discussion on the issue, see II-A2(b) *infra*.

<sup>58</sup> Jonathan Rickford, 'Reforming Capital, Report of the Interdisciplinary Group on Capital Maintenance' (2004) EBLR 919, 967.

<sup>59</sup> Luca Enriques and Jonathan R Macey, 'Creditors Versus Capital Formation: The Case Against European Legal Capital Rules' (2000) 86 Cornell LRev 1165, 1192-1193.

bargaining, the regime in effect reduces the transaction costs for creditors. However, it seems rather optimistic for it to assume that its 'one-size-fits-all' approach would accommodate every creditor in any situation with its default terms.

There are two main problems with this. First and foremost, creditors have different horizons. Not all of them voluntarily extend credit to the company, and those voluntary creditors each have claims that are different in their size and duration. Thus, each group of creditors holds a distinct position with respect to the company and could have some ability to address the risks they face. Accordingly, Professors Bebchuk and Fried categorise creditors by their supposed ability to 'adjust' their claims.<sup>60</sup> 'Adjusting creditors' hold sizable and usually long-term claims; they are therefore eager to incur transaction costs, such as negotiation and renegotiation costs, and enforcement costs, to mitigate the risks that they bear by adjusting the terms of how they extend credit to the company.<sup>61</sup> 'Non-adjusting creditors', on the other hand, are made up of two sub-groups: first, involuntary creditors, who are unable to control the terms on how they extend credit to the company and therefore also unable to adjust them; and second, voluntary creditors, who prefer not to adjust due to the costs involved with adjusting.<sup>62</sup>

Consequently, the next problem is that the universal terms supplied by the legal capital regime cannot be expected to accommodate the interests of every type of creditor,

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<sup>60</sup> Lucian A Bebchuk and Jesse M Fried, 'The Uneasy Case for the Priority of Secured Claims in Bankruptcy' (1996) 105 Yale LJ 857, 864-865.

<sup>61</sup> John Armour, 'Legal Capital: An Outdated Concept', (2006) 7 EBOR 1, 6.

<sup>62</sup> Lucian A Bebchuk and Jesse M Fried, 'The Uneasy Case for the Priority of Secured Claims in Bankruptcy' (1996) 105 Yale LJ 857, 881-890.

particularly adjusting-creditors,<sup>63</sup> who already have significant control of how they extend credit to the company. Debt markets demand loan agreements to be tailor-made for each transaction as “determinants of covenants range from company-specific considerations (such as size, internal governance structure, ownership, management reputation and business risk) to contract-specific characteristics (such as the term and size of the loan)”.<sup>64</sup> Thus, there is little or no benefit to supplying default terms to the market, when the market actors are the better fit to accommodate their interests.<sup>65</sup> The legal capital regime looks rather like a ‘one-size-fits-none’ under pressure from the debt markets.<sup>66</sup>

#### *(b) Non-adjusting creditors*

The question, thus, becomes whether the legal capital regime supplies non-adjusting creditors the default protection they otherwise unable to obtain.<sup>67</sup> As outlined above, non-adjusting creditors can be further divided into two sub-groups: (1) those, which voluntarily extend credit to the debtor company, such as trade creditors; and (2) those, which become creditors to a company without any previous contact with the company (involuntarily), principally tort victims.

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<sup>63</sup> There are, however, circumstances in which even the able creditors, who would be able to adjust, may choose not to do so: Lucian A Bebchuk and Jesse M Fried, ‘The Uneasy Case for the Priority of Secured Claims in Bankruptcy’ (1996) 105 Yale LJ 857, 887-891.

<sup>64</sup> Eilis Ferran, ‘The Place for Creditor Protection on the Agenda for Modernisation of Company Law in the European Union’ (2006) 2 ECFR 179, 187-188.

<sup>65</sup> Ibid, 189.

<sup>66</sup> Richard A Booth, ‘Capital Requirements in United States Corporation Law’ in Lutter (ed), *Legal Capital in Europe* (De Gruyter Recht 2006) 645.

<sup>67</sup> Eilis Ferran, ‘The Place for Creditor Protection on the Agenda for Modernization of Company Law in the European Union’ (2006) 2 ECFR 179, 191.

Trade creditors are mostly unable (or at least less able than adjusting-creditors) to bargain for contractual protections because this could cost them the business altogether.<sup>68</sup> They have, however, different means of protection. For instance, they could be able to price the risk of default into the credit they are extending, or seek additional security, or diversify risk by having a larger customer list, or, if necessary, not deal with the company at all.<sup>69</sup> However, even without these options the legal capital regime would not be able to protect trade creditors against the risk of asset dilution by the shareholders. As weak creditors they would be unable to seek any remedy against the company before insolvency; and in insolvency, the decision would generally be to forego a claim due to costs associated with such endeavour.<sup>70</sup>

The creditors in the second category are pure non-adjusting creditors, as they have the least or no means to bargain for contractual protections. They are unlikely to have prior information about the company to which they are involuntarily extending credit. Thus, the question of protection is actually whether the rules decrease the risk of insolvency *ex ante* by devoting the capital to creditors. Nevertheless, there is no empirical evidence suggesting that the jurisdictions with legal capital rules have lesser risks of insolvency than the jurisdictions without, in any case, when the company is insolvent, it is already

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<sup>68</sup> Brian Cheffins, *Company Law: Theory, Structure and Operation* (Clarendon Press 1997) 82.

<sup>69</sup> Bayless Manning and James J Hanks Jr., *Legal Capital*, (3rd edn, The Foundation Press 1990) 101-102.

<sup>70</sup> Luca Enriques and Jonathan R Macey, 'Creditors Versus Capital Formation: The Case Against European Legal Capital Rules' (2000) 86 *Cornell LRev* 1165, 1190-1191.

too late for the rules to intervene given that they do not take into account the specific risks associated with the business.<sup>71</sup>

There are, however, better and more efficient ways to protect this weakest category of creditors. One suggestion is to hold shareholders liable on a pro-rata basis for the excess amount of the tort liability.<sup>72</sup> A similar suggestion is to hold the shareholders, who had a controlling stake in the risky activities, fully and personally liable.<sup>73</sup> The practice in Brazil takes this 'unlimited shareholder liability' approach to its extreme. In Brazil, piercing the corporate veil is the norm whenever the company is left unable to compensate damages to workers, consumers or the environment.<sup>74</sup>

The views of Hansmann and Kraakman, and Mendelson must be treated with care because the authors reflect on the US practice, in which the quantum of damages is driven up first by the particularities of the US with its healthcare and social security system, and second (more importantly) by the punitive element that damages claims tend to include.<sup>75</sup> More generally, though, a move towards unlimited shareholder liability is problematic. For instance, a study by Armour and Cumming found that the ease and efficacy of access to limited liability is associated with high levels of

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<sup>71</sup> Ibid, 1193-1195.

<sup>72</sup> Henry Hansmann and Reinier Kraakman, 'Towards Unlimited Shareholder Liability for Corporate Torts' (1991) 100 Yale LJ 1879.

<sup>73</sup> Nina A Mendelson, 'A Control-Based Approach to Shareholder Liability' (2002) 102 Columbia LRev 1203.

<sup>74</sup> John Armour, Luca Enriques and others, *Anatomy of Corporate Law: A Comparative and Functional Approach* (3rd edn, OUP 2017) 116.

<sup>75</sup> Louise Gullifer and Jennifer Payne, *Corporate Finance Law: Principles and Policy* (Hart Publishing 2014) 297.

entrepreneurship.<sup>76</sup> It is against the very nature of the system to incentivise risk-taking by providing limited liability for entrepreneurs, just to take it back when the risk taking has failed.

Further, in the UK, it is highly unlikely that the legislature could take such a bold position to undermine the limited liability principle embedded by the landmark case *Salomon v. Salomon & Co Ltd*.<sup>77</sup> The Salomon principle is entrenched in English Company Law; it has lasted for more than a hundred years and is expected to endure for hundreds more.<sup>78</sup> Rather, a better way to tackle the question of tort victims may be to grant them with priority in insolvency.<sup>79</sup> However, in practice, it is important to recognise that tort victims do not form a substantial part of the category of unsecured creditors.<sup>80</sup> Thus, there is likely no urgent need to radically change the system. Tort claims for road accidents and accidents at work, which form a significant part of the relevant overall tort claims, are covered by compulsory liability in the UK.<sup>81</sup> Perhaps an even a better solution would be to require companies to have mandatory insurance against tort claims, proportionate to the potential risk they carry in undertaking their business.<sup>82</sup>

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<sup>76</sup> John Armour and Douglas Cumming, 'Bankruptcy Law and Entrepreneurship' (2008) 2 ALER 303.

<sup>77</sup> [1897] AC 22.

<sup>78</sup> Dan D Prentice, 'Veil Piercing and Successor Liability in the United Kingdom' (1995) 10 Fla JInt'l L 469.

<sup>79</sup> David W Leebron, 'Limited Liability, Tort Victims and Creditors' 91 Columbia Law Review 1565.

<sup>80</sup> Louise Gullifer and Jennifer Payne, *Corporate Finance Law: Principles and Policy* (Hart Publishing 2014), 298.

<sup>81</sup> *Ibid*, 297.

<sup>82</sup> John Armour, 'Legal Capital: An Outdated Concept', (2006) 7 EBOR 1, 12.

*(c) Shifting Creditor Protection towards Solvency Standards and Insolvency Law*

The final point of debate rests on the feasibility of an alternative regime. The current regime fails to provide any meaningful protection to creditors, and yet, by its mere existence it is restricting corporate activities while increasing compliance costs. An alternative regime should, thus, take a more enabling approach. It should seek to set a more efficient restriction on corporate activities and provide only the minimum necessary protection to market participants.<sup>83</sup> To put it more succinctly, the ‘formalistic approach’ of the current regime should be replaced by a more ‘business-oriented approach’ in which the prospects of the company as a going concern would be the primary ‘yardstick’ for corporate finance decisions instead of the historical legal capital.<sup>84</sup>

The Rickford Group proposes such a forward-looking alternative in which the directors of a company would have the power to make distributions to shareholders or reduce capital based on the solvency of the company.<sup>85</sup> The company’s solvency is certified by the directors, if, in their opinion, the company “for the reasonably foreseeable future, taking account of the company’s expected prospects in the ordinary course of business, can reasonably be expected to meet its liabilities”.<sup>86</sup> The proposed solvency test would result in a more enabling company law that is less concerned with the protection of the

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<sup>83</sup> Jonathan Rickford, ‘Reforming Capital, Report of the Interdisciplinary Group on Capital Maintenance’ (2004) EBLR 919, 968-969.

<sup>84</sup> For the distinction between the ‘formalistic (legal) approach’ and the ‘business approach’, see Wolfgang Schön, ‘Balance Sheet Tests or Solvency Tests – or Both?’ (2006) 7 EBOR 181, 187-188.

<sup>85</sup> Jonathan Rickford, ‘Reforming Capital, Report of the Interdisciplinary Group on Capital Maintenance’ (2004) EBLR 919, 979ff.

<sup>86</sup> *Ibid*, 979-981.

creditors. Thus, 'life without legal capital' would depend on the protection of creditors by other means, primarily by way of insolvency law.<sup>87</sup> Accordingly, an alternative based on solvency should be supplemented by a regime of directors' liabilities<sup>88</sup> in which the decisions of the directors could be checked against a standard of 'wrongful trading' (or similarly 'fraudulent transfer') to see whether they had due regard for the interests of the creditors.<sup>89</sup>

Section 172 of the *Companies Act 2006* requires directors to "promote the success of the company" and "have regard for the likely consequences of any decision in the long term". Section 172 prescribes a shareholder primacy model by requiring directors to act in the best interest of the shareholders, however they must also have due regard for the interests of other stakeholders.<sup>90</sup> Subsection 3 underlines the need for the directors to "consider or act in the interests of the creditors" where necessary. As the company remains solvent, the duty is not owed to the creditors, at least regarding enforcement.<sup>91</sup> Once insolvency becomes inevitable, the content of the duty shifts by requiring the directors to take reasonable care in protecting the creditors' interests or else, they could

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<sup>87</sup> Andreas Engert, 'Life Without Legal Capital: Lessons from American Law' in Lutter (ed), *Legal Capital in Europe* (De Gruyter Recht 2006) 693-694.

<sup>88</sup> For a detailed discussion of director's liability, see Dan D Prentice, 'Corporate Personality, Limited Liability and the Protection of Creditors', in R Grantham and C Ricketts (eds), *Corporate Personality in the Twentieth Century* (Hart Publishing 1998) 108-122.

<sup>89</sup> Jonathan Rickford, 'Reforming Capital, Report of the Interdisciplinary Group on Capital Maintenance' (2004) EBLR 919, 971.

<sup>90</sup> Paul L Davies and Sarah Worthington, *Gower's Principles of Modern Company Law* (10th ed, Sweet & Maxwell 2016) 16-40 - 16-44.

<sup>91</sup> Jennifer Hill, 'Evolving Directors' Duties in the Common Law World' (2013) ECGI Working Paper Series in Law 209/2013, 33-34 <[http://ssrn.com/abstract\\_id=2243187](http://ssrn.com/abstract_id=2243187)> accessed 20 March 2017.

be liable, in particular, for 'wrongful trading'.<sup>92</sup> The enforcement of this duty, however, may only be triggered in insolvency.<sup>93</sup> Consequently, an alternative regime would move away from the strict rules-based protection of creditors under the legal capital regime to a more flexible system whereby the protection of creditors is shifted to insolvency law by the use of solvency standards.

The discussion then becomes a typical debate on rules versus standards.<sup>94</sup> Proponents of the legal capital regime make the case that a shift from the rigid *ex ante* rules-based protection towards more flexible *ex post* standards-based protection would create uncertainty, particularly by allowing questions about the abuse of the corporate form to be invoked in insolvency.<sup>95</sup> Because rules prescribe *ex ante* a particular course of action to be taken when the triggering event occurs. The only question will, thus, be whether the event has occurred or not. The 'recapitalize or liquidate' rule<sup>96</sup> is a good example of this proposition. If there is a significant loss of capital, the director is obliged to call a general meeting, where the shareholders have to decide to either to make good the loss or to cease trading and put the company into liquidation. By calling a general meeting directors may avoid personal liability.

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<sup>92</sup> *Insolvency Act 1986, s 214; West Mercia Safety Wear Ltd (in liq) v Dodd and others* [1988] BCLC 250 [252].

<sup>93</sup> Paul Davies, 'Directors' Creditor Regarding Duties in Respect of Trading Decisions Taken in the Vicinity of Insolvency' (2006) 7 EBOR 301, 316-321.

<sup>94</sup> For a detailed economic analysis of the rules versus standards, see Louis Kaplow, 'Rules versus Standards: An Economic Analysis' (1992) 42 Duke LJ 557.

<sup>95</sup> Massimo Miola, 'Legal Capital and Limited Liability Companies: the European Perspective' (2005) 4 ECFR 413, 460ff.

<sup>96</sup> For a critique, see Luca Enriques and Jonathan R Macey, 'Creditors Versus Capital Formation: The Case Against European Legal Capital Rules' (2000) 86 Cornell LRev 1165, 1183-1184.

Standards, on the other hand, do not limit the freedom of action when the triggering event occurs but evaluate *ex post* whether the action that was taken was in accordance with the required standard. Thus, there will be an additional question regarding whether the preferred course of action was in conformity with the standard or not. A comparable example would be where there is no specified course of action to address a significant loss of capital, but rather a ‘wrongful trading’ (or similarly a ‘fraudulent transfer’) standard to later evaluate the action to be taken. This freedom of action would promote a ‘rescue culture’ in which directors would be free to take risks to turn around the company’s fortunes and avoid insolvency altogether because they would be held liable only if their actions make the company worse off as a result.<sup>97</sup> A prescribed action requiring directors to give up on the company even though there is a chance of rescue could be viewed as a “coward’s way out”.<sup>98</sup>

A criticism of the freedom of action under the standard regime is that there may be no safe harbour for the directors as they could face litigation with regard to the decision that they had taken when the company was nearing insolvency regardless.<sup>99</sup> Nevertheless, to some extent the regime has a built-in safe harbour because the directors are required to take full account of the accounting statements of the company in order to certify its solvency.<sup>100</sup> Even the rigorous shareholder litigation against

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<sup>97</sup> Paul Davies, ‘Directors’ Creditor Regarding Duties in Respect of Trading Decisions Taken in the Vicinity of Insolvency’ (2006) 7 EBOR 301, 325.

<sup>98</sup> *Re The Continental Assurance Co of London plc* [2001] BPIR 733 para 281 (Park J).

<sup>99</sup> Wolfgang Schön, ‘Balance Sheet Tests or Solvency Tests – or Both?’ (2006) 7 EBOR 181, 193-196.

<sup>100</sup> Jonathan Rickford, ‘Reforming Capital, Report of the Interdisciplinary Group on Capital Maintenance’ (2004) EBLR 919, 976.

directors in the US was found not to translate into financial risk to directors.<sup>101</sup> The solvency-based regime has also not caused any problems in the US, under the Model Business Corporation Act, and in New Zealand, undermining fears that the directors to take excessive risks at the expense of the creditors.<sup>102</sup> Consequently, the alternative regime would provide the creditors with legal security rather than certainty; therefore, the so-called safe harbour should not be an excuse for directors to avoid liability for a failure to take reasonable care.<sup>103</sup>

Another criticism of this alternative is that a more extensive and efficient regime of directors' liability would be required.<sup>104</sup> First, only a liquidator (or an administrator)<sup>105</sup> has the right to bring s 214 actions against a potentially liable director.<sup>106</sup> This limitation is criticised on the basis that a liquidator would naturally be cautious to expend the already minimal funds he or she has in litigation, meaning that 214 actions would be pursued only in obvious cases. However, this problem could be tackled by transferring a body of less-likely cases to a third party financier who could spread the risk and also pursue supposedly risky claims, which a liquidator would not likely pursue.<sup>107</sup>

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<sup>101</sup> John Armour and others, 'Private Enforcement of Corporate Law: An Empirical Comparison of the US and the UK' (2008) American Law & Economics Association Papers 50/2008, 40-41 <<http://ssrn.com/abstract=1105355>> accessed 20 March 2017.

<sup>102</sup> Jonathan Rickford, 'Reforming Capital, Report of the Interdisciplinary Group on Capital Maintenance' (2004) EBLR 919, 981.

<sup>103</sup> *Ibid*, 968.

<sup>104</sup> Marcus Lutter, 'Legal Capital of Public Companies in Europe' in Lutter (ed), *Legal Capital in Europe* (De Gruyter Recht 2006) 5.

<sup>105</sup> *Small Business, Enterprise and Employment Act 2015*, s 246ZB.

<sup>106</sup> Thomas Bachner, 'Creditor Protection Through Insolvency Law in England' in Lutter (ed), *Legal Capital in Europe* (De Gruyter Recht 2006) 447-448.

<sup>107</sup> Paul Davies, 'Directors' Creditor Regarding Duties in Respect of Trading Decisions Taken in the Vicinity of Insolvency' (2006) 7 EBOR 301, 325-326.

The second criticism asserts the need for robust private enforcement, such as in the US, if the rules on directors' liability are to become key to creditor protection.<sup>108</sup> Unlike the US, there is limited private enforcement in the UK, primarily due to some important differences in civil procedure. For example, the UK has an opt-in system for class actions rather than an opt-out, the 'loser pays' rule rather than the parties paying their own costs and more importantly the US has a strong culture of an 'entrepreneurial lawyer' who actively seeks legal violations and suitable litigants, while being engaged on a contingency basis.<sup>109</sup> A study by Professor Armour and others found, however, that private enforcement in the form of eager litigation against directors of companies was only one way of achieving a robust securities market; and that there was even room for the US to reduce the level of litigation without affecting the market considering the example of the UK for the other means available to achieve the same goal.<sup>110</sup>

The almost non-existent private enforcement in the UK is in part alleviated by the work done by the public enforcement agencies and through the shareholders' governance entitlements.<sup>111</sup> The public enforcement in the form of directors' disqualification for

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<sup>108</sup> Marcus Lutter, 'Legal Capital of Public Companies in Europe' in Lutter (ed), *Legal Capital in Europe* (De Gruyter Recht 2006), 6.

<sup>109</sup> For a detailed analysis of the differences between the two systems, John Armour and others, 'Private Enforcement of Corporate Law: An Empirical Comparison of the US and the UK' (2008) *American Law & Economics Association Papers* 50/2008, 24-34 <<http://ssrn.com/abstract=1105355>> accessed 20 March 2017.

<sup>110</sup> John Armour and others, 'Private Enforcement of Corporate Law: An Empirical Comparison of the US and the UK' (2008) *American Law & Economics Association Papers* 50/2008, 40-41 <<http://ssrn.com/abstract=1105355>> accessed 20 March 2017.

<sup>111</sup> John Armour, 'Enforcement Strategies in UK Corporate Governance: A Roadmap and Empirical Assessment' (2008) *ECGI Working Paper Series in Law* 106/2008 <<http://ssrn.com/abstract=1133542>> accessed 26 April 2017.

unfitness<sup>112</sup> mitigates the supposed lacuna for private enforcement in the regime of civil liability for wrongful trading.<sup>113</sup> Additionally, the eager enforcement by the Department of Business Enterprise and Regulatory Reform (BERR) acts as a check on company directors in general, with the exception of listed companies because these companies are seldom wound up.<sup>114</sup>

For the directors of listed companies, the presence of activist investors in the UK may also act as a check. The *Companies Act 2006* provides shareholders with strong shareholder governance rights. For example, it is relatively easy for shareholders to remove a director by ordinary resolution under s 168. A category of shareholders, such as insurance companies, pension funds and unit trusts, referred to more broadly as 'institutional investors', tend to engage in the governance of the companies, in which they own shares, by setting executive pay for directors and influencing decisions to appoint or discharge them.<sup>115</sup> Furthermore, an influential investor with a non-controlling stake in the company may build up his holding and could exert a significant degree of control over the company for higher returns in what is called 'offensive shareholder activism'.<sup>116</sup> Consequently, the UK arguably has adequate means of disciplining directors even without resorting to extensive litigation.

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<sup>112</sup> *Insolvency Act 1986*, s 6.

<sup>113</sup> Thomas Bachner, 'Creditor Protection Through Insolvency Law in England' in Lutter (ed), *Legal Capital in Europe* (De Gruyter Recht 2006) 476.

<sup>114</sup> John Armour, 'Enforcement Strategies in UK Corporate Governance: A Roadmap and Empirical Assessment' (2008) ECGI Working Paper Series in Law 106/2008, 33-34 <<http://ssrn.com/abstract=1133542>> accessed 26 April 2017.

<sup>115</sup> Brian Cheffins, *Company Law: Theory, Structure and Operation* (Clarendon Press 1997) 63-64.

<sup>116</sup> Brian Cheffins, *Corporate Ownership and Control: British Business Transformed* (OUP 2008) 392ff.

## **B. Time for a Change?**

With this overview of the key debates in mind, the paper's core argument is that it is hard to justify the current legal capital rules in any sensible way, yet they remain an important part of almost all European legal systems. Why might this be the case? In particular, this could be due to the influence of certain interest groups in Europe.<sup>117</sup> For example, a particularly influential interest group is the incumbent management of companies in Europe, who are usually also the major block-holders of the companies they manage. It may also be a direct result of the contrasting governance structures across the Channel, where companies often tend to have major block-holders and multiple classes of shares. In the UK, conversely, public companies (and in particular listed companies) have widely dispersed ownership and usually only one class of shares, particularly if they are listed companies. In listed companies, most shares are held in blocks by institutional investors, which cement their control of the company by imposing the 'one-share-one-vote' rule, and requiring strict compliance with the *Corporate Governance Code*.<sup>118</sup>

This fundamental difference in corporate ownership could be the reason why the legal capital regime is granted such importance on the Continent. It delivers the insiders of the company the 'certainty' they desire by prescribing a particular course of action and limiting their liability so that they may cruise to that safe harbour. Whereas in a

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<sup>117</sup> For the discussion on different interest groups and how the current regime benefits them, see Luca Enriques and Jonathan R Macey, 'Creditors Versus Capital Formation: The Case Against European Legal Capital Rules' (2000) 86 Cornell LRev 1165, 1202-1204.

<sup>118</sup> Brian Cheffins, *Corporate Ownership and Control: British Business Transformed* (OUP 2008) 383ff.

company where there is dispersed ownership and investors that are genuinely interested in the success of the company, the insiders of the company could strive to turn things around and save the ship rather than desert it. Consequently, the way forward for the British *plc* should be a more tailored approach to its particular ownership structure in which the companies' freedom of action of the would not be shackled by the legal capital regime.

### **III. Minimum Capital**

#### **A. Introduction**

The legal capital is essentially a number, which represents the initial contribution by the subscribers of a company. Although it may sound simple, the law has a very complex way of arriving at this number.<sup>119</sup> It begins with the founders of a company setting a nominal value to the shares they are to offer to the subscribers of the enterprise. Thus, a monetary value has to be attached to the shares, and this value may be anything; it does not need to bear a relevance to the market value of the shares. Then, a rule of minimum capital determines the least contribution that ought to be made for the company to start trading. This minimum contribution should be in the form of 'nominal (par) value' of the shares. In other words, any premium paid for the shares in the market do not count towards the minimum capital. Therefore the legal capital is then the consideration received by the subscribers of a company to the extent that it represents

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<sup>119</sup> Paul L Davies and Sarah Worthington, *Gower's Principles of Modern Company Law* (10th edn, Sweet & Maxwell 2016) 11-3.

the nominal value of the shares, meeting the minimum amount required to access the corporate form.

This method is no different than a ceremony for a legal transaction, such as *mancipatio*.<sup>120</sup> In Roman Law, *mancipatio* or ‘mancipation’ was a formal ceremony for the sale of a particular type of goods (*res Mancipi*).<sup>121</sup> Similarly, par value reflects such tradition. Originally, the corporate form was a medium for entrepreneurs to fund their ventures. They sought investors hoping to subscribe by acquiring shares in the company.<sup>122</sup> The entrepreneur fixed an amount of contribution, which the subscribers would pay so that they would know they were equally invested in the company and would thus share in the profits proportionately.<sup>123</sup> The development of a market for shares, however, has rendered the ‘par value’ of shares as the ‘no mind value’.<sup>124</sup> The ‘transferability of shares’ ensures that there is always a price for the shares in a company; the case is even stronger for shares that are freely tradable.<sup>125</sup> Likewise prescribing a minimum amount of contribution—made up of no more than simple arithmetic of par value multiplied by the number of subscribers—is equally inconvenient.

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<sup>120</sup> William M Gordon and OF Robinson (trs), *The Institutes of Gaius* (Duckworth 1988) I.118.

<sup>121</sup> “It is carried out as follows: There are brought together not less than five witnesses, adult Roman citizens, together with another of the same status, who holds bronze scales and is called the ‘scale-holder’. The person who is taking by mancipation, while holding the object says the following words: ‘I declare that this man is mine by quiritary right and let him bought to me with this bronze and bronze scales.’ Then he strikes the scales with the bronze, and gives it to him from whom he is taking by mancipation by way of a price”: Ibid, I.119.

<sup>122</sup> Bayless Manning and James J Hanks Jr., *Legal Capital* (3rd edn, The Foundation Press 1990) 22.

<sup>123</sup> Ibid, 23.

<sup>124</sup> Jonathan Rickford, ‘Reforming Capital, Report of the Interdisciplinary Group on Capital Maintenance’ (2004) EBLR 919, 929-930. For the argument on ‘true’ no par value shares, see also, Ibid, 993-994.

<sup>125</sup> John Armour, Luca Enriques and others, *Anatomy of Corporate Law: A Comparative and Functional Approach* (3rd edn, OUP 2017) 10-11.

The rule of minimum capital was a stranger to British Law until the Second European Company Law Directive of 1977,<sup>126</sup> which obliged the UK to implement such a restriction on the incorporation of the British *plc*.<sup>127</sup> The Second Company Law Directive, which replaced the Directive of 1977, prescribes a minimum capital of a public limited to be at least 25,000 EUR.<sup>128</sup> The UK Companies Act goes further by setting the amount at 50,000 GBP.<sup>129</sup> The minimum capital is then supplemented by 'anti-avoidance provisions' to warrant that it is in fact contributed.<sup>130</sup> Accordingly, the subscribers of a company are required to pay up at least 25 percent of the subscribed capital in advance as consideration for the shares.<sup>131</sup> Furthermore, non-cash considerations in exchange for shares need to be valued by independent experts.<sup>132</sup>

## **B. Discussion**

The minimum capital has two apparent functions. First, it imposes in effect an 'entry price' for limited liability in which the 'seriousness' of an enterprise is tested.<sup>133</sup> The minimum capital supposedly acts to deter frivolous entrepreneurs from accessing limited liability via the corporate form. However, considering the minimal amount of

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<sup>126</sup> Second Council Directive 77/91/EEC of 13 December 1976 on coordination of safeguards which, for the protection of the interests of members and others, are required by Member States of companies within the meaning of the second paragraph of Article 58 of the Treaty, in respect of the formation of public limited liability companies and the maintenance and alteration of their capital, with a view to making such safeguards equivalent [1976] OJ L26/1.

<sup>127</sup> Paul L Davies and Sarah Worthington, *Gower's Principles of Modern Company Law* (10th edn, Sweet & Maxwell 2016) 11-2.

<sup>128</sup> Art 6(1).

<sup>129</sup> *Companies Act* 2006, s 763 (1).

<sup>130</sup> John Armour, 'Legal Capital: An Outdated Concept', (2006) 7 EBOR 1, 5.

<sup>131</sup> *Companies Act* 2006, s 586; *Second Company Law Directive*, Art 9.

<sup>132</sup> *Companies Act* 2006, s 594; *Second Company Law Directive*, Art 10.

<sup>133</sup> John Armour, 'Legal Capital: An Outdated Concept', (2006) 7 EBOR 1, 10.

capital needed to organise a business under the public company form, the required amount of capital appears insignificant.<sup>134</sup> Smaller businesses may be restricted by such a requirement,<sup>135</sup> however; even then they could incorporate under the private company form instead, for which most major jurisdictions do not prescribe such a minimum.<sup>136</sup> Thus, the so-called test of seriousness to curb access to limited liability by frivolous entrepreneurs is frustrated by the option of achieving limited liability under a different corporate form. The supposed restriction to trade then in effect becomes a restriction of choice (of corporate form).

Abolishing the obligation to put up a minimum of capital would not *per se* prevent entrepreneurs from committing a moderate amount. For example, when France lowered the minimum capital requirement of € 7,500 for the SARL (counterpart of the British *Ltd*) to a symbolic € 1 in 2003, among the companies incorporated that year 86.8 per cent set their initial capital less than the previous minimum, while only 4.9 per cent set theirs to the trivial € 1.<sup>137</sup> Furthermore, even any minimum capital requirement that appears to be insignificant could still be decisive for small businesses, for which financing constraints could be a great concern.<sup>138</sup> It would, in turn, cause the entrepreneurs to be judged not by the quality of their ventures but rather by whether

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<sup>134</sup> John Armour, Luca Enriques and others, *Anatomy of Corporate Law: A Comparative and Functional Approach* (3rd edn, OUP 2017) 124-125.

<sup>135</sup> John Armour, 'Legal Capital: An Outdated Concept', (2006) 7 *EBOR* 1, 10-11.

<sup>136</sup> John Armour, Luca Enriques and others, *Anatomy of Corporate Law: A Comparative and Functional Approach* (3rd edn, OUP 2017) 124.

<sup>137</sup> *Ibid*, 125 n 106.

<sup>138</sup> Marco Becht and others, 'Where Do Firms Incorporate? Deregulation and Cost of Entry' (2008) 14 *JCF* 241.

they hold sufficient funds to access a particular corporate form or not.<sup>139</sup> Last but not least, ‘ready access’ to limited liability—and thus lower or no minimum capital requirements—was found to foster entrepreneurship.<sup>140</sup>

There is no point in restricting access to a certain corporate form or limited liability in general, and it is more appropriate to provide ‘ready access’ to companies and let the market sort out the ‘bad-apples’.<sup>141</sup> For instance, in France following the trivialization of the minimum capital, the lack of significant capital was mitigated in practice; banks increasingly sought personal guarantees and a more liberal approach to liability for corporate torts<sup>142</sup> was applied by the *Cour de Cassation* in cases where the capital was “obviously too low in view of the relevant activity”.<sup>143</sup>

The second function of the minimum capital rule is to ensure that creditors, who are dealing with a company with a low level of capital, can nevertheless be adequately compensated.<sup>144</sup> However, the determination of the minimum capital inevitably runs the risk of either ‘under-inclusivity’ or ‘over-inclusivity’ because the prescribed capital will inevitably bear none or little relation to the specifics of a company, such as its financial needs or the type of activity it undertakes.<sup>145</sup> Professors Enriques and Macey give a striking example that the rule does not differentiate between “a highly leveraged

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<sup>139</sup> John Armour, ‘Legal Capital: An Outdated Concept’, (2006) 7 EBOR 1, 11.

<sup>140</sup> John Armour and Douglas Cumming, ‘Bankruptcy Law and Entrepreneurship’ (2008) 2 ALER 303.

<sup>141</sup> Thomas Bachner, ‘Creditor Protection Through Insolvency Law in England’ in Lutter (ed), *Legal Capital in Europe* (De Gruyter Recht 2006) 478.

<sup>142</sup> This approach may, however, be undesirable in the UK context, see II-A2(b) *supra*.

<sup>143</sup> Joelle Simon, ‘A Comparative Approach to Capital Maintenance: France’ (2004) 15 EBLR 1037.

<sup>144</sup> Dan D Prentice, ‘Corporate Personality, Limited Liability and the Protection of Creditors’, in R Grantham and C Ricketts (eds), *Corporate Personality in the Twentieth Century* (Hart Publishing 1998) 102.

<sup>145</sup> *Ibid*, 102; Eilis Ferran and Look C Ho, *Principles of Corporate Finance Law* (2nd edn, OUP 2014) 80.

company that transports radioactive waste” and “a company with little leverage that designs software”.<sup>146</sup> Last but not least, the rule does not prevent the capital from being lost in the ordinary course of business.<sup>147</sup> Consequently, the minimum capital requirement is no use to creditors; yet, it can be a serious impediment to entrepreneurship.<sup>148</sup> It should be done away with as “useless provisions are always worth repealing”.<sup>149</sup>

## **IV. Restrictions on Dividend Distributions**

### **A. Introduction**

The legal capital regime assumes that the creditors transacting with a company would rely on its capital. A supposedly significant amount of capital should be properly invested in the company and that should be maintained. The capital, however, could diminish through business operations. Unless the company can make good that loss, it may not return value to its shareholders. The rule restricting the return of capital serves to protect creditors as “[t]hey are entitled to assume that no part of the capital which has been paid into the coffers of the company has been subsequently paid out”.<sup>150</sup> A

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<sup>146</sup> Luca Enriques and Jonathan R Macey, ‘Creditors Versus Capital Formation: The Case Against European Legal Capital Rules’ (2000) 86 Cornell LRev 1165, 1186.

<sup>147</sup> Lord Watson conceded that the diminishing of the capital “is a result which no legislation can prevent”: *Trevor v Whitworth* [1887] 12 App Cas 409 (HL) 423-424; Eilis Ferran and Look C Ho, *Principles of Corporate Finance Law* (2nd edn, OUP 2014) 80.

<sup>148</sup> cf High Level Group of Company Law Experts, A Modern Regulatory Framework for Company Law in Europe (4 November 2002) 82.

<sup>149</sup> Jonathan Rickford, ‘Reforming Capital, Report of the Interdisciplinary Group on Capital Maintenance’ (2004) EBLR 919, 931 n 33.

<sup>150</sup> *Trevor v Whitworth* [1887] 12 App Cas 409 (HL) 423-424 (Watson LJ). See also, *Guinness v Land Corporation of Ireland* [1882] 22 Ch D 349 (CA) 375 (Cotton LJ).

return of capital may, therefore, only be made if and when the assets of the company cover its liabilities, called-up share capital and undistributable reserves. Or, in other words, if the company's net assets cover its legal capital.<sup>151</sup> It can be made either directly by way of dividends or share buy-backs, or indirectly by a reduction of capital;<sup>152</sup> referred to broadly as distributions.<sup>153</sup>

A further restriction is that a distribution may only be made out of accumulated realised profits.<sup>154</sup> Accumulated profits are the surplus of aggregate profits, except for those that are already either distributed by way of dividend or capitalised,<sup>155</sup> over aggregate losses, apart from those that are not previously written off through a reduction or a reorganisation of capital.<sup>156</sup> Thus, a return of capital may not be made to shareholders unless the company first makes good any loss incurred in the previous years.<sup>157</sup> A subsequent requirement is that such profits need to be 'realised'. The issue of whether profits—or losses—have been realised is not defined in the *Companies Act 2006*, and is left to the accounting practice.<sup>158</sup>

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<sup>151</sup> *Companies Act 2006*, s 831. See also, *Second Company Law Directive*, Art 17.

<sup>152</sup> Jonathan Rickford, 'Reforming Capital, Report of the Interdisciplinary Group on Capital Maintenance' (2004) EBLR 919, 937.

<sup>153</sup> *Companies Act 2006*, s 829.

<sup>154</sup> *Companies Act 2006*, s 830.

<sup>155</sup> For the issue of capitalisation, see Paul L Davies and Sarah Worthington, *Gower's Principles of Modern Company Law* (10th edn, Sweet & Maxwell 2016) 11-20.

<sup>156</sup> Eilis Ferran and Look C Ho, *Principles of Corporate Finance Law* (2nd edn, OUP 2014) 215; Paul L Davies and Sarah Worthington, *Gower's Principles of Modern Company Law* (10th edn, Sweet & Maxwell 2016) 12-3.

<sup>157</sup> cf *Lee v Neuchatel Asphalte Co* [1889] 41 Ch D 1 (CA); the 'nimble dividend relaxation' for distributions under Delaware Law: Jonathan Rickford, 'Reforming Capital, Report of the Interdisciplinary Group on Capital Maintenance' (2004) EBLR 919, 1020.

<sup>158</sup> *Companies Act 2006*, s 853(4). For the determination of those profits, see Eilis Ferran and Look C Ho, *Principles of Corporate Finance Law* (2nd edn, OUP 2014) 218-220.

## **B. Discussion**

Together these two tests function to limit a company's ability to make excessive payouts to the detriments of creditors. In other words, they make up a system in which the legal capital regime addresses the problem of asset dilution by the shareholders. It may be claimed that the regime decreases transaction costs for creditors by supplying such default 'creditor terms'.<sup>159</sup> The distribution restriction, however, provides creditors with little, if any, benefit. Absent the rule, creditors with "commercial muscle" are able to contract for protection, for example, by imposing a covenant that restricts dividends.<sup>160</sup> The rules may also not be justified by the existence of non-adjusting creditors, who are unable, or less able to bargain for their protection, because they receive no benefit from them either.<sup>161</sup> Assuming there was any benefit to be derived from the rules, it is still difficult to understand why the net assets of a company should cover an extra margin, the historical contribution made by the shareholders, when even the relevance of a mere net asset test can be disputed.<sup>162</sup>

The adoption of the International Financing Reporting Standards marked a move away from historical cost accounting towards fair value accounting.<sup>163</sup> The fair value is

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<sup>159</sup> For a critique, see John Armour, 'Legal Capital: An Outdated Concept', (2006) 7 EBOR 1, 13-14; cf Wolfgang Schön, 'The Future of Legal Capital' (2004) 5 EBOR 429, 438-442

<sup>160</sup> Eilis Ferran and Look C Ho, *Principles of Corporate Finance Law* (2nd edn, OUP 2014) 215; For the discussion on contractual protection in general, see Section II-A2(a) *supra*.

<sup>161</sup> For the discussion on the protection the regime offers to non-adjusting creditors and its possible alternatives, see Section II-A2(b) *supra*.

<sup>162</sup> John Armour, 'Legal Capital: An Outdated Concept', (2006) 7 EBOR 1, 10.

<sup>163</sup> For a detailed discussion on the effects of the accounting trends on creditor protection under the Second Company Law Directive, see Eilis Ferran, 'The Place for Creditor Protection on the Agenda for Modernisation of Company Law in the European Union' (2006) 2 ECFR 179, 200-213.

described as “the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm’s length transaction”.<sup>164</sup> This approach corresponds more closely to the preferences of shareholders and investors rather than that of creditors as it allows for the exploitation of the fluctuations in values on both sides of the ledger.<sup>165</sup> Consequently, the company’s accounts have become less representative of its ability to pay its debts and consequently creditor protection based on such accounts has become a “delusion”.<sup>166</sup>

### **C. Alternative**

Creditors are not in practice concerned with a debtor company’s share capital or accounts; they are much more interested in the quality and the certainty of its future cash flows and any risk of insolvency.<sup>167</sup> The so-called enhanced net asset test does not help them in this regard. The IAS accounts, upon which the test is performed, were found not to be a sound measure for solvency of the banks by prudential regulators, such as the Basel II Committee and the UK Financial Services Authority.<sup>168</sup> Professor Rickford duly questions the merits of the test “to determine the prudence of company

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<sup>164</sup> Eilis Ferran, ‘The Place for Creditor Protection on the Agenda for Modernisation of Company Law in the European Union’ (2006) 2 ECFR 179, 205.

<sup>165</sup> Paul L Davies and Sarah Worthington, *Gower’s Principles of Modern Company Law* (10th edn, Sweet & Maxwell 2016) 12-16.

<sup>166</sup> High Level Group of Company Law Experts, *A Modern Regulatory Framework for Company Law in Europe* (4 November 2002) 79.

<sup>167</sup> Jonathan Rickford, ‘Reforming Capital, Report of the Interdisciplinary Group on Capital Maintenance’ (2004) EBLR 919, 932. See also, High Level Group of Company Law Experts, *A Modern Regulatory Framework for Company Law in Europe* (4 November 2002) 79.

<sup>168</sup> For the view of the prudential regulators, see Jonathan Rickford, ‘Legal Approaches to Restricting Distributions to Shareholders: Balance Sheet Tests and Solvency Tests’ (2006) 7 EBOR 135, 169-170.

distributions, including distributions by those very banks”.<sup>169</sup> Furthermore, from the company’s perspective the test creates a “divorce between a company’s real capacity to pay distributions and the result under the rules” because it is prone to result in “either an unduly generous or an unduly restricted outcome”.<sup>170</sup> Consequently, an alternative yardstick based on the solvency of the company and the prospects of its business should be used to test whether a return of capital may be made instead of the costly legal capital.

A suitable alternative is the solvency statement procedure for the reduction of capital available to private companies in the UK.<sup>171</sup> In fact it is such a simple and a convenient method of reducing capital that it is argued whether it has, in effect, caused the dividend test to become solvency based.<sup>172</sup> The procedure is initiated by a special resolution,<sup>173</sup> which is supported by a statement on the company’s financial on the date of that statement by the directors.<sup>174</sup> Each directors declare that he or she (a) has formed the opinion, as regards the company’s position at the date of the statement, that there is no ground on which the company could then be found to be unable to pay (or otherwise discharge) its debts and (b)<sup>175</sup> has also formed the opinion that the

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<sup>169</sup> Ibid, 170.

<sup>170</sup> Jonathan Rickford, ‘Reforming Capital, Report of the Interdisciplinary Group on Capital Maintenance’ (2004) EBLR 919, 938.

<sup>171</sup> *Companies Act 2006*, ss 642-644.

<sup>172</sup> For the discussion, see Paul L Davies and Sarah Worthington, *Gower’s Principles of Modern Company Law* (10th edn, Sweet & Maxwell 2016) 13-43.

<sup>173</sup> *Companies Act 2006*, s 283. Class consent may be required for should rights attached to a class of shares are to be varied as a result of proposed reduction of capital: *Companies Act 2006*, s 630(2)(b).

<sup>174</sup> *Companies Act 2006*, s 641(1)(a).

<sup>175</sup> If the directors, however, have an intention to commence the winding up of the company then the opinion that has to be formed with regards to (b) is that the company would be able to pay its debts ‘in full’ within the twelve months of the commencement of winding up: *Companies Act 2006*, s 643(1)(b)(i).

company will be able to pay (or otherwise discharge) its debt as they fall due during the year immediately following that date.<sup>176</sup> Last but not least, in forming those opinions the directors must take into account all of the company's liabilities (including any contingent or prospective liabilities).<sup>177</sup>

The adoption of the solvency test for dividend distributions in public companies would benefit both the company and its creditors. For the creditors, the test is more representative of their interests as it addresses whether a corporate payout undermines its solvency in the short term. Furthermore, it is supplemented by a regime, which "brings home" liability for directors who harm creditors by taking on excessive risks.<sup>178</sup> For the company, the more enabling regime could better reflect its actual ability to payout its shareholders.

The company could adopt a more generous dividend policy. An increase in payouts can lead to higher share prices for the company because investors tend to value the shares based on their expectations of a future dividends.<sup>179</sup> Such expectations may lead to a decrease in the value given to the prospects of a high growth company,<sup>180</sup> which could pressure the company into paying higher dividends.<sup>181</sup> Especially for listed companies

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<sup>176</sup> *Companies Act 2006*, s 643(1).

<sup>177</sup> *Companies Act 2006*, s 643(2).

<sup>178</sup> Paul Davies, 'Directors' Creditor Regarding Duties in Respect of Trading Decisions Taken in the Vicinity of Insolvency' (2006) 7 EBOR 301, 324. For the discussion on directors liability, see also *supra* II-A2(c).

<sup>179</sup> Myron J Gordon, 'Dividends, Earnings and Stock Prices' (1959) 41 *Review of Economics and Statistics* 99.

<sup>180</sup> It is suggested for companies with high growth opportunities not to pay dividends to the greatest extent possible: Franklin Allen and Roni Michaely, 'Payout Policy' in George M Constantinides and others (eds) *Handbook of the Economics of Finance* (Elsevier 2003) 422.

<sup>181</sup> Myron J Gordon, 'Dividends, Earnings and Stock Prices' (1959) 41 *Review of Economics and Statistics* 99, 103.

the possible higher prices could increase their equity funding. Such potential might even lure more public companies, whose shares are not publicly traded, to tap the equity capital markets.

In listed companies, dividends could also have a signalling<sup>182</sup> effect that could counterweigh the information asymmetry between the management of the company and the investors.<sup>183</sup> The regular payment of steady dividends signals to the market that the managers are optimistic about the outlook of the business.<sup>184</sup> Nevertheless, the significance of the signalling theory is contested. For example, a study by Professor Brav and others, in which the managers view on their companies' payout policies were examined, found that managers did not view dividends as self-imposed discipline to "signal firm quality or separate from competitors."<sup>185</sup> They conceded, however, that dividends at least conveyed information and at least the reluctance to cut dividends were linked to signalling.<sup>186</sup>

In another study, Professors Allen and Michaely concluded that a company should avoid giving costly signals, and that dividends could be costly especially when there were available positive net-present-value projects.<sup>187</sup> If there were no such projects, however, it would still be more rational to distribute earnings. Even if it is assumed that dividends

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<sup>182</sup> For a review of the literature, see Franklin Allen and Roni Michaely, 'Payout Policy' in George M Constantinides and others (eds) *Handbook of the Economics of Finance* (Elsevier 2003).

<sup>183</sup> Eilis Ferran and Look C Ho, *Principles of Corporate Finance Law* (2nd edn, OUP 2014) 205.

<sup>184</sup> *Ibid*, 204-205.

<sup>185</sup> Alon Brav and others, 'Payout Policy in the 21st Century' (2005) 77 JFE 483.

<sup>186</sup> *Ibid*, 513.

<sup>187</sup> Franklin Allen and Roni Michaely, 'Payout Policy' in George M Constantinides and others (eds) *Handbook of the Economics of Finance* (Elsevier 2003) 422.

had little signalling effect, the enhanced net assets test burdens the European companies by unduly restricting their ability to payout. This, in effect, causes a problem of overinvestment,<sup>188</sup> in which the companies are forced to invest even in the absence of any profitable projects.<sup>189</sup>

The comparison on the current regime and its alternative should be based on appropriateness. “Where a distribution rule is appropriate, it creates a benefit, and where inappropriate, a cost”.<sup>190</sup> No benefit is derived from the undue restriction of dividends under the current rules; yet, they increase the costs for companies. On the other hand, the proposed alternative of solvency statement should be put in its place because it better reflects a company’s capacity to pay out while it restricts companies no more than it is necessary.

## **V. The Way Forward for Britain**

On 23 June 2016 the United Kingdom has voted to leave the European Union. Following the so-called ‘Brexit’ vote, the UK government has triggered Article 50 of the Treaty on the European Union on 29 March 2017, which marked the start of two years of rigorous negotiations on the future relations between Britain and Europe. The UK is now facing a decision whether to have a ‘hard’ or a ‘soft’ Brexit and will also face decisions as to the future applicability of EU Law.

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<sup>188</sup> For the problem of overinvestment in the case of bond covenants unduly restricting dividends, see Clifford W Smith, Jr. and Jerold B Warner, ‘On Financial Contracting: An Analysis of Bond Covenants’ (1979) 7 J Fin Econ 117, 134.

<sup>189</sup> Luca Enriques and Jonathan R Macey, ‘Creditors Versus Capital Formation: The Case Against European Legal Capital Rules’ (2000) 86 Cornell LRev 1165, 1196.

<sup>190</sup> John Armour, ‘Legal Capital: An Outdated Concept’, (2006) 7 EBOR 1, 10.

Before the Brexit vote, the Department for Business, Innovation and Skills (BIS) was ambitious to “make the UK one of the best places to start, finance and grow a business”.<sup>191</sup> Planning towards that end, it found that the “burden of regulation” was the main impediment to businesses in Britain.<sup>192</sup> Its action plan was to push the EU for “a culture change” to reduce the overall regulatory burdens.<sup>193</sup> The legal capital regime obliged by the Second Company Law Directive is such a burden, to public companies in the UK.

After Brexit, the repeal of the regime should be in the agenda for change to the extent it is possible. It could in fact be feasible should a ‘softer’ Brexit occurs. Under the so-called ‘Swiss Model’ the UK could be able to ‘pick and choose’ the rules of EU Law it is willing to implement. A preference to free the British *plc* may result in an inflow of public companies to the UK, not so different than that of the private companies after the decisions of the European Court of Justice.<sup>194</sup> In such a case, the BIS might even achieve its ambition from outside the EU.

Under a ‘harder’ Brexit, the benefit of liberating the *plc* may be on the global level. Company laws in developed jurisdictions have been converging towards a uniform model, yet diversity still seems to matter.<sup>195</sup> The initial public offering of Snap Inc., in which Snap offered shares without votes, might have marked the beginning of a

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<sup>191</sup> Department for Business, Innovation and Skills, *The Plan for Growth* (March 2011) 5.

<sup>192</sup> *Ibid*, para 1.24.

<sup>193</sup> *Ibid*, para 1.33.

<sup>194</sup> For the analysis of the inflow of private companies to the UK, see Marco Becht and others, ‘Where Do Firms Incorporate? Deregulation and Cost of Entry’ (2008) 14 JCF 241.

<sup>195</sup> Eilis Ferran, ‘The Place for Creditor Protection on the Agenda for Modernisation of Company Law in the European Union’ (2006) 2 ECFR 179, 214.

divergence in protection of shareholders in the US.<sup>196</sup> The World Bank already ranks the US particularly low as the 41<sup>st</sup> in protecting minority investors significantly behind the UK, which is the 6th.<sup>197</sup> The UK should exploit this divide in investor protection by levelling the flexibility attained to its public companies to those in the US by abolishing the legal capital and adopting an alternative system based on solvency. Both cases could serve to increase the competitiveness of Britain as a destination for international businesses in a 'race to the top'.

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<sup>196</sup> John Plender, 'Snap and the 21st Century Governance Vacuum' *Financial Times* (London, 22 February 2017) <<https://www.ft.com/content/1c618f6a-f45b-11e6-8758-6876151821a6>> accessed 6 April 2017.

<sup>197</sup> World Bank, *Report on Doing Business* (14th edn, 2017) 248.

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