Conflict between Shareholders and Creditors: A Critical Analysis

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Abstract

Within a company there are many groups of actors, as for example, majority shareholders, minority shareholders, management, employees and creditors. These groups all have various interests in a corporation's cash flow, and these interests inevitably come into conflict.[2] This paper is based on one of these conflicts, the conflict between shareholders and creditors. The origin of the shareholder–creditor conflict arises as a consequence of the fact that shareholders in corporations are not held personally responsible for the debts of the company. This paper aimed at to examine the unveiled problems between the shareholders and creditors to find out the arena of the shareholders and creditors role in corporate governance in Bangladesh as well as to provide the possible way out to minimize the unveiled inadequacies between them. Also this paper is mainly based on the laws and regulations of the European Union because of the more modern and sophisticated in comparison to our domestic laws are, for upbringing with the standard limit and for suggesting the workable solutions.

Key words: Interests of Protection; Interests and Incentives; Capital Formation Rules.

Introduction

The members and the investors in a company are not liable for more money than the amount they invested in the company.[3] Consequently, all persons that may have claims on a company's capital, the creditors, are restricted to the assets of the company.[4] This characteristic is usually justified by the fact that ordinary persons would not be willing to start-up companies if they risked being personally responsible for debts that the corporation may incur. Notwithstanding the advantage of corporations for

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2 Clas Bergstrom and Per Samuelsson, *Limited Company due to problems* (Nordestedts Juridik AB Publication, 2nd ed, 2001) pp. 28-29.

3 Eric Werlauff, *EU Company Law Common Business Law of 28 States,* (Djoef Publishing, Copenhagen, Denmark, 2nd ed, 2003) p. 23.

4 Bergstrorm and Samuelsson, above n. 2, p. 188.

society, the benefit of limited liability does not eliminate the risk of business failure. Limited liability simply shifts the risk from the shareholders to the creditors.[5] While shareholders have an interest in obtaining yield of the money they have invested in the company, creditors have an interest in the corporation having enough capital to pay its debts. Accordingly, there is a conflict between shareholders and creditors regarding the usage of a company's capital.[6]

The key questions of this paper are how the interest of conflict between shareholders and creditors arise; what are the highlighted issues of conflicting interest between them; how has the conflict been looked into by the corporate management; does the principle of limited liability unfairly shift the risk of corporate failure from a company's shareholders onto its creditors; what are the approximate measures taken for mitigating the conflict by the company; does there any third party beneficiary to overlook the conflict by depriving any of them; what are the possible ways out for dissolving the problem the conflict; what are the loopholes of the Company law regarding this purpose?

The conflict between shareholders and creditors

***Interests and Incentives; the Reason for Legislating* -** A limited liability corporation is based on the notion of making profit to its shareholders. However, since shareholders are not held personally liable for debts of the company, shareholders in companies with heavy debts often have strong incentives to act opportunistically. These opportunistically actions regularly occur at the expense of existing creditors since the result is that company assets are reduced.[7] The temptation of making more profit is moreover held to increase the risk-taking. If there is a slight chance of increasing the value of equity, the chance will often be taken, often at the risk and the expense of the creditors.[8] The result is thus that the limited liability may create incentives for shareholders to, for example, invest in projects that are riskier than planned when the creditors extended the credit.[9]

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5 Christoph Van der Elst, 'Economic Analysis of Corporate Law in Europe: an Introduction' [2002-01] (January) Working Paper Series, Financial Law Institute, University of Gent, Belgium p. 7.

6 Jonathan R. Macey and Luca Enriques, 'Creditors versus Capital Formation: The Case against the European Legal Capital Rules' (2001) 86: 1165 *Faculty Scholarship Series 1413*, pp. 4-5. < http://digitalcommons.law.yale.edu/fss_papers/1413 (accessed 23rd August, 2012)

7 Bergstrom and Samuelsson, above n. 2, p. 190.

8 *Ibid* p. 191.

9 Enriques & Mecey, above n. 6, pp. 2-3.

Furthermore, shareholders interest in obtaining profit may create incentives to engage in asset diversion from the creditors to themselves.[10] This diversion may, for example, take place in forms of dividend payments to the shareholders, payment of expensive salaries etc. All of these distributions will, naturally, reduce the capital upon which creditors depend when they extend credit to a company.[11] Furthermore, shareholders, or managers, may engage in claim dilution and in this way affect the financial stability of the company. This situation may, for example, arise if the shareholders increase debt leverage by taking another loan at the same or a higher priority than the old debts. Creditors may also be affected negatively by shareholder behaviour if assets are purchased which is connected to a better safety right. The result is the elimination of the advantage that the existing creditors have connected to their claims, if the company becomes insolvent.[12] The reason for having legislations on the area is accordingly to prevent misconduct and create a balance in these presented situations.

***Contractual Creditors & Involuntary Creditors* -** Creditors as a group comprise of a wide range of actors and may primarily be divided into contractual creditors and non-contractual creditors. Contractual creditors are those creditors who contract with company and in this way their claim towards the company arises. The major contract creditors are banks and other finance houses, but also different suppliers extend credit when supplying products, rents and electricity.[13]

Non-contractual, or involuntary, creditors on the other hand, do not have the possibility of contracting with the company. One examples constitute of tort victims, who receive claims towards the company after being hurt by the company in any way and thus has the right to damages, for instance under environmental law.[14] Other involuntary creditors are employees and the public as tax and VAT collector. All these creditors have no possibility of protecting their interests alone and they are therefore dependent on other mechanisms that will secure that the company covers their claim.[15]

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[10] Bergstrom and Samuelsson, above n. 2, p. 191.

[11] Enriques and Mecey, above n. 6, p. 2.

[12] Bergstrom and Samuelsson, above n. 2, p. 192; Enriques & Mecey, above n. 6,

[13] Knut Rodhe, *Corporate Law* (Nordestedts Juridik AB publication 20th ed, 2002) p. 21.

[14] Friedrich Kubler, 'The Rule on Capital under the Pressure of the Securities Markets' (Position Paper for the Siena Conference on "Company Law and Capital Market Law) 9.

[14] Rodhe, above n 13, 21.

[15] Sandra Ax, *Legal Capital, Creditor Protection & efficiency?- An Analysis of the European Legal Capital Regime in the Light of Recent Developments & Debates* (LLM Thesis, Goteborg University, 2004) 11
(24 august 2012) < https://gupea.ub.gu.se/bitstream/2077/1976/1/200492.pdf>

***Interests of Protection* -** As illustrated in the previous paragraphs, the opposite interests in the present conflict are, on one side, shareholders´ freedom of action regarding the company capital, and on the other side, creditors' interest of keeping the same capital in the company. Which of these actors and interests that is regarded more meriting protecting, have been regarded differently in different legislations? In other words, the extent to which creditors are protected by law varies among national legal systems, and reflects the values and exceptions of each society.[16]

The European "Civil Law" Legal Culture

Under European Civil Law tradition, creditors have always been benefices of a strong legislative protection from shareholders' interests. The interest of protecting creditors in company law goes back a long time and is by now deeply rooted in the European culture.[17]

Some scholars have even held that one of the fundamental purposes of corporate law in Europe is to protect creditors.[18] The reason for this position has always been the fear that creditors would not invest in companies if they were not protected by shareholder misconduct and guaranteed a certain amount of assets if the company went bankrupt.[19] Thus, the security of creditors is held to be equal to the capital of the company, and therefore the European starting-point is that the company capital must be controlled. As a result, shareholders´ freedom of action will be restricted with several rules aiming to protect the company capital. These rules are called *legal capital rules,* and the compliance with these rules can be seen as the trade-off for shareholders to obtain the benefits of limited liability.[20] Consequently, legal capital rules are the protectors of both contractual and involuntary creditors in Europe.[21]

From the heading of this subsection it was stated that the legal culture presented concerns European Civil Law countries. However, with regards to the UK which de facto is a European state, the situation is more complex. Britain namely has a Common Law tradition and as a result the British legal tradition differs widely from the rest of

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17 Klaus J. Hopt and Eddy Wymeersch (eds), *Capital Markets and Company Law*, (Oxford University Press, 2003) keynote speech.

18 Enriques and Mecey, above n 6, 4-5.

19 Rodhe, above n 13, 21.

20 Kubler above n 14, 9.

21 Rodhe, above n 13, 21.

Europe.[22] Hence, what is stated in the next subsection will in many aspects be more correct concerning the UK tradition. This "dual" position of the UK will be further illustrated under part 3.3.2 and 3.4.2 where the material rules of the country are presented.

The Anglo-American "Common Law" Legal Culture

The legal culture in Common Law systems, as for example the US and to a certain extent in the UK, is nearly the opposite compared to the European tradition of statutory creditor protection. The Anglo-American system is instead based on values of individualism, equal rights and opportunities are upheld, not equal results or conditions. As a result market forces are often let to run freely with merely a modest involvement of government and legislation.[23]The fundamental purpose of existing corporate law is accordingly to provide the utmost flexibility for private ordering within a structure that seeks to maximize value for shareholders.[24]Creditors are seen as individuals, and not a homogenous group, resulting in that creditors who wish to protect themselves from shareholders behaving opportunistically, must do so by contract based on credit references etc.[25]The starting-point under Anglo-American Common Law tradition is thus that creditors participate in corporate governance at their peril.[26]

Also with regards to involuntary creditors, statutory legal capital rules are rejected. The argument is that such rules do not consider the individual situation of each company in relation to its business activity; hence they cannot provide any meaningful protection to creditors.[27] However, because involuntary creditors are not able to create protection through contracts, other means of protection have been created. First of all, there is a system of disregarding the corporate entity and the limited liability, and thereby raise claims directly against the shareholders under what is called the doctrine of "*piercing the corporate veil*".[28] Second, corporations are also obliged

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22 Kubler, above n 14, 3.

23 Oscar G Chase, 'American "Exceptionalisms" and Comparative Procedure' (2002) *American Journal on Comparative Law,* 277.

24 Enriques and Mecey, above n 6, 5.

25 Ibid.

26 Ibid 4-5.

27 Kubler, above n 14, 3-4.

28 Sandra K. Miller, ' Piercing the Corporate Veil among Affiliated Companies in the European Community and in the US: A Comparative Analysis of US, German and UK Veil piercing Approaches' (1998) 36 American Business Law Journal 76.

to take out mandatory insurances that will cover the claims of these creditors.[29]

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

Bangladeshi Legal Culture

(a) Variation of Shareholders Rights and their Protection in Bangladesh

Section 71 of the Companies Act, 1994 protects the rights of holders of special classes of shares by requiring that to change their rights there should be a provision to that extent in the memorandum or articles of association and hat these should be sanctioned by a specified majority of shareholders of that class. Any number of dissenting members holding at least ten percent of the issued shares of that class may within fourteen days o the resolution apply to the Court for cancellation of the resolution and such resolution shall not be effective until then it is confirmed by the Court. The consideration before the Court will then be whether the variation will unfairly prejudiced the shareholders of the class.[30]

(b) Creditor protection

Turning to the creditor protection aspect of redemptions, the rules for the company limited by shares, if so authorized by the articles, are, in brief, that redeemable shares can be redeemed only out of distributable profits or out of the proceeds of a fresh issue of shares made for the purpose. Any premium payable on redemption must be paid out of distributable profits alone, unless the redeemed shares were issued initially at a premium, in which case the redemption premium is

29 Kubler, above n 14, 8.

30 Dr. M. Zahir, *Company and Securities Laws* (Dhaka: The University Press Limited, '3rd revised ed' 2005) 33.

payable out of the proceeds of a new issue, up to the amount of the premium received on issue or the value of the company's current share premium account, whichever is the less. Once the shares have been redeemed, they are treated as cancelled and the amount of the company's issued share capital is diminished by the nominal value of the shares redeemed. Finally, the company must create an (undistributable) "capital redemption reserve" equivalent to the amount by which the company's issued share capital is diminished by a purchase wholly out of profits; or where the redemption is financed partly by the proceeds of a new issue and partly by distributable profits, the company must create a capital redemption reserve equal to the amount by which the proceed of the new issue fall short of the amount paid on redemption.[31]

Legal Capital Doctrine in Europe and Bangladesh

Rules on capital of companies emerged in Europe in the 2nd half of the 19th century and are, as been stated, generally viewed as a reaction to the separation of liability.[32] Today all of the EU Member States, more or less, adhere to the legal capital doctrine. In most states the rules on capital are considered cornerstones and various company and closely related regulations are built up around these rules. However, in a few states rules on capital have no tradition, but have been imposed by the EU through its endeavor of harmonizing national company legislation within the Member States. The objective of this chapter is thus to present and explain the legal capital rules in Europe and how it has been affected by the EU harmonization work. Before beginning with this presentation, an important distinction of company forms must be made.

***Publicly and Privately Held Companies* -** Within most states of the EU there are two forms of limited-liability companies, one *public* form[33] and one *private* form.[34] The main difference between the two is that only the public form may issue shares to the public for procurement of capital.[35] Moreover, and irrespective of this difference, the distinction between the two forms is highly important since only *publicly* held companies are comprised by the harmonization work of the EU. As a result, all publicly

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31 *Companies Act (1994),* s. 154.

32 Kubler, above n 14, 1.

33 Sandra Ax, above n 16, 16.

34 Ibid.

35 Rodhe, above n 13, 22.

held European companies are regulated by similar national regulations since they all are subject under the same minimum regulations.[36]

Contrarily, with respect to *privately* held companies, there are no EU rules, or any other guidelines for that matter, that Member States must oblige to. Regulations concerning privately held companies are thus entirely the task of each national Parliament.

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

Capital Formation Rules in the European Union **-** With regards to public companies, the first tier of the Second Directive deals with the raising of company capital through a minimum share capital requirement. Article 6 of the Directive thus obliges Member States to pass laws requiring public companies to have a minimum share capital of at least 25,000 European

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36 *Second Council Directive 77/91/EEC* of 13 December 1976 on coordination of safeguards which, for the protection of the interests of members and others, are required by Member States of companies within the meaning of the second paragraph of Article 58 of the Treaty, in respect of the formation of public limited liability companies and the maintenance and alteration of their capital, with a view to making such safeguards equivalent [1977] OJ L 26/1-13, art 1.

37 Ibid, preamble.

38 Enriques and Mecey, above n 6, 5.

39 Bergstrom and Samuelsson, above n 2,190.

40 Jan Andersson, *Capital protection of limited liability companies* (Literature compagniet AB (Jure AB) publication, 4th ed, 2002) 9.

Units, i.e. euro, before they may commence business.[41] In addition, Article 7 moreover states that this subscribed capital only may consist of "assets capable of economic assessment".[42]

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

Capital Formation Rules in the UK

Following a Common Law culture, Britain has a tradition of viewing the corporation as merely a "*network of contracts*".[49] This metaphor signifies that all a company is regarded to be, is a system of different contracts. Accordingly, a company is not considered to have any further responsibility towards the society. The sole purpose of a company is instead to make profit to its shareholders. In accordance

41 Second council directive, above note 35, art 6(2).

42 Sandra Ax, above n 16, 18.

43 Werlauff, above n 3, 114.

44 Persons who act as independent experts can be either natural or legal persons, according to the provisions of each Member State.

45 Vanessa Edwards, *EC Company Law*, (Oxford University Press, 1999) 62.

46 Werlauff, above n 3, 114.

47 Second council directive, above n 36, art 7.

48 Second council directive, above n 36, art 7.

49 Kubler, above n 14,7.

with Common Law tradition, the role of the legislator is to involve as little as possible, and hence the traditional British view of corporate law drastically differs from the traditional European view. As a consequence of the British Common Law tradition, the UK was the Member State that had to change its corporate legislation most in adapting its regulations to the Second Company Law Directive. Before the EU entry, there was, for example, no requirement of minimum share capital. Due to this background the UK, and also Ireland, loudly opposed the extending of legal capital rules to private companies which the countries, as known, succeeded in.[50] As a result, the regulations regarding public and private companies diverge to a great extent in the UK, though the two companies are regulated in the same statue, the Companies Act (CA).

British legislation does not only differ with regards to culture and tradition, but also the terms used are different. The British capital regulation system is, first of all, based upon a distinction between what is called *authorized* and *issued* share capital. The authorized share capital must be stated in the memorandum of association and represents the maximum amount of share capital that a company can issue at any given time.[51] This capital operates as a limit on a company's ability to raise new finance through share issues, but it does not indicate how much finance has previously been raised by shares issues.[52] The issued share capital, on the other hand, is the amount of share capital that has been allotted by a company at any time.[53]

The shareholders of a British *privately* held company, have the unique position of deciding by themselves what the share capital shall be.[54] It should also be noted, that even when the shareholders decide to have a share capital, there is no regulation of the amount which a company must raise before incorporating. Many private companies do in fact operate with a token amount of share capital £ 100 or less.

Capital Formation Rule in Bangladesh

The nominal or authorized capital is merely the amount of share capital which the company is authorized to issue. In the case of a

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50 Enriques and Mecey, above n 6, 5.

51 *Companies Act 1985*, Article 2 (5)(a).

52 Eilis Ferran, *'Principles of Corporate Finance Law'* (Oxford University Press, 2008) 44.

53 Ibid, 45.

54 Andersson, above n 40, 94.

> limited company the amount of potential share capital with which it proposes to be registered, and the division thereof into shares of a fixed amount, must be set out in the memorandum of association.[55] This as well as the paid up amount may be increased or reduced.[56]
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> The amount of the company's nominal capital depends on its business requirements, actual or potential. At the time of registration of the company the promoters will have to pay fees and stamp based on the amount of the nominal capital.[57]
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> The issued or allotted capital is that part of the company's nominal capital which has been issued to the shareholders. The company is not bound to issue all its capital at once. Further issues of capital are made as they are needed.[58]
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> The uncalled capital is the remainder of the issued capital and can be called up at any time by the company from the shareholders in accordance with the provisions of the articles. The paid up capital of the company includes the value of the shares paid up and any premium on such shares although the share premium will be shown as share Permian account in the balance sheet. The Securities and Exchange Commission has to be satisfied before shares can be at a premium as to the justification for it.[59]

***Capital Maintenance Regulations* -** Since corporations aim to generate profit to shareholders, the regulations on capital formation would be rather meaningless as creditor protection if there were not complementary regulation of how the paid-up capital may be distributed from a company.[60] The *second* tier of the Second Directive therefore deals with the maintenance of the share capital contributed. To prevent capital from being distributed from the company, Article 15 of the Directive hence limits the amount that the company may distribute to its shareholders. The term *distribution* in this assignment concerns dividend distribution in forms of either money or other property to the shareholders. Both *open distributions*, i.e. distributions where the decision of making distributions have been taken at the ordinary shareholders meeting, or by other authorized decision making organ as for example the board of directors, as

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55 *Companies Act, 1994,* s. 6.

56 Ibid, ss. 53 and 58.

57 Zahir, above n 30, 29.

58 Ibid; also see *Companies Act, above n 54,* s. 155.

59 Zahir, above n 30, 29.

60 Andersson, above n 40, 68.

well as *colorable transaction*, i.e. where no such formal decision has been taken, are comprised by the Second Directive.

Article 15 is based on the distinction between *restricted* and *non-restricted* equity. In conformity with the first-tier-rules, the paid-up share capital is considered restricted equity of the company, together with the premium fund,[61] legally required reserves that are not distributable, the revaluation reserve and other reserves that are not distributable according to the articles of association.[62] For the protection of creditors, the restricted equity may never be distributed back to the shareholders. Contrarily, a company may distribute other means, i.e. non-restricted equity. As a consequence of this principle on protection of the restricted equity, a *balance-sheet test* must be made before any distributions are made, ensuring that the distribution will not trespass the restricted equity.[63] Nevertheless, it must be noticed that even when a cushion of restricted equity is built up in the company, this capital is not kept in a box or in an account reserved for the creditors. This capital may be used in the business of the company and may accordingly decrease as the company starts trading. All assets may be lost legally if the company conducts loss-making business activity, this situation cannot be prevented by the legislator.[64] The legal principle is, however, that the members may not plunder the company of the capital that they have paid in.

As a consequence, the shareholders may not freely dispose over the company assets.[65] A further security for the creditors is provided by Article 16. The Article prescribes that any distribution made contrary to Article 15, always must be returned by the shareholder who received it, if the company proves that the shareholder knew of the irregularity of the distributions made to him, or could not in view of the circumstances have been unaware of it.[66]

Distribution to Shareholders in the UK

Traditionally, the regulations regarding distribution of dividends have been extremely liberal in Britain compared to the rest of Europe. The principle rule has been that companies were able to make distributions

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61 This fund consists of the premiums that arise when to company issues new shares.

62 Andersson, above n 40, 76-77.

63 Edwards, above n 44, 70.

64 Andrew Hicks, & S.H Goo, *Cases and Material on Company law*, (Blackstone Press Limited, 4th ed, 2001) 274.

65 Bergstrorm and Samuelsson, above n 2, 170.

66 Edwards, above n 44, 70.

to the shareholders as long as the company at the time of the distribution was not, or as a consequence of the distribution would become, insolvent.[67] However, also in this area the regulations became more stringent as the UK adjusted to the requirements of the Second Company Law Directive. Today, Article 263 to 281 CA therefore limits distributions to be made legally. The regulations are mandatory and the stated Articles include "*every description of distribution of a company's assets to its members, whether in cash or otherwise*".[68] If something else has not been stated in the articles of association, the decision regarding distribution of dividends is taken by the shareholders meeting. If, however, the company uses the standard articles of association, the shareholders meeting may decide to distribute assets amounting to maximum what has been suggested by the board of directors.[69] Thus, the power of the shareholders meeting may be significantly limited, applies in European states. Assets of a company available for distribution to the shareholders are assets within the scope of the company's net profit of the year and profit brought forward from earlier years, with a reduction of accumulated losses, Article 263 (1) and (3).[70] Hence, distributions are permissible as long as they do not trespass on the share capital. Concerning *public* companies there is also a further requirement under Article 264 (1). The Article prescribes that distributions may only be made when the amount of the company's net assets is not less than the aggregate of its called up share capital and nondistributable reserves. Furthermore, distributions may only be made if, and to that extent that, the distribution does not reduce the amount of those assets to less than that aggregate. Consequently, this additional requirement gives effect to Article 15 of the Second Company Law Directive and the result is that only non-restricted capital may be distributed in a public company.[71] Concerning *private* companies, only Article 263 is applicable. Consequently, private companies may distribute assets as long as the distribution does not trespass the *share capital*.

However, it must be noted that even though the principle is that distributions may not trespass on the share capital, the result of the provision is dramatically different whit respect to the private companies. As been states, there is no requirement of a minimum share capital in private companies. Many private companies do also in

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67 Andersson, above n 40, 95.

68 Ferran, above n 51, 417.

69 Hicks and Goo, above n 58, 280; Andersson, above n 40, 98.

70 Hicks and Goo, above n 58, 280-281.

71 Ferran, above n, 51, 419.

fact have a share capital of £ 100 or less, why more or less all of the company's assets may be distributed in practice.[72] Creditors of private Ltd companies are however not without all protections as it may seem. In accordance with the provisions that applied before the UK entered into the EU, there is a well-developed doctrine of "*piercing the corporate veil*", implying that creditors may put forward their claims directly towards the shareholders as these under certain circumstances may be personally liable for the company's debts.[73]

The consequence if distributions are made in contravention of the law is, according to Article 277, for both private and public companies, that a receiver in bad faith is liable to repay the amount to the company.[74] Furthermore, directors who authorized the illegal distribution are liable to repay the money to the company, unless they justifiably relied on the accuracy of the accounts.[75] This provision accordingly goes further than what is required under the Second Directive and may compensate poorly protected creditors in private companies to some extent.

Distribution to Shareholders in Bangladesh

Dividends are paid according to the amounts paid on the shares and the directors may, before recommending any dividend, set aside out of the profits of the company such sums as they think proper as a reserve or reserves which shall, at the discretion of the directors, be applicable for meeting contingencies and no dividend may bear interest against the company (Regulations 99, 100 and 103 of the Schedule 1 Regulations to the Companies Act 1994). [76]

A dividend declared in the general meeting (Articles 51and 96-103 of the Schedule 1 Regulations to the Companies Act 1994) but this may not exceed the amount recommended by the directors. Interim dividends may be declared by the directors (Regulation 97 of the Schedule 1 Regulations to the Companies Act 1994) and no dividend shall be paid otherwise than out of profits of the year or any other

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72 Ibid, 417-419.

73 Andersson, above n 40, 159.

74 See also *Precision Dippings Ltd v Precisions Dippings Marketing Ltd (Court of Appeal)* [1986] Ch 447; Hicks and Goo, above n 58, 283.

75 According to case *Re Exchange Banking Co. (Court of Appeal)* [1882] 21 ChD 519, *Flit croft's Case;* see Hicks and Goo, above n 58, 282-283.

76 Zahir, above n 30, 157.

undistributed profits (Regulation 98 of the Schedule 1 Regulations to the Companies Act 1994).[77]

Although dividends can be paid only out of profits the English Courts found that 'profits' was an elusive and baffling concept better left to accountants and businessmen. Unfortunately, however, when litigation ensued it had to be decided by lawyers after listening to the expert evidence of accountants. The result was often one which bluffed lawyers, accountants and businessmen alike. What the courts seem to have decided can be briefly summarized as follows:

(a) So long as the properly presented accounts of the company showed a trading profit for the accounting period (normally a year) that could be distributed by way of dividend without regard to losses made in previous years; in other words 'nimble dividends' as the Americans describe payments in such circumstances, were permissible.

(b) A realized profit made on the sale of a fixed asset could also be so distributed and according to the English Courts (but not Scottish Courts) so could an unrealized profit on a revaluation of fixed assets.[78] Both the English Court and the Scottish Courts accepted that such profits could be used to pay-up a bonus issue. Buckeley J. in Dimbula Case (1961) did not see how that could be possible unless the profits were distributed by way of dividend.

(c) Accumulated profits of previous years could also be so distributed unless they had been capitalized by a bonus issue or transfer to the capital redemption reserve.[79]

The English law has now been amended to provide a standard for calculating profits that may be available for dividend but since our law is similar to that prevailing in England before the amendments there so Professor Gower's summary of the pre 1981 position is relevant in our country.[80]

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77 Ibid.

78 *Dimbula valey (Ceylon) Tea Company vs. Laurie* [1961] a Ch. 353; see also Zahir, above n 30, 157.

79 Gower, *Principles of Modern Company Law* (Sweet & Maxwell Publication, 6th 'revised ed', 1997) 281.

80 Zahir, above n 30, 158.

In practice, it is unusual for private companies to declare dividends. Many such companies are small family concerns where all the shareholders also act as the directors. Such companies will usually distribute profits by way of director's remuneration instead of by way of formal declaration of dividends – a practice dictated by taxation considerations. Shareholders in public companies are much less likely to be directors and therefore would expect that dividend payments would be made in the usual way when profits are made available. For listed public companies, a failure to maintain a significant level of dividend payout each year can have a serious impact on their share price. Shareholders are known in this country to have forced the company to declare dividends in excess of what is recommended by the directors irrespective of the facts that here may not be any profit available for the dividend – an extreme case of what is known as 'short – termism' problem.[81]

Rules on Legal Capital; Protective & Economically Effective?

Criticism of Rules on Capital Formation as Creditor Protection -

Share Capital Requirements as Creditor Protection are Arbitrary Insufficient…….

The minimum requirement is unrelated to the *size* of the company, to *sort* of business activities that a company may pursue and to the *risks* related to that activity. As a consequence, the requirement imposed on companies will be unrelated to the debt that a company may incur.[82] This argument must be considered well-founded since the situation where a company that transports radioactive waste, has the same minimum share capital requirement as a company with little leverage and which designs software, has little connection with real life.[83]

Since the share capital is arbitrary it will also be insufficient in many situations. Therefore, criticism have moreover been put forward that the minimum capital amount required by the Second Directive and by Member States is too trivial to provide any protection.[84]As a result, the cushion in the company will be insufficient in situations of insolvency.

81 Ibid.

82 Kubler, above n 30, 5.

83 Enriques and Mecey, above n 6, 11.

84 Sandra Ax, above n 16, 46.

Accordingly, it may be held that the cushion which the minimum capital requirement intends to build up as creditor protection is too small to provide any real protection in practice.

…and Misleading if Trusted

Since the share capital will not provide any meaningful protection for contractual creditors, minimum capital requirements are often held to be misleading as an indicator of creditor security.[85] The legal capital doctrine assumes that the fixed amount of a company's share capital informs current and potential creditors of the recourses that a company possesses and may not freely distribute to its shareholders. As been stated before, however, as soon a company starts to operate, this capital can be used to purchase assets which later may decline in value.[86] Since a company may begin to incur losses either in the normal course of business, or by entering into unfair transaction, the initial paid-in capital will be a meaningless amount. Creditors who wish to inform themselves about a company's existing equity cushion thus must examine the entire balance sheet. Accordingly, it can be held that legal capital rules will lull creditors into a false security to the extent that they believe that the legal capital legislation will protect them.[87]

***Criticism of a Balance-Sheet Test as Creditor Protection concerning Shareholder Distribution* -** Criticism has moreover been put forward that the European system, as such, is not an efficient and satisfying model of controlling distribution of dividends to shareholders.[88] One argument considers that systems based on minimum regulations, in general tend to encourage different sorts of *circumventions* and *manipulations* of the rules.[89] Scholars have even held that it is part of the "human nature" trying to go around minimum regulations, and the classical example is taken from the taxation area where activities of planning to evade the rules are common.[90] If there is any veracity in this argument, the current European system can even be said to encourage accounting measures which are objectively incorrect. For example, there is a discussion in many Member

[85] Andersson, above n 40, 38.

[86] John Armour, 'Share Capital and Creditor Protection: Efficient Rules for a Modern Company Law?'(Working Paper No. 148 at ESRC Centre for Business Research, University of Cambridge, December 1999) 18 ; Enriques and Mecey, above n 6, 11.

[87] Andersson, above n 40, 39.

[88] Enriques and Mecey, above n 6, 16.

[89] Van der Elst, above n 5, 8.

[90] Andersson, above n 40,43.

States whether the *gross method* (the market value) or the *net method* (the booked value) should be applied when valuating assets, as both methods are permissible under the Second Company Law Directive. Hence, as the net method is acceptable and used, it can be claimed that there is a contradiction in the system; on the one hand, creditor protection is meant to be guaranteed, but on the other hand, companies are allowed to underestimate its assets.[91]

Does Legal Capital Protect Involuntary Creditors? - The conclusion from the criticism presented above is that contractual creditors regard the share capital insufficient and therefore provide themselves with security through various contractual arrangements. Involuntary creditors, on the other hand, do not have this possibility of contraction, and are thus dependent on the legal capital to cover their claims in Europe.[92]

However, not surprisingly, also for these creditors the legal capital rules may be held to not provide any meaningful protection.[93] First of all, the amount of the minimum capital is both arbitrary and relatively low. Furthermore, little of any legal capital is ever likely to be received by involuntary claimants in a process of winding-up or bankruptcy. Such parties namely rank as *unsecured creditors,* and will accordingly be paid only after the secured and preferential creditors have had their parts of the company's assets.[94] As a consequence, there is typically little or nothing left to the involuntary creditors.[95]

Recommendations

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

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91 Ibid.

92 Kubler, above n 14, 12.

93 Armour, above n 86,18-19.

94 Kubler, above n 14, 13.

95 Armour, above n 86,19.

SLIM and the High Level Group Report

In 1996 the European Commission launched a project to modernize and simplify key Common Market legislation. The program was named SLIM (*Simpler Legislation for the Common Market*) and comprised 17 different legislative key sectors.[96] One of these key sectors to analyze was the company law sector, and thus a SLIM working party was set up for this purpose.[97] The objective of the working party was to identify whether a simpler legislation could replace the existing one in the field the First and the Second Company Law Directive.[98] The working party submitted a number of proposals, of which, with regards to this essay, the most interesting was to eliminate the need for an expert's valuation report where contributions consisted of securities traded in a regulated marked. Though the SLIM proposals were presented to the Commission already in 1999, no further action was taken during some years. In September 2001, however, the Commission set up a new group to continue and complete the SLIM project. This group comprised of seven company law experts[99], and worked under the name *The Group of High Level Company Law Experts* (also called the "Winter Group" after the chairman of the group Jaap Winter).

Consultations Revealing Dissatisfaction of the System

Three alternative approaches to reform were presented by the Group in the consultation document and subsequently considered by the interest groups participating. The *first* alternative presented was based on the previous SLIM proposals and represented the least radical change. This approach did not imply a radical departure from the current system in Europe; instead it may be seen as an evolution of the current regime to a more simplified and modern capital regime.[100] The *second*

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96 Recommendation by the Company Law SLIM Working Group on the Simplification on the First and the Second Company Law Directive. Brussels. (1999) <http://users.ugent.be/~ewymeers/WP/SLIM.pdf>

97 Report of the High Level Group of Company Law Experts on a Modern Regulatory Framework for Company Law in Europe. Brussels, 4 November (2002); http://europa.eu.int/comm/internal_market/en/company/company/official/6037en.pdf

98 Ibid, 1, 4.

99 The company law experts comprised of: Chairman Jaap Winter, Klaus J. Hopt, Jonathan Richford, Guido Rossi, Jan Schans Christensen and Joelle Simon. Rapporteur was Dominique Thienpont and Karel Van Hulle was Secretariat.

100 "*Report of the High Level Group of Company Law Experts on a Modern Regulatory Framework for Company Law in Europe*", presented to the European Commission on the 4th November 2002, 79-80.

approach was much more radical and more or less based on the experience of US jurisdictions. This approach would imply nearly revolutionary changes from the Europe perspective if it were to be implemented.[101] Lastly, a *third* approach was contemplated which may be considered as something in between the other two alternatives.[102]
As the US approach, this alternative was also based on the elimination of the concept of legal capital, but which seek to integrate that fundamental change with some of the basic features of European company law. Accordingly, this approach would not copy a US capital regime, but instead rebuild the regime from a European point of view, making use of some ideas coming from the US experience but also from other legal systems[103]. Taking into consideration the consultation results, the Winter Group made two important recommendations.

First recommendation; Amendment of the Second Company Law Directive

The first recommendation from the Group was put forward as a matter of priority. This recommendation was based on the *first* approach mentioned in the previous paragraph, and implied that the Commission should present a number of proposals to reform the Second Company Law Directive. This reform would follow the proposals suggested by the SLIM working party, but also further modifications and supplementary proposals which were made by the Group in what was called the *SLIM-plus Report*.[104] Under the SLIM-plus approach, the concept of legal capital was recommended to remain as the basis together with other fundamental European legal capital features. The minimum share capital requirement would remain in present form, even though the Group stated that the only function it served was to deter individuals from light-heartedly starting a public limited company.[105] However, in accordance with what the SLIM working party proposed, the Winter Group recommended the elimination of expert's valuation reports of non-cash contributions since these were regarded to be expensive and not able to offer a total guarantee of the assets real value. This abolition was recommended to apply when (1) contribution consists of securities traded in a regulated market and there is a market price, (2) where there is a recent evaluation and there

101 Ibid, 80, 148.

102 Ibid, 148.

103 Ibid, 80.

104 Ibid, 81.

105 Ibid, 82.

are no new qualifying circumstances that need to be taken into account and (3) where values derive from audited accounts provided that the accounting principles used are still applicable to the assets.[106]The presented consultations clearly demonstrate the fact that there is a pressure of reviewing the current legal capital regulations. This first recommendation of change can be held to be a step in the right direction of a more efficient regime, at least with regards to business activity.

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

Second recommendation; Development of an Alternative Regime

On basis of the consultations the Group observed that the criticism directed at the current regime was both fundamental and serious. Therefore, it was considered necessary to create a new approach which abandoned the current legal capital regime, but which at the same time fit in the European company law structure.[107] A second recommendation of the Group was therefore that the Commission, at a later stage, should conduct a review into the achievability of an *alternative regime*, based on more modern solutions for creditor protection.[108] This regime would be based on the *third* approach presented in the consultation document. The idea of this alternative

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[106] Ibid, 83.

[107] Ibid, 81,86.

[108] Ibid, 86-87.

approach was not to replace the capital formation and maintenance rules of the Second Directive, as amended according to the SLIM-plus proposals. Rather, this new regime was suggested to be offered as an alternative option. Member States should be able to decide whether to impose the alternative regime or to retain requirements of the Second Directive.[109]

Under the recommended alternative approach, the share capital requirement would be fully abolished. Creditor protection would instead come by means of a *solvency test*, which would be applied to *all* distributions of capital.[110] The Group held that this method had all potential to be at least as effective, even superior, in achieving the objectives of creditor protection as the current regime based on legal capital.[111]As an argument, the Group stated that creditors would be better protected if an *adequate solvency test* was developed, since under the present system there are possibilities that solvent companies are unable to make distributions which clearly harm creditors. Also controversially, there are possibilities under the current system that insolvent companies are able to make distributions, which would be prevented if an adequate solvency test was developed.[112]

Considering the critique presented towards the first recommendation of the Group, this second recommendation clearly views the recommended approach as an entirety, building up the regime from the start. Though the Group does not deal with this alternative model in detail, but refers to coming investigations, it has all the potential to become a complete and coherent system. Personally, I believe that the idea of a European solvency test regime can provide both a more flexible system, and at the same time attain a better creditor protection. First of all, with regards to contractual creditors, their way of acting would not drastically differ from today since contractual creditors already manage their own risk by insisting on contracts. Instead, the recommended approach regards creditors more individually and would accordingly conform better to the existing reality. It could of course be argued that a mandatory legal regime may save the parties from extensive contracting. This argument is, however, only persuasive as long as it can be assumed that the legal capital regime in fact is able to grant creditors satisfactory amount of certainty that they will be repaid

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109 Ibid, 87.

110 Ibid, 87-88.

111 Ibid, 87.

112 Ibid, 87.

out of corporate funds.[113] But this is not the situation under the current system.

Furthermore, this alternative regime can be seen to be in conformity with the recent development of new and more sophisticated instruments to protect creditors contractually. For example, banks constantly refine the use of receivables as collateral, and there are moreover many contractual forms – sureties, guarantees, standby letters of credit, performance bonds which allow shifting liability back to the shareholders.[114] These new opportunities have in several ways contributed to the erosion of the capital regime. Moreover, their proliferation demonstrates that creditors have lost confidence in being protected by rules on capital. At the same time they provide a better protection by enabling creditors to seek satisfaction from specific assets.

This situation, however, imply that these assets are no longer available for protection of the other creditors. Accordingly, this situation obviously increases the problem for involuntary creditors as they are unable to rely on any form of contracting.[115]

Even though the issue of involuntary creditors was not directly addressed in the Report, the Group suggested two ways in which a solvency test could offer also these non-contractual creditors a stronger protection compared to, for example, the US model. First, the Group suggested that it might be considered whether there should be a certain *solvency margin,* meaning that a company distributing dividends must have assets exceeding its liabilities by at least a certain percentage.[116] Adapting such solvency margin, would, according to me, offer a proper mechanism to integrate legal and statutory reserves into a regime where there is no legal capital. Second, and as a further protection, the Group suggests that on the basis of the solvency test recommended, the directors would have to issue a *solvency certificate*, which would contain an explicit confirmation that the proposed distributions meet the solvency test. A valid distribution could thus be made only when such certificate is issued. It was moreover suggested, that directors should be responsible for the correctness of this solvency certificate, and that Member States should impose proper sanctions if

113 Kubler, above n 14, 9.

114 Ibid.

115 Ibid.

116 Report, above n 100, 88.

the certificate was proven to be misleading.[117] In addition to what the Winter Group has recommended, alternatives based on mandatory insurances might furthermore be regarded to avoid an extended use of the piercing of the corporate veil doctrine.

However, in accordance with the recommendations made, the Group advised the Commission to set up an *Action Plan* to move forward with the objective of modernizing European company law.

Summary and Conclusions

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

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

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[117] Ibid.

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

As a consequence of the present EU development and the presented criticism, the assignment moreover examined the future of the legal capital doctrine. Primarily, the recommendations in the High Level Group of Company Law Expert's report on modernizing European company law were considered.

The recommendations of the High Level Group, presented to the EU Commission, were primarily two with regards to legal capital regulations. *First* some amendments of the Second

Directive concerning contributions in kind were made. These recommendations may be seen as a first step of adjusting the current regime to provide more efficient and enterprising regulations, in conformity with the Common Market.. In its *second* recommendation the Group request the Commission to initiate an investigation to the feasibility of an "alternative regime" to the Second Directive, based on creditor protection through a solvency test. The assignment concludes that such regime would constitute a more modern and efficient approach than the current, while at the same time being in conformity with values of creditor protection and goals of a Common Market. Moreover, such alternative regime may be regarded to constitute a balanced solution, bearing in mind the status of the legal capital doctrine as deeply rooted tradition.

Changing rules on capital into a solvency test approach, would in some Member States, based on the strict German regulations, imply nearly revolutionary adjustments. Through the solution of an alternative regime, however, Member States can amend their legislations when they consider them to be ready, or they do not have to change at all. Nevertheless, the important thing is that there are other possibilities which conform better to current economic life and development.

Summarily, the current and ongoing development within the EU clearly denotes a distinct shift from the approach taken in the Member States today with respect to legal capital rules.

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

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