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A synthetic view of different concepts of creditor protection - or: A high-level framework for corporate creditor protection

Law Working Paper N°.60/2006
February 2006

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ECGI Working Paper Series in Law

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Earlier versions of the paper were presented at the 4th Asian Corporate Governance Conference in Seoul and the conference on "Efficient Creditor Protection in European Company Law" in Munich. I am grateful to all participants and to Ulrich Haas for helpful comments. The usual caveats apply.

Comments on the draft are most welcome and should be sent to the author at muelbert@mail.jura.uni-mainz.de

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Abstract

Protection of corporate creditors has become an important topic within the EU. At EU level, discussion has been sparked by widespread dissatisfaction with some very rigid and cumbersome provisions, and even with the whole concept of the Second Company Law Directive; at EU Member States' level, three landmark decisions by the European Court of Justice - Centros, Überseering, Inspire Art – opened the way for an all-out competition between the different company forms provided for by national company laws. At both levels, albeit for different reasons, British company law – and in particular the absence of any legal capital in the private limited company – acts as the main driving force putting pressure on the concept of legal capital as enshrined in the Second Directive which, in turn, was modeled on German company law notions.

The High Level Group of Company Law Experts provided the appropriate starting point for the present discussion by dealing not only with the raising and maintenance of capital, but by also taking up the wrongful trading remedy (Sect. 214 British Insolvency Act) and the equitable subordination remedy. This present article builds upon this broader approach, seeking to develop a conceptual framework for an efficient creditor protection regime within a purely national setting, i.e., leaving aside the additional problems created by pseudo-foreign companies and the impact of the provisions of the EU treaty for the free movement of companies on national company laws.

Given the rich variety of creditor protection mechanisms within EU Member States, any attempt at developing even a high-level framework has to start by identifying the relevant risks, against which creditors need protection, and the required extent of creditor protection. Against this backdrop, any jurisdiction has to make a choice whether to rely mostly on creditor self-help or on mandatory protection rules. Since all mechanisms for creditor self-help are inherently costly and fail to protect involuntary (tort) creditors and "weak" contractual creditors as effectively as they do "strong" contractual creditors, in principle, there is a case for mandatory protection rules. The article then goes on to review the different well-known mechanisms for mandatory creditor protection. In line with earlier findings and the criticism mostly from English scholars, the case for a German-style legal capital regime turns out to be weak, at best.

On the other hand, since shareholders' incentive to act to the detriment of creditors increases with the company becoming financially distressed, it is important to provide for mechanisms that will work to effectively control any opportunistic behavior on the shareholder's part. In this respect, equitable subordination of a shareholder's right as well as the wrongful trading remedy may serve important roles. The article concludes by taking a brief look at the resultant high-level framework for an efficient creditor protection regime.

Keywords: High Level group, creditor protection, limited liability, financial covenants, legal capital, minimum capital requirement, capital maintenance, undercapitalization, wrongful trading, equitable subordination, recharacterization.

JEL Classifications: K22

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A synthetic view of different concepts of creditor protection
- or: A high-level framework for corporate creditor protection

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I. Introduction

The ultimate goal in integrating different concepts of creditor protection is to arrive at a system for efficient creditor protection. An investor protection regime based on such a system would consist of a set of well-adapted legal institutions or mechanisms – each comprising a sub-set of rules - that, as a whole, would ensure the required level of creditor protection, but would not accord overprotection. However, until now, such a system is not to be found anywhere.

EU Member States' creditor protection regimes are the result of an evolutionary process rather than of any comprehensive institutional design. At EU level, the Second Company Law Directive, to a large extent, reflects the state of German law at the beginning of the 1970s[1], while the current proposal of the EU Commission for alterations[2] responds to demands by other Member States and the EU business world to relinquish some of the more cumbersome requirements. Moreover, the Second Directive covers only parts of the various legal mechanisms dealing with the protection of creditors. Finally, Eastern European countries' rules on creditor protection are mostly the result of institutional design in the form of legal transplants.

Legal writers will often confine themselves to a partial analysis by only discussing a particular rule or mechanism for creditor protection and the problems involved therein. In contrast, scholars in the law and economics tradition employ a broader approach, but choose the opposite perspective. Their focal concern is whether limited liability is an economically beneficial institution,[3] and if they find, as has been the case with limited liability for tort claims, that the costs outweigh the benefits, they will tend to favor the abolition of limited liability as such[4].

Only very recently, the new Pan-European discussion on creditor protection brought about by the European Court of Justice with three landmark decisions – *Centros*, *Überseering*, *Inspire Art* – has moved in the direction of a more systemic approach. In

[1] For a description of the pertinent rules of the Directive s. P.O. Mülbert and M. Birke, 'Legal Capital – Is There a Case against the European Legal Capital', 3 *EBOR* (European Business Organization Law Review) (2002) p. 695 at p. 700 et seq.

[2] Proposal for a Directive of the European Parliament and of the Council amending Council Directive 77/91/EEC, as regards the formation of public limited liability companies and the maintenance and alteration of their capital of 21 September 2004, COM(2004)final

[3] See, e.g., F.H. Easterbrook and D.R. Fischel, *The Economic Structure of Corporate Law* (Cambridge, Mass., Harvard Univ. Press 1991) p. 41 et seq.; cf. P.L. Daies, *Gower and Davies' Principles of Modern Company Law*, 7th edn. (London, Sweet & Maxwell 2003) p. 176 et seq.; B. Pettet, 'Limited liability – a principle for the 21st century?', in M.D.A. Freemann, ed., *Current Legal Problems* Vol. 48 (Oxford, Oxford University Press 1995) p. 125 at p. 141 et seq.; H.C. Grigoleit, *Gesellschafterhaftung für interne Einflussnahme im Recht der GmbH*' (München, C.H. Beck 2006) p. 31 et seq.

[4] See, e.g., H. Hansmann and R. Kraakman, 'Toward Unlimited Shareholder Liability for Corporate Torts', 100 *Yale Law Journal* (1991) p. 1879 et seq.

particular, the High Level Group of Company Law Experts recommended that the EU Commission should conduct a study into the feasibility of an alternative regime to the legal capital regime, doing away altogether with the concept of legal capital. Above all, the Group specified that the alternative regime should provide for a solvency test to be conducted before any payment of a dividend or making any other asset distribution to shareholders, and that the directors should be held responsible for the issue of a formal solvency certificate incorporating the results of the solvency test. In addition, and this recommendation in particular reflects the "systemic approach", the Group recommended that, as an element of good corporate governance, a European framework rule should be introduced on "wrongful trading", i.e. on the responsibility of directors close to insolvency, and that the concept of the subordination of insiders' claims should be at least considered.[5] Similarly, as a contribution to the ongoing British company law reform process, the Rickford Report on "Reforming Capital" not only called for a substitution of the present capital maintenance rules by a far simpler solvency test, but supported this call for a drastic change by broader reflections on different mechanisms available for creditor protection[6]. Finally, the EU Commission, after having taken up the recommendations of the High Level Group in its Communication on the Company Law Action Plan[7], very recently published a tender for a study into the feasibility of an alternative to the capital maintenance regime contained in the Second Directive requiring the contractor "to evaluate whether, under alternative regimes … creditors' and shareholders' protection can be achieved at least as effectively in a way which better supports economic growth … In particular, the study aims at establishing the degree of effectiveness of the current legal capital regime and whether there are other means to protect creditors' and shareholders' rights. … Particular reference will be needed about the role of insolvency legislation to guarantee creditors' interests"[8].

The present paper takes up the idea of a "systemic approach" by trying to identify the appropriate starting point(s) from which a discussion on how to protect corporate creditors efficiently may proceed, as well as the relevant building blocks for such a creditor protection regime, and possible interactions between these mechanisms. Admittedly, for a

[5] Report of the High Level Group of Company Law Experts on a Modern Regulatory Framework for Company Law in Europe, 4 November 2002, p. 14 et seq., Recommendations IV.1./10./11.
[6] Report of the Interdisciplinary Group on Capital Maintenance "Reforming Capital", 15 *EBLR* (European Business Law Review) (2004) p. 919 et seq. (edited by J. Rickford; hereafter, "Rickford Report").
[7] Communication of the Commission to the Council and the European Parliament "Modernising Company Law and Enhancing Corporate Governance in the European Union – A Plan to Move Forward" of 21 May 2003, COM(2003) 284 final, p. 17 et seq.
[8] Feasibility study on alternative to capital maintenance regime as established by the Second Company Law Directive 77/91/EEC of 13.12.1976 and the examination of the implications of the new EU-accounting regime on profit distribution, B-Brussels: general management consultancy services 2006/S 50-051751, Sect. II.1.5. (available at: http://europa.eu.int/comm/dgs/internal_market/calls_en.htm)

variety of obvious reasons, the paper must restrict itself to trying to establish a sort of high-level framework that may serve as a basis for future elaboration and refinement.

II. Foundations

1. Three layers of creditor protection problems within the EU

The basic question is how to protect corporate creditors within a purely national setting. Do the laws and court-made rules of a given jurisdiction constitute a creditor protection regime that achieves an efficient protection of the corporate creditors of a company incorporated in the said country. If not, what alterations, amendments and, sometimes, even deletions are necessary to arrive at such a regime?

Additional problems arise in case of a foreign company:[9] This is particularly true with respect to so-called pseudo-foreign corporations, i.e. if the country of a company's incorporation and the country of its main or even exclusive commercial activities differ. Then, the problems of efficient creditor protection are exacerbated by conflicts of law issues, i.e. which national laws and rules are applicable, and by enforcement issues, i.e. which state is competent to enforce the applicable national laws and rules, and whether the competent country is able and willing to enforce the applicable rules.

The third layer of problems only exists within the EU. Companies incorporated in another Member State enjoy the freedom of establishment enshrined in Article 43 et seq. of the EC Treaty, even if they conduct business solely in their host Member States. Consequently, the freedom of the host Member State to provide for national laws and rules that aim at establishing an efficient creditor protection regime is subject to the limitations resulting from Article 43 et seq. of the EC Treaty. This restriction comes into play regardless of whether the laws and rules of the host Member State that are to be applied will be categorized as corporate law or, for example, tort law or insolvency law.

2. The approach to designing a system for efficient creditor protection

Even in a purely national setting, it is difficult, at best, to design a coherent system for the efficient protection of corporate creditors. Apart from company law proper, other areas of law, e.g. contract law, tort law, accounting law and insolvency law, have to be taken into

[9] For a comprehensive treatment from the German perspective of the problems associated with the treatment of foreign companies, in particular companies incorporated in another EU Member State, see H. Eidenmüller, ed., *Ausländische Kapitalgesellschaften im deutschen Recht* (München, C.H. Beck 2004); M. Lutter, ed., *Europäische Auslandsgesellschaften in Deutschland* (Köln, Dr. Otto Schmidt 2005); cf. further ==. Sandrock and ==. Wetzler, eds., *Deutsches Gesellschaftsrecht im Wettbewerb der Rechtsordnungen* (Frankfurt am Main, Recht und Wirtschaft 2004).

account as well. Moreover, criminal law as well as administrative law may also serve a useful function.

Because of the many ways a jurisdiction may provide for creditor protection, any inter-country comparison of the respective levels of creditor protection is notoriously difficult, at best.[10] Such a comparison cannot proceed by positing a particular jurisdiction as a yardstick and by asking whether the legal order in question provides for the same or at least similar laws and rules. In particular, the comparison must not be limited to comparing the same areas of law, e.g., company law or insolvency law. Instead, such a comparison must employ a functional approach, by taking the different creditor risks and the required extent of creditor protection as its starting point, and by examining a legal system as a whole with respect to its protection of corporate creditors.

The same two factors – the different types of creditor risks and the required extent of creditor protection – can also serve as the basis for designing a system of creditor protection. Regardless of a given legal system, two basic questions have to be answered at the outset: what are the relevant risks against which corporate creditors are to be protected, and what is the extent of protection to be accorded. The answers to these two questions may vary according to the legal system in question. In particular, different legal systems may opt for different approaches to determine the required extent of creditor protection.

These basic choices establish a sort of high-level framework that a given legal system has to flesh out by selecting an array of creditor protection mechanisms that cover the relevant creditor risks and provide for the appropriate extent of protection, i.e. neither leaving corporate creditors vulnerable to exploitation by the company nor according overprotection to creditors. Obviously, the selection of the creditor protection mechanisms employed varies within different legal systems. The choices are shaped by a multitude of factors,[11] e.g. which particular legal remedies and actions are available in a given legal system or not, whether a legal system relies more on mandatory disclosure facilitating creditor self-help or on substantive rules according protection, whether company law or other areas of law, e.g. tort law and insolvency law will be charged with protecting creditors, and whether a legal system relies more on rules or standards for regulating the behavior of a corporation, its directors and its shareholders, i.e. whether a legal system relies more on rules that define admissible behavior precisely ex ante, or on more general standards that require ex post clarification by courts[12].

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[10] Cf., e.g., G. Hertig and H. Kanda, 'Creditor protection' in R. Kraakman, et al., *The Anatomy of Corporate Law* (Oxford, Oxford Univ. Press 2004) p. 97 et seq.
[11] See Hertig and Kanda, loc. cit. n. 10, at p. 97 et seq.
[12] As to this, see Hertig and Kanda, loc. cit. n. 10, at p. 87 et seq.

3. The principle of non-liability of corporate decision-makers towards corporate creditors

Any framework for the protection of corporate creditors has to incorporate two additional problem dimensions as compared with the case of a natural person being the debtor. The first is the principle of limited liability or, to be more precise, the principle of non-liability of shareholders for corporate debts. As a consequence of limited liability, shareholders causing a corporation to act to the detriment of creditors are not liable for their decisions with their personal assets towards creditors. This divergence between decision-making power and personal liability fundamentally alters the incentive structure as compared with a natural person, the latter being personally liable towards the creditors. Moreover, corporations exhibit the same structural divergence between decision-making power and personal liability with respect to the directors of the company. The particular incentive structure that results from this split goes against the interests of corporate creditors, in particular, if the corporation is approaching insolvency. Hence, a framework for corporate creditor protection has to incorporate this aspect as well.

4. Possible reason for protecting corporate creditors

Why a legal system would want to protect corporate creditors at all against the risks arising from limited liability is the most fundamental question. The answer has profound implications with regard, for example, to the required extent of protection.

Again, different legal systems may opt for different answers. To name but three possible responses: Some German scholars (e.g. Herbert Wiedemann) perceive creditor protection by means of company law as an ethical necessity,[13] and the German Federal High Court may concur in view of some judgments rendered in recent years[14]. The British Interdisciplinary Group on Capital Maintenance in its report on "Reforming Capital" (Rickford Report) discusses desirable limits to the distribution of corporate assets to shareholders as "a question of reasonable balance, or proportionality"[15], i.e. the Group basically invokes notions of fairness and common sense. Finally, for example John Armour in his inquiry into efficient creditor protection rules for a modern company law[16], as well as

[13] H. Wiedemann, *Gesellschaftsrecht I* (München, C.H. Beck 1980) p. 515.
[14] See, in particular, BGH of 27 September 1999 – II ZR 371/98, 53 *WM* (Wertpapiermitteilungen) (1999) p. 2071: Commercial law starts from the principle of unlimited liability, unless statutory exceptions exist, and shareholders have to pay for the privilege of personal non-liability by compliance with the legal capital rules. Cf. BGH of 16 March 1992 – II ZB 17/91, 46 *WM* (1992) p. 870; BGH of 9 December 2002 – II ZB 12/02, 57 *WM* (2003) p. 348 at p. 349; BGH of 7 July 2003 – II ZB 4/02, 57 *WM* (2003) p. 1814 at p. 1816
[15] Rickford Report, loc. cit. n. 6, at p. 967 (similarly p. 971)
[16] J. Armour, 'Share Capital and Creditor Protection: Efficient Rules for a Modern Company Law', 63 *The MLR* (Modern Law Review) (2000) p. 355 et seq.

Gerard Hertig and Hideki Kanda while analyzing the "The Anatomy of Corporate Law" with respect to creditor protection[17] advocate an economic cost-benefitanalysis.

Whether the protection of corporate creditors is based on ethical considerations and notions of fairness respectively will mostly bear on the scope and contents of court-made creditor protection rules. Before the courts, issues of creditor protection will normally arise in cases where an insolvent company is unable to settle its debts. If creditor protection is rooted in notions of ethics or fairness, courts will then tend rather to favor stringent liability rules, disregarding the ex ante incentives which would emanate from the rule in question. Generally speaking, ex post court intervention will lead to a very high or even an excessive level of creditor protection if courts do not base their decisions on economic welfare considerations reflecting the ex ante incentives.

The "Video" liability doctrine developed by the German Federal High Court (Bundesgerichtshof) in the mid-1990s may serve as an extreme case in point.[18] The pertinent decision virtually abolished the principle of limited liability for German one-person limited liability companies (Ein-Personen-GmbH). The Federal High Court only revoked this judge-made liability doctrine in its TBB-decision after a broad public outcry by practitioners and scholars alike.[19]

5. Approach and organization of the paper

A combined economic and legal analysis offers the most rational approach to the problem of creditor protection. This is particularly true if – as this paper does - one seeks to develop a framework for a system of rules that ensures efficient creditor protection. Neither non-specific notions of fairness and other ethical considerations, nor the more or less arbitrary set of rules that will evolve in a particular jurisdiction can serve as the starting point for designing such a system. Instead, one has to start with the different types of creditors and the respective risks they face, since the rules to be designed must correspond above all to these risks.

Reflecting this approach, the rest of the paper is thus organized as follows: Sect. III briefly describes the different types of creditors, and Sect. IV discusses the risks different types of creditors face for several dimensions. On the basis of this analysis, Sect. V turns to one of the core questions: what are the risks against which corporate creditors need protection, and to what extent? Sect. VI discusses whether the different strategies

[17] Hertig and Kanda, loc. cit. n. 10, at p. 72
[18] BGH of 23 September 1991 – II ZR 135/90, 45 *WM* (1991) pp. 1837-1841 (*Video*).
[19] BGH of 29 March 1993 – II ZR 265/91, 47 *WM* (1993) pp. 687-693 (*TBB*); as to this reversal, see V. Röhricht, 'Von Rechtswissenschaft und Rechtsprechung', 28 *ZGR* (Zeitschrift für Unternehmens- und Gesellschaftsrecht) (1999) p. 445 at p. 464 et seq.

available to creditors for protecting themselves are a more or less perfect substitute for mandatory rules designed to protect creditors. Sect. VII reflects on strategies for creditor protection by mandatory law in general. Sect. VIII deals with mandatory disclosure as a means to enable creditor self-help. Sect. IX discusses some of the internationally used mechanisms that aim at reducing the risk of a company approaching financial distress, and Sect. X explores strategies that aim at minimizing losses that existing creditors of a company in financial distress will incur. Sect. XI takes up some more technical problems the legislator and the courts face when providing for preventive or, put differently, ex ante creditor protection and ex post creditor protection by civil liability of directors and of shareholders. Finally, Sect. XII offers some concluding remarks.

III. Types of corporate creditors

As is well known, voluntary and involuntary corporate creditors raise different questions with respect to creditor protection.

However, the most important involuntary creditors, namely the state (e.g. taxes) and public agencies (e.g. social insurance), can be left out of the picture. As a rule, states establish particular liability regimes that extend the liability for any taxes and social security contributions that the corporation owes to the tax authorities or other public agencies, to the directors and sometimes even to the (dominant) shareholder.

As for the remaining types of involuntary creditors, “pure” tort creditors can serve as an exemplary case.

IV. Types of corporate creditor risks

Whether corporate creditors voluntarily enter into a relationship with the corporation or not, has a bearing on the types of risks they face. Moreover, since corporate creditors enter into a relationship with the corporation itself, an in-depth risk analysis has to take into account whether the risks result from decisions and actions respectively by the shareholders or by the directors.

1. Voluntary corporate creditors

The different risks that voluntary creditors face can be analyzed in three dimensions: time, cause, and originator.[20]

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[20] CF. further P.O. Mülbert, ‘Zukunft der Kapitalaufbringung/Kapitalerhaltung’, 2 *Der Konzern* (2004) p. 151, at p. 153 et seq.

a. Time

Upon establishing a contractual relationship, creditors face the risk that the terms and conditions of the contract are (initially) inappropriate, i.e. that they do not fully reflect the risk of future non-performance by the company existing then or, in more technical parlance, that at the time of concluding the contract the initial net present value of a contractual claim is less than its nominal value. Once, creditors have entered into a contract they face the risk of a subsequent devaluation of their claim. This risk, in turn, reflects an increase in the probability that at the time the claim is due for repayment the debtor will be unable or at least unwilling to fully honor his debt, i.e. an increased probability of partial or complete non-performance by the debtor. From this perspective, default on the debtor's part simply signifies a 100% probability of non-performance.

b. Cause

Initially inappropriate contracts, i.e. if the net present value of a creditor's claims is initially less than its nominal value, are often due to inadequate or even misleading information provided by the debtor. Alternatively, the creditor may not spend enough time and energy in properly informing himself about the risks, or may have miscalculated the required risk premium because of bounded rationality.

An ex post-devaluation of a claim - be it temporary or permanent – may simply result from business misfortune due, for example, to unsuccessful management, poor business conditions, or even exogenous shocks, e.g. a steep rise in the cost of raw materials or a sharp hike in workers' wages. Alternatively, it may result from opportunistic behavior on the company's part, i.e. if the company willingly takes on additional risk. This risk increase may, in turn, be due to[21]

- a waste of company assets because of substandard business conduct, i.e. if the company does not conduct its business in accordance with the standards of a diligent and conscientious businessman (weak-form opportunism);
- a distribution of company assets to the shareholders, be it in the form of dividend payments or share repurchases, or in disguised form, e.g. by an exchange of economic goods between the corporation and a shareholder at terms that the corporation would not have agreed to if dealing with an unrelated third party (strong-form opportunism);

[21] For more details see, e.g., L. Enriques and J.R. Macey, 'Creditors Versus Capital Formation: The Case Against the European Legal Capital Rules', 86 *Cornell Law Review* (2001) p. 1165 at p. 1168 et seq.; Mülbert and Birke, loc. cit. n. 1, at p. 708 et seq.

- a shift to a more risky business strategy (strong-form opportunism). Prime examples are strategic business decisions that cause rating agencies to downgrade a company's outstanding debt, e.g. the decision to launch a tender offer for another company or, in the case of banks, a strong expansion of the more volatile investment banking business. In addition, a shift to a riskier business strategy occurs if a company continues to do business while the probability of becoming insolvent has (sharply) increased, or if it continues to do business even beyond the point where "there is no reasonable prospect that the company would avoid going into insolvent liquidation"[22]. On the other hand, for a company to continue its business even after having become insolvent does not signify a shift per se to a riskier business strategy. This would only be the case if, because of the company's suffering further losses from continuing to do business, the dividend paid to the creditors of the insolvent company would drop even further;
- a repayment of a credit, in particular a loan, extended by a shareholder when the company is in financial distress (strong-form opportunism);
- a commingling of company and shareholder assets (strong-form opportunism).

c. Originator

Opportunistic behavior on the company's part may be due to actions by either its directors or its shareholders.

With regard to the directors, the most common form of opportunism is a waste of corporate assets caused by directors who, when exercising their functions, do not comply with the standard of a diligent and conscientious director, i.e. who violate their duty of care or their duty of loyalty owed to the company. In addition, if the company headed by the directors continues to do business even though it is already insolvent or, according to all reasonable expectations, will become insolvent in the future, directors may still benefit from opportunism since they continue to receive salary payments and enjoy other privileges linked with their position.

With respect to the shareholders, the lack of personal liability for the corporation's debts (limited liability) will serve as a powerful incentive to cause the company to act opportunistically, either in the form of a subsequent distribution of assets to its shareholders or by taking on riskier business projects, i.e. projects with more volatile earnings prospects. In practice, such kinds of opportunistic behavior will most often be initiated either by a shareholder acting in his capacity as a director or by the shareholders

[22] Sect. 214 (2) (b) British Insolvency Act 1986 (hereafter, IA).

issuing a binding directive to the directors, or by a dominant shareholder making use of his actual influence.

2. Involuntary corporate creditors

The risks involuntary corporate creditors face are much the same as those run by voluntary creditors. The net present value of non-contractual claims may be less than their nominal value already at their time of coming into existence, or, alternatively, such claims may suffer a subsequent devaluation. As opposed to contractual claims, the only difference concerns possible causes for initial inappropriateness. If a claim does not adequately reflect the risk of future non-performance by the company at the time the claim comes into existence, this will be due to the company's being in financial difficulties or even being insolvent, not because of misleading information supplied by the debtor or bounded rationality on the creditor's part.

3. Particularities of corporate creditors' risks

Contrary to conventional wisdom, corporate creditors do not incur fundamentally different risks in comparison with creditors of natural persons. In particular, the principle of limited liability does not create unique risks but only acts to severely exacerbate the risks a creditor faces in the case of a natural person's unlimited personal liability.[23]

Neither corporations nor natural persons possess unlimited funds. Thus, the net present value of a claim when coming into existence may be less than its nominal value, regardless of the type of debtor, i.e. regardless of whether the debtor is a corporation or a natural person. This observation holds true even for non-contractual claims, e.g., tort claims, even if the probability that a small corporation will cause large or mass tort claims is far greater than in the case of a natural person[24].

With regard to the ex post-devaluation of claims because of opportunistic behavior, corporations as debtors and natural persons as debtors differ only in quantitative, not in qualitative terms. Put differently, unlimited liability does not completely prevent people from acting opportunistically. Obviously, weak-form opportunism is also present among natural persons, e.g. if a person chooses a lesser paid instead of a higher paid job, thus reducing any chances of a future settlement of all of his debts. Even strong-form opportunism may be found among natural persons, for example in the case of a (nearly) insolvent debtor who transfers his assets to his spouse or children in order to prevent creditors from

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[23] In the same sense, see Hertig and Kanda, loc. cit. n. 10, at p. 71 et seq.
[24] For a more detailed discussion, see Mülbert and Birke, loc. cit. n. 1, at p. 714 et seq.

realizing their claims by obtaining judgment and levying execution on the debtor's goods. In this respect as well, corporations as debtors and natural persons as debtors do only differ insofar as corporations are dramatically more prone to show strong-form opportunism than natural persons, since directors and shareholders, as the corporate decision-makers, are not directly liable towards the creditors.

V. The extent of corporate creditor protection

1. Efficient corporate creditor protection and its limits

The principle of limited liability acts as a one-sided default risk-sharing rule. Notwithstanding contractual arrangements to the contrary, shareholders do not participate in any losses the creditors suffer from dealing with a corporation. Creditor protection rules and mechanisms seek to mitigate the effects of a "blind" or automatic application of the principle of non-personal liability of shareholders and directors. Developing a framework for efficient corporate creditor protection, then, begs the following question: to what extent are corporate creditors to be protected against (i) the risk of acquiring an initially overvalued claim and (ii) the risk of an ex post-devaluation of a claim?

With respect to efficient creditor protection, the relevant criterion seems to be straightforward. Creditors are to be protected against those risks that a fully informed rational creditor would not accept voluntarily when contracting the claim in question. However, upon closer inspection, things are more complicated. On the one hand, "pure" tort creditors, for example, would not willingly accept any risks of non-performance, and even voluntary creditors will try to avoid any risk of non-performance, including the risk of simple business misfortune. If banks and other important creditors are in a position to enforce their demands, they will require the corporation to provide collateral; additionally, they will seek personal guarantees or collateral from the shareholders and/or the directors. Generally speaking, rational corporate creditors will even try to avoid the risk of simple business misfortune since, on the other hand, they do not participate in the residual earnings. Hence, the relevant criterion for efficient creditor protection needs a qualification: Creditors are to be protected against those risks that a fully informed rational creditor would not accept voluntarily when contracting the claim in question – except for the risk of simple business misfortune, since the essence of the principle of limited liability is to burden creditors with this risk.

Moreover, companies without a viable business and/or capable management will go bankrupt over time regardless of the amount of capital initially available to them – in the long run they are all dead. Admittedly, for individual creditors it makes an often decisive difference whether bankruptcy will occur in the near or the more distant future since the

creditor population changes over time. However, the overall result does not change along the time-line: some creditors will suffer financial losses. At first glance, this observation seems to eliminate completely the need for mandatory creditor protection, except for one case: protection against directors or/and shareholders directing the company to act opportunistically if the company would have stayed in business, had this action not been taken, i.e., if the company, given its business prospects over time, would not have gone bankrupt at all. Upon closer reflection, however, this bottom-line for mandatory creditor protection may be too restrictive. First, there are often long-term creditors, in particular employees holding a pension claim against the company. For them, at least, creditor protection is of major interest, even in the long-run perspective. Second, lacking any means of creditor self-help, creditors would resort to extreme short-term financing if mandatory rules would only prohibit directors and/or shareholders from taking decisions that will cause an otherwise viable company to go bankrupt. On balance, then, the "in the long term they are all dead"-argument does not completely eliminate the need for mandatory protection. However, it does caution against any premature calls for raising the existing level of creditor protection simply on the grounds that introducing stricter rules serves to lower a company's probability of default. Take the case of limitations on distributions.[25] Any distribution, *ceteris paribus*, will raise a company's probability of default, albeit the increase will often be even less than tiny. On the other hand, distributions serve to attract investors. Thus, mandatory rules on limitations of distributions will have to strike a balance between the diverging interests based on economic efficiency considerations. The benefits to creditors from raising the level of creditor protection must outweigh the efficiency losses suffered by existing and future shareholders, and vice versa.

Finally, even given this refinement, the exact delineation of those risks corporate creditors are to be protected against does pose some problems. In particular, creditors do come as a heterogeneous group.[26] They differ with respect to their appetite for risk, the size of their credit portfolio, their time horizon priorities and repayment schedules, and last, but not least, the exact point of time when entering into a (non-)contractual relationship with the company. The following discussion serves to illustrate some of the resultant problems.

[25] See also *infra* IX.1.b.(3).
[26] See, e.g., Armour, loc. cit. n. 16, at p. 376 et seq.

2. Initially inappropriate contractual terms and conditions

Efficient contracts fully reflect the risk that the corporation will not be able to honor its obligation in full at the time the claim falls due for payment. At a first glance, then, a strong case does seem to exist for creditor protection against the risk of entering into a contract the conditions of which, i.e. the risk premium paid to the creditor, do not fully reflect the risk of future non-payment.[27]

However, things are more complicated than that. From the point of view of the holder of a single claim, accepting a risk premium as compensation for a given probability of future non-performance is like placing a bet on whether the corporation will honor its debt or not. Thus, depending on the individual risk preferences, risk averse creditors will either completely refrain from entering into a contractual relationship with the corporation, or they will ask a much higher premium than those creditors holding a sufficiently diversified portfolio of claims. The latter type of creditor will demand a much lower premium, since he will calculate a risk premium for each contract to ensure that he will not suffer a financial loss with respect to the whole portfolio of claims.

An important consequence ensues from this analysis. With respect to creditor protection mechanisms targeting the formation of the contract, the appropriate level of protection depends on whether the “model creditor” to be protected is one holding a single claim, or a diversified creditor. The former will need full protection against the risk of concluding a contract if the probability of default on the part of the envisaged debtor should exceed a certain threshold. The latter needs full protection against the risk of concluding a contract, the terms and conditions of which do not fully reflect the risk of non-performance by the debtor. Using the Basel II framework and terminology, in order to calculate the adequate risk premium, such a creditor would need to know the probability of default by the debtor and the expected loss in the event of default, among other things

3. Ex post-devaluation of a claim

The protection of corporate creditors against the ex post-devaluation of a claim crucially depends on whether the risk is due to opportunism on the company's part or simple business misfortune.

[27] By definition, this problem does not arise, if the debtor provides sufficient collateral at the time of the formation of the contract since any expected loss in the event of the debtor’s default will be (practically) nil.

a. Strong- form opportunism

Strong-form opportunism, i.e. distribution of assets to shareholders or other forms of a deliberate increase in risk, on the corporation's part seems to be an obvious case for legal intervention in its creditors' favor. However, closer inspection reveals a more complicated picture.

To begin with, the effects of a distribution of assets to shareholders are not fundamentally different from a move by the company to a business model with more volatile earnings prospects: the probability of default increases. Nevertheless, jurisdictions all over the world pay much closer attention to the first type of behavior than to the latter and, moreover, provide for stricter limitations.[28] Virtually all industrialized countries' jurisdictions stipulate rules that limit the admissible amount of dividend payments or other forms of distributions of assets to shareholders. In this respect, jurisdictions do not differ fundamentally, regardless of whether they operate with a German-style legal capital system – involving a minimum capital requirement, rules on the raising of capital, and rules on capital maintenance – or not.

Put more generally, separating acceptable non-opportunistic from unacceptable opportunistic behavior will often be difficult. Actions by the corporation that only marginally increase the risk of default cannot be regarded as opportunistic behavior. Otherwise, dividend payments or share repurchases as well as a tiny increase in the company's leverage would constitute opportunistic behavior. However, take the recent decision by Deutsche Börse AG to pacify its mostly hedge-fund owners by dispensing nearly all of its cash reserves within the next two years by way of dividend payments and share buy-backs, or, inter alia, the decision in the 1990s of Dresdner Bank AG to invest heavily in highly volatile investment banking which led rating agencies to downgrade the bank's outstanding corporate bonds. Do such far-reaching strategic decisions qualify as opportunistic behavior towards creditors or not?

The answer is notoriously difficult to give since the interests of creditors as fixed claimants and the interests of shareholders as holders of residual claims do diverge: creditors are more risk-averse.[29] Given a project's or a company's risk, creditors will prefer a lower debt-equity-ratio, and, conversely, for a given ratio, shareholders will prefer the company to pursue more risky projects than creditors will favor. Furthermore, with a

[28] See *infra* IX.1.b./2.
[29] See, e.g., Mülbert and Birke, loc. cit. n. 1, at p. 710 et seq.

company moving more and more towards insolvency the divergence becomes ever more pronounced.[30]

Moreover, even if one were, for example, to qualify a huge distribution of assets to shareholders, a company's move to a much riskier business strategy or the continuation of a company's business subsequent to a major loss of working capital as being opportunistic behavior,[31] this would only hold true in relation to the creditors already existing at that time. Anybody becoming a creditor later on would not suffer from opportunistic behavior, but from having accepted a riskier debtor as a party to the contract.

The upshot is, then, that only more extreme corporate decisions and actions constitute a kind of opportunistic behavior that warrants legal intervention. The bottom line is reached when, as a consequence of the company's behavior, there is no reasonable prospect that the company would avoid becoming insolvent on the ground that its liabilities exceed its assets. Creditors who feel the need for protection against less egregious behavior on the corporation's part can still impose covenants tailored to their specific needs.

b. Weak-form opportunism

Weak-form opportunism is different from strong-form opportunism insofar as the company itself suffers losses due to substandard business conduct on the directors' part, i.e. due to the directors violating their duty of care or their duty of loyalty. Here, too, creditors can protect themselves against this type of risk only by obtaining collateral or personal guarantees supplied by the directors or/and the shareholders.

c. Business misfortune

Limited liability acts as a default rule for sharing the risks between creditors and shareholders that result from business misfortune, e.g. unsuccessful management, poor business conditions or exogenous shocks.

Obviously, the resulting partition of risks changes over time for a given company and, moreover, varies for different companies. For example, if a company becomes insolvent, all creditors belonging to one class will recover the same dividend, i.e. the same percentage of their claim, regardless of the company's risk of becoming insolvent at the

[30] See e.g., H.C. Hirt, 'The Wrongful Trading Remedy in UK Law: Classification, Application and Practice Significance', 1 *ECFR* (European Company and Financial Law Review) (2004) p. 71 at p. 83 et seq.; C. Kuhner, 'Zur Zukunft der Kapitalerhaltung durch bilanzielle Ausschüttungssperren im Gesellschaftsrecht der Staaten Europas', 34 *ZGR* (2005) p. 753 at p. 769 et seq.
[31] But see *infra* IX.2.

time a particular claim came into existence. Moreover, the amount of time and resources spent by a creditor in informing himself about his future debtor is irrelevant. Even creditors who completely failed to collect any information will not suffer any adverse consequences, e.g. a reduction of the dividend. However, these effects result from insolvency law, not from limited liability. Hence, limited liability does not give rise to concerns with respect to any unequal treatment of creditors.

At best, one may want to take issue with the characteristics of the partition of risks established by limited liability: shareholders will take the residual profits regardless of the amount of the investment they committed themselves to up front when founding the corporation. However, this sharing arrangement constitutes the core element of the principle of limited liability, and this paper definitely does not wish to take issue with the universally recognized proposition that, at least with respect to the partition of risks between shareholders and contractual creditors, limited liability has economically beneficial effects[32]..

VI. Mandatory protection rules v. creditor self-help

Creditor self-help as an alternative to creditor protection by mandatory rules is not available per se to "pure" tort creditors, but only to contractual creditors. For the latter, self-help comes in four forms: collecting information on the intended party to the contract, taking out third-party credit insurance, inserting covenants into the contract, and obtaining collateral from the corporation and/or its directors and shareholders. However, even though British law appropriately favors self-help over mandatory protective rules, at least as a starting point,[33] all four approaches to self-help do not act as a perfect substitute for creditor protection by mandatory law.

To begin with, any form of self-help is inherently costly. This is true for information gathering as well as for taking out third-party credit insurance, for writing[34] and contracting covenants and for supplying collateral and personal guarantees. Because of these costs, statutory limitations seem to provide a superior off-the-rack "boilerplate" solution available even to "weak" creditors with respect to those covenants, at least, that replicate the restrictions on asset distributions to shareholders mandated by the Second Company Law Directive.[35]

[32] *Supra* n. 3 with accompanying text.
[33] See Armour, loc. cit. n. 16, at p. 357 et seq.
[34] However, model financial covenants are available. See, e.g., American Bar Foundation, *Commentaries on Model Debenture Indenture Provisions 1965, Model Debenture Indenture Provisions All Registered Issue 1967 and Certain Negotiable Provisions Which May Be Included in a Particular Incorporation Indenture, Buffalo* (N.J., William S. Hein & Company 1986) (Reprint).
[35] Covenants contracted in the US, albeit with greatly declining frequency, impose restrictions similar to the limitations stipulated by the Second Directive. As to the extent of similarity see, e.g. E. Ferran, *The Place for*

With regard to information gathering in particular, severe adverse selection problems would arise since directors, when providing information voluntarily, are often tempted by strong incentives to misrepresent the company's financial situation. Mandatory disclosure rules facilitating information gathering by addressing these informational asymmetries and their causes, thus, do not form an alternative to mandatory creditor protection but a precondition for efficient creditor self-help.

Taking out third-party credit insurance is a very costly way for creditors to protect themselves. A superior alternative would be compulsory third-party insurance, since the company as debtor would be incentivized to reduce the riskiness of its business if insurance rates were designed accordingly.

Covenants as a mechanism for self-help only serve to prevent the corporation from acting opportunistically, i.e. to prevent an ex post-devaluation of a claim.[36] Moreover, as a rule, smaller creditors are not in a position to impose covenants. The well-known argument that smaller creditors also benefit from covenants imposed by larger creditors is not wholly convincing.[37] First, some clauses, of necessity, do work to the detriment of other non-secured creditors. An obvious case in point is the event risk clause or poison put clause that gives bondholders an option to put the bonds back to the issuer since other creditors will suffer from this drain on the company's liquidity. More generally speaking, a violation of contractual covenants entails very different consequences from those resulting from a violation of restrictions stipulated by mandatory rules. Take the case of an illegal distribution of assets. If the distribution violates contractual covenants the creditor will either be able to renegotiate the terms of the credit, in particular to enforce an upward readjustment of the interest rate, or will obtain a claim for damages and, because of an acceleration clause or a clause that empowers him to terminate the contract for cause, will be entitled to recover the amount due at once. All these different consequences may lead to a further deterioration of the company's financial position, thus hurting the smaller creditors, too. Conversely, a distribution of assets in violation of statutory restrictions will entitle the company to reclaim the funds distributed to shareholders, thus strengthening its

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Creditor Protection on the Agenda for Modernisation of Company Law in the European Union, ECGI Law Working Paper No 51/2005 (Brussels, European Corporate Governance Institute 2005) p. 5 et seq.; Armour, loc. cit. n. 16, at p. 373 et seq.; M.R. Alberth, 'USA: Vertraglicher Gläubigerschutz und Ausschüttungsbemessung durch Covenants als Vorbild zur Änderung des deutschen Bilanzrechts?', 50 *WPg* (Die Wirtschaftsprüfung) (1997) p. 744 at p. 747.

[36] For typical contents of financial covenants see. e.g., Mülbert and Birke, loc. cit. n. 1, at p. 723.

[37] As to the following, see Mülbert and Birke, loc. cit. n. 1, at p. 724, 730 et seq. In the same sense H. Eidenmüller, *Unternehmenssanierung zwischen Markt und Gesetz*, (Köln, Dr. Otto Schmidt 1999) p. 146 et seq.; W. Schön, 'The Future of Legal Capital', 5 *EBOR* (2004) p. 431, at p. 443; H. Merkt, 'Der Kapitalmarktschutz in Europa - ein rocher de bronze?', 33 *ZGR* (2004) p. 305 at p. 313 et seq.; same, 'Creditor protection and capital maintenance from a German perspective', 15 *EBLR* (2004) p. 1045 at p. 1050; Ferran, loc. cit. n. 35, at p. 10; J. Hennrichs, 'Bilanzgestütze Kapitalerhaltung, HGB-Jahresabschluß und Maßgeblichkeitsprinzip – Dinosaurier der Rechtsgeschichte?', 82 *StuW* (Steuer und Wirtschaft) (2005) p. 256 at p. 260 et seq.; Alberth, loc. cit. n. 35, at p. 748 et seq.

financial position. More generally speaking, mandatory rules do not suffer from the sort of collective action problems that limit the role of covenants as a mechanism for protecting even “weak” creditors.

The most effective form of creditor self-help is to obtain collateral from the corporation, its directors and shareholders. Sufficient collateral protects the creditor against any information risks, i.e. against the risk of entering into a contract with a company that is already insolvent, or that will surely become insolvent, as well as against the risk of ex post-opportunism on the company's part. Indeed, being personably liable acts as a powerful check on directors and/or shareholders to refrain from causing the corporation to act opportunistically. Still, this solution does suffer from some obvious drawbacks as opposed to creditor protection by mandatory rules. First, in practice, creditors systematically differ in their ability to obtain collateral from the corporation or personal guarantees from directors or shareholders. Large creditors and banks in particular will often be fully secured, whereas smaller creditors, in particular suppliers of services, will have no securities at all. Moreover, even personal liability towards one or more larger creditors will not prevent a shareholder or director from causing the corporation to act opportunistically if the expected benefits are large enough. In practice, a shareholder-director will often continue to do business, even though he is personally liable for the company's debt and the corporation is in a crisis or even on the brink of insolvency.

VII. Strategies for mandatory creditor protection

Prevention is the holy grail of all efforts to protect creditors by mandatory rules. Providing for mechanisms that ensure full compensation of creditors once the debtor has gone bankrupt only comes second.[38] From an economic perspective, prevention by mandatory rules serves to lower transaction costs, since creditor self-help as well as insolvency proceedings are costly mechanisms, and contributes to a superior allocation of resources, since adverse selection problems, i.e., because of potential creditors withholding funds altogether or investing funds with less risky debtors, will be less acute. Thus, creditor protection regimes should be geared towards mechanisms and rules that block the realization of potential creditors risks, i.e. that protect creditors against concluding a contract that, from the outset, does not adequately reflect the risk of future non-performance by the debtor, and against a subsequent devaluation of a creditor's claim caused by opportunistic behavior on the corporation's part. With a view to this aim a

[38] But see W. Zöllner, ‘Konkurrenz für inländische Kapitalgesellschaften durch ausländische Rechtsträger, insbesondere durch die englische Private Limited Company’ 97 *GmbHR* (GmbH-Rundschau) (2006) p. 1 at p. 12: primary goal of creditor protection consists in making sure that creditors will be fully compensated when the company is bankrupt.

number of different mechanisms are available, e.g. mandatory disclosure, capital requirements, the subordination of shareholder claims, and rules that sanction opportunistic behavior. However, if, despite all efforts at prevention, a risk has materialized, effective creditor protection calls for mechanisms and rules that minimize the losses incurred by existing creditors. This last line of defense requires, inter alia, rules that require the restructuring or winding-up of a financially distressed company, procedural rules that allow for a successful enforcement of creditors' claims against the company, its directors and shareholders, and appropriately designed bankruptcy proceedings.

The following observations will focus on prevention. In this context, legislators and courts have two basic strategies for creditor protection at their disposal: regulating structure and regulating behavior.

Providing for structural requirements in order to protect creditors acts as a risk-preventing mechanism. The most comprehensive structural approach to creditor protection would be to disallow corporations altogether or – for a slightly less intrusive option - to disallow limited liability. Far less heavy-handed variants of this regulatory strategy are capital requirements or the mechanism of the disqualification of directors.

A particular problem common to all these pre-emptive mechanisms is overshooting. It is notoriously difficult to calibrate these structural requirements in a way that neither prevents the coming into being of "desirable" risks nor allows for the existence of an "undesirable" risk. In other words, the costs of having such structural requirements may easily exceed the benefits that may result therefrom.

Regulating behavior to protect corporate creditors boils down to providing for legal standards of behavior for directors and shareholders. The sanctions attached to these standards can either take the form of civil sanctions, most often civil liability, or criminal fines and administrative sanctions. For a particular jurisdiction, the choice between these enforcement mechanisms will depend on numerous factors, e.g. legal traditions or whether criminal fines are reserved for highly unethical behavior or are perceived as being a regular enforcement alternative.

With respect to creditor protection, at least two factors, in particular, should be kept in mind. First, contrary to criminal or administrative sanctions, civil liability provides not only for ex ante incentives to comply with legal standards of behavior but also for compensation for losses suffered by the creditors. Moreover, the level of deterrence of criminal and administrative sanctions depends crucially on the amount of public resources, e.g. personnel etc., available for this purpose. By contrast, creditors are inherently given an incentive to spend their own funds on efforts to recover at least part of the money that is due to them. However, enforcement by private litigation only provides directors and shareholders with sufficient ex ante incentives to comply with the legally mandated behavioral standards if creditors are in a position to effectively enforce their claims. This

observation begs, for example, the question when and to what extent directors and shareholders should be liable only to the corporation and not to creditors directly, and whether the directors or the shareholders should be liable for opportunistic behavior on the corporation's part.

VIII. Reducing the risks of creditors when contracting with a financially distressed company

a. Mandatory disclosure unrelated to insolvency

Mandatory disclosure is universally acknowledged as an indispensable mechanism for creditor protection. More to the point, mandatory disclosure will often be a necessary prerequisite for creditor self-help, be it by way of abstaining from concluding a contract or by demanding an adequate risk premium, covenants and/or collateral. The difficult question, then, is the extent of disclosure required. From a repeat player's point of view, e.g. a creditor holding a diversified portfolio of claims, this should ideally be all the information needed to calculate the appropriate risk premium. However, this would imply a prohibitively costly obligation to make ongoing disclosure.

On the other hand, disclosure of the amount of nominal capital, as mandated by the Second Directive, does not help much in protecting creditors since they will not know whether the company's net assets still amount to the equivalent of the nominal capital, at least.[39]

From the creditors' point of view, the informational content of the annual accounts is much higher. Still, as experience shows, the publication of the annual accounts will not protect creditors as much as one may hope. In particular, this is true for small creditors. To name but three reasons: Annual accounts are published only once a year, for lack of time and transaction cost constraints, small creditors will often not bother to obtain the annual accounts, and even if they did, they would often lack the necessary knowledge and skills to analyze the accounts in sufficient detail.

Conversely, effective creditor protection by mandatory disclose will only be achieved if the following prerequisites are fulfilled:

- the information is easily available, e.g. via the Internet from the company's homepage or the commercial register,
- the information is renewed periodically, e.g. every three months,

[39] Mülbert, loc. cit n. 20, at p. 157.

- the information is standardized, i.e. all companies, inter alia, employ the same framework, e.g. standardized methodologies and calculations, and reporting format, and
- the information is easily understood and can easily be acted upon accordingly.

Against that backdrop, one may want to consider requiring the directors to periodically assess and publish the company's probability of default for a given timeline, e.g. within the next six months. However, assessing the risk of default is at best not an easy task. Smaller companies, in particular, will often lack the resources and ability to assess their own probability of default with any accuracy. Moreover, the higher the probability of default, the more directors would be tempted to lie, since it would be difficult to detect ex post whether the directors had lied about the probability of default or whether they had correctly calculated but were proven “wrong” by the subsequent developments. As a consequence, disclosure of more or less well informed guesses on one's own probability of default would not serve any meaningful purpose since potential creditors would not use them as a basis for their decision-making.

An apparently less demanding requirement would be to disclose periodically whether the company has sufficient working capital, i.e. whether the company is undercapitalized or not. However, since broadly or even universally accepted criteria for determining the amount of working capital required for a given company are not available,[40] a simple statement that the amount of working capital is “sufficient” would not be meaningful. Instead, creditors would want to know the amount of working capital available in order to decide for themselves whether the working capital is sufficient or not. This publication could be in the form of “in excess of … “, available on the corporation's homepage (with a reference contained in the company’s letterhead), and calculated four times annually.

The upshot is that the problem of creditor protection by efficient disclosure obligations - the benefits from having more extended disclosure obligations must still exceed the additional costs incurred by this – warrants still further exploration.

b. Insolvency-related mandatory disclosure

(1) German v. British law

Insolvency-related mandatory disclosure seems to be a particularly thorny issue. In this respect, German law and British law even adopt diametrically opposed disclosure philosophies.

[40] *Infra* IX.2.

German law, on the one hand, requires the directors of a company to file a petition in bankruptcy without undue delay, but within three weeks at the latest if the company has become insolvent because of illiquidity, i.e. inability to pay debts as they fall due (cash-flow test), or because of an excess of liabilities over assets (balance-sheet test).[41] Decisions by the bankruptcy court – be it the preliminary appointment of a "weak" administrator, the decision to open insolvency proceedings and to appoint an administrator or the decision not to open up the proceedings due to a lack of sufficient funds to cover the costs of the proceedings – will be entered into the appropriate commercial register for the company,[42] thereby informing the public about its financially distressed situation and warning potential creditors against entering into any contractual relationship with it. If, due to negligence or even intent, the directors fail to comply with the requirement, they will be held liable towards all creditors. However, if the company does enter into a contract with a new creditor during the three-week grace period, the directors are not obliged to inform the other party about the company's critical situation.[43]

British law, on the other hand, does not stipulate any obligation on the directors to file a petition in bankruptcy. However, it the company does go into insolvent liquidation (net asset test) a director will be held liable according to the provision on wrongful trading contained in Section 214 of the British Insolvency Act (hereafter, IA), if he did not take "every step with a view to minimizing the potential loss to the company's creditors as … he ought to have taken". Given this risk, directors will often decide to apply for a winding-up by the court (Sect. 122 IA) in order to avoid personal liability. Only then will all actual and potential creditors be informed about the company's critical financial situation.

Quite in line with these differences, German law and British law also differ with respect to damages awarded to those creditors who entered into a contractual relationship with the company after the pertinent "moment of truth". According to a landmark ruling by the German Federal High Court in the mid–1990s, (only) those creditors are indeed entitled to recuperate the total amount lost to the company: If they had known the company's distressed situation they would not have entered into a contract with the company.[44] British law, on the other hand, does not differentiate whether a person has become a creditor before or after the moment of truth.[45] This uniform treatment adequately

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[41] Sect. 64 Para. 1 Limited Liability Company Act (GmbHG), Sect. 92 Para. 2 German Stock Corporation Act

[42] Sect. 32 German Commercial Code.

[43] BGH of 6 June 1994 - II ZR 292/91, 48 *WM* (1994) pp. 1428-1436.

[44] BGH of 6 June 1994 - II ZR 292/91, 48 *WM* (1994) pp. 1428-1436. As to this concept, see H. Fleischer, 'The responsibility of the Management and of the Board and its Enforcement', in G. Ferrarini et al., eds., *Reforming Company and Takeover Law in Europe* (Oxford, Oxford University Press 2004) p. 373 at p. 399 et seq.; T. Bachner, 'Wrongful Trading – A New European Model for Creditor Protection?', 5 *EBOR* (2004) p. 293 at p. 317 et seq.

[45] See Fleischer, loc. cit. n. 44, at p. 398 (with further references).

reflects the position of British law that potential (voluntary) creditors are not in need of preventive protection by mandatory disclosure obligations.

(2) Timing

Taking the position of German law as starting point, i.e. opting for the protection even of potential voluntary creditors by mandatory disclosure obligations, begs the follow-up question as to the appropriate time for the start of such additional obligations.

German law has opted for the exact point in time at which the company becomes formally insolvent, but employs a two-pronged insolvency test: assets over liabilities and inability to pay.[46] If the company fails one of the two tests, directors are under an obligation to file a petition in bankruptcy.[47] By contrast, at least according to its wording and legislative intent, the British provision on wrongful trading contained in Sect. 214 IA has adopted a slightly earlier point in time, namely when a director knows that "there is no reasonable prospect that the company would avoid going into insolvent liquidation". One may doubt, though, whether this subtle difference between British and German law would matter much in practice.[48] Indeed, it may well be that Sect. 214 IA, as interpreted by British courts, only kicks in at a later stage than the German provisions requiring the directors to file a petition in bankruptcy. At least some British courts have held that the "moment of truth" has not yet come with an excess of liabilities over assets (balance-sheet test) but only when the company is unable to pay its debts as they fall due (cash-flow test) or have opted even for a latter point in time.[49]

Apart from these considerations the fundamental question remains, namely whether mandatory disclosure obligations should set in far earlier than provided for at present by German law, e.g. when the company is unable to obtain credit from third parties (i.e. non-shareholders), or, e.g., when it was "more likely than not" that the company would at some point become unable to pay its debts as they fell due. As has been well known for a long time, this problem amounts to an unavoidable choice between Scylla and Charybdis. A disclosure obligation that sets in early will prevent some people from becoming creditors at all, but the flipside is that financially distressed companies will stand a lower chance of a successful private workout, and vice versa. Given that, because of the lack of negative publicity and more flexibility, private workouts are increasingly recognized as a superior

[46] Sect. 17, 19 Insolvency Act.
[47] *Supra* n. 41 with accompanying text.
[48] Cf. M. Habersack and D.A. Verse, 'Wrongful Trading – Grundlage einer europäischen Insolvenzverschleppungshaftung?', 168 *ZHR* (Zeitschrift für das gesamte Handelsrecht und Wirtschaftsrecht) (2004) p. 174 at p. 186 et seq. and at p. 213 et seq.
[49] For an overview of relevant cases see Hirt, loc. cit. n. 30, at p. 106 et seq.; Bachner, loc. cit. n. 44, at p. 301 et seq.; Habersack and Verse, loc. cit. n. 48, at p. 186 et seq.

alternative to formal insolvency proceedings[50] disclosure obligations regarding the company's financial situation should not kick in any earlier than presently mandated by German law

IX. Reducing a company's probability of entering into financial distress

1. Legal capital

A comprehensive (German-style) legal capital regime comprises a whole set of statutory provisions and court-made rules.[51] They provide for a minimum capital, regulate the raising and maintenance of capital, and prohibit any circumvention of the statutory provisions on the raising and the maintenance of legal capital; the latter prohibitions are known in German law as the doctrine of disguised contributions in kind and the doctrine of disguised distributions.

The core element of any meaningful legal capital regime, as the authors of the Rickford Report aptly demonstrated by calling themselves the "Interdisciplinary Group on Capital Maintenance", consists in capital maintenance rules, i.e. restrictions on the distribution of company assets to shareholders. With respect to the protection of creditors, complicated rules on the raising of capital would serve no purpose if the company did not face any restrictions on the redistribution of assets received from shareholders to those shareholders.

The uncontested economic effect of any (mandatory or voluntary) capital reserve on the part of the company, i.e. a surplus of assets over liabilities, is to make the company less prone to become insolvent because of simple business misfortune or even exogenous shocks.[52] Put differently, rules restricting the distribution of assets reduce the likelihood of the insolvency of a venture by effectively binding all of the initial equity contribution to the venture. After all, it is true that *ceteris paribus* the lower the rate of debt to equity, the lower

[50] See, e.g., Eidenmüller, op. cit. n. 37, at p. 332 et seq.

[51] For a brief description on the basis of the pertinent Articles of the Second Directive see Mülbert and Birke, loc. cit. n. 1, at p. 700 et seq. Note, however, two qualifications: First, shareholders can dispose even of share premiums (contra Mülbert and Birke, loc.cit. n. 1, at p. 704; W. Schön, 'Deutsches Konzernprivileg und europäischer Kapitalschutz – ein Widerspruch?', in K.-H. Forster, et al., eds., Festschrift für Bruno Kropff (Düsseldorf, IDW-Verlag 1997) p. 285 at p. 294; M. Habersack, *Europäisches Gesellschaftsrecht*, 2nd edn. (München, C.H. Beck 2003) n. 164), since Art. 15 Para. 1 lit. c of the Directive allows for distributions made from reserves available for that purpose, and share premium reserves are available in this sence, since the share premium account is not part of the "subscribed capital" (see Rickford Report, loc. cit. n. 6, at p. 939 et seq.; T. Bezzenberger, *Das Kapital der Aktiengesellschaft* (Köln, Dr. Otto Schmidt 2005) p. 28 et seq.). Second, some EU Member States do not know (or accept?) the doctrine of disguised contributions in kind and the doctrine of disguised distributions (for the UK, see *infra* n. 65 et accompanying text). Telling in this respect the description of the EU legal capital regime by Enriques and Macey, loc. cit. n. 21, at p. 1174 et seq.

[52] See Mülbert and Birke, loc. cit. n. 1, at p. 718 et seq.; Mülbert, loc. cit. n. 20, at p. 154.

the chance of any insolvency of the firm. On the other hand, it is also true that capital maintenance rules, in particular, and the complex set of rules of a German-style legal capital regime, in general, do come at a cost. Most obvious are the costs of compliance for a company, perhaps most serious are the costs that the rules impose on firms by way of impeding or even blocking beneficial corporate transactions.[53]

Whether, in the name of creditor protection, the aforementioned and other economic effects do, on balance, justify a comprehensive – to the point of being hardly comprehensible any more[54] - German-style legal capital regime, or whether a much leaner set of rules will suffice, has lately been strongly contested outside the US, as well[55], and even among German lawyers.[56] Here below, the salient points of the discussion will be summarized.

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[53] For details see, e.g. Enriques and Macey, loc. cit. n. 21, at p. 1195 et seq.; Mülbert and Birke, loc. cit. n. 1, at p. 721 et seq.; Mülbert, loc. cit. n. 20, at p. 153; Ferran, loc. cit. n. 35, at p. 8 et seq. In addition, because of the recent ruling by the German Federal High Court severely restricting the scope for admissible up-stream loans (BGH of 24 November 2003 – II ZR 171/01, 58 *WM* (2004) p. 325) the setting up of a group-wide cash pool has become noticeably more difficult. See, e.g., W. Goette, 'Aus der neueren Rechtsprechung des BGH zum GmbH-Recht', 26 *ZIP* (Zeitschrift für Wirtschaftsrecht) (2005) p. 1481 at p. 1484 et seq.; M. Habersack and J. Schürnbrand, 'Cash Management und Sicherheitenbestellung bei GmbH und AG im Lichte des richterrechtlichen Verbots der Kreditvergabe an Gesellschafter', 7 *NZG* (Neue Zeitschrift für Gesellschaftsrecht) (2004) p. 689 et seq.; A. Cahn, 'Das richterrechtliche Verbot der Kreditvergabe an Gesellschafter und seine Folgen', 2 *Der Konzern* (2004) p. 235 et seq.; W. Bayer and J. Lieder, 'Darlehen der GmbH an Gesellschafter und Sicherheiten aus dem GmbH-Vermögen für Gesellschafterverbindlichkeiten', 34 *ZGR* (2004) p. 133 et seq.

[54] For diametrically opposing views see V. Röhricht, 'Insolvenzrechtliche Aspekte im Gesellschaftsrecht', 26 *ZIP* (2005) p. 505 at p. 515 (president of the Second Senate of the German Federal High Court, responsible for corporation law, till May 2005) and W. Goette, 'Wo steht der BGH nach "Centros" und Inspire Art"?', 43 *DStR* (Deutsches Steuerrecht) (2005) p. 197 at p. 198 (currently president of the Second Senate of the German Federal High Court).

[55] Enriques and Macey, loc. cit. n. 21, at p. 1165 et seq.; for the UK see Rickford Report, loc. cit n. 6, at p. 966 et seq.; Armour, loc. cit. n. 16, at p. 355 et seq.; Ferran, loc. cit. n. 35, at p. 10; for France see J. Simon 'A comparative approach to capital maintenance: France', 15 *EBLR* (2004) p. 1037 at p. 1040 (all parties concerned now agree that registered capital does not perform the functions assigned to it by the EU and national legislators).

[56] Critical as to the present German legal capital regime, e.g., F. Kübler, *Aktie, Unternehmensfinanzierung und Kapitalmarkt* (Köln, Dr. Otto Schmidt 1989); same, 'Kapitalmarktgerechte Aktien?', 44 *WM* (1990) p. 1853 et seq.; same, 'The Rules of Capital Under Pressure of the Securities Markets', in K.J. Hopt and E. Wymeersch, eds., *Capital Markets and Company Law* (Oxford, Oxford University Press 2003) p. 95 et seq.; same, 'A comparative approach to capital maintenance', 15 *EBLR* (2004) p. 1031 et seq.; Mülbert and Birke, loc. cit. n. 1, at p. 716 et seq.; Mülbert, loc. cit. n. 20, at p. 154 et seq.; R. Kulms, 'Die US-amerikanische Limited Liability Company – Vorbild für eine deregulierte GmbH', 102 *ZVglRWiss* (Zeitschrift für vergleichende Rechtswissenschaft) (2003) p. 272 at p. 285; S. Grundmann, 'Wettbewerb der Regelgeber im Europäischen Gesellschaftsrecht – jedes Marktsegment hat seine Struktur', 30 *ZGR* (2001) p. 783 at p. 816 et seq.; cf. Röhricht, loc. cit. n. 54, at p. 515; in defense of the existing legal capital regime see, in particular, Arbeitsgruppe Europäisches Gesellschaftsrecht 'Stellungnahme zum Report of the High Level Group of Company Law Experts on a modern Regulatory Framework for Company Law in Europe', 24 *ZIP* (2003) p. 863 at p. 871 et seq.; as to individual members of the working group see, e.g., M. Lutter, 'Gesetzliches Garantiekapital als Problem europäischer und deutscher Rechtspolitik', 43 *AG* (Die Aktiengesellschaft) (1998) p. 375 et seq.; Karsten Schmidt, *Gesellschaftsrecht*, 4th edn. (Köln, Carl Heymanns 2002) § 18 II 2 c (p. 519); H. Fleischer, Grundfragen der ökonomischen Theorie im Gesellschafts- und Kapitalmarktrecht', 30 *ZGR* (2001) p. 1 at p. 13 et seq.; W. Bayer, 'Die EuGH-Entscheidung "Inspire Art" und die deutschen GmbH im Wettbewerb der europäischen Rechtsordnungen', 39 *BB* (Betriebs-Berater) (2003) p. 2357 at pp. 2364 and 2366; see further Schön, loc. cit. n. 37, at p. 431 et seq. (except for the minimum capital requirement);

a. Minimum capital

Minimum capital requirements come in two forms; initial and ongoing minimum capital.

(1) Initial minimum capital requirement

An initial minimum capital requirement is increasingly regarded as a preventive mechanism that does not serve a useful function,[57] even among German scholars.[58] First, if the required amount is too high, even economically beneficial projects will be deterred, whereas if the amount is too low, the requirement does not perform any screening function since practically anybody will have access to the funds necessary. Second, a uniform minimum capital requirement lacks any economic rationale since, for a given amount of working capital companies operating in different lines of businesses will not exhibit a uniform probability of insolvency. Third, regardless of the amount chosen, a minimum capital requirement will not prevent a company from becoming insolvent as a result of ongoing poor management or ongoing poor business conditions since, in the course of time, continuous losses will inevitably deplete all a company's assets. Insolvency may just be somewhat farther down the road.[59]

Proponents of a minimum capital requirement may respond by arguing as follows: An entrepreneur with a viable business project who lacks the necessary funds to comply with a minimum capital requirement will often be able to get credit financing. Since the prospective creditor will screen the business proposal relatively carefully, he will act as a gatekeeper selecting economically promising projects. Admittedly, the gatekeeper will turn down some viable prospects, and the screening process itself entails transaction costs.

H.J. Priester, 'Die deutsche GmbH nach "Inspire Art" – brauchen wir eine neue?', 58 *DB* (Der Betrieb) (2005) p. 1315 et seq.; Bezzenberger op. cit. n. 51, at p. 72 et seq.; R. Wilhelmi, 'Das Mindestkapital als Mindestschutz – eine Apologie im Hinblick auf die Diskussion um eine Reform der GmbH angesichts der englischen Limited' 97 *GmbHR* (2006) p. 13 et seq.; S. Rammert, 'Lohnt die Erhaltung der Kapitalerhaltung', 56 *BFuP* (Betriebswirtschaftliche Forschung und Praxis) (2004) p. 578 at p. 591 et seq.; Hennrichs, loc. cit n. 37, at p. 256 et seq.

[57] Davies, op. cit. n. 3, at p. 229 et seq.; Easterbroook and Fischel, op. cit. n. 3, at p. 60; Enriques and Macey, loc. cit n. 21, at p. 1185 et seq.

[58] Mülbert, loc. cit. n. 20, at p. 157 et seq.; Schön, loc. cit. n. 37, at p. 439 et seq.; H. Eidenmüller, 'Europäisches und deutsches Gesellschaftsrecht im europäischen Wettbewerb der Gesellschaftsrechte', in S. Lorenz, et al., eds., *Festschrift für Andreas. Heldrich* (München, C.H. Beck 2005) p. 581 at 593; B. Grunewald and U. Noack, 'Zukunft des Kapitalerhaltungssystems der GmbH – Ein-Euro-GmbH in Deutschland', 96 *GmbHR* (2005) p. 189 et seq.; G.H. Roth, 'Gläubigerschutz bei der GmbH: Was ist unverzichtbar?' in S. Kalss, et al., eds., *Festschrift für Peter Doralt* (Wien, Manzsche Verlags- und Universitätsbuchhandlung 2004) p. 479 at p. 482 et seq.; in favor of a minimum capital requirement, e.g., Arbeitsgruppe Europäisches Gesellschaftsrecht, loc. cit. n. 56, at p. 872; ambiguous H. Eidenmüller and A. Engert, 'Rechtsökonomie des Mindestkapitals im GmbH-Recht', 96 *GmbHR* (2005) p. 433 et seq.

[59] Mülbert and Birke, loc. cit. n. 1, at p. 719; Mülbert, loc. cit. n. 20, at p. 155.

Still, on balance, the benefits from having excluded some non-viable projects may exceed these costs.

However, on closer inspection, this argument is flawed. In order to start doing business, the entrepreneur needs some operating capital. Hence, he has to obtain credit financing anyway, and the financier will act as a gatekeeper, regardless of whether the law requires a minimum capital or not. Moreover, informational asymmetries between the entrepreneur and the financier, e.g. regarding his abilities and the viability of the project do impair the gatekeeper function, regardless of whether the entrepreneur needs the funds in order to pay his contribution in cash or to extend credit to the company in need of working capital.

The upshot, then, is that a minimum capital requirement only deters those individuals from setting up a company who are not willing to commit enough own funds – be it as a cash contribution/contribution in kind or as collateral for bank financing – to meet the capital requirement. However, one may doubt whether, in practice, this deterrent effect will often result from a prospective founder's more careful assessment of the viability of the business project or instead from his unwillingness to put financial assets as well as human resources at risk.

(2) Ongoing minimum capital requirement

Various EU Member States provide for an ongoing minimum capital by prescribing a recapitalization rule.[60] Typically, the shareholders will have to recapitalize the company if the net assets fall below a threshold of 50 % of the company's nominal capital. If they fail to comply, the company will be dissolved by law.

On a theoretical level, the economic effects of such rules are rather complex. At first glance, the rules seem to clearly reduce the probability of insolvency since, in the event of a company's suffering ongoing smaller losses due to unsuccessful management or long-lasting poor business conditions, the rule will require shareholders to react long before the company approaches insolvency. On the other hand, any recapitalization rule provides shareholders with an incentive to choose a nominal capital figure that is as low as possible, since that will facilitate any possible future recapitalization and will reduce the chances that a shareholder will not be able to partake in the recapitalization because of a lack of funds. As a consequence, companies may become more prone to insolvency because of exogenous shocks. Moreover, investors may be less willing to invest in share

[60] See J. Oelkers, 'Mindestkapital und Nennkapital – Leistungskraft für den Gläubigerschutz (Teil II)', 34 *GesRZ* (Der Gesellschafter) (2005) p. 27 et seq. for a comprehensive overview of the pertinent Member State rules. For a critical assessment of this mechanism see Enriques and Macey, loc. cit. n. 21, at p. 1201 et seq.

capital. If a recapitalization did become necessary and shareholders were unable to provide the required funds, the business venture would have to be liquidated, either by closing it down altogether or by selling it off. Both occurrences would have a negative effect on shareholders' future earnings, i.e. lower the expected rate of return for share investments. For this and related reasons, one Nordic country is in the process of reviewing its rules on recapitalization.

b. Limitations on asset distributions to shareholders

(1) General observations

As noted above, limitations on the permissible distribution of assets to shareholders are a core element of any legal capital regime. However, as the rules relating to the British private limited company and US corporation law, e.g., Sect. 6.40 of the Revised Model Business Corporate Act, demonstrate, prohibitions limiting the distribution of assets specifically to the shareholders as members of the company can also exist quite independently from the concept of legal capital. Moreover, these jurisdictions as well as, for example, German law provide for additional restrictions on distributions in the form of fraudulent transfer rules, either solely as part of insolvency law (England) or also as a separate statute (Germany, US[61]). In effect, regardless of whether they provide for a legal capital or not, virtually all industrialized countries' jurisdictions stipulate rules as part of corporation law and outside corporation law that limit the admissible amount of dividend payments or other forms of distributions of assets to shareholders.[62]

Major differences do, however, exist with respect to the minimum amount of assets that may not be distributed to the shareholders in order to prevent[63] the company from becoming financially distressed. Restrictions on "fraudulent transfers", that often complement the restrictions contained in company law proper, do not significantly alter the incoherent picture.[64] Differences exist within the US between the corporation laws of some

[61] For an outline of the US fraudulent transfer laws see M. Kahan, 'Legal Capital Rules and the Structure of Corporate Law: Some Observations on the Differences Between European and U.S. Approaches' in K.J. Hopt and E. Wymeersch, eds., *Capital Markets and Company Law* (Oxford, Oxford University Press 2003) p. 145 et seq. For a brief sketch of the interaction between the restrictions stipulated by the RMBCA and bankruptcy and fraudulent transfer law respectively see Mülbert, loc. cit. n. 20, at p. 160.

[62] The point is rightly stressed by the Rickford Report, loc. cit. n. 6, at p. 999 et seq.

[63] Prevention as the overriding goal of capital maintenance rules is completely missed by those (e.g., F. Rüffler, 'Gläubigerschutz durch Mindestkapital und Kapitalerhaltung in der GmbH – überholtes oder sinnvolles Konzept?', 4 *GeS* (Zeitschrift für Gesellschafts- und Steuerrecht) (2005) p. 140 at p. 146) who maintain that these rules provide for very efficient creditor protection if they are effectively enforced, "in particular by liquidators in case of insolvent liquidation".

[64] For an overview of statutory limitations to permissible distributions existing in major jurisdictions see Rickford Report, loc. cit. n. 6, at p. 969 et seq. and at p. 1004 et seq. See also J. Vetter, 'Grundlinien der GmbH-Gesellschafterhaftung', 34 *ZGR* (2005) p. 788 at p. 802 et seq.

States, to a larger degree within EU Member States with regard to limited liability companies, at least, and are most pronounced between the US and Member States of the EU. Contrary to conventional wisdom, for example, the British law on the private limited company provides for stricter limitations than the German statute on the GmbH. A private limited company's distributions to its shareholders are restricted to retained earnings, whereas distributions by a GmbH are permissible as long as the company retains assets the value of which corresponds to the nominal capital figure shown on the balance sheet, at least. On the other hand, German law is much stricter with respect to so-called disguised asset distributions, i.e. distributions by means of a contract that is unusually favorable to the shareholder, e.g. favorable intra-group transfer pricing. While German law – in line with the Second EC Directive on company law – completely prohibits disguised distributions by a stock corporation and limits such distributions by a GmbH in accordance with the balance sheet test, British law is probably much more lenient. In particular, the pending Company Law Reform Bill provides for two new sections – s. 275a and s. 280a – to be introduced in the Companies Act 1985 in order to remove doubts to which the decision in Aveling Barford Ltd. v. Perion Ltd. [1989] BCLC 626 has given rise about when a transfer of an asset to a member amounts to a distribution. These new clauses preserve the position in the Aveling Barford case such that where a company that does not have distributable profits makes a distribution by way of a transfer of assets at undervalue, this will be an unlawful distribution. If, however, a company does have distributable profits, the amount of any distribution arising from the sale, transfer or other disposition of a non-cash asset to a member of the company should be calculated by reference to the “book value”, i.e. if an asset is transferred for a consideration equal to its book value, the amount of the distribution is zero”.[65]

(2) The bottom-line test

Except for the Rickford Report, the internationally acknowledged bottom-line test for permissible distributions is a two-part distribution test. Leaving all important details aside, this adds up to the requirement that, immediately after a distribution has been made, the company’s assets must still exceed its liabilities (net asset or balance sheet test), and that the company will be able, as a going concern, to meet its debts as they fall due for the foreseeable future (cash flow test). In contrast, the Rickford Report proposes having a two-part solvency test: short-term solvency and long-term solvency.[66]

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[65] Explanatory Notes Company Reform Law Bill [HL] as of 1 November 2005 [HL Billl 34] n. 1048 et seq.
[66] Rickford Report, loc. cit n. 6, at p. 979 et seq.; concurring Ferran, loc. cit. n. 35, at p. 29.

Given the two-part distribution test, among the important "details" with respect to the net asset test is the valuation issue. The relevant question, phrased from the perspective of German law, then is whether the general principles and rules for preparing the annual accounts should apply or, arguably, those for drawing up the balance sheet governing whether a company has to file a petition in bankruptcy because of an excess of liabilities over assets? Another question is whether only to allow "open" distributions, i.e. in the main, dividend payments and share buy-backs, or also disguised distributions in the form, for example, of intra-group transactions based on centrally fixed transfer prices. From the perspective of the bottom-line test the latter seems to be the case. Then, however, contrary to the recommendations of the High Level Group[67] and the Interdisciplinary Group on Capital Maintenance[68], a lawful distribution of assets to shareholders cannot depend on the prior drawing up of a formal solvency statement. Compliance with a requirement to draw up a solvency statement for every intra-group transaction would not be possible in practice.

(3) Providing for stricter limitations?

The economic rationale[69] for an even stricter limitation of admissible distributions is weak, at best.[70] If a company becomes insolvent for reasons other than an inadmissible distribution, the remaining assets will normally not cover its liabilities. By definition, this is true if insolvency law (also) applies a net asset test, i.e. if an excess of liabilities over assets triggers insolvency. Moreover, if a company lacks a profitable business model and/or a capable management, stricter limitations on the distribution of assets only work to the effect that it will take longer for the company to become insolvent. Creditors will still be hurt, even though that will be a different population of creditors.[71] Hence, the only relevant effect of any such stricter limitation is to lower the probability of a company's becoming insolvent because of an isolated exogenous shock. Whether this theoretical effect is also of practical importance is, however, difficult to ascertain. Statistical evidence is not available. Casual empiricism suggests that US companies are not significantly more prone to become insolvent because of exogenous shocks than their German counterparts.

[67] See *supra* n. 5 with accompanying text.
[68] Rickford Report, loc. cit. n. 6, at p. 972 et seq. and at p. 979 et seq.
[69] Qualifying the maintenance rules contained in the Second Directive (Art. 15) and the German Stock Corporation Act (Sect. 57 et seq.) as an optional collective guarantee against distributions that is provided by the shareholders (Schön, loc. cit n. 37, at p. 440 et seq.) neither explains the underlying economic rationale nor the legal mechanism at work, since creditors will not obtain a direct (contractual?) claim against the shareholders. See also Merkt, loc. cit n. 37, at p. 319 et seq.; same, loc. cit. N. 37, at p. 1055.
[70] As to the following, see Mülbert, loc. cit. n. 20, at p. 154 et seq.
[71] See also *supra* V.1.

Admittedly, creditors in the US often impose financial covenants that provide for rules on the limitation of distributions by the company that are somewhat similar to the rules on distributions stipulated by the Second Company Law Directive.[72] Thus, the lack of statistical evidence could also be due to the fact that German companies and their US counterparts face similar restrictions, albeit imposed by different legal mechanisms. However, even if this explanation did hold true - which one may question anyhow, since financial covenants even in standardized form[73] were known in the US long before the Revised Model Business Corporation Act paved the way to the widespread abolition of legal capital[74] -, it would not serve as an argument for mandatory limitations on the distribution of assets above the bottom-line test. Mandatory rules are only called for if private contracting would produce only less efficient solutions, e.g. because of prohibitive transaction costs or adverse selection problems. Since voluntary creditors of European companies are as free to impose financial covenants as creditors of US companies[75] and since covenants are costly to contract and do not protect free-riding "weak" creditors as well as the party to the covenant[76], the lack of statistical evidence on the superior welfare effects of statutory restrictions on distributions may even serve as an argument against mandatory rules providing for limitations beyond the bottom-line test just prescribed.

Involuntary creditors, such as tort creditors, on the other hand, are much better served by other approaches to creditor protection.[77] The most promising mechanism in this respect is compulsory third party insurance,[78] offering the additional advantage of giving the company an incentive to reduce the riskiness of its business, whereas according tort creditors super-priority in bankruptcy proceedings will not offer a solution if the insolvent company is left without any assets anyway. Indeed, compulsory third party insurance may even offer a superior solution with respect to weak creditors such as, e.g., employees or small savers. With respect to these weak creditors, even Germany did not rely on creditor protection by a comprehensive legal capital regime, but decided decades ago to introduce compulsory insurance for employees' pension benefit plans and deposit insurance.

Recently, some proponents of German-style legal capital have resorted to a very different argument. Directors who are under pressure from shareholders to make a distribution will be in a much better position to withstand this pressure if they can point to a

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[72] *Supra* VI.
[73] See *supra* VI.
[74] Mülbert, loc. cit n. 20, at p. 157.
[75] Admittedly, in Europe, financial covenants did not see a widespread use in the domestic context but changes may be under way even on the Continent. See Kuhner, loc. cit. n. 30, at 785; Ferran, loc. cit. n. 35, at p. 6, and the studies cited by them.
[76] *Supra* VI.
[77] For a brief overview on possible mechanisms see Hertig and Kanda, loc. cit. n. 10, at p. 77.
[78] See in more detail, e.g., Armour, loc. cit. n. 16, at p. 372; Mülbert, loc. cit n. 20, at p. 157.

balance-sheet test based on the traditional (conservative) accounting principles of the German Commercial Code (hereafter, HGB) instead of to a solvency test, since limitations on distributions derived from German-style balance-sheet figures have been less prone to subjective interpretation or even manipulation,[79] and, thus, provide for more legal certainty.[80] However, to begin with it still remains to be seen whether, in the future, German companies will still be allowed to draw up an individual company's balance sheet in accordance with the HGB principles, or whether the legislator will extend the use of the International Financial Reporting Standards (IFRS) from group level to that of individual companies. Moreover, very often, particularly in case of small companies which are dramatically more prone to become insolvent than large ones, the director(s) will be shareholders, as well. Given such a structure, strengthening the position of directors towards shareholders is a pointless solution. Finally, above all, the argument does nothing to demonstrate that stricter limits on permissible distributions would be economically beneficial. At best, it implies that the net asset test component of a two-part distribution test should be based on the accounting rules and principles presently contained in the HGB[81] – and one may doubt even this conclusion, since less precise standards may cause shareholders to refrain from distributions in opaque situations thereby generating a higher level of creditor protection[82].

The upshot, then, of the foregoing discussion is that mandatory restrictions for the distribution of company assets should be limited to a two-part distribution test. As a corollary, given such a simplified system of capital maintenance, any complicated rules on the raising of capital as, in particular, developed by the German Federal High Court, are dispensable, at least for the purpose of credit protection.

2. “Sufficient” working capital (undercapitalization)

The judge-made doctrine of piercing the corporate veil because of undercapitalization, from a functional perspective, aims at establishing a particular structure, namely a corporation having “sufficient” working capital in relation to its business activities to lessen the probability of a company's becoming insolvent because of exogenous shocks. Hence, in parallel to the statutory mandated minimum capital requirement, courts may decide to lift the veil not only, if, at any time after incorporation, the company’s assets were manifestly

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[79] Schön, loc. cit n. 37, at p. 448 et seq.; cf. Rammert, loc. cit. n. 56, at p. 591.
[80] Providing for legal certainty is a paramount concern among German discussants, cf. Lutter, loc. cit n. 56, at p. 377; Rüffler, loc. cit. n. 63, at p. 145 et seq. and at p. 148.
[81] For additional counter-arguments see Mülbert, loc. cit. n. 20, at p. 160 et seq.
[82] Kuhner, loc. cit. n. 30, at 778 et seq.

insufficient with respect to its business activities but also, if the company's insufficient capital basis already existed at the time of incorporation.

Moreover, subsequent undercapitalization may not only result from losses the company incurred because of previous business activities, but also from a shift to a much riskier business strategy. Consider, for example, the case of a limited liability company that just meets the minimum capital requirement but forms part of a well-known group, and engages in trading commodities to the extent of holding, at one (final) point in time, a bundle of commodity contracts, the volume of which exceeded EUR 250 million. Obviously, such a shift to a far riskier business strategy may lead to undercapitalization, as well. The company's working capital, even without suffering any decrease will then be "insufficient" in relation to the company's business activities.

The pros and cons of of piercing the veil because of undercapitalization have been widely discussed for a long time. To this day, the main counter-argument results from the fact that there is no broad or even nearly universal consensus among economists (and lawyers) as to how to determine the working capital necessary for a given corporation. More to the point: the concept of "sufficient" working capital, prescribed by statutory law or derived from court decisions, is not workable - either in theory or in practice. Depending on the individual risk preference, shareholders who are more risk averse will be given the incentive to inject excess capital while those who are less risk-averse will still not inject enough capital to escape liability. In addition, even given a working capital that the courts or statutory provisions deem "sufficient", more risk-averse creditors, had they known about the true state of the company, would not have concluded a contract with the company or, at the very least, would have demanded a higher risk premium than the premium contracted. Conversely, those creditors who did know the actual amount of working capital available or who did not care to collect any pertinent information will benefit from a windfall profit if it comes to a piercing of the corporate veil.

Hence, the concept of "sufficient" working capital serves less to provide for reliable ex ante incentives for shareholders' behavior than to provide courts with a means for ex post intervention in extreme cases based on notions of fairness.[83] Up to now, the German Federal High Court has refrained from piercing the corporate veil because of a company's undercapitalization[84] whereas British courts[85] and US courts, in particular, show somewhat

[83] Mülbert and Birke, loc. cit. n. 1, at p. 725.
[84] As to this see W. Goette, *Die GmbH*, 2nd edn. (München, C.H. Beck 2002) § 9 n. 45 (p. 346); M. Gehrlein, *GmbH-Recht in der Praxis* (Frankfurt am Main, Recht und Wirtschaft 2005) p. 378. However, among legal scholars, the doctrine is finding increasing acceptance. See, e.g., Habersack and Verse, loc. cit. n. 48, at p. 210 (with further references); contra, e.g., Hueck and L. Fastrich, '§ 5 n. 6', in A. Baumbach and A. Hueck, *GmbH-Gesetz*, 18th edn. (München, C.H. Beck 2006); H. Eidenmüller and A. Engert, 'Die angemessene Höhe des Grundkapitals', 50 *AG* (2005) p. 97 at p. 100; Vetter, loc. cit. n. 64, at p. 817 et seq..
[85] See Davies, op. cit. n. 3, at p. 189

less reserve in this regard. A superior alternative may be an obligation to disclose information on the working capital available on a more or less ongoing basis.[86]

3. Subordination of shareholder claims

Subordination of shareholder claims is a mechanism for creditor protection that has gained widespread acceptance only within the last three decades. Known as ´recharacterization in the US, it is Germany that has developed the most complex set of rules of and the most extensive practical experience with regard to subordination. In recent years, Austria, Italy and Spain have followed the German example by introducing statutory provisions on subordination. On the other hand, to this day, British law provides for the possibility of subordination only as a consequence of fraudulent trading and wrongful trading, i.e. as a sanction against directors and not against shareholders as members of the company.[87]

a. The German subordination regime

German law on the subordination of shareholder claims comprises an intricate set of rules, or, to be more precise, two sets of rules.[88] This dualism has prevailed to this day because of the substantial differences between the two sets. Regarding the limited liability company, the German Federal High Court started to practice subordination in its present form in 1979, and the legislator, taking up judicial guidance, introduced statutory provisions on subordination already in 1980. However, since these provisions are less stringent than the court-made rules, in a subsequent ruling, the German Federal High Court decided to apply both sets in parallel, instead of deferring to the legislator. Since then, the legislator has slightly amended the statutory provisions.[89] The resulting regime in its present form can be roughly sketched like this:

Both sets of rules apply if a shareholder of a limited liability company, as a rule, owns more than 10 % of the membership rights, or if a shareholder of a stock corporation is not only a passive finance investor but pursues an entrepreneurial interest, i.e. if, as a rule, a shareholder owns at least 25 % of stock. Transactions covered are a shareholder loan extended to the company but also equivalent financing techniques, i.e. if the shareholder refrains from cashing in a claim against that company that has fallen due (“Stehenlassen”),

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[86] See *supra* VIII.1.
[87] For opposition to a subordination of shareholder claims in the British context see Rickford Report, loc. cit. n. 6, at p. 985.
[88] See, e.g., A. Hueck and L. Fastrich, ’notes on §§ 32, 32b’, in A. Baumbach and A. Hueck, *GmbH-Gesetz*, 18th edn. (München, C.H. Beck 2006); M. Lutter and P .Hommelhoff, ’notes on §§ 32, 32b’, in same, *GmbH-Gesetz*, 16th edn. (Köln, Dr. Otto Schmidt 2004).
[89] The relevant provisions currently are Sect. 32a, 32b of the Limited Liability Company Act (GmbHG), Sect. 39 Para. 1 No. 5, 135 of the Insolvency Act, Sect. 6 of the Fraudulent Transfer Act (“Anfechtungsgesetz”).

or if the shareholder supplies a security for the company's third-party credit financing. Moreover, said "transactions" must have occurred while the company was in financial distress ("Krise"), or, to be more precise, at a time when the company is not in a position to obtain credit from unrelated third parties at arm's-length conditions, and subsequently, the company must not have left the zone of financial distress.

Given these facts, the consequences vary according to the exact set of rules in question. The *statutory* provisions do provide for subordination in insolvency proceedings (Sect. 39 Para. 1 No. 5 Insolvency Act) of any claims that result from said "transactions" but do no prohibit the repayment of a subordinated claim before the opening of insolvency proceedings by the court. However, they entitle the liquidator to mount a challenge to the repayment and to recover the funds on behalf of the company's assets if the repayment occurred during the time of the company being in financial distress ("Krise"); as a corollary, the fraudulent transfer act enables such a challenge to be mounted on behalf of creditors when formal insolvency proceedings do not take place.

The *court-made* provisions do not only provide for subordination (Sect. 39 Para. 1 No. 5 Insolvency Act), but also prohibit any repayment as long as the company is in financial distress. They even entitle the company to recover any paybacks on subordinated loans that occurred during the last five years. On the other hand, in contrast to the situation under the statute, the prohibition on repayments and the possibility to recover pertinent paybacks is limited. The court-made rules apply only insofar, as, because of the (intended) repayment, the value of the company's remaining assets is (will be) less than the nominal capital figure shown on the balance sheet.[90]

To this day, the entrenched German Federal High Court notwithstanding, doubts as to the merits of subordination do persist. Criticism is leveled at the Court's insistence to apply the court-made rules alongside the statutory provisions,[91] and at the arguments employed by the Court to justify these rules. In addition, the legal rationale[92] as well as the economic rationale[93] is still contested. With respect to latter, some even question whether a valid economic rationale for subordination does exist at all.[94] In part, at least, even the

[90] The limitation results from the court's approach to derive the rules on subordination from Sect. 30 and 31 Limited Liability Act, i.e. the statutory provisions on distributions. See *infra* IX1.b.(1) on the statutory restrictions for distributions under Sect 30 of the Act.
[91] See, e.g., L. Fastricht, 'Ketzerisches zur sogenannten Finanzierungsverantwortung', in M. Lieb et al., eds., *Festschrift für Wolfgang Zöllner*, *Vol. I* (Köln, Carl Heymanns 1999) p. 143 at p. 159; T. Bezzenberger, 'Kapitalersetzende Gesellschafterdarlehen im Recht der GmbH', in H.P. Westermann, et al., eds., *Festschrift für Gerold Bezzenberger* (Berlin, de Gruyter 2000) p. 23 at p. 45; Grunewald and Noack, loc. cit. n. 56, at p. 194.
[92] For a brief discussion of the different arguments submitted see A. Cahn, 'Gesellschafterfremdfinanzierung und Eigenkapitalersatz', 50 *AG* (2005) p. 217 at p. 218 et seq.
[93] See, e.g., Cahn, loc. cit. n. 92, at p. 222 et seq.; A. Engert, 'Die ökonomische Begründung der Grundsätze ordnungsgemäßer Unternehmensführung', 33 *ZGR* (2004) p. 813 at p. 816 et seq., cf. Bezzenberger, loc. cit. n. 91, at p. 38 et seq.
[94] See, e.g., Eidenmüller, loc. cit. n. 37, at p. 389 et seq.; Bezzenberger, loc. cit. n. 91, at p. 34 et seq.

German legislator seems to concur. In 1998, it amended Sect. 32a of the Limited Liability Company Act (GmbHG) to the effect, that claims of shareholders who own 10 % or less of the GmbH and who do not hold the office of a director, are exempt from subordination, and that even a general exemption applies if the creditor acquires shares to operate a financial reorganization of the company. Finally, as a kind of collateral damage caused by above mentioned three decisions of the European Court of Justice – Centros, Überseering and Inspire Art -, German lawyers are currently debating whether the two sets of rules form a part of company law or of insolvency law.[95] Arguably, the first is true for the court-made rules, whereas the statutory provisions contained in the Limited Liability Act should probably to be qualified as insolvency law.

b. The economic rationale

The comprehensive German rules on subordination, and, indeed, probably all of the existing subordination regimes, are not to be explained by a single rationale but require a two-part explanation.

(1) Restrictions on repayments of shareholders loans

Restrictions on repayments of shareholders loans, be it an outright prohibition or a fraudulent transfer control, i.e. provisions that enable a challenge to be mounted in favor of the company's assets or in favor of creditors, serve to prevent opportunistic behavior by shareholders, often based on inside information. Shareholders who know or have reason to suspect, at least, that the company is approaching insolvency, are prevented from realizing their claims as creditors ahead of other creditors. Moreover, when the company is in distress any repayment will act as a further drain on its liquidity and will push it closer to insolvency. Thus, restrictions on repayments serve to eliminate shareholders' informational advantages over other creditors. In addition, if shareholders are not in a position to realize their claims ahead of other creditors, thereby aggravating the company's liquidity problems, the company's probability of insolvency will be slightly lower. To achieve these economically beneficial effects, private contracting is not readily available since private ordering would require an agreement between shareholders and all other creditors.

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[95] See, e.g., Röhricht, loc. cit. n. 54, at p. 505 et seq.: U. Haas, 'Der Normzweck des Eigenkapitalersatzrechts', 4 *NZI* (Neue Zeitschrift für Insolvenzrecht) (2001) p. 1 et seq.; J. Oechsler, 'Der Kapitalersatz als Kreditsicherheit', 169 *ZHR* (2005) p. 61 at p. 62 et seq.; K. Schmidt, 'Vom Eigenkapitalersatz in der Krise zur Krise des Eigenkapitalersatzrechts? Betrachtungen zu §§ 32a, b GmbHG, §§ 129a, 172a HGB, §§39, 135 InsO', 96 *GmbHR* (2005) p. 797 at p. 805 et seq.

Admittedly, for this mechanism to be fully effective, an ex post fraudulent transfer control does not suffice.[96] This would even hold true if one were to extend the possibility to mount a challenge to all repayments to shareholders that have occurred within the last year or even two to three years before insolvency or, under the German system, before the filing of a petition in bankruptcy.[97] Instead, repayment of shareholder's credit financing must be prohibited as long as the company is in financial distress. Otherwise, shareholders would be even more strongly incentivized to obtain a repayment and hope for the best, i.e. that the liquidator or the creditors will not take note of the transaction or that they will not be willing or able to enforce repayment etc.

b. Subordination as such

Subordination as such presents a far more difficult case to justify. Obviously, other creditors will benefit, since, because of subordination, they will receive (slightly) higher dividend payouts. Given that, one may argue that the differential will compensate those shareholders, at least in part, for any losses they suffered from a reduction of the dividend due to the fact that the financially distressed company, because of shareholder credit financing, was able to continue its business activities somewhat longer before becoming insolvent.

However, this line of reasoning offers, at best, an ex post rationalization when the company, despite a shareholder loan, goes bankrupt anyway, but does nothing to explain the economic effects in case of a successful reorganization of the company. Indeed, any meaningful explanation must concentrate on the ex ante incentives of subordination for shareholders as potential creditors (and for other creditors).

To begin with, the ex ante incentives resulting from the threat of future subordination are often small anyway, if the company, upon insolvency, is only left with negligible assets or even no assets at all. In the case of the German GmbH, this is true for around 50 % of all companies going bankrupt. Admittedly, some shareholders of such companies may even have been apprehensive of subordination. But still, it does seem fair to assume that, in a fair number of cases, the threat of subordination does not operate as an effective deterrent.

Apart from that, for at least two reasons, shareholders will often be willing to extend credit to the company, even though third-party creditors are no longer willing to take the risk: informational asymmetries and different incentive structures. Shareholders as insiders will sometimes be in a position to identify options for a company's successful

[96] Contra, e.g., Fastricht, loc. cit. n. 91, at p. 157; Bezzenberger, loc. cit. n. 91, at p. 49 et seq.
[97] In favor of such a one-year clawback-solution, e.g., Röhricht, loc. cit. n. 54, at p. 513.

reorganization that third parties will not. In addition, shareholders face a different incentive structure from third-party creditors. In contrast to the latter, they will not only benefit from a successful reorganization in the form of interest paid by the company, but also from their stake in the company gaining in value. Thus, their upside in a successful reorganization is much higher than that of other creditors. Conversely, they will be willing to extend credit to the company under more favorable conditions, i.e. at lower interest rates, than third parties or/and given a higher risk of insolvency.

Against this backdrop, some consider subordination as an effective mechanism for creditor protection by arguing that subordination helps to control shareholders' preference for the company to take on ever more risk in the vicinity of insolvency.[98] Because of the threat of subordination, shareholders will sometimes decide not to extend credit at all, or at least, they will prefer the company to pursue less risky business projects than otherwise, thereby reducing the probability of default.

However, consider an alternative scenario. Shareholders are interested in maximizing the expected pay-off from extending a credit to the company. Now, since subordination will result in a lower (nil!) payout to shareholders if the company does become insolvent, ex ante they may prefer to allow the company to take on even more risk. Thus, ex ante, the lower pay-off in insolvency will be compensated for by a higher pay-off in case of a successful reorganization. If this scenario were true, subordination would incentivize shareholders to pursue even riskier strategies than without subordination.

The actual strategy chosen by shareholder-creditors will depend on their appetite for risk. At all events, it is submitted here, that the overall ex ante incentives of subordination are, at best, difficult to discern and may even be harmful. Thus, subordination of shareholder claims in insolvency is dispensable and should even be discarded.[99] Highly recommendable, however, is a ban on any repayment of a shareholder loan while the company is in financial distress, regardless of the company's financial position when shareholder extended the credit.[100]

4. Controlling other forms of opportunistic behavior

Distributions of a company's assets to shareholders, continuing to do business without "sufficient" working capital, be it because of previous losses or a shift to a much riskier

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[98] See, e.g., Cahn, loc. cit. n. 92, at p. 223; cf. Engert, loc. cit. n. 93, at p. 825 et seq.

[99] In the same sense Bezzenberger, loc. cit. n. 91, at p. 43 et seq.

[100] In addition, it follows from the analysis presented here that subordination of shareholder claims does not serve as a functional equivalent to piercing the veil because of undercapitalization. But see Goette, loc. cit. n. 54, at p. 198.

business strategy, and the repayment of a shareholder loan while the company is in a crisis are prime examples of opportunistic behavior that, if unchecked, may result in causing a company to become financially distressed, even to the point of insolvency. However, from the point of view of creditors, other forms of opportunistic behavior do still exist, for example a commingling of assets or a transfer of assets to related parties on favorable terms, i.e. not at arm's-length. Jurisdictions will often control this type of behavior either by invoking the doctrine of piercing the veil and tort law respectively, or by insolvency law, i.e. provisions on fraudulent transfers.

5. Disqualification of directors

Disqualification of directors, although known in many EU Member States, is currently most extensively used under British law[101]. Directors are banned by a court injunction or an administrative order for some longer period of time from taking up a management position in a company with limited liability if they have violated a varying number of statutory prohibitions or requirements designed to protect corporate creditors. Hence, disqualification of directors cuts in two ways: as an ex post sanction for past violations, and as a preemptive mechanism for creditor protection.

Precisely because of this, the costs and benefits of disqualification are particularly difficult to assess. If disqualification is geared towards an optimal level of deterrence, it may well result in a sub-optimal, i.e. a too far-reaching, exclusion of former directors from the future management of companies. This is a particularly thorny issue since disqualification, in order to be effective, would have to extend to persons who, on the basis of their influence as shareholders, acted as de facto directors and, in addition, would have to prohibit violators from taking up a position in a company that would allow them to act as de facto directors. Thus, if a company form like the German GmbH allows shareholders to issue binding directives to the directors, effective disqualification would even require a violator to be barred from becoming a (dominant?) shareholder in such a company. Finally, as recent British experience has shown, whether disqualification will be an effective mechanism depends crucially on whether the state is willing to make the necessary funds available for a comprehensive enforcement effort.[102]

On balance, even from a purely economic perspective, any enthusiasm shown towards introducing more extensive provisions on disqualification seems premature, at best.[103]

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[101] See, e.g., Davies op. cit. n. 3, at p. 211 et seq.
[102] See Hertig and Kanda loc. cit. n. 10, at p. 97 n. 148.
[103] In the same sense, Fleischer loc. cit. n. 44, at p. 413 et seq.

X. Reducing the risks of existing creditors from a company's being financially distressed

Minimizing potential losses of existing creditors is a further building block for efficient creditor protection by mandatory rules. In this respect, two basic intertwined questions of strategy merit closer inspection, in particular: At what point in time should mandatory rules intervene in the interest of existing creditors, and to what effect? Both questions are closely related to the above discussion of mandatory disclosure in the vicinity of insolvency.[104] Hence, in this context as well, the juxtaposition of British law and German law helps to identify the core problems. To recall the salient features:

British law does not stipulate a duty of the directors or the shareholders to file a petition in bankruptcy if the company is formally bankrupt. Instead, the provisions on fraudulent trading (Sect. 213 IA) and on wrongful trading (Sect. 214 IA), in particular, aim at inducing the directors to choose a future course of action with respect to the company that will minimize the losses of existing creditors. The obligation under Sect. 214 comes into play already "when there is no reasonable prospect that the company would avoid going into insolvent liquidation", i.e. even before formal insolvency. Moreover, in the vicinity of insolvency directors are under an obligation at common law to act in the interest of the creditors as a group[105] at the expense of the shareholders, the protection required varying according to the severity of the threat. This obligation does not serve as a basis for individual creditors' claims against directors[106] but opens up the possibility of challenges at common law, on creditors' behalf, to dispositions of the company's assets by the directors when insolvency is in prospect even though the distributions have been approved by the shareholders.[107]

In contrast, German law does require the directors to file a petition in bankruptcy without undue delay, i.e., within three weeks at the latest,[108] if the company is insolvent either according to a balance-sheet test (excess of liabilities over assets) or a cash-flow test (permanent inability to pay). Moreover, once the company is insolvent according to one of these two tests, directors are forbidden to make any payments "except for payments which even after the occurrence of insolvency or over-indebtedness are

[104] *Supra* VIII.2.
[105] See, e.g., Davies, op. cit. n. 3, at p. 372 et seq. This is also true for US corporations, see M.M. Sheinfeld and J.H. Pippitt, 'Fiduciary Duties of Directors of a Corporation in the Vicinity of Insolvency and after Initiation of a Bankruptcy Case', 60 *Business Lawyer* (2004) p. 79 at p. 88 et seq. (brief overview). Cf. Fleischer, loc. cit. n. 44, at p. 394 et seq.
[106] See Hirt, loc. cit. n. 30, at p. 82 (with further references).
[107] See, e.g., Davies, op. cit. n. 3, p. 372 et seq.
[108] *Supra* n. 41 and accompanying text.

consistent with the care of a diligent and conscientious manager".[109] On the other hand, with the exception of the tort standard established by Sect. 826 of the Bürgerliches Gesetzbuch not to act intentionally *contra bones mores,* German law does not recognize any pre-insolvency duties towards the creditors as a group or even towards existing creditors as individuals. Admittedly, one seeming exception is the doctrine called "Existenzvernichtungshaftung" recently developed by the German Federal High Court, i.e. personal liability of shareholders towards creditors if shareholders divest the company of assets and if, as a consequence of the asset transfer caused by the shareholders, the company's liabilities exceed its assets.[110] However, upon closer inspection, this doctrine boils down to holding shareholders personally liable for a particular set of distributions prohibited anyway by capital maintenance rules:[111] distributions that (i) impose damages on the company that are not quantifiable, and (ii) cause the company to become insolvent. Contrary to scholars' suggestions,[112] the doctrine does not extend to excessive risk-taking instigated by shareholders.

Obviously, British law and German law pursue different strategies with respect to ex post creditor protection in the vicinity of insolvency. German law is geared towards creating legal certainty for the directors, at least as far as possible. Directors must know with as much certainty as possible when they have to act in the creditors' interest, instead of in the company's and its shareholders' interest. To this end, the law provides for insolvency as the event triggering the directors' obligation to act in the interest of creditors by prohibiting any payments except those required even despite insolvency.
This holds true despite the well-known fact that creditors will (almost) invariably be hurt since, with the advent of insolvency, the valuation of a company's assets will no longer be based upon the going concern-premise. Legal certainty prevails over efficient creditor protection.

British law, on the other hand, emphasizes the function of mandatory rules to minimize the losses of existing creditors at the expense of legal certainty[113]. Even before

[109] Sect. 64 Para. 2 of the Limited Liability Company Act (GmbHG), Sect. 92 Para. 3 of the German Stock Corporation Act

[110] BGH of 17 September 2001 – II ZR 178/99, 55 *WM* (2001) p. 2062 (*Bremer Vulkan*); BGH of 24 June 2002 – II ZR 300/00, 56 *WM* (2002) p. 1804 (*KBV*); BGH of 25 February 2002 – II ZR 196/00, 56 *WM* (2002) p. 960; BGH of 13 December 2004 – II ZR 206/02, 59 *WM* (2005) p. 176 et seq.; BGH of 13 December 2004 – II ZR 256, 59 *WM* (2005) p. 332 et seq.

[111] Cf. Röhricht, loc. cit. n. 54, at p. 514 (the doctrine would suffice to make German capital maintenance rules completely superfluous) and at p. 515. However, some uncertainty does exist as to which transactions do fall within the ambit of the term contribution, see, e.g., Grigoleit, op. cit. n. 3, at p. 86 et seq.

[112] P.O. Mülbert, 'Abschied von der TBB-Haftungsregel für den qualifiziert faktischen Konzern', 39 *Deutsches Steuerrecht* (2001) p. 1937 at p. 1942; G.H. Roth, 'Gläubigerschutz durch Existenzschutz', 6 *NZG* (2003) p. 1081 at p. 1082 et seq.; cf. W. Schön,' Zur „Existenzvernichtung" der juristischen Person', 168 *ZHR* (2004) p. 268 at p. 289 et seq. But see Vetter, loc. cit. n. 64, at p. 815 et seq. (doctrine should not be extended to serve as an all-purpose remedy).

[113] With regard to the difficulties in construing the term "no reasonable prospect of avoiding insolvent liquidation" see Hirt, loc. cit. n. 30, at p. 104 et seq.

insolvency, directors are under the obligation to avoid harming existing creditors as far as possible. Seen from this perspective, suggestions for amending British law to the effect that directors have to act in the interest of creditors when it is "more likely than not" that the company would at some point become unable to pay its debts as they fall due, were fully compatible with the philosophy of British law in this area.

A comparison of the approach chosen by British law and by German law in terms of a partial cost-benefit analysis may well lead to the conclusion that, at least in theory, the British approach may produce superior economic welfare effects. [114] In particular, the British approach may be construed to directly address the aforementioned problem that, upon approaching insolvency, companies will choose a (far) riskier business strategy since rational shareholders will perceive such a shift as being beneficial to them. Admittedly, this interpretation crucially depends on whether a director's duty to act in the interest of creditors does kick in even before the company does become formally insolvent, but, as already mentioned, British case law is ambivalent, at best, with respect to this problem.[115] Moreover, building on the wrongful trading concept instead of a director's duty to file a petition in bankruptcy opens up the way to a (private) out of court-workout even for those companies that are formally insolvent due to an excess of liabilities over assets (balance-sheet test). Coupling this possibility with a very lenient petition right for creditors under Sect. 123 IA – default with an undisputed debt of over £750 suffices to prove insolvency[116] – may indeed provide superior incentives for directors to act in the interest of creditors, as opposed to the reliance of German law on a director's duty to file a petition in bankruptcy.

On the other hand, the different approaches under British and German law can be understood as a prime example of the often-noted standards v. rules-contrast between British and German company law. Thus, the two mechanisms, established by British law and German law respectively are maybe more strongly path-dependent solutions than even legal capital and its absence respectively. This observation implies first looking for complementary features within a particular jurisdiction's creditor protection regime, each reinforcing the effects of the other, before comparing different creditor protection regimes. While two such complementary mechanisms - undercapitalization[117] and subordination of

[114] For a very critical assessment see Habersack and Verse, loc. cit. n. 48, at p. 206 et seq. However, their man concern is that the wrongful trading-rule is at odds with important elements, and even with the whole structure of the German creditor protection regime.
[115] *Infra* VIII.2.b. at n. 48 et seq.
[116] As to the petition right under Sect. 123 IA see A. Schall, 'The UK Limited Company Abroad – How Foreign Creditors are Protected after Inspire Art (Including a Comparison ot UK and German Creditor Protection Rules)' 16 *EBLR* (2005) p. 1534 at. p. 1538 et seq. However, to attribute the "genius of British creditor protection law" mainly to the petition right is probably an overstatement.
[117] *Supra* IX.2.

shareholder claims[118] – have already been discussed above, the interrelation among the three will be considered below in some detail[119].

XI. Civil liability of directors and shareholders

1. General observations

The most widely used mechanism for enforcing creditor protection is civil liability or, to be more precise, a variety of mandatory rules prescribing the civil liability of directors and/or shareholders.

Civil liability may serve to enforce the preventive disclosure obligations discussed above, in particular those in the vicinity of insolvency.[120] In addition, civil liability may serve to impede directors and shareholders from causing the company to act opportunistically towards its creditors. The latter function begs the question as to whom to hold liable if the corporation acts opportunistically towards its creditors. As a rule of thumb, this will be the person(s) that caused the company's opportunistic behavior, regardless of whether that person is a director or a shareholder. Inter alia, this concept underlies the notion of a shadow director and a de facto director, respectively, which are known in many jurisdictions.

In order to protect creditors effectively, these rules on civil liability should satisfy some well-known requirements of a more general nature, e.g. the elements of the rule should be clearly specified and be easily observable in reality. In addition, creditor protection by liability rules also raises some specific issues. Here below, some of these are taken up briefly.

2. Direct liability towards creditors

a. Direct liability as an exceptional solution

Arguably, directors' or shareholders' direct liability towards creditors should mainly be considered if the company is insolvent, or, to be more precise: if the company's liabilities exceed its assets. Given any other situation, and that includes even an illiquid company, creditors will still be able to recover the total amount due to them. However, even in the case of insolvency, one may want to question whether direct liability is the appropriate solution. Creditors who hold direct claims against either the directors or the shareholders

[118] *Supra* IX.3.
[119] *Infra* XII.
[120] *Supra* VIII.

will be favored since they do not have to be content with the results of a pro rata-distribution of the debtor's assets in formal insolvency proceedings. Hence, one may want to go even further by limiting creditors' direct claims against directors or/and shareholders to either of two situations: (i) insolvency proceedings aimed at the pro rata-distribution of the corporation's remaining assets do not take place; (ii) direct liability (of directors) results precisely from the fact that new creditors were not prevented from entering into a contractual relationship with a (nearly) insolvent company or from the fact that existing creditors suffered a loss because the directors, at the time when the company became (nearly) insolvent, failed to take the appropriate action, e.g. failed to file a petition in bankruptcy.

Admittedly, for different reasons, both exceptions are far from universally accepted.[121] The first exception depends on whether it is possible for the shareholders as a whole – be it just a question of a single shareholder or all of the shareholders acting in unison – to violate the company's interests and, thus, became liable towards the company. If a jurisdiction does not recognize this concept, it will indeed be very difficult to avoid the conclusion that, from the outset, only a direct claim by a creditor against a shareholder can exist.

The second exemption, for example, is contested between German and British law. German law provides for a direct claim for compensation of damages against the directors who fail to file a petition in bankruptcy, whereas the British provision on wrongful trading (Sect. 214 IA) provides for the liability of directors towards the corporation for an indeterminate amount.

b. Determining the directly liable person

Admitting direct liability for even some exceptional situations begs the follow-up question as to the persons who are directly liable towards the creditors: the directors, the shareholders, or both? For various reasons, the creditor-friendly solution of making both groups liable will not be the preferred one. Instead, the principle will be to hold that person liable who is ultimately responsible for checking that the creditor risk in question will not materialize. Hence, at least in general, the internal distribution of competences and responsibilities between directors and shareholders will also determine who is externally liable towards creditors. The internal distribution of competences and responsibilities, in turn, will be determined by law or by the articles of association.

[121] For an in-depth analysis under German law see J. Meyer, *Haftungsbeschränkung im Recht der Handelsgesellschaften* (Berlin, Springer 2000) p. 1017 et seq.; G. Bitter, 'Der Anfang vom Ende des „qualifiziert faktischen Konzerns" - Ansätze einer allgemeinen Missbrauchshaftung in der Rechtsprechung des BGH', 55 *WM* (2001) p. 2133 at p. 2137 et seq.

3. Consequences of unlawful distributions in particular

As a general principle, directors and shareholders will be liable towards the company only if they have violated their own duties. Against this backdrop, the unlawful open (dividend payments) or disguised distribution of assets to shareholders raises some intricate questions.

First: Do shareholders have to return unlawful distributions, in particular dividend payments? Regarding dividends, the answer may very well vary according to whether the company's shares are publicly traded or not, i.e. whether the company is listed or not. Moreover, even given a non-listed company, shareholders should not be obliged to return any dividend payments if they acted in good faith, i.e. if they neither knew nor ought to have known that the distribution was unlawful. With respect to disguised distributions one may well want to apply a stricter standard, i.e. strict liability, regardless of whether the company in question is listed or not.

Second: will shareholders be held liable for any damage caused by the unlawful open or disguised distribution of assets? In contrast to the question just mentioned, the answer should probably not depend on whether the company is listed or not, even if the problem will normally be more acute with non-listed ones. However, shareholders should only be liable if they acted negligently, at least by causing the company (through its directors) to make the distribution. If the damage caused by a shareholder-induced distribution of assets of the company cannot be assessed with any certainty, for example if the shareholder appropriated a corporate opportunity, compensation can either take the form of unlimited liability towards the company or a piercing of the corporate veil. The German Federal High Court, for example, has chosen the second solution, i.e. direct liability of a shareholder towards the company's creditors, if, as a consequence of the asset transfer caused by the shareholder, the company's liabilities exceed its assets ("Existenz-vernichtungshaftung").[122]

XII. The resulting framework

The above discussion sought to elaborate a high-level framework for the design of an efficient system of mandatory rules for creditor protection. Hence, the finer structure of European company law and, a fortiori, of any particular jurisdiction had to be left aside. In particular, no attempt has been made to qualify any of the rules discussed as being necessarily a part of, for example, company law, tort law or insolvency law. Admittedly,

[122] *Supra* n. 110 et seq. with accompanying text.

those and other questions are important on the level of individual jurisdictions because they have far-reaching implications for the practical effectiveness of creditor protection rules. Obviously, those rules must fit the legal environment in which they are supposed to operate, i.e., in the case of EU companies operating in another Member State, first and foremost the restrictions ensuing from Art. 43 et seq. of the EC Treaty to guarantee the freedom of establishment. On the other hand, precisely for this reason, the decisions as to how to implement the suggested framework and how to flesh out the details of a creditor protection regime must still be left to each jurisdiction.

The high-level framework for creditor protection ensuing from the preceding analysis is less lean than economists may care for, and much leaner than (practicing) lawyers might wish for. This is to be explained by three reasons, at least:

- Corporations enjoying the benefit of limited liability operate, by and large, along similar principles in major jurisdictions and, as a corollary, creditors face roughly the same risks when entering into a contractual or non-contractual relationship with the company: informational asymmetries and ex post opportunism due to directors or/and shareholders.
- Since the existing variety of mechanisms for creditor protection among different jurisdictions must be understood as an answer to particular risks of creditors, the basic mechanisms for creditor protection show, by and large, similar characteristics. Obviously, this is not to negate the existence of substantial divergences among different jurisdictions, e.g., between British law and German law. However, the extent of any difference is greatest at the micro-level of particular rules, i.e. whether a jurisdiction relies more on company law, tort law or insolvency law for creditor protection, not with respect to the risks covered.
- Within a particular jurisdiction, overlapping, i.e. creditor protection by multiple mechanisms against a specific risk caused by the behavior of directors or shareholders, does exist but is less common than one might suspect. Rather, different mechanisms address different types of risks and, thus, are mostly complementary instead of redundant.

As a consequence, any systemic approach to developing a creditor protection regime will have to identify (i) the relevant creditor risks and their causes, (ii) the extent to which creditors are to be protected by mandatory rules against these risks, and (iii) the mechanisms available for controlling these risks.

Following this approach, the paper proceeded first to identify the realm of creditor self-help, which, with respect to “weak” creditors, seems to be much smaller than often posited or suspected. This finding is of pivotal importance since, theoretically at least, large creditors are able to write and impose covenants that replicate most of the statutory provisions and judge-made rules on creditor protection. However, even large creditors refrain from such a complete contracts approach. Moreover, they do impose covenants,

not with a view to enforcing the contracted behavior in the event of the debtor's non-compliance, but with a non-altruistic view to be entitled to prematurely realize their claims.

This observation opens up the way to justify and even necessitate mandatory protective rules, even with respect to voluntary creditors. Ex ante protection, i.e. protection against entering into an initially disadvantageous contract will often be far less pronounced than protection against ex post opportunism. In view of the paper's goal to present a "synthetic view of different concepts of creditor protection" the most important insight from the discussion of different mechanisms for controlling ex post opportunism, be it due to the behavior of directors or shareholders, is the problem of controlling the shareholders' preference for the company to pursue a riskier business strategy in the vicinity of insolvency. Legal capital as well as any limitations on distributions that exist independently from legal capital, will not offer substantive protection. Instead, three mechanisms emerged as possible candidates: the piercing of the corporate veil because of undercapitalization, the subordination of shareholder claims, and the wrongful trading concept. However, upon closer inspection, neither piercing of the veil nor subordination will achieve the desired effect of chilling shareholders' propensity to opt for a riskier business strategy.[123] Instead, at first glance, the wrongful trading remedy seems to be a promising mechanism. However, directors will benefit from the corporation's taking on more risk only if they are shareholders, as well. Otherwise, for the wrongful trading mechanism to be effective, "pure" shareholders must also be reached, e.g. either by treating influential shareholders as de facto directors or by explicitly extending the rule to those shareholders that take management decisions.

Whether, as a further facet of the systemic approach, the British concept of wrongful trading is compatible with a regime, e.g. German law that, upon insolvency, requires the directors to file a petition in bankruptcy, will have to be examined elsewhere in more detail.[124] After all, the present paper has only aimed to establish a high-level framework for efficient corporate creditor protection.

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[123] Thus, contrary to A. Schall, 'Englischer Gläubigerschutz bei der Limited in Deutschland', 26 *ZIP* (2005) p. 965 at p. 971, equitable subordination is not a functional equivalent to the wrongful trading remedy.
[124] Compatibility is contested, e.g, by Röhricht, loc. cit. n. 54, at p. 515; Habersack/Verse, loc. cit n. 47, at p. 174, at p. 187, and at p. 213. For a preliminary corroboration of this finding see infra X. at n. 116.

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