Share Capital and Creditor Protection: Efficient Rules for a Modern Company Law

John Armour*

This article examines the case for rules of company law which regulate the raising and maintenance of share capital by companies. The enquiry has practical relevance because the content of company law is currently under review, and the rules relating to share capital have been singled out for particular attention. The existing rules, which apply generally, are commonly rationalised as a means of protecting corporate creditors. The analysis considers whether such rules can be understood as responses to failures in the markets for corporate credit. It suggests that whilst the current rules are unlikely, on the whole, to be justified in terms of efficiency, a case may be made for a framework within which companies may 'opt in' to customised restrictions on dealings in their share capital.

Introduction

A number of provisions of the Companies Act 1985 regulate dealings with corporate share capital.[1] These are commonly thought to be unduly complex,[2] and to lack coherence.[3] Some have questioned whether their existence is justified.[4] The provisions have been identified as a 'key issue' for reform under the ongoing Company Law Review.[5] This article seeks to elucidate the function of these rules, and to investigate their role – if any – in a 'modern company law'.

A common rationalisation of the share capital provisions is that they protect corporate creditors from the abuse of limited liability by shareholders.[6] The idea that creditors need such protection is of course used to explain a wide range of company and insolvency law doctrines. Yet a principle of 'creditor protection' *per se* tells us little about the *extent* to which such rules are required. By itself, it fails to have regard to the consequences for other stakeholder groups, or the economy more generally.

---

* School of Law, University of Nottingham and ESRC Centre for Business Research, University of Cambridge.

I thank Brian Cheffins, Simon Deakin, Eilís Ferran, Dan Prentice, Chris Riley, Adrian Walters and two anonymous referees for helpful comments and suggestions on earlier versions. I am also grateful for comments received following presentations to the SPTL's Company Law Section at the annual conference in Leeds, September 1999, and to a University of Cambridge Centre for Corporate and Commercial Law Seminar in November 1999. The usual disclaimers apply.

1 Companies Act 1985, Parts IV, V and VIII.
2 eg L.S. Sealy, *Company Law and Commercial Reality* (London: Sweet & Maxwell, 1984) 8–16; J.H. Farrar and B.M. Hannigan, *Farrar's Company Law*, 4th ed (London: Butterworths, 1998) 180.
3 eg *Re Scandinavian Bank Group plc* [1988] Ch 87, 101 *per* Harman J.
4 B.R. Cheffins, *Company Law: Theory, Structure and Operation* (Oxford: OUP, 1997) 528–533. See generally B. Manning, *Legal Capital*, 2nd ed (Mineola, NY: Foundation Press, 1982).
5 Department of Trade and Industry, *Modern Company Law for a Competitive Economy* (London: DTI 1998) 6; Company Law Review Steering Group, *The Strategic Framework* (London: DTI, 1999) 19.
6 eg Company Law Review Steering Group, *Company Formation and Capital Maintenance* (London: DTI, 1999) 22.

Economic analysis offers a way of making questions involving difficult trade-offs, such as the extent to which creditors should be protected, more tractable. This mode of reasoning has become increasingly prominent in UK company law debates, informing a number of academic contributions,[7] and even featuring in a recent Consultation Paper by the Law Commissions.[8] Furthermore, the Company Law Review Steering Group (CLRSG)'s *Strategic Framework* document expresses a commitment to 'competitiveness' and 'efficiency', and promises reforms that will 'maximise wealth and welfare as a whole'.[9] In the wake of these developments, the present enquiry asks what light economic analysis can shed on the following question: to what extent should the law relating to share capital seek to protect creditors?

The content is structured as follows. The opening section develops an evaluative framework, building on the 'goals' set out in the *Strategic Framework*. This is applied in the next three sections, which investigate respectively: (i) how laws which 'protect' creditors *might* – in theory – enhance efficiency; (ii) how the law relating to share capital can be seen as a means of protecting creditors; and (iii) whether the current law is in fact *likely* to enhance efficiency. It then concludes with some general observations about the CLRSG's preliminary suggestions for reform. At the outset, it should be emphasised that the continuing evolution of the Company Law Review, along with a relatively limited academic literature on share capital,[10] imply that this contribution is only preliminary.

The goals of a modern company law

The starting-point for the analysis is taken from the three 'guiding principles' for the reform of company law, set out in the *Strategic Framework* document.[11] The first is entitled 'facilitation of transactions', and intones that a key role for law in the corporate arena is the support and enhancement of market-led contractual solutions. The Review adopts a 'presumption against prescription', suggesting that the merit of regulation must henceforth be demonstrated in terms of its 'costs and benefits'.[12] The second guiding principle is entitled 'accessibility: ease of use and identification of the law'.[13] Its aim is that the law should entail 'minimum complexity and maximum accessibility.' The third principle suggests that the allocation of responsibility for enforcement of a particular rule be chosen with sensitivity.[14]

These guiding principles are presumably intended to provide a basic methodology for the assessment of current company law and the development of

7 For an overview, see B.R. Cheffins, 'Using Theory to Study Law: A Company Law Perspective', (1999) 58 CLJ 197, and sources cited therein.

8 The Law Commissions, *Company Directors: Regulating Conflicts of Interests and Formulating a Statement of Duties*, LCCP 153, SLCDP 105 (London: TSO, 1998) Part III. See also The Law Commissions, *Company Directors: Regulating Conflicts of Interests and Formulating a Statement of Duties*, Law Com 261, Scot Law Com 173 (London: TSO, 1999) 13–31.

9 n 5 above, 8–9.

10 Outstanding exceptions include E. Ferran, *Company Law and Corporate Finance* (Oxford: OUP, 1999) 279–454, and in the US context, Manning, n 4 above. From an economic perspective, see G.P. Miller, 'Das Kapital: Solvency Regulation of the American Business Enterprise', University of Chicago Working Paper in Law & Economics (2d) No 32, April 1995; Cheffins, n 4 above, 521–537.

11 n 5 above, 15–17.

12 *ibid* 16.

13 *ibid.*

14 *ibid* 17. The third principle is accorded considerably less detailed treatment than the first two.

reforms. The first principle seems to be the most fundamental. It is concerned with the justification of the very *existence* of legal rules, whilst the second and third are concerned with their *form*. The *Strategic Framework* document contemplates that the 'presumption against prescription' may be rebutted by showing that:

> [M]arkets and informal pressures combined with transparency cannot be expected to work; this may happen because the participants lack the market power, skill or resources to contract effectively.[15]

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

The first guiding principle begs a further question: on what basis is the 'adequacy' of a market to be measured? A standard technique employed by economists is to compare the system under consideration with an environment of 'perfect competition'. In the context of corporate creditors, we might begin by imagining a world of perfect capital markets, in which *inter alia* all parties have perfect information and financial contracting is costless.[16] Under these conditions, creditors need no legal protection, because their contracts will provide them with interest rate returns perfectly correlated to the risks that they bear. Moreover, shareholders could never benefit at creditors' expense by undercapitalising a company.

A world of perfect capital markets is of course not the real world.[17] Yet as a thought-experiment it is a means of identifying the weaknesses of *real* markets for corporate credit. Such weaknesses may lead to wealth being transferred from creditors to shareholders. This in turn may justify legal rules which 'protect' creditors. The justification may be noninstrumental, for example if such expropriation is thought to violate norms of fairness. Alternatively, it might be instrumental, grounded on a claim that these wealth transfers mean that markets fail – as perfect markets would not – to allocate resources to those who value them most highly: in other words, that they are (allocatively) inefficient.[18] For example, the possibility of expropriation may deter creditors from investing in sound business projects, and distort firms' selection of projects away from those which *create* wealth in favour of those which merely *transfer* wealth. Legal rules which restrict such transfers may thereby be justifiable on the basis that they enhance efficiency. In light of the *Strategic Framework*'s emphasis on 'efficiency', the current analysis focuses on this latter justification.

A critic might assert that simply to diagnose that markets do not meet a hypothetical standard of perfection is insufficient to justify prescribing legal

15 *ibid.*

16 F. Modigliani and M. Miller, 'The Cost of Capital, Corporation Finance and the Theory of Investment' (1958) 48 *American Economic Review* 261. See A. Barnea et al, *Agency Problems and Financial Contracting* (Englewood Cliffs, NJ: Prentice-Hall, 1985) 6–24; W.L. Megginson, *Corporate Finance Theory* (Reading, MA: Addison-Wesley, 1997) 316–323; R.A. Brealey and S.C. Myers, *Principles of Corporate Finance* (New York, NY: McGraw-Hill, 6th ed, 2000) 473–484.

17 A leading corporate finance textbook warns students that they may find the perfect capital market assumptions 'almost laughably unrealistic' when they first encounter them (Megginson, *ibid* 316).

18 On the different meanings of 'efficiency', see S. Deakin and A. Hughes, 'Economic Efficiency and the Proceduralisation of Company Law' (1999) 3 CfiLR 169, 173–175.

intervention as the remedy. Such a critic would demand that it be demonstrated that a real market, with the addition of the proposed rule, would be superior to such a market left to its own devices.[19] The CLRSG's reference to the 'costs and benefits' of legal rules may be read as being attuned to such a critic, and implying that a comparison of aggregate social wealth must be drawn between 'a world with legal rule *x*' and 'a world without it'.[20]

No claim is made here that efficiency should be the sole or even the major goal of company law,[21] or indeed that the CLRSG necessarily subscribe to either of these views. As the Company Law Review progresses, some fundamental questions about the extent to which company law should seek to further noninstrumental goals must be answered.[22] Yet unless – contrary to the way in which the *Strategic Framework* is written – the answers suggest that efficiency has *no* normative role to play, it is still important to analyse company law in terms of its ability to achieve that goal.

How might law assist in facilitating transactions with corporate creditors?

The first step in the analysis considers factors which detract from the perfection of real markets for corporate credit, and asks – at a fairly high level of abstraction – whether rules of company law which 'protect' creditors *might* be able to ameliorate them.

Market power

Where one party has market power, the other has limited freedom in contracting.[23] This is likely to give rise to inefficiencies in the terms of trade – for example, a monopolist will tend to under-produce. Some creditors may enjoy a degree of market power – for example, banks are commonly alleged to be in such a position vis-à-vis small firms. However, in other cases, a firm enjoys market power as against some of its creditors, as with trade suppliers who rely on a firm for a large proportion of their business. And in many cases, there will be no market power either way. Hence it seems unlikely that general rules of company law – as opposed to competition law, for example – would be an appropriate means of regulating market power.

19 See eg G.J. Stigler, *The Citizen and the State: Essays on Regulation* (Chicago: University of Chicago Press, 1975) 103–113; see also A.I. Ogus, *Regulation: Legal Form and Economic Theory* (Oxford: Clarendon Press, 1994) 30. Stigler's argument goes further, demanding that it also be shown that the rules to be compared are those which a *real political process* is *capable* of implementing (*ibid* 114–141). The problems raised by 'public choice' theory are, however, beyond the scope of the current analysis, and the assumption is made throughout that it is possible to craft legislation in the public interest.

20 ie a version of the 'Kaldor-Hicks' efficiency criterion. See J. Coleman, 'Efficiency, Utility, and Wealth Maximization' (1980) 8 Hofstra LR 509, 512–520.

21 See S. Deakin and A. Hughes, 'Economics and Company Law Reform: A Fruitful Partnership?' (1999) 20 Co Law 212.

22 See eg *The Strategic Framework,* n 5 above, 49–51.

23 *ibid* 15.

Precontractual information asymmetries

One pervasive imperfection of real credit markets is thought to be the asymmetric distribution of information. This can give a party with superior information an opportunity to redistribute wealth from a less-informed party to themselves. Unless it is costless to acquire information about borrowers, there will be a class of creditors who remain 'rationally ignorant' of relevant information. Such creditors will under-price some loans, but we would expect the costs of this to be passed on to other borrowers through pricing according to *average* borrower risk. However, this may make the rate seem unattractively high to borrowers with good financial prospects.[24] An 'adverse selection' effect will be generated if the result is that these borrowers decide not to enter the market for loans. The only borrowers who remain will be those with poor financial prospects.

These problems may be mitigated by market-based mechanisms, such as 'signalling'. A signal is something which a high-quality party can do cheaply, but is costly for a low-quality party.[25] Hence signalling behaviour can convey positive information to uninformed parties. Borrowers with good financial prospects have an incentive to signal this where the costs of signalling are less than the difference in price which they can secure as a result.

Legal rules may also have a role to play: the law relating to fraud and misrepresentation is one instance. An example relevant to the market for corporate loans is the mandatory disclosure of financial information, coupled with scrutiny by an independent third party.[26] This will tend to lower the cost of acquiring information about potential borrowers, thus reducing the size of the category of 'rationally ignorant' creditors. Whether or not rules mandating disclosure are efficient is a different question, however. For this to be the case, it must be shown that the social savings in information costs are greater than the total costs of compliance with the provisions.[27]

Incomplete contracts and postcontractual opportunism

Economists use the notion of a 'complete' contract to denote one which describes every possible contingency relevant to the performance of the contract, and specifies what parties must do under each circumstance so as to maximise their joint returns.[28] Real contracts are incomplete because specification of contingencies is costly – not only the costs of writing a term, but also those of quantifying the probability of the contingency's occurrence and of determining appropriate actions. Beyond a certain point the costs of specification outweigh the expected benefits. Similarly, where one party is better informed about the

24 G. Akerlof, 'The Market for Lemons: Quality Uncertainty and the Market Mechanism' (1970) 89 *Quarterly Journal of Economics* 488; See generally C. Wilson, 'Adverse Selection' in J. Eatwell et al (eds), *Allocation, Information, and Markets* (London: Macmillan, 1987) 31–34.

25 See A. Schwartz, 'Security Interests and Bankruptcy Priorities: A Review of Current Theories' (1981) 10 J Leg Stud 1, 14–15; G.G. Triantis, 'Secured Debt Under Conditions of Imperfect Information' (1992) 21 J Leg Stud 225, 250. See generally A.M. Spence, *Market Signalling: Information Transfer in Hiring and Related Screening Processes* (Cambridge, MA: Harvard University Press, 1974).

26 Cheffins, n 4 above, 512–521.

27 *ibid* (taking a sceptical view of the likely efficiency of disclosure rules). See also D.G. Baird et al, *Game Theory and the Law* (Cambridge, MA: Harvard University Press, 1994) 79–109.

28 O. Hart, *Firms, Contracts, and Financial Structure* (Oxford: Clarendon Press, 1995) 21–24; L. Kaplow and S. Shavell, 'Economic Analysis of Law' NBER Working Paper 6960 (February 1999) 27–28.

circumstances relevant to his performance, and it is costly for the other party to observe what has happened or been done, or to verify this information to a third party such as a court, it may not be worth parties' while to include terms which depend on that information.[29] Contractual incompleteness and postcontractual information asymmetries can be exploited opportunistically by one party taking actions which favour him and impose a cost on the other party.

In the context of corporate credit markets, the managers of debtor firms are likely to know more than creditors and courts about the circumstances relevant to their business. There are also a number of activities in which such managers may engage which will enhance the interests of shareholders at the expense of creditors.[30] A classic example is so-called 'asset substitution', although similar wealth transfers may be effected in several other ways.[31] If creditors are able to price loans accurately on the basis of the riskiness of a borrower's business projects, then shareholders may benefit at creditors' expense by subsequently switching to higher-risk projects with the possibility of higher returns. This increases what shareholders can expect to gain if the project succeeds, but – because of limited liability – does not affect what they stand to lose if it fails. Conversely, its only effect on creditors' interests is to increase their losses if the project fails.

This analysis assumes that corporate managers act in the interests of shareholders. This is obviously true for owner-managed businesses. In public firms, managers' private interests are likely to diverge from those of shareholders, with the latter in the first instance bearing the costs generated by managerial self-serving behaviour. Paradoxically, however, the better the incentive mechanisms – executive option schemes, threats of hostile takeovers, and the like – for resolving this 'problem' and ensuring that managers act in shareholders' interests, the stronger will be the managers' incentives to transfer wealth to shareholders from creditors.[32]

These sorts of activity may result in net social losses, even if we assume that both creditors and shareholders are able to diversify or insure so as to be risk-neutral. First, debtors' investment decisions may be skewed: they may choose projects on the basis of their potential for transferring wealth from creditors, rather than their potential to generate new wealth. Second, the supply of credit may become restricted. As the creditors' perceived risks increase, the necessary risk premium required to compensate them in advance rises sharply. Lenders would start to ration credit beyond a certain level of risk,[33] with less aggregate credit being offered in the market for corporate loans. If companies have restricted access to equity finance, then this would lead to a social cost: good business projects would go unfunded.

29 A. Schwartz, 'Relational Contracts in the Courts: An Analysis of Incomplete Contracts and Judicial Strategies' (1992) 21 J Leg Stud 271; A. Schwartz, 'Incomplete Contracts' in P. Newman (ed) *The New Palgrave Dictionary of Economics and the Law* (Basingstoke: Macmillan, 1998) 277.

30 M.C. Jensen and W.H. Meckling, 'Theory of the Firm: Managerial Behaviour, Agency Costs and Ownership Structure' (1976) 3 *Journal of Financial Economics* 305, 333–343; S.C. Myers, 'Determinants of Corporate Borrowing' (1977) 5 *Journal of Financial Economics* 147; C.W. Smith and J.B. Warner, 'On Financial Contracting: An Analysis of Bond Covenants' (1979) 7 *Journal of Financial Economics* 117; Barnea et al, n 16 above, 33–38.

31 eg text to notes 89–91 and n 102, below.

32 eg 'Share and Share Unalike' *The Economist*, 7 August 1999.

33 One reason is that under the Insolvency Act 1986 s 244, 'extortionate' credit transactions are unenforceable in the borrower's insolvency.

It is therefore rational for parties to spend money writing contractual prohibitions on wealth-reducing activities, coupled with monitoring by the creditor to observe the borrower's actions.[34] As well as the all-important terms relating to duration and repayment, lenders in fact frequently contract for 'loan covenants' which impose restraints on the borrower's investment and financing policies. Economists suggest that these can be explained as the parties' best efforts to reduce the costs of lender-borrower conflicts of interest,[35] sometimes referred to as 'financial agency costs'.[36] This is supported by studies which show that both the prevalence and restrictiveness of loan covenants increase with the debtor's ratio of debt to equity ('gearing'), a factor which would intensify shareholders' incentives to expropriate creditors.[37]

The ability of parties to neutralise financial agency costs by contract will depend in part on information costs – how easy it is for the creditor to observe the debtor's actions and to verify instances of opportunism to the court – and in part on the cost of contractual specification. Given these difficulties, there is a risk not only that prohibitions will be under-inclusive, but also that they may turn out to be over-inclusive, in which case they will need to be renegotiated. These limitations are exacerbated by 'free-riding' amongst creditors. Because creditors contract in 'parallel', the debtor's freedom of action is determined by the most restrictive covenant to which it is subject and which is enforced. The creditors can therefore free-ride on each others' investments in contracting, monitoring and enforcement, with the result that they each invest less than would be collectively justified.[38] Whilst small firms may be able to reduce this problem by concentrating a large part of their external finance with a single creditor such as a bank,[39] the frequent use of 'cross-default' clauses – defining 'default' to include a breach of any other loan covenant – suggests that creditors of larger firms do indeed attempt to free-ride in this way.[40]

In theory, statutory rules might assist parties in reducing their costs of contractual specification, by acting as 'terms' supplied into parties' bargains. The state's investment in term design could be spread over many parties, potentially capturing economies of scale and generating better-specified terms than parties could justify writing for stand-alone contracting. It might also help to overcome the creditors' free-rider problem as it affects investment in specification costs. A corollary of this, emphasised in the law and economics literature, is that the state-supplied rules should generally be *defaults* – ie only applicable unless parties specify otherwise – rather than *mandatory*, so parties to whom they are not suited

34 Jensen and Meckling, n 30 above, 334–343.

35 eg Smith and Warner, n 30 above.

36 eg G.G. Triantis, 'A Free-Cash-Flow Theory of Secured Debt and Creditor Priorities' (1994) 80 Va LR 2155, 2158.

37 On UK practices, see D.B. Citron, 'Financial Ratio Covenants in UK Bank Loan Contracts and Accounting Policy Choice' (1992) 22 *Accounting & Business Research* 322, 326; J.F.S. Day and P.J. Taylor, 'Evidence on the Practice of UK Bankers in Contracting for Medium-term Debt' [1995] JIBL 394, 397. On US practices, see eg J.C. Duke and H.G. Hunt III, 'An Empirical Examination of Debt Covenant Restrictions and Accounting-Related Debt Proxies' (1990) 12 *Journal of Accounting and Economics* 45; E.G. Press and J.B. Weintrop, 'Accounting-Based Constraints in Public and Private Debt Agreements' (1990) 12 *Journal of Accounting and Economics* 65.

38 Saul Levmore, 'Monitors and Freeriders in Commercial and Corporate Settings' (1982) 92 Yale LJ 49, 53–54; M. Kahan, 'The Qualified Case Against Mandatory Terms in Bonds' (1995) 89 Nw U LR 565, 596–598.

39 see J. Armour and S. Frisby, 'Rethinking Receivership', forthcoming.

40 J.F.S. Day and P.J. Taylor, 'Loan Contracting by UK Corporate Borrowers' [1996] JIBL 318, 323; P.R. Wood, 'Term Loan Agreements: A Guide to Basics, Part 3' (1996) 1(8) Com Law 51, 52.

do not find themselves saddled with inferior terms.[41] This idea was most famously applied to corporate law by Easterbrook and Fischel, who argue that its principal function is to supply 'off the rack' defaults terms to 'corporate contracts'.[42]

Collective action problems and insolvency

'Collective action' problems arise where the rational behaviour of individuals is inconsistent with their interests as a group. As such, they may justify legal rules which 'protect' creditors, not from the debtor, but from *each other*. Although creditors face some collective action problems – in the form of free-rider effects – whilst the debtor firm is solvent,[43] they become particularly acute if the debtor becomes insolvent. The structure of individual enforcement procedures can put creditors of an insolvent firm into a 'prisoner's dilemma' situation, where each has inefficient incentives to engage in a 'race to collect', thereby dismembering the debtor's business even where this is not warranted.[44] These costs justify some form of *collective* transformation of creditors' enforcement rights on the debtor's insolvency, so as to ameliorate their incentives. That said, there is considerable scope for variation in the way in which this is done.[45]

A related problem is so-called 'hold up' behaviour, which can be illustrated by reference to the renegotiation of loan covenants. It may be that renegotiation is in the interests of the creditors as a group, but because each creditor has a discrete contract with the firm, unanimous consent will be required. Some creditors may demand a payment, greater than their share of the collective benefits from renegotiation, simply as the price of their consent.[46] Such hold-ups may create significant obstacles to efficient renegotiation. This problem may justify the supply by the state of some form of *collective* renegotiation mechanism whereby a majority of creditors can bind a minority.[47]

'Creditors' who do not contract

A rather different set of issues is raised by so-called 'involuntary' creditors. The basic problem is by now well known, having been frequently discussed in the literature related to limited liability.[48] Consensual creditors are – in theory at least – able to decide whether or not to lend, and if so how much, and on what terms. Nonconsensual claimants, such as tort victims, the Environment

41 eg I. Ayres and R. Gertner, 'Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules' (1989) 99 Yale LJ 87, 87–89.

42 F.H. Easterbrook and Daniel R. Fischel, *The Economic Structure of Corporate Law* (Boston, MA: Harvard University Press, 1991) 14–15.

43 Text to notes 38–40 above.

44 T.H. Jackson, 'Bankruptcy, Non-Bankruptcy Entitlements, and the Creditors' Bargain' (1982) 91 Yale LJ 857.

45 One technique is for the state to impose a collective liquidation procedure. However, the use of security interests can also resolve the prisoner's dilemma, by establishing in advance who will get what (R.C. Picker, 'Security Interests, Misbehaviour, and Common Pools' (1992) 59 U Chic LR 645).

46 M.J. Roe, 'The Voting Prohibition in Bond Workouts' (1987) 97 Yale LJ 232, 238.

47 eg Companies Act 1985, ss 425–427; Insolvency Act 1986, Part I.

48 eg P. Halpern et al, 'An Economic Analysis of Limited Liability in Corporation Law' (1980) 30 U Toronto LJ 117, 144–147; n 42 above, 49–55; H.B. Hansmann and R. Kraakman, 'Towards Unlimited Shareholder Liability for Corporate Torts' (1991) 100 Yale LJ 1879; D. Leebron, 'Limited Liability, Tort Victims, and Creditors' (1991) 91 Colum LR 1565; B. Pettet, 'Limited Liability – A Principle for the 21st Century?' (1995) 48 CLP 125, 152–157; Cheffins, n 4 above, 506; D. Goddard, 'Corporate Personality: Limited Recourse and its Limits' in R. Grantham and C. Ricketts (eds.), *Corporate Personality in the Twentieth Century* (Oxford: Hart Publishing, 1998) 11, 32–40.

Agency and the Inland Revenue, are not. The idea is that since these parties are unable to adjust the terms on which credit is extended, shareholders may be able to profit at their expense by, for example, undercapitalising a firm or its subsidiaries.

The implications for efficiency depend not on the involuntary nature of the obligation, but on the economic rationale behind imposing it on the firm. One such basis is the control of externalities. At its simplest, the idea of an 'externality' encompasses any welfare effect felt by one party as a result of another actor's production or consumption decisions that is not mediated via the price system.[49] Economic actors can be encouraged by the state to 'internalise' the social cost by awarding liability claims to those affected by their activities.[50] However, the incentives are dulled where a firm's assets are worth less than the expected value of an obligation which might be imposed upon it by tort or environmental law, and its managers will maximise shareholder value by reducing expenditure on precaution against causing harm.[51] Limited liability readily facilitates such 'judgment proofing': each hazardous activity can be carried on by a separate company, with limited assets, and the costs of any harm it generates thereby insulated from all other assets. It may be that general rules designed to prevent such 'judgment proofing' and thereby protect 'involuntary' creditors might enhance efficiency.

How does the law relating to share capital protect creditors?

We now turn to an examination of the rules which restrict dealings in corporate share capital. Whilst some of the provisions have at times been rationalised as protecting the interests of shareholders,[52] or even the general public,[53] the current analysis follows the CLRSG in focusing on their role as mechanisms of 'creditor protection'.[54] It should be emphasised that the operation of these rules does not depend on the debtor firm being insolvent, and that the protection they offer is in *addition* to a battery of other mechanisms that swing into operation at or near the latter's insolvency.[55]

In this section, we will examine the rules broken down into the following four categories: (i) raising capital; (ii) minimum capital requirements; (iii) capital maintenance; and (iv) financial assistance. As a preliminary matter, it is useful to observe that the statutory provisions as a whole form two tiers of regulation.[56] At a basic level are rules which are applicable to all companies, and which originate in nineteenth-century case law. Superimposed on these is a set of more restrictive

49 eg J.-J. Laffont, 'Externalities' in Eatwell et al (eds), n 24 above, 112.

50 Other techniques include direct regulation and taxation according to social cost. See R. Coase, 'The Problem of Social Cost' (1960) 3 JL & Econ 1, 1; Kaplow and Shavell, n 28 above, 21–24.

51 Hansmann and Kraakman, n 48 above, 1882–1884.

52 eg Preamble to the Second Council Directive of 13 December 1976 (77/91/EEC) [1977] OJ L26/1.

53 eg *The Purchase By a Company of its Own Shares – A Consultative Document*, Cmnd 7944 (HMSO: London, 1980) paras 5, 16 (rules restricting share repurchases protect 'market integrity'). See also n 99 below.

54 *The Strategic Framework*, n 5 above, 81; *Company Formation and Capital Maintenance*, n 6 above, 22.

55 eg (i) directors' fiduciary duties to creditors (see eg, *West Mercia Safetywear Ltd* v *Dodd* [1988] BCLC 250, 252); (ii) wrongful trading (Insolvency Act 1986, s 214); (iii) creditors' ability to commence collective insolvency proceedings (*ibid* ss 8(1)(a) 122(1)(f)); and (iv) provisions allowing a liquidator or administrator to 'unwind' certain transactions (*ibid* ss 238–245).

56 n 1 above.

provisions derived from the Second EC Directive on Company Law.[57] This second tier of rules applies only to public companies, leaving the basic regime largely untouched in respect of private companies.

Raising capital

A number of provisions apply to transactions whereby a company raises capital through an issue of shares. The basic common law rule, now reflected in section 100 of the Companies Act 1985, is that shares may not be issued at a discount to their par value.[58] The 'par value' is a notional capital amount associated with each share. It need bear no resemblance to their market value. An issue of shares is recorded in a company's accounts by entering a figure of 'issued capital' equal to the number of shares, multiplied by their par value. Any amount by which the issue price exceeds par must be entered as 'share premium'.[59] Together, these are represented on the 'right hand side' of the corporate balance sheet, as part of the shareholders' funds.[60]

Paradoxically in the light of the insistence on the minimum issue price, if shares in private companies are allotted for *non-cash* consideration, then no serious attempt is made to ensure that the assets supplied are in fact worth the par value of the shares.[61] In the case of public companies, the value of non-cash consideration must be subjected to an independent expert's valuation.[62] However, there is no requirement that shares in any company be issued at their full market price, where this is greater than par.[63]

These rules provide creditors with information about the value of the assets contributed by the shareholders to the company – which might be relevant to lending decisions – and seek to guarantee that this information is truthful.[64] Would-be creditors may view a company's public documents and be misled if assets representing the share capital were never actually contributed to the company. Considerations of this sort are apparent in the reasoning of the House of Lords in *Ooregum (Gold Mines of India) Ltd* v *Roper*.[65] As Lord Halsbury stated, in laying down the rule that a company may not allot shares for less than par, '[t]he capital is fixed and certain, and every creditor of the company is entitled to look to that capital as his security'.[66]

In economic terms, these rules might be understood as a response to problems of information asymmetry in corporate credit markets. They publicise to investors the value of the assets that shareholders put into the company, and seek to ensure that

57 n 52 above, implemented by the Companies Act 1980 and now consolidated into the Companies Act 1985. See generally D.D. Prentice, *The Companies Act 1980* (London: Butterworths, 1980).

58 *Ooregum (Gold Mines of India) Ltd* v *Roper* [1892] AC 125.

59 Companies Act 1985, s 130.

60 *ibid* Sch 4. See generally Ferran, n 10 above, 44–48.

61 *Re Wragg* [1897] 1 Ch 796 is the *locus classicus* of the doctrine that, 'The value paid to the company is measured by the price at which the company agrees to buy what it thinks it worth its while to acquire.' (*ibid* 831, *per* Lindley LJ). It does not apply where the transaction is a sham or colourable (*ibid* 830) or where it is clear from the terms of the contract that the consideration bears no resemblance to the par value of the shares (*Hong Kong Gas Company* v *Glen* [1914] 1 Ch 527).

62 Companies Act 1985, ss 103, 108. The regime also prohibits outright the giving of services as consideration (s 99(2)) or arrangements which *may* take more than five years to perform (s 102)).

63 *Hilder* v *Dexter* [1902] AC 474. That said, issuing shares below market value may constitute a breach of directors' duties (see *Shearer* v *Bercain Ltd* [1980] 3 All ER 295, 307).

64 See Ferran, n 10 above, 283.

65 n 58 above.

66 *ibid* 133. See also *ibid* 137 *per* Lord Watson, 140–141, *per* Lord Herschell.

this information is truthful. Two observations should be made about this rationale. First, this mechanism can obviously only assist consensual creditors. Second, the rationale suffers from an internal weakness: the ease with which the rules may be side-stepped by private companies through the use of non-cash consideration. However, the 'expert valuation' rules introduced to comply with the Second Directive can be seen as a means of plugging this gap, at least in relation to public companies.

Minimum capital

The rules relating to minimum capital apply only to public companies. They stipulate that such a company may not commence trading unless it has an allotted capital of at least £50,000.[67] Furthermore, if such a company's net assets fall below one-half of its called-up share capital, then the company is required to convene a shareholders' meeting 'for the purposes of considering whether any, and if so what, steps should be taken to deal with the situation'.[68]

These rules can be understood as a system of creditor protection when viewed in conjunction with the 'expert valuation' rules regarding the raising of capital. Together, they seek to ensure that at least a minimum level of assets is contributed to a (public) company by its shareholders, and that if for some reason the company's net worth should subsequently fall below a 'threshold level', then steps should be taken to remedy the situation.[69] Such a regime can act to protect creditors without their even being aware of its existence. Because of this, it might be seen as a means of protecting so-called 'involuntary' creditors.[70]

Capital maintenance

The *Oxford English Dictionary* defines the verb 'to maintain' as, 'to keep up, preserve, cause to continue in being . . . to keep vigorous, effective or unimpaired, to guard from loss or derogation'.[71] In accordance with this definition, we might expect the doctrine of capital maintenance to require the preservation intact of the value of the shareholders' contribution of assets to a company – ie a rule requiring the 'maintenance' of some net asset value. As we have seen, the minimum capital rules for public companies go some way towards this. Yet the classical capital maintenance doctrine, as developed by the courts and now reflected in the Companies Act 1985, does nothing of the kind.[72] It directs merely that capital must not be *returned to shareholders*. 'Capital' in this sense refers not to the assets of the company – the left hand side of the balance sheet – but to the right hand side. An ordinary shareholder has rights: (i) to such dividends as the directors from time to time declare (whilst the company is a going concern), and (ii) should the company be wound up, to a *pro rata*

67 Companies Act 1985, ss 11, 118. Only one-quarter of this need actually be paid-up (*ibid* s 101(1)). See E. Ferran, 'Creditors' Interests and 'Core' Company Law' (1999) 20 Co Law 314, 317.

68 Companies Act 1985, s 142.

69 cf Ferran, n 67 above.

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

71 *Oxford English Dictionary*, 2nd ed (Oxford: Clarendon Press, 1989) Vol IX, 223.

72 On the doctrine's history, see B.S. Yamey, 'Aspects of the Law Relating to Company Dividends' (1941) 4 MLR 273; E.A. French, 'The Evolution of the Dividend Law of England' in W.T. Baxter and S. Davidson, *Studies in Accounting*, 3rd ed (London: ICAEW, 1977) 306. For practical purposes, the common law principle has been surpassed by the statutory rules introduced in 1980.

share of capital and surplus, insofar as these exceed the company's liabilities. It is therefore possible to think of capital as an indefinitely deferred *claim* against the company, which is payable only in winding-up,[73] and subordinate to the claims of the company's creditors.[74] The capital maintenance doctrine seeks to ensure that it remains that way.

The key statutory provision embodying the capital maintenance rule is section 263 of the Companies Act 1985. This prohibits any form of distribution of corporate assets to shareholders except where the value of the distribution is less than that of the profits available for distribution. Distributable profits are defined as the company's cumulated net realised profits,[75] minus dividends paid and losses written off to capital.[76] The definition of 'distribution' is very broad, including for example the redemption or repurchase of shares.[77] Indeed, it extends to cover a wide range of transactions whereby assets are directly or indirectly transferred to shareholders for less than market value.[78] As profits are necessarily defined in contradistinction to capital – which for these purposes includes any share premium and capital redemption reserve,[79] this means that capital may not be returned to shareholders.[80]

The capital maintenance rules allow for the adjustment of the restrictions they impose on companies. A company may increase its share capital either through a fresh issue of shares, or by capitalising retained earnings with a bonus issue.[81] Capital may be decreased, in response to a long-term drop in the firm's net assets, by reducing the nominal value of shares through a reduction of capital pursuant to section 135 of the Companies Act 1985. This requires the court's approval, but because it does not involve any direct transfer of assets to the shareholders, the creditors do not usually have any right to object.[82]

Alternatively, the capital maintenance principle may be bypassed altogether. One route by which this may be done is through a return of surplus capital under section 135 of the Companies Act 1985. In this case the court is concerned to ensure that creditors' interests are protected.[83] This can usually be done by the

73 see *Re Northern Engineering Ltd* [1994] 2 BCLC 704, 712 *per* Millett LJ.

74 Insolvency Act 1986, s 74(2)(f); *Soden* v *British & Commonwealth Holdings plc* [1998] AC 298. See Ferran, n 67 above, 318.

75 On which profits count as 'realised', see ICAEW, 'The Determination of Realised Profits and Disclosure of Distributable Profits in the Context of the Companies Acts 1948 to 1981' (TR 481) (1982) 93 No 1070 *Accountancy* 122; R. Lewis and D. Pendrill, *Advanced Financial Accounting*, 5th ed. (London: Pitman, 1996) 66–69; ICAEW, 'Draft Guidance on the Determination of Realised Profits and Distributable Profits Under the Companies Act 1985' 31 August 1999, <http://www.icaew.co.uk/depts/com/aug99/31aug99.htm>

76 A public company must also show that its net assets exceed the sum of its capital accounts plus its cumulated net *un*realised profits by at least the amount of the distribution (Companies Act 1985, s 264).

77 See *ibid* s 263(2)(b). These are permitted, but only in such a way that they do not reduce share capital: they must be funded by distributable profits (s 160(1)) and because they involve a cancellation of shares (s 160(4)) an equivalent amount must be accredited to a 'capital redemption reserve' and subsequently treated as capital (s 170).

78 *Re Halt Garage (1964) Ltd* [1982] 3 All ER 1016; *Aveling Barford Ltd* v *Perion Ltd* (1989) 5 BCC 677; *Barclays Bank plc* v *British & Commonwealth Holdings plc* [1995] BCC 19.

79 *ibid* ss 130(3) 170(4).

80 R. Mathias, 'The Myth of Maintenance of Capital' (1995) 116 No 1228 *Accountancy* 92.

81 Companies Act 1985, s 263(2)(a); Table A art 110. Bonus shares may also be funded from share premium or capital redemption reserve (ss 130(2) 170(4)) but this only recycles capital from one account to another.

82 *ibid* s 136(2); *Re Meux' Brewery* [1919] 1 Ch 28. If the loss might only be temporary, the court may require the company to promise to create a capital reserve account if it is recovered (*Re Jupiter House Investments Ltd* [1985] 1 WLR 975; *Re Grosvenor Press plc* [1985] 1 WLR 980).

83 Companies Act 1985, ss 136–137.

company providing the court with evidence of a bank guarantee for all existing debts.[84] The principle may also be bypassed by private companies through a repurchase of shares out of capital.[85] Finally, any company may make use of the schemes of arrangement or company voluntary arrangement provisions, which allow for general renegotiations of creditors' rights.[86]

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

> The creditor, therefore, I may say, gives credit to th[e] capital, gives credit to the company on the faith of the representation that the capital shall be applied only for the purposes of the business, and he therefore has a right to say that the corporation shall keep its capital and not return it to the shareholders.[87]

This envisages protecting creditors from the risk that shareholders would subsequently withdraw their capital investment. Conversely, the risk that the capital would be lost in ordinary business activities was one which the creditor had to bear.[88]

It is therefore possible to understand the capital maintenance doctrine as a means of reducing the costs of postcontractual opportunism by shareholders.[89] Distributions to shareholders reduce a company's net assets, making it more exposed to the risk of default. Creditors' interests can be harmed even if the company does not actually become insolvent.[90] If lenders' loans were priced on the basis of the pre-existing levels of net assets, then this will decrease the *expected* value of their claims,[91] whilst commensurately enhancing the combined value of shareholders' private wealth and their stake in the firm. Where, in order to fund such a distribution, assets are withdrawn from valuable projects available to the firm, this will result in a net social loss, as well as a redistribution from creditors.

It might be thought that a straightforward solution to these problems would simply be to ban all asset transfers to shareholders. However, there may be circumstances in which such transfers are efficient. Where a firm has surplus cash and no good projects in which to invest, it is efficient for the money to be returned to shareholders for investment elsewhere, rather than be ploughed into an underperforming project.[92] Hence an efficient restriction would prohibit some but not all such payments. The difficulty, of course, lies in specifying that only *inefficient* transfers will be prohibited.

One technique is to use a conditional restriction. In other words, provided the firm is able to meet a certain minimum financial condition, shareholders are free to

84 The statute prescribes a lengthy procedure whereby creditors must be informed of the proposed reduction and either consent to it or be paid off (*ibid* s 136). However the court may waive this where satisfied that the 'special circumstances of the case' demonstrate creditors are protected (*ibid* s 136(6)). To avoid the expense of the full procedure, it is usual to satisfy the court by obtaining a bank guarantee of all outstanding debts (A.J. Boyle et al (eds), *Gore-Browne on Companies*, 44th ed (Bristol: Jordans, 1986) supp 31 (1999) 13.012).

85 Companies Act 1985, ss 171-177.

86 n 47 above.

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

88 *Trevor* v *Whitworth* (1887) 12 App Cas 409, 423–424 *per* Lord Watson.

89 Miller, n 10 above, 5; Cheffins, n 4 above, 521–524.

90 Other legal provisions protect creditors if the transfer renders the company insolvent (n 55 above).

91 This will be their face value, discounted for the time value of money and the risk of default. Even if the debtor does not become insolvent, creditors are prejudiced if the *risk* of default increases above that at which they priced it, and if they wished to realise the value of the loan before maturity, as with bonds, secondary markets for syndicated loans, factoring of book debts, etc.

92 eg Megginson, n 16 above, 377–380.

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

The maintenance of capital doctrine can be understood as providing a conditional restriction of this sort. Rather than have each creditor contract separately with the firm for a restriction, the statutory framework can be understood as writing a *collective* 'creditor term' into the corporate constitution. Its application will be determined by the size of a company's share capital and share premium account, which the shareholders are able to adjust. Seeing the rules in this light allows us to *explain* a number of their features. First, it shows us why all distributions to shareholders are restricted, rather than just dividends. Second, it allows us to see why the doctrine does not restrict gratuitous transfers of assets to parties other than shareholders.[93] It is the shareholders', rather than the creditors', interest which is depleted (or conceivably, enhanced) by such a transfer. Third, it explains why distributions are allowed if the condition relating to distributable profits is satisfied. Fourth, it explains the existence and nature of the reduction of capital procedure. Where capital is paid out to shareholders, this acts as a mechanism whereby the firm *prospectively* changes the terms on which it contracts with creditors to reflect changing circumstances. Note, however, that this 'implied covenant' explanation of the capital maintenance rules suggests that, of themselves, they only assist consensual creditors. Because the maintenance of capital doctrine does not specify the *level* at which the restriction on distributions is to be set, it can only protect involuntary creditors when *coupled* with a minimum capital requirement.

Financial assistance

Sections 151–152 of the Companies Act 1985 impose very broad prohibitions on the giving by companies of financial assistance for the purpose of an acquisition of their shares. The original rationale for the introduction of these provisions, as proposed by the Greene Committee, was the prevention of 'asset-stripping' takeovers.[94] They had in mind transactions whereby a purchaser would borrow heavily to buy a majority holding of a 'target' company's shares for cash, and then rapidly sell the latter's assets, using the proceeds to discharge the loan. This can be seen as an indirect return of capital, whereby the 'old' shareholders are cashed out at the expense of the creditors. Hence the provisions are commonly treated as part of the capital maintenance regime.[95]

However, the ambit of the financial assistance provisions is broader than is necessary to ensure capital is not returned to shareholders. The basic prohibitions apply to any assistance which depletes the company's net assets, regardless of

93 cf *Barclays Bank plc* v *British & Commonwealth Holdings plc* [1995] BCC 19, 29–31 *per* Harman J.
94 *Report of the Company Law Amendment Committee,* Cmd 2657 (London: HMSO, 1926) para 30.
95 eg *The Strategic Framework*, n 5 above, 86; n 6 above, 39.

whether it has distributable profits,[96] and even to some transactions – such as loans – which may not deplete its assets at all.[97] Interestingly, the Jenkins Committee, reporting in 1962, felt that the link between capital maintenance and the financial assistance prohibitions was tenuous.[98] Whilst rationales can be offered for the prohibitions which do not turn on the protection of creditors,[99] it seems that Committee saw the 'problem' of the debt-laden acquiror as necessitating protection for creditors over and above that given by the capital maintenance doctrine.[100]

We might today refer to a debt-laden acquisition as a 'leveraged buyout' (LBO).[101] There are a variety of ways in which a LBO purchaser might use a target's assets and credit rating to assist in financing such a transaction, of which asset transfers of the sort that would fall foul of the capital maintenance rule are just a part. What is more, all of these have the potential to effect wealth transfers from the target's 'old' creditors. Consider a *loan* to the debt-laden purchaser. This is a classic example of asset substitution – replacing one asset with a riskier one. Alternatively, the target could be procured to borrow heavily and then on-loan the proceeds to the acquiror – or similarly to guarantee the acquiror's debt – in each case, diluting the value of the target's 'old' debt claims.[102] The basic prohibitions cover each of these transactions. Coupled with the Jenkins Committee's remarks, this suggests that the desire to protect creditors from 'LBO risk' may provide an explanation for the financial assistance restrictions.

This account begs one important question. Firms which are not undergoing LBOs are also capable of engaging in similar types of wealth transfers. Why should these far-reaching restrictions be imposed only in the context of an acquisition of shares? By way of a partial answer, note that the group with the greatest incentive to behave opportunistically in a LBO is not the 'old' shareholders, but the purchasers. The legal 'purchaser' will typically be a corporate vehicle for a fairly concentrated group of owner-managers.[103] The congruence between managers' and shareholders' interests in this vehicle, coupled with high gearing, will mean that it faces unusually severe financial agency costs.[104] Probably for this reason, lenders to such ventures typically demand stringent covenants and a well-developed business plan.[105] Yet the 'old' creditors, who find themselves suddenly exposed to a firm whose controllers have much greater incentives to gamble with their money than the one they lent to, are unlikely to have the benefit of such stringent covenants. Indeed in the US, where corporate laws do not contain financial assistance prohibitions, there were a

96 Companies Act 1985, ss 152(1)(a)(iv) 152(2). See Ferran, n 67 above, 319.

97 *ibid* s 152(1)(a)(iii). The value of a loan depends on the borrower's creditworthiness and the adequacy of any security. See Ferran, n 10 above, 373–374.

98 *Report of the Company Law Committee*, Cmnd 1749 (HMSO, London: 1962) paras 173–176.

99 eg protecting market integrity by preventing companies engaging in 'price support' schemes for their shares, and protecting minority shareholders from 'asset-stripping' where the acquiror purchases only a majority holding. Arguably, other regulatory developments now perform these functions, meaning these rationales are no longer compelling (see Ferran, n 67 above).

100 n 98 above.

101 In the UK, it is more common to speak of a management buyout (MBO). However, the term 'LBO' is used to emphasise a transaction principally financed by *debt*.

102 See A. Schwartz, 'A Theory of Loan Priorities' (1989) 18 J Leg Stud 209, 228–234.

103 Brealey and Myers, n 16 above, 982; M. Wright et al, 'Venture Capitalists, Buy-outs and Corporate Governance' in K. Keasey et al, *Corporate Governance: Economic, Management and Financial Issues* (Oxford: OUP, 1997) 147, 152–153.

104 Text to n 37 above.

105 See D. Citron et al, 'Loan Covenants and Relationship Banking in MBOs' (1997) 27 *Accounting & Business Research* 277.

number of well-documented cases in the 1980s where bondholders alleged that the values of their securities had been significantly downgraded by a sudden and massive increase in gearing brought on by a LBO.[106]

This account of the financial assistance provisions must, however, be tempered by reference to the so-called 'whitewash' procedure which can be used if the target company is private.[107] This requires that the assistance not reduce the target's net assets or, to the extent that it does, that it be covered by distributable profits.[108] The directors must also give a statutory declaration that the company will remain solvent for 12 months.[109] Superficially, this two-tier approach to regulation seems in keeping with the 'LBO risk' rationale. The rationale is at its strongest for public companies, where the shares are broadly-held, and hence the potential for a 'step up' in ownership concentration – and thereby financial agency costs – is greatest. However, this neglects the point that precisely because LBO transactions are based on concentrating ownership, it will not be difficult for the acquiror to convert the target to a private company. Thus the real measure of the protection against 'LBO risk' offered to creditors of *all* firms is perhaps viewed as the safeguards of the 'whitewash' procedure.

Does the 'protection' offered by the law enhance efficiency?

We have surveyed a number of possible 'creditor protection' rationales for aspects of the law relating to share capital, couched in terms of possible failings in markets for corporate credit which legal rules might ameliorate. In this section, we ask whether the existence of these rules generates *net* social savings.

Raising capital and information asymmetries

For the regulation of allotments of shares to be efficient, the social savings which such rules generate – as compared with a system without such rules – must be greater than the concomitant costs. Consider first the costs of compliance. Historically, if a company's share price fell below par, then it was rendered unable to raise equity finance. This might have proved disastrous if a fresh injection of funds was required to save a financially distressed firm. However, the matter can now be dealt with by splitting shares into multiples with a smaller par value, provided that the total share capital is not reduced.[110] The expert valuation rule is likely to generate more significant costs, requiring firms to retain professional valuers each time an issue of shares is made.

The benefit of these rules will be felt in the increased informational efficiency of markets for corporate credit, the extent of which depends in no small way on how useful the information is to investors. A number of empirical studies have investigated the information taken into account by sophisticated parties in making

106 M. McDaniel, 'Bondholders and Corporate Governance' (1986) 41 Bus Law 413, 442–450; K. Lehn and A. Poulsen, 'Contractual Resolution of Bondholder-Stockholder Conflicts in Leveraged Buyouts' (1991) 34 J L & Econ 645, 654–657. See also *Metropolitan Life Ins Co* v *RJR Nabisco Inc* (1989) 716 F Supp 1504.

107 Companies Act 1985, ss 155–158.

108 *ibid* s 155(2). The net assets are measured according to their book value at the time of the financial assistance. A loan to, or a guarantee on behalf of, an acquiror will only deplete the target's net assets where the acquiror is of doubtful solvency (see *Hill* v *Mullis & Peake* [1999] BCC 325, 331–333).

109 Companies Act 1985, ss 155(6) 156.

110 *ibid* s 121.

investment decisions. In some, share capital ranks as a very minor variable,[111] and in others, it does not feature at all.[112] Furthermore, the majority of the respondents to the CLRSG's *Strategic Framework* document stated that they considered a company's share capital is now relatively unimportant as a measure of its ability to repay credit.[113] These findings are readily explicable. Share capital is an indication of value contributed to a firm by its shareholders at some time in the past. Yet since that value has been put into the firm, it may well have been dissipated.[114] Since the information they generate seems to be of little use to investors, these rules are unlikely to be justifiable as a 'stand-alone' response to information asymmetries in corporate credit markets.

Minimum capital and 'creditors' who do not contract

We hypothesised that the policy goal of the minimum capital regime might be to protect 'creditors' who are unable to contract. If so, then it is poorly implemented by the current law. First, the rules apply only to public companies, yet there is no evidence that these are more likely to have involuntary creditors than private companies. Second, the rules do not go so far as to create a true net asset value maintenance regime. Although the capital maintenance doctrine restricts transfers to shareholders, there is no guarantee that assets will not be depleted through trading losses.[115] Yet before dismissing the idea altogether, it is worth considering whether there is a case for *strengthening* the law so as to implement this function better. It is certainly possible to point to other European corporate codes which offer more vigorous minimum capital regimes. For example, if the net assets of a Swedish company fall below half its share capital, then the shareholders must either inject fresh equity to restore the net asset level, or liquidate the company. [116]

Whilst a stronger minimum capital regime – eg a universal requirement, coupled with the current capital maintenance rules, or even with a true net asset maintenance system – might reduce the extent to which limited liability can be used for judgment proofing against involuntary creditors, the benefits would be haphazard. The amount necessary to internalise the risk of hazardous activity will depend on the activity in question. A universal minimum share capital is unlikely to achieve an appropriate level of deterrence in many cases.[117] The price of judgment proofing would go up, but the practice would not be eliminated. Furthermore, little of any minimum share capital is ever likely to be received by involuntary claimants. Such parties generally rank as unsecured creditors in a winding-up, and share with consensually unsecured creditors whatever is left of the company's liquidation value after secured and preferential creditors have been

111 J.F.S. Day, 'The Use of Annual Reports by UK Investment Analysts' (1986) 16 *Accounting & Business Research* 295.

112 A.J. Berry et al, 'Financial Information, the Banker and the Small Business' (1993) 25 *British Accounting Review* 131; D. Deakins and G. Hussain, 'Financial Information, the Banker and the Small Business: A Comment' (1994) 26 *British Accounting Review* 323.

113 n 6 above, 23–24.

114 Cheffins, n 4 above, 532.

115 Companies Act 1985, s 142 requires a general meeting be called to decide what should be done if a public company loses more than half its called-up share capital. However, there is no *obligation* for anything to be done, and the decision is given to shareholders, whose interests are likely to conflict with those of creditors (D.D. Prentice, 'Corporate Personality, Limited Liability and the Protection of Creditors' in Grantham and Ricketts, n 48 above, 99, 103).

116 C. Norberg, 'Undercapitalized or Insolvent Companies in Company Law – Conflicts of Interest and Protection of Shareholders and Creditors' mimeo, Lund University (November 1998).

117 Prentice, n 115 above, 102.

paid. Typically this will be very little.[118]

Such a regime would also generate costs. There would first be the administrative cost of 'policing' firms' compliance, which would generate a disproportionate burden for smaller companies. Second, firms unable to raise (or maintain) the minimum would be unable to obtain limited liability. Easterbrook and Fischel suggest that this would put such firms at a competitive disadvantage, creating barriers to entry and thus reducing the competitive pressure on incumbent firms.[119]

We might question how significant this second effect would be. Many of the benefits claimed for limited liability – for example, that it:[120] (i) permits share prices to be independent of the purchaser's wealth and thereby to reflect information about the value of the firm; (ii) allows for diversification by shareholders, reducing the cost of risk-bearing; and (iii) makes *passive* investment a rational strategy, allowing for specialisation in the management and risk-bearing functions – are likely to be at their smallest in relation to small companies.[121] The shares of such companies are not listed, and the shareholders and managers are often the same people.[122] Furthermore, many owner-managers are subject to unlimited liability anyway, through the expedient of personal guarantees granted to banks.[123]

Both the benefits from deterred judgment proofing, and the costs through denial of limited liability, would seem to be increasing functions of the threshold at which the 'minimum' is set. If a minimum capital regime were the only possible means of internalising the costs of hazardous business activity, the debate would not be closed until further empirical data became available. However, superior alternatives exist. One is to regulate hazardous activity and to require that firms carry insurance commensurate with their potential risk. The pricing of insurance premia would be a more precise internalisation mechanism than a 'fixed-rate' minimum capital requirement. Furthermore, the Third Parties (Rights Against Insurers) Act 1930 transfers liability insurance claims against an insurer of an insolvent firm from the firm to the party to whom it has incurred the liability, ensuring that tort victims need not share their recoveries with the debtor's contract creditors. Other techniques include granting involuntary claimants priority over other claimants in corporate insolvencies,[124] or imposing *pro rata* unlimited liability on shareholders for corporate torts.[125] These would cause voluntary creditors or shareholders respectively to increase the firm's cost of finance in proportion to the level of hazardous activity in which it is engaged. Even a rough-and-ready mechanism such as a judicial doctrine of 'piercing the corporate veil' in cases of 'unreasonably low' capitalisation would be likely to be cheaper in terms of administrative costs than a general minimum capital requirement.[126]

---

118 eg Society of Practitioners of Insolvency, *Company Insolvency in the United Kingdom: 8th SPI Survey* (London: SPI, 1999) 17 Fig 33 (12.6 per cent of face value).

119 n 42 above, 60–61.

120 *ibid* 41–44.

121 eg Halpern et al, n 48 above, 148. See also J. Armour, 'Corporate Personality and Assumption of Responsibility' [1999] LMCLQ 246, 252–253.

122 See A. Cosh and A. Hughes, 'Size, Age, Growth, Business Leadership and Business Objectives' in A. Cosh and A. Hughes (eds), *Enterprise Britain: Growth, Innovation and Public Policy in the Small and Medium Sized Enterprise Sector 1994–1997* (Cambridge: ESRC Centre for Business Research, 1998) 3, 10.

123 J. Freedman and M. Godwin, 'Incorporating the Micro Business: Perceptions and Misperceptions' in A. Hughes and D.J. Storey, *Finance and the Small Firm* (London: Routledge, 1994) 232, 246.

124 eg Leebron, n 48 above.

125 Hansmann and Kraakman, n 48 above.

126 eg n 42 above, 59.

Capital maintenance, financial assistance and loan covenants

In the previous section, we noted that the maintenance of capital doctrine and the rules prohibiting financial assistance impose restrictions on transactions which might harm creditors' interests. However, restrictions of the sort these rules create might alternatively be generated through loan covenants. Thus the 'benefits' of the legislation are not the costs which the prohibited transactions would impose on creditors, but rather the savings in contracting costs which might otherwise be incurred. We need now to ask: how great are these savings likely to be? And what are the costs of having such restrictions framed as general company law rules?

Consider first capital maintenance. Several commentators argue that the relevant legal provisions are unlikely to be terms which *any* creditor would choose for themselves.[127] Share capital is based on historic valuations ascribed to assets transferred to the firm, and as time goes on, it will become less and less appropriate as a 'minimum financial condition' on which to base conditional distribution restrictions. It is suggested that instead, tests which restrict shareholder asset transfers on the basis of gearing (ratio of debt to equity) or liquidity (ability to realise cash for assets) would be more appropriate. If this is the case, then the 'savings' in terms of drafting costs will be non-existent.

The strength of this conjecture may be tested through examining actual loan contracting practices. The available empirical evidence suggests that loan covenants used in UK lending agreements typically take the form of gearing and other financial ratios, but rarely restrict distributions to shareholders on the basis of capital and/or profits.[128] This in itself is not conclusive, because the evidence is equally consistent with the hypothesis that parties do not write such covenants into loan agreements because of the general law restrictions.

It is interesting therefore to note that in the US, where capital maintenance regimes are – depending on the state – either vestigial or extinct,[129] conditional restrictions on distributions to shareholders based on retained profits are reported to be amongst the most common form of covenant.[130] What is more, Kalay's study found that bond issues almost universally made use of a dividend restriction in similar form to the American Bar Foundation's indenture 'boilerplate',[131] which is in several respects analogous to section 263 of the Companies Act 1985.[132] The boilerplate restricts the firm's ability to engage in dividend payments, share

127 J.R. Grinyer and I.W. Symon, 'Maintenance of Capital Intact: An Unnecessary Abstraction?' (1980) 10 *Accounting & Business Research* 403, 408; D.A. Egginton, 'Distributable Profit and the Pursuit of Prudence' (1980) 11 *Accounting & Business Research* 3, 14; Manning, n 4 above, 33–34; Cheffins, n 4 above, 531–532.

128 See D. Citron, 'Accounting Measurement Rules in UK Bank Loan Contracts' (1992) 23 *Accounting & Business Research* 21, 23–24; Day and Taylor, n 37 above, 397–398; Day and Taylor, n 40 above, 321.

129 The doctrine was expunged from the post-1979 version of the Model Business Corporations Act (MBCA) and its successor the Revised MBCA (Manning, n 4 above, 164–180). The pre-1979 MBCA, whilst formally restricting dividends, allowed for: (i) payments out of share premium; and (ii) reductions of capital by *shareholder* resolution (Manning, n 4 above, 59–76; J.D. Cox et al, *Corporations* (Guttersburg, NY: Aspen Law and Business, 1995, supp 1999) § 21.16.

130 eg A. Kalay, 'Stockholder-Bondholder Conflict and Dividend Constraints' (1982) 10 *Journal of Financial Economics* 211, 214–216 (100 per cent of sample); Duke and Hunt, n 37 above, 55-56 (55.1 per cent of sample); Press and Weintrop, n 37 above, 74 (61 per cent of sample); cf M. McDaniel, n 106 above, 424-426 (35 per cent of sample).

131 Kalay, *ibid*, 216, footnote 9.

132 See American Bar Foundation, *Commentaries on Debentures* 410–411, in M.A. Eisenberg (ed), *Corporations and Business Associations: Statutes, Rules, Materials and Forms*, 1995 ed (Westbury, NY: Foundation Press, 1995) 782–786.

repurchases and other gratuitous transfers to shareholders, and the amount which may be paid is based on net retained profits made since the bonds were issued. The studies also found that gearing and net asset covenants are also commonly used in US lending agreements. One interpretation is therefore that the capital maintenance regime does in fact save UK lenders from having to draft similar loan covenants.[133]

Several factors suggest that this conclusion should be treated as speculative, even if we assume that US contracting practices are not contingent on localised institutional factors.[134] First, the commonly-used boilerplate ties dividends to cumulative net profits since the bonds were *issued*, rather than since the firm has been *incorporated*. A creditor lending to a UK firm with significant reserves of distributable profits will in contrast find that the firm can continue to pay dividends even if it loses money subsequent to the loan being advanced. Second, the terms of loan covenants presumably factor into creditors' lending and interest rate decisions. If the capital maintenance rules acted as an implied loan covenant, one would therefore expect to find that creditors check its 'terms' before lending: ie enquire as to the size of the debtor company's share capital. The available evidence suggests that UK creditors do not do this.[135]

Thus, whilst there may be *potential* savings in contracting costs to be had through the use of a 'collective term' restricting dividends, we cannot be certain how much, if any, are captured by the capital maintenance doctrine. The doctrine also generates costs. Where firms have no good projects to pursue, it may be impossible for capital to be returned to owners without incurring the cost of a reduction of capital procedure. The impact of these costs will be felt disproportionately by small firms, and this may provide a deterrent to the contribution of equity finance to such businesses.[136]

Turning to the financial assistance provisions, is a restriction on LBO activity of the sort they imply likely to be efficient? This question is made harder to answer because of the somewhat schizophrenic way in which the law is structured.[137] First consider the position under an outright ban (ie if the 'whitewash' exception did not exist). This would greatly curtail LBO activity, as appears to have been the case prior to the Companies Act 1981.[138] Whilst LBOs do have the capacity to harm the interests of creditors, it seems that most such transactions are not motivated by 'asset stripping'. A number of empirical studies suggest that, in general, losses to 'old' creditors consequent on LBOs are small compared to gains in operating performance experienced by the restructured company.[139] These gains are thought principally to come from a reduction in *managerial* agency costs, through the high-powered incentives which share ownership and high levels of debt give to managers.[140] Evidence from US lending agreements suggests that increased awareness of 'LBO risk' has led to a growth in the use in of 'poison puts' which allow bondholders to

133 C. Leuz et al, 'An International Comparison of Accounting-Based Payout Restrictions in the United States, United Kingdom and Germany' (1998) 28 *Accounting & Business Research* 111.

134 cf M. Klausner, 'Corporations, Corporate Law, and Networks of Contracts' (1995) 81 Va LR 757; M. Kahan and M. Klausner, 'Standardization and Innovation In Corporate Contracting (or "The Economics of Boilerplate")' (1997) 83 Va LR 713.

135 Notes 111–112 above.

136 n 123 above, 259.

137 Text to notes 107–109 above.

138 I. Webb, *Management Buy-Out* (Aldershot: Gower, 1985) 11–13.

139 See Wright et al, n 103 above, 158–161, and sources cited therein.

140 eg M.C. Jensen, 'Agency Costs of Free Cash Flow, Corporate Finance and Takeovers' (1986) 76 *American Economic Review* (Papers and Proceedings) 323, 325–326.

accelerate their claims should a change in control occur.[141] These will deter expropriatory transactions, but allow efficient ones to go ahead. Where the shareholder gains are greater than the creditor losses, the former will be able to pay the latter off. Thus even for public companies, an outright ban on financial assistance seems unnecessarily restrictive: it would affect all acquisitions of shares, regardless of whether a change in control is involved, and regardless of whether the transaction is efficient.

Consider now a less restrictive bar of the sort implied by the 'whitewash' regime. As we have seen, the possibility of a bought-out company being switched from public to private means that realistically, this embodies the protection offered to creditors of public as well as private companies against LBO risk. Terms dealing with 'LBO risk' are not standard in UK lending agreements.[142] This might suggest that the statutory provisions save parties from having to contract for similar protection. Once again, there are reasons for doubting this interpretation. First, there are several differences between the loan covenants which US parties write to cover this risk and the 'protection' offered under the whitewash regime. The legal rules are broader – applying to all acquisitions of shares, rather than just changes in control. Thus they catch many transactions which do not harm creditors. Yet where a change of control does take place, they are less intensive in their protection than a 'poison put'. Second, Lehn and Poulsen find that in the US, 'poison put' terms tend only to be adopted in lending agreements where debtors are perceived to be takeover targets – about 30 per cent of their random sample.[143] That they are not standard in the UK is consistent with a similar pattern. The fact that the savings in contracting costs are limited at best should be set against the opportunity costs which the provisions surely create through inhibiting transactions – particularly in small firms where the 'LBO risk' is marginal.

'Creditor terms' as default rules?

We have investigated whether the financial assistance and capital maintenance rules might act as loan covenants supplied by company law, thus saving parties the costs of writing such terms themselves. A recurrent problem is that the 'terms' supplied come in one form only, and apply mandatorily. An issue which seems worth exploring is whether terms like these could not be supplied instead as 'defaults', allowing parties to contract out if they wish and thereby reducing the costs of poor 'fit'.[144]

Default terms might be supplied into a creditor's *contract with the company*, with the normal accompanying remedies. We might refer to these as 'individual terms', because they would form part of each creditor's separate contract. As creditors contract in parallel, it would be very costly for firms to contract out of such default rules: all the creditors would need to agree. A default term supplied into individual creditor contracts would therefore seem to be similar in effect to a mandatory rule.[145] An alternative proposal might run as follows: recall that a significant role for company law vis-à-vis creditors was seen to be the supply of mechanisms for *collectivising* creditors' rights when a corporate debtor becomes

141 Lehn and Poulsen, n 106 above, 671. See also Kahan and Klausner, n 134 above, 740–743
142 P.R. Wood, *International Loans, Bonds and Securities Regulation* (London: Sweet & Maxwell, 1995) 51; Day and Taylor, n 40 above, 323.
143 n 106 above, 658–659, 671.
144 Text to notes 41-42 above.
145 See LCCP 153, SLCDP 105, n 8 above, 36.

insolvent.[146] It may be that a role exists for the provision by the state of default rules as *collective*, rather than individual, terms restricting opportunistic behaviour by a solvent debtor. These would not be enforceable by creditors individually, but rather by an agent or a group of creditors on behalf of them all.[147]

As we have seen, the capital maintenance provisions are an example of one such 'collective term'. A breach of the capital maintenance rules gives creditors no direct rights of action against the company, but they are enforceable by a liquidator on behalf of creditors should the company go into insolvency.[148] The financial assistance provisions are another example, in this case enforceable in part by the state through the criminal law, and in part by a liquidator on behalf of creditors. Such collective terms could be made into default rules by giving the choice whether or not to include them in the 'corporate constitution' to the subscribers at the outset, or to give firms some collective mechanism for opting into – or out of – them subsequently.[149] Provided that it is made clear to persons dealing with a company what sort of restrictions (if any) it is subject to, then those controlling it have appropriate incentives to decide whether these are efficient.[150]

What would be the appropriate *content* of default rules supplied as such collective terms? Easterbrook and Fischel's approach suggests that default rules should be chosen according to what the majority of parties 'would have wanted', had they been able to contract at zero cost, thereby enabling the state to capture economies of scale in specification costs.[151] A number of scholars have since questioned whether such 'majoritarian' default rules are in fact able to enhance efficiency.[152] One of the most telling criticisms for these purposes is the observation that creditors are heterogeneous in their preferences as to terms. They differ both within firms – having differing time horizons, priorities, and repayment schedules – and between firms – requirements varying with the debtor's business and size. The implication is that because parties differ in their needs, the state is unlikely to have significant economies of scale in providing such 'off the rack' terms.[153]

However, not all defaults need be structured on an 'opt out' basis, nor need a sole default rule serve for all circumstances.[154] An alternative approach would be for the state to supply an opt-in 'menu' of covenants,[155] from which firms could

146 Text to notes 43–47, above.

147 Possible mechanisms include: (i) *ex post* enforcement by a liquidator; (ii) the creation of a representative committee of creditors which will have power to enforce and renegotiate rights on their behalf (see Y. Amihud et al, 'A New Corporate Governance Structure for Bonds' (1999) 51 Stan LR 447); and (iii) enforcement by a state regulatory body.

148 *Mills* v *Northern Rly of Buenos Ayres* (1870) 5 Ch App 621. See N. Furey, 'The Protection of Creditors' Interests in Company Law' in D. Feldman and F. Meisel (eds), *Corporate and Commercial Law: Modern Developments* (London: LLP, 1996) 173, 176–179.

149 The reduction of capital procedure provides a mechanism for *adjusting* the constraints imposed by the maintenance of capital doctrine, but does not allow firms to *opt out* altogether. The only way a (private) company may currently opt out of restrictions on the withdrawal of share capital is by not raising it in any significant quantity. This may distort firms' financing decisions (text to n 136, above).

150 See n 42 above, 17.

151 *ibid* 15.

152 A term coined by Ayres and Gertner, n 41 above, 93.

153 H. Kanda, 'Debtholders and Equityholders' (1992) 21 J Leg Stud 431, 440, Kahan, n 38 above, 609–610. See also Schwartz, 'Incomplete Contracts', n 29 above, 279; M.J. Whincop, 'Painting the Corporate Cathedral: The Protection of Entitlements in Corporate Law' (1999) 19 OJLS 19, 28–29.

154 Ayres and Gertner, n 41 above, 93–95; Cheffins, n 4 above, 217–218.

155 Klausner, n 134 above, 839–841. See also (in the context of corporate insolvency procedures) R.K. Rasmussen, 'Debtor's Choice: A Menu Approach to Corporate Bankruptcy' (1992) 71 Tex LR 51; A. Schwartz, 'A Contract Theory Approach to Bankruptcy' (1998) 107 Yale LJ 1807.

then select provisions to become 'collective terms' in the sense just described. We might imagine that some firms would want to offer creditors particular covenant-like restrictions. Others would wish to avoid this, leaving the matter purely to market contracting.

It might be argued that even a *range* of default terms will not be sufficient to cater for the widely divergent needs of different parties. This probably overstates the heterogeneity point. Within firms, creditors contract in parallel, and hence the debtor's freedom of action will be determined by the strictest loan covenant. And between firms, the evidence on loan contracting practices suggests that several reasonably well-defined types of term are used by a wide variety of firms.[156]

Another possible objection is the fear that firms would not opt in to *any* restrictions, thus leaving creditors with less protection than they have at the moment. However, the evidence on loan contracting suggests that firms currently spend money writing and negotiating complex covenants into their loan contracts. If the same result can be achieved more cheaply through a 'collective term', then there are obvious incentives to opt in. Nor would the position of involuntary creditors would be made worse by such a step. The capital maintenance and financial assistance regimes do nothing to protect such groups unless coupled with a commitment to a minimum capital regime – itself, as has been argued, an inferior regulatory strategy.[157]

Conclusions

The current law relating to share capital can be rationalised as an attempt to protect corporate creditors from expropriation by shareholders. Whilst in theory, rules which prevent such wealth transfers can enhance efficiency, the arguments involved do not justify regulation in the form of the current provisions. The law imposes haphazard restrictions on companies which are ill-tuned to the needs of parties. On the whole, the costs of such restrictions are likely to outweigh any benefits they bring.

Whilst a case may be made for legal intervention to prevent shareholders from using limited liability companies to 'judgment proof' themselves when engaging in hazardous activities, the sporadic approach of the current minimum capital regime seems inadequate to do so. A case may be made for strengthening the regime's application, but there are a variety of alternative mechanisms which could be used to achieve the same policy goal more cheaply and effectively.

The information which is disclosed and 'verified' by the rules which regulate the raising of share capital seems to be of little, if any, relevance to creditors in making lending decisions. Attempts to justify these provisions as a means of minimising information asymmetry problems in corporate credit markets are therefore unpersuasive. It is possible to view the capital maintenance doctrine and financial assistance prohibitions as attempts to save contracting costs through the provision of 'collective loan covenants'. Whilst the empirical evidence on loan covenants shows that there are *potential* savings in contracting costs to be had, it is unclear to what extent – if at all – these are captured by the current law. Furthermore, because the 'terms' supplied are mandatory and general in their application, firms for which they are not suited must incur the opportunity costs of transactions frustrated by the

156 Notes 37, 40 above.
157 Text to notes 124–125, above.

restrictions. However, if companies were allowed to 'opt in' to one or more of a variety of such 'collective terms', then this would allow greater savings in contracting costs to be captured, with less risk of frustrating value-enhancing transactions. Establishing the realistic possibilities for such a regime is an important question for future research.

This article offers a tentative validation of the CLRSG's approach. The analysis suggests that the use of an efficiency-oriented framework can provide meaningful insights into some, at least, of the difficult trade-offs involved in reforming company law. The CLRSG's preliminary proposals for public companies are largely of an incremental nature.[158] Perhaps the most significant is that the requirement that the court approve a reduction of capital would be replaced by a declaration of solvency by directors.[159] Yet the possibilities for reform as respects public companies are of course curtailed by the Second Company Law Directive.[160] The CLRSG's proposals for *private* companies have recently been amplified in a fifth consultation document, published in March 2000.[161] In it, they take the view that the financial assistance provisions impose unjustified costs on private companies, and propose that they be repealed in this context.[162] The document also considers whether a more comprehensive minimum capital requirement – or even a 'solvency margin' (ie net asset maintenance) regime – should be introduced.[163] This are rejected on the grounds, respectively, that minimum capital provides no protection against subsequent depletion, and that a solvency margin is 'disproportionate . . . and over-regulatory'. The analysis in this article provides support for this reasoning, and suggests that the reform proposals are likely to enhance the efficiency of company law.

158 See n 6 above, 22–54.

159 *ibid* 34–35. Creditors of public companies would, however, retain a right to obect to the court.

160 *The Strategic Framework*, n 5 above, 21–23. However, the Directive is due to be simplified in line with recommendations from Phase IV of the Simpler Legislation for the Internal Market (SLIM) Initiative. These include the relaxation of the financial assistance ban and the 'expert valuation' rules (E. Wymeersch, 'Company Law in the 21st Century'. Universiteit Gent Financial Law Institute Working Paper 1999–14, 4; *Single Market News* No 19, December 1999).

161 *Modern Company Law for a Competitive Economy: Developing the Framework* (London: DTI, 2000).

162 *ibid* 232–234.

163 *ibid* 306.