The case to reform the EU capital maintenance rules: where do we stand now?

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Introduction

The legal capital doctrine has always been regarded as the cornerstone of European company law. It became mandatory in all EU Member States with the implementation of the Second Company Law Directive ("Second Directive")[1] and had worked without significant controversy until the end of the last century. In its basic design it requires shareholders to contribute certain assets of a determined minimum value to the company and establishes several rules that prevent such assets and value from being returned to shareholders during the company's life. This system aims to protect creditors by the creation

[1] 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, OJ 1977 L26/1.

of a "cushion" on which they can in principle rely. While on the other side of the Atlantic it was earlier perceived that this system did not properly protect creditors, in Europe only recently general attention has been drawn to this question.

There have been two main drivers to this debate. First, the decision of the European Court of Justice ("ECJ") in the *Centros*[2] case. This decision subjected the minimum capital rules to the freedom of establishment and concluded that they did not pass the *Gebhard*[3] test. According to the ECJ, minimum capital requirements were not a necessary or a proportionate form of achieving the protection of creditors. This decision was followed by two similar decisions in the *Überseering*[4] and *Inspire Art*[5] cases and gave rise to some regulatory arbitrage. In fact, as noted by John Armour "many continental entrepreneurs have responded by choosing to incorporate their businesses in the United Kingdom, where legal rules for private companies are relatively permissive"[6]. Since that moment some Member States have abolished their minimum capital requirements for private companies and the question whether legal capital rules are useful or desirable was eventually raised. Secondly, there was the transition to the International Financial Reporting Standards ("IFRS") in the European Union. Through the adoption of Regulation (EC) No. 1606/2002 ("IAS Regulation")[7] the International Accounting Standards ("IAS") were made applicable to the consolidated accounts of listed companies. As it was believed that these new accounting rules would also impact on the accounts of individual companies[8] and as they brought a significantly new approach to companies accounts, it was alleged that these new standards would further undermine the already weak arguments in favour of the rules of the Second Directive, particularly the capital maintenance and dividend distribution rules.

[2] Case C-212/97 *Centros Ltd* v. *Erhvervs-og Selskabssyrelsen* [1999] ECR I -1459.

[3] Case C-55/94 *Gebhard* v. *Colsiglio dell'Ordine degli Avvocati e Procuratori di Milano* [1995] ECR I-4165.

[4] Case C-208/00 Überseering BV v. *Nordic Construction Company Baumanagement GmbH* (NCC) [2002] ECR I – 9919.

[5] Case 167/01 *Kamer van Koophandel en Fabrieken voor Amsterdam* v. *Inspire Art Ltd.* [2003] ECR I - 10155.

[6] John Armour, "Legal Capital: An Outdated Concept?", European Business Organization Review 7, 2006, 7.

[7] Regulation (EC) No. 1606/2002 of 19 July 2002 on the application of international accounting standards, OJ 2002 L243/1.

[8] See Eilís Ferran, "The Place for Creditor Protection on the Agenda for Modernisation of Company Law in the European Union", European Company and Financial Law Review 178, 2006, 201-202.

At the same time, the European Commission was trying to modernize the Second Directive. Initially by virtue of the Simpler Legislation for the Single Market ("SLIM")[9] initiative and later through the agenda of the High Level Group of Company Law Experts ("Winter Group", as this work was chaired by Jaap Winter)[10]. On a Communication from the Commission to the Council and the European Parliament it was stated that "the Commission considers that, before deciding to introduce an alternative regime which would fundamentally depart from the capital maintenance regime currently organised by the Second Directive, further work is needed as to both the exact characteristics of a possible alternative regime and its ability to achieve an effective protection of shareholders and third parties. A study into the feasibility of an alternative to the capital maintenance regime will be launched by the Commission in the medium term. The study will have to identify in particular the exact benefits that an alternative regime would offer in comparison with the Second Directive rules amended in the short term"[11].

An increasing number of voices was joining the appeal for reform when, on 2006, the accounting giant KPMG was hired to conduct the above mentioned study on the feasibility of an alternative to the capital maintenance regime established by the Second Directive. The results of this study were made public two years later[12] and the Commission divided its conclusions into two main findings: i) the current minimum legal capital requirements and rules on capital maintenance do not constitute a major obstacle to dividend distribution; and ii) regarding the impact of the IFRS on dividend distribution, several Member States have required or permitted the application of the IFRS to individual accounts without any apparent difficulty for the distribution of dividends[13].

9 European Commission, Simpler Legislation for the Single Market: Extension to a Fourth Phase, SEC (1998) 1944, Brussels, 16 November 1998, 3.

10 High Level Group of Company Law Experts, "Report on a Modern Regulatory Framework for Company Law in Europe", Brussels, 4 November 2002, 86-93.

11 Communication from 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, Brussels, 21 May 2003, 18. http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2003:0284:FIN:EN:PDF

12 KPMG, "Feasibility study on an alternative to the capital regime established by the Second Company Law Directive 77/91/EEC of 13 December 1976 and an examination of the impact on profit distribution of the new EU-accounting regime", Contract ETD/2006/IM/F2/71, February 2008.

13 Communication from the Commission, Results on the external study on the feasibility of an alternative to the Capital Maintenance Regime of the Second Company Law Directive and the impact of the adoption of IFRS on profit distribution, 1-2. http://ec.europa.eu/internal_market/company/docs/capital/feasbility/markt-position_en.pdf

As a consequence, the Commission took the view that the Second Directive did not cause significant operational problems for companies and decided that no follow-up measures or changes to it should be implemented in the near future[14].

The conclusions of the KPMG study had a major impact on the lively debate that was then taking place. Either because the theoretical possibility of reform was curtailed by convincing argumentation from KPMG or because the Commission's position effectively dismissed the practical possibility of a reform in the near future, the truth is that the voices that were raised in favour of reform seemed to accept its postponement. It will be argued in this article that, although it changed the course of the discussion, this study did not significantly affect the case for reform. Not only did the European Commission misunderstand some of the findings of the KPMG study, but the study itself has also deficiencies that do not justify the vast reliance it seems to have achieved. On the one hand, the study is a mere assessment of the administrative costs of some very specific processes and is therefore incapable of evaluating the general coherence and completeness of a legal system and of determining costs that are not easily calculated. On the other hand, it cannot be seen as evidence that the transition to the IFRS is being done without serious difficulties and risks. The study identifies a substantial lack of harmonisation and even recognises the need for changes.

To better support the strengths of the case for reform this article will be divided into six parts. Part I provides a brief description of the legal capital doctrine implemented by the Second Directive. This is important to give an overview of the global doctrine and its relationship with the main focus of this article, the capital maintenance and profit distribution rules of the Second Directive. Part II describes the main criticisms of the regime established by the Second Directive and the foundations of the case for reform. Part III presents the problems and challenges brought by the new accounting regime. In Part IV, reference will be made to the main proposals for reform, with special emphasis on the most complete and sustained proposal made so far – the one of the Rickford Group[15]. Part V summarises the KPMG study and the interpretation that the European Commission made of its results. Part VI starts with a critical analysis of the KPMG study and the way in which it was interpreted by the European Commission and then goes on to an assessment of the strength of the arguments for reform of the capital maintenance rules of the Second Directive in the current context. Finally, it will be concluded that

[14] Communication from the Commission, *supra* note 13, 2.

[15] Jonathan Rickford (ed.), "Reforming Capital: Report of the Interdisciplinary Group on Capital Maintenance", 15 European Business Law Review, 2004.

the KPMG study did not substantially affect the case for reform and that the arguments in favour of it remain as strong as before. It will then be suggested that the reform procedure should be resumed and, if not politically possible or convenient, a "think small first" approach should be pursued.

I. **Overview of the Second Directive regime**

The main essentials of the legal capital doctrine were adopted in most EU Member States in the mid to late nineteenth century. The Second Directive was imposed on all Member States in 1976 and incorporates a moderately strict version of the legal capital doctrine. The Second Directive is only applicable to public companies, reason why Member States remain free to adopt a different regime to their private companies. When addressing the legal capital doctrine one can separate the capital maintenance and dividend distribution rules from the remaining parts of the legal capital doctrine. Although a reform of the capital maintenance and dividend distribution rules could be done without changing the remaining parts of the legal capital regime, it is the argument of this article that a complete reform of the doctrine would be preferable, as occurred in New Zealand in the early 1990's. Hence, a general doctrine overview is now provided and is also criticised in Part II. This would allow the reader to better understand and frame the reform that will be suggested below.

The starting point of the legal capital doctrine is the establishment of a minimum capital. Article 6 of the Second Directive imposes a minimum capital of 25.000 EUR for European public companies. Although only 25% of the nominal value of the shares need to be paid at the time the company is incorporated, this amount is viewed as a device to protect the so-called "involuntary" creditors, the ones that do not have the possibility to adjust the terms of a contract with the company.

Connected with this is the requirement for valuation by independent experts of non-cash consideration for shares issued on formation and in subsequent capital increases. This requirement was alleviated in the amendment to the Second Directive[16], but it is still criticised as will be shown below. In addition, undertakings to perform work or supply services are ineligible consideration for shares. These rules aim to guarantee that the value of the minimum contributions is effectively transferred to the company. Allegedly

[16] Directive 2006/68/EC of 6 September 2006 amending Directive 77/91/EEC as regards the formation of public limited liability companies and the maintenance and alteration of their capital, OJ 2006 L264/32.

to protect the existing shareholders against dilutions, the Second Directive also prohibits shares from being issued at a discount, i.e. at a price lower than their nominal or par value.

An issue of shares is then recorded in the accounts of the company by entering a figure of "issued capital" equal to the number of shares multiplied by their nominal or par value. The amounts by which the issue price exceeds the nominal or par value are entered as "share premium". Both items will be included on the right hand side of the company's balance sheet, as part of the shareholders' funds.

Once the shareholders' contributions are made, the concern of the system changes and is then oriented towards their preservation. This second stage of the legal capital regime is known as the capital maintenance doctrine. It was viewed by the nineteenth century judges who developed it as a means of protecting corporate creditors against the risks associated with limited liability of shareholders[17]. This part of the regime is mainly composed of rules governing the distribution of dividends, purchases and redemptions of own shares, reductions and loss of capital. The first three deal with different forms of returning social assets to shareholders and constitute the main focus of this article. The loss of capital rules deal with losses in the normal trading or activity of the company.

One of the most controversial rules of the Second Directive is Article 15. It states that:

> a) Except for cases of reductions of subscribed capital, no distribution to shareholders may be made when on the closing date of the last financial year the net assets as set out in the company's annual accounts are, or following such a distribution would become, lower than the amount of the subscribed capital plus those reserves which may not be distributed under the law or the statutes.
>
> c) The amount of a distribution to shareholders may not exceed the amount of the profits at the end of the last financial year plus any profits brought forward and sums drawn from reserves available for this purpose, less any losses brought forward and sums placed to reserve in accordance with the law or the statutes.

The effect of both tests is to make sure that the nominal value received for the shares is maintained as an undistributable reserve. Some countries, like the United Kingdom and Germany, also treat share premiums as part of this

[17] John Armour, "Share Capital and Creditor Protection: Efficient Rules for a Modern Company Law", Modern Law Review 63, 2000, 367.

undistributable reserve[18]. The first of these tests is called the "net assets" or "balance sheet" test and the second one the "earned surplus" or "running profit and loss account" test. These tests establish a strict linkage between dividend distribution and the accounts. This logic is accused of provoking a divorce with the company's real capacity to pay dividends and makes Article 15 of the Second Directive the main target of reform proponents.

According to Articles 19 and 39 of the Second Directive, both the purchase and redemption of own shares must conform to the above mentioned tests. They can only be made out of distributable profits and with the creation of a matching reserve to cover the relevant share capital. Indeed, both these transactions are economically identical to a distribution of dividends. For the same reason only fully paid-up shares may be included in a purchase or redemption of own shares.

In this regard and with relevance to the reform proposals that will be presented at a later stage, reference should be made to the special concessions that were made to private companies in the United Kingdom. In the 1981 reforms it was decided that private companies should be empowered to redeem or buy their own shares otherwise than out of their distributable profits or the proceeds of a fresh issue of shares. Such a payment is called "out of capital". The procedure is set out in Sections 709 to 723 of the Companies Act and its main creditor protection devices are the requirement for a solvency statement from the directors and the availability of a right of objection to the court. The content of this statement is described in Section 714 of the Companies Act and is basically composed of a declaration in which the directors state the amount of the permissible payment for the shares in question and that, having made full inquiry into the affairs and prospects of the company, they have formed the opinion that there will be no grounds on which the company could be found unable to pay its debts immediately following the date of the payment and that in the following year the company will be able to continue to carry on business as a going concern. As Paul Davies points out, "the emphasis is thus on an opinion which envisages a continuing business, not just the ability of the company to pay its debts"[19].

If share capital is to provide security for creditors, then the fund should not be subject to reductions without proper creditor protection. That is why the current version of Article 32 of the Second Directive establishes that creditors whose claims antedate the publication of the decision of reduction shall at least

[18] For a criticism of this interpretation, see Jonathan Rickford (ed.), *supra* note 15, 939-941.

[19] Paul Davies, "Gower and Davies – Principles of Modern Company Law", Eighth Edition, 2008, 335.

have the right to obtain security for claims which have not fallen due by the date of that publication. Member States can set aside this right if the creditor has adequate safeguards or if such safeguards are not necessary considering the assets of the company. In any case, creditors shall be authorised to apply to the appropriate administrative or judicial authority for safeguards provided they can demonstrate that due to the reduction in subscribed capital the satisfaction of their claims is at stake. However, Article 33 of the Second Directive determines that Member States need not to apply these protections if the purpose of the reduction in the subscribed capital is to offset losses incurred. This limitation has been seen as anomalous and inconsistent with the remaining theory of capital maintenance[20].

Once again the regime established by the United Kingdom for its private companies deserves a reference. To avoid the delays and costs involved in court confirmation, a system that relies on a solvency statement made by directors was put in place. The procedure with court approval is still available for both public and private companies, but this particular possibility is now offered to private companies. Under this system, a resolution of members is still required, but the resolution has to be supported by a solvency statement from directors. This solvency statement is a declaration that each director of the company has formed the opinion that, at the date of the statement, there are no grounds on which the company could be found unable to pay its debts and that if (i) it is intended to commence the winding up of the company within twelve months, the company will be able to pay its debts in full; or (ii) in any other case, the company will be able to pay its debts as they fall due during the year immediately following the date of the statement. The Company Law Review wanted to extend this possibility to public companies, but once again the Second Directive rules worked as a deterrent[21].

The last piece of the capital maintenance puzzle would always be the loss of capital rule. Nothing precludes loss of share capital by trading. The Second Directive provides that in case of serious loss of the subscribed capital a general meeting of shareholders must be called to consider whether the company should be wound up or any other measure taken. The concept of serious loss is not defined, but it is established that Member States may not set it at a figure higher than half of the subscribed capital. The criticism of this provision as a creditor protection technique will be dealt with in Part II. However, it could

[20] High Level Group of Company Law Experts, *supra* note 10, 87.

[21] Company Law Review, "Company Formation and Capital Maintenance", URN 99/1145, para. 3.27.

be mentioned at this stage that, due to the vagueness of this rule, harmonisation is far from being reached on one of the main pillars of the regime.

The financial assistance provisions are sometimes coupled with the capital maintenance rules. The original rationale for the introduction of the financial assistance provisions in the United Kingdom was the prevention of "asset--stripping" takeovers. They had in mind transactions whereby a purchaser would borrow heavily to buy a majority holding of a target company's shares for cash and then rapidly sell the latter's assets, using the proceeds of the sale to discharge the loan. This can be seen as an indirect return of capital, whereby shareholders are cashed out at the expense of creditors. However, the ambit of financial assistance provisions goes beyond what is necessary to make sure that capital is not returned to shareholders[22]. Financial assistance was prohibited in the original version of the Second Directive. With the amendment to the Second Directive[23] it became permitted, but in such tight conditions that even the British Government regarded the relaxations as not significant[24]. It should be noted that the Companies Act 2006 removed the financial assistance prohibition from private companies, reason why nowadays only public companies are prevented from giving financial assistance in the United Kingdom. The Company Law Review also proposed a series of amendments to the rule as it applies to public companies, but even here the Second Directive rules blocked further changes[25].

Having established the essentials of the legal capital regime, it is now time to turn to its drawbacks and establish the foundations of the case for reform.

II. **Weaknesses and inefficiencies of the Second Directive regime**

Vast literature exists about the weaknesses and inefficiencies of the Second Directive rules and the legal capital doctrine it incorporates. Problems with this system are also felt by practitioners who daily experience the burdens and costs of the theory or its incapability to properly protect creditors. The need for change is fairly consensual. The type and the extent of this change is where the disagreements begin. To point the direction of a future reform

[22] John Armour, *supra* note 17, 368.

[23] See note 16.

[24] Department of Trade and Industry ("DTI"), Implementation of Companies Act 2006: A Consultative Document, February 2007, para. 6-26.

[25] Company Law Review, *supra* note 21, paras. 3.42 and 3.43.

is, however, fundamental to determine these problems and that is what will be done in this Part.

The first criticism that can be made against the legal capital doctrine is that it relies on a concept, share capital, whose importance in the equity finance of modern companies is quite low. In the KPMG study, for example, it was found that "a comparison of the ratio of subscribed capital to the total shareholders' equity for companies on the main stock exchanges indices of the five EU Member States showed that equity financing is not largely dependent on it"[26]. It only reflects the value of shareholders' contributions and will become less and less significant as time goes on. In the same way that share capital does not reflect a company's cash flows and activities, it would not reflect the level of borrowing or the contingencies that surround that company. It is unrelated with the risks a company takes. Thus, the "cushion" provided by legal capital rules is clearly inadequate and of little relevance for creditors who deal with that company.

Furthermore, the setting of the "reserve fund" at the amount of the aggregate nominal value of the shares actually issued is also arbitrary, given the varying needs of different companies over time and the role that nominal values play in company financing. There is no reason why the aggregate amounts of nominal value over time (which are an accident of history) should constitute an appropriate amount for a capital reserve. Moreover, the amounts obtained through the application of these rules could vary greatly between companies with the same needs for such reserves[27].

Secondly, the minimum capital requirement creates an entry price for limited liability. The principal benefit brought by limited liability is the reduction on risk it offers to entrepreneurs. Hence, restrictions on access to limited liability might deter individuals from engaging in entrepreneurial activity. Confirming this view, one study found a negative correlation between the size of minimum capital requirements, scaled for gross domestic product ("GDP"), and self-employment – a common proxy for entrepreneurship – in European countries in the 1990's[28]. Moreover, an entrepreneur can easily signal the quality of his or her project without a minimum capital requirement, either by committing his or her funds to the company or by agreeing to stand guarantor for its debts. As long as adjusting creditors are capable of distinguishing project quality or require shareholders to give a personal guarantee, a minimum capital

[26] KPMG, *supra* note 12, 2.

[27] Jonathan Rickford (ed.), *supra* note 15, 931.

[28] J. Armour and D.J. Cumming, "Bankruptcy Law and Entrepreneurship", University of Cambridge ESRC Centre for Business Research Working Paper No. 300, March 2005, 20 (Table 3).

requirement will impose a social cost by preventing some entrepreneurial projects from being undertaken[29].

In addition to that, superior alternatives seem to exist. One is to regulate hazardous activity and to require that firms carry insurance commensurate with their potential risk. Other techniques include granting involuntary claimants priority over other claimants in corporate insolvencies or imposing *pro rata* unlimited liability on shareholders for corporate torts[30]. Even a rough-and-ready mechanism such as the judicial doctrine of "piercing the corporate veil" in cases of low capitalisation would be likely to be cheaper in terms of administrative costs than a general minimum capital requirement[31].

Thirdly, the no-issue-at-a-discount rule of the Second Directive impedes the issue of true no par value shares combined with a "stated" capital fund that provides a reserve for creditors and prevents a company from issuing shares of a class already in issue where their value is less than the nominal value. It restricts companies' flexibility and seriously hinders restructurings. While it is true that these difficulties can be overcome if the company engages in a reconstruction to reduce the nominal value of its shares or creates a new class of shares, it is also true that these solutions will involve additional expense and complexity. Furthermore, they usually attract unwelcome publicity about the company's situation.

Fourthly, the fact that shares cannot be paid up by an undertaking to perform work or supply services is also unduly restrictive. As recognised by the Winter Group, the acceptance of services as a valid contribution in kind could be particularly useful for certain types of companies, namely startups, technological or professional companies in which specialised services play a decisive role[32]. This rule is not applicable to British private companies and, if repealed from the Second Directive, would provide managements of European public companies with an additional and valuable tool.

Fifthly, the requirement for independent valuation of non-cash consideration for shares is costly and ineffective in practice. On the one hand, these valuations give rise to potential liabilities on the valuers, who are invariably insured at the company's expense. On the other hand, they can be easily avoided. As the Rickford Group points out a company can issue the shares for a cash price and purchase the relevant non-cash asset, either before or after the issue, at the same

[29] John Armour, *supra* note 6, 18-19.

[30] Hansmann and Kraakman, "Towards Unlimited Shareholder Liability for Corporate Torts", Yale Law Journal 100, 1991, 1879.

[31] John Armour, *supra* note 17, 372.

[32] High Level Group of Company Law Experts, *supra* note 10, 83.

price[33]. Furthermore, these valuations are time consuming and inconvenient in urgent cases. Thus, reliance should instead be placed on fiduciary duties and minority remedies.

Sixthly, the strict linkage of the dividend test to the accounts generates a divorce between the company's real capacity to pay dividends and the result obtained under the rules of the Second Directive. This may either produce unduly generous or unduly restricted outcomes. Where asset values are volatile over time and liabilities are to be met over time the accounts may produce deficiencies or surpluses that do not correspond to the real prospects of solvency. As will be explained in Part III, these problems could be worsened by the adoption of the fair value approach in modern accounting practice. Even if the calculation of the assets available for distribution were to be based on a more commercial and less mechanical assessment, the question of whether it is appropriate to adopt a balance sheet test which insists on the maintenance of the capital fund in all circumstances would still arise. As previously pointed out, the share capital figure, which is a historic fact, bears no sensible connection with the company's financial needs on a going concern basis. That is why a solvency test, which takes account of all economic and financial factors surrounding a company, seems to be preferable as the fundamental criterion to determine distributions of dividends to shareholders[34].

What was just stated for the distribution of dividends could also be said for the purchase and redemption of own shares, as they rely on the very same test to be permitted. Moreover, it should be added that concerns about market manipulation should be dealt with by financial regulation tailored for the purpose and not by company law instruments.

Regarding reductions of capital, it was already mentioned that the possibility given to Member States of not applying the protections offered to creditors by Article 32 of the Second Directive in case of a reduction of capital to offset losses calls into question the value of the harmonisation achieved and of the attempt to implement the capital maintenance theory at all[35]. In this sense, the question posed by the Rickford Group is fully pertinent: "If the capital reserve can be reduced when assets are lost, regardless of the interests of creditors, and there is no requirement to replenish it before distributions may take place, what real value does the so-called «security for creditors» which the Directive pretends to provide really have?"[36].

[33] Jonathan Rickford (ed.), *supra* note 15, 988.
[34] Jonathan Rickford (ed.), *supra* note 15, 938.
[35] This option is exploited in several Member States, including Germany, France, Italy and Spain.
[36] Jonathan Rickford (ed.), *supra* note 15, 943.

Similar concerns can be raised about the loss of capital rule. As explained in Part I, the Second Directive only establishes that if more than 50 per cent of the subscribed capital is lost a general meeting must be called to consider the matter. Nothing is provided as to further consequences. So the rules do not go so far as to create a true net asset value maintenance regime. Even though the capital maintenance doctrine limits transfers to shareholders, there is no guarantee that assets will not be depleted through trading losses. In some Member States companies are required to make good the capital lost or to reregister in a new form, where minimum capital is not required[37]. However, the possibility of implementing a more vigorous capital regime does not seem to be exploited by many Member States, as the situation in the United Kingdom and Germany attests[38]. Therefore, it can be concluded that not only is the legal capital regime trivial and inefficient in several of its aspects, but that it is incomplete as a theory in the way it is implemented by the Second Directive.

In Part I it became clear that the prohibition of financial assistance imposed by the Second Directive defends the quality of the company's assets, but is not related to the preservation of the share capital fund. Although its regime does not constitute the focus of this article, it could nevertheless be pointed out that it is becoming well established that the costs of this prohibition are disproportionate to any benefit it may provide and that the risks to which financial assistance give rise are now dealt with by other better targeted provisions[39]. It was already mentioned that the financial assistance regime was one of the aspects of the Second Directive that was amended in 2006, but a complete removal of the provisions that govern it should be considered in the next review. With the existing company law tools, this is one of the issues that could well be left to financial services legislation.

A final major criticism against the legal capital doctrine established by the Second Directive is that it is not relied on in practice. A number of empirical studies have investigated the information taken into account by sophisticated parties in making investment decisions and in some share capital ranked as a

[37] John Armour, *supra* note 17, 371, presents Sweden as a country in whose regime shareholders of a company that fall below half of its share capital must either inject fresh equity to restore the net asset level or liquidate the company.
[38] Regarding this point and the efficiency concerns raised by "recapitalise or liquidate" rules, see Enriques and Macey, "Creditors versus Capital Formation: The Case Against the European Legal Capital Rules", Cornell Law Review 86, 2001, 1201-1202.
[39] Company Law Review, "Developing the Framework", URN 00/656, para. 7.16-7.27.

very minor variable[40], while in others it did not feature at all[41]. Furthermore, the majority of the respondents to the Company Law Review's Strategic Framework document affirmed that they considered share capital a relatively unimportant tool for measuring a company's ability to repay credit[42]. These results were confirmed in subsequent enquiries, where it became clear that what matters to creditors is the risk of insolvency and the quality and certainty of future cash flows[43]. These findings are readily explicable. Share capital is an indication of the value contributed to the company by its shareholders at some point in the past. Yet since that value has been put into the company, it may well have been dissipated. None of these conclusions can be viewed as surprising. Indeed, they seem to be shared well beyond the borders of United Kingdom.

In conclusion, there is very little to be said in favour of the Second Directive provisions. The regime it implements is disproportionate in its effects, ill-targeted for its purpose, inconsistent in its own terms and has led to widely divergent and misleading rules across EU Member States. Furthermore and as was just shown, it is not relied on by those it wanted to protect: creditors. Part III will present further difficulties that accounting rules pose to the current regime. Subsequent parts will consider alternatives and the case for reform with a special focus on the creditor protection aspects of capital maintenance.

III. **Accounting Standards and the Second Directive regime**

Having presented the legal capital regime established by the Second Directive and identified the main criticisms that can be drawn against it, it is now time to focus on the capital maintenance provisions and their specific problems. From the above, it is already possible to say that the main discussion regarding capital maintenance is related to the test imposed by Article 15 of the Second Directive. Indeed, this test is applicable to both the distribution of dividends and the purchase and redemption of own shares and represents the key element of creditor protection of the whole theory.

[40] J.F.S. Day, "The Use of Annual Reports by UK Investment Analysts", Accounting & Business Research 16, 1986, 295.

[41] A.J. Berry et al., "Financial Information, the Banker and the Small Business", British Accounting Review 25, 1993, 131; D. Deakins and G. Hussain, "Financial Information, the Banker and the Small Business: A Comment", British Accounting Review 26, 1994, 323.

[42] Company Law Review, "The Strategic Framework", URN 99/654, 23-24.

[43] Company Law Review, "Final Report", URN 01/942 and URN 01/943, ch 7.

As previously seen, the test is composed of two different parts: the "net assets" or "balance sheet" test and the "earned surplus" or "running profit and loss account" test. According to the "net assets" or "balance sheet" test, distributions may not be of more than the excess of net assets over the amount of the aggregate subscribed capital and any reserves which are not distributable under the law or constitution of the company. It was already mentioned that, although the Second Directive does not require share premiums to be treated as capital[44], some Member States include them in the undistributable reserve created to protect share capital from distribution to shareholders. According to the "earned surplus" or "running profit and loss account" test, distributions may not also exceed the profits for the year, plus profits brought forward and any sums drawn from reserves available for this purpose, less any losses brought forward and sums placed to reserve in accordance with the law and the constitution of the company.

The link between this test and companies accounts is evident. Therefore, to make a critical analysis of the current capital maintenance regime established by the Second Directive one would always have to bear in mind the accountability rules in force in the European Union.

According to Jonathan Rickford[45], there are now four main versions of the balance sheet operating in parallel. Following his methodology this Part will be divided into four sections. Section A will outline and analyse the two 1978 versions of the balance sheet under the Fourth Directive[46]. Section B will outline and analyse the Modernised Fourth Directive[47] and the transition to the IFRS through the adoption of the IAS Regulation. Section C will identify problems with balance sheet tests in general and Section D will identify specific problems with the four balance sheet tests outlined and analysed in Sections A and B.

[44] Jonathan Rickford (ed.), *supra* note 15, 939-941.

[45] Jonathan Rickford, "Legal Approaches to Restricting Distributions to Shareholders: Balance Sheet Tests and Solvency Tests", European Business Organization Law Review 7, 2006, 146.

[46] Fourth Council Directive 78/660/EEC of 25 July 1978 based on Article 54 (3) (g) of the Treaty on the annual accounts of certain types of companies, OJ 1978 L 222/11.

[47] Which results from Directive 2001/65/EC of 27 September 2001 amending Directives 78/660/EEC, 83/349/EEC and 86/635/EEC as regards the valuation rules for the annual and consolidated accounts of certain types of companies as well as banks and other financial instruments, OJ 2001 L 283/28 ("Fair Value Directive") and from Directive 2003/51/EC of June 2003 amending Directives 78/660/EEC, 83/349/EEC, 86/635/EEC and 91/674/EEC on the annual accounts and consolidated accounts of certain types of companies, banks and other financial institutions and insurance undertakings, OJ 2003 L 178/16 ("Modernisation Directive").

A. *The two 1978 versions of the balance sheet under the Fourth Directive*

The Second Directive anticipated the rules, namely the availability of a harmonised balance sheet and profit and loss account, later implemented by the Fourth Directive. By that time historic cost theory was dominant in Europe. Assets were generally registered at their purchase price or production cost and depreciated over their economic lives. Liabilities, even long-term liabilities, were registered at their nominal amount. The accounting principle of prudence played a major role. Financial information had to be presented in a limited number of detailed formats, one of two for balance sheets and one of four for profit and loss accounts. Hence, the Fourth Directive provided a stratified picture of the history of the business, bearing little necessary relationship to current values of assets and liabilities, in a heavily regulated format that aimed to produce comparable numbers[48].

However, during the negotiation of the Fourth Directive the principle of the "true and fair view" ("T&FV") was included, together with provisions for revaluation of fixed assets and inflation accounting[49]. The T&FV principle required that, notwithstanding contrary provisions of the Directive, if in exceptional circumstances a different accounting treatment was necessary to give such a view of the assets, liabilities, financial position and profit or loss then it should be adopted. Reconciling these two contradictory methodologies presented considerable difficulties[50].

Several doubts were cast on what profits and losses should be considered or what reserves could be treated as distributable under Article 15 of the Second Directive. It was not clear what test should be applied to consider a profit made, namely if profits arising on a revaluation could be considered made. Nevertheless, in view of Article 33 of the Fourth Directive, which allowed Member States to permit or require several revaluations if a revaluation reserve was then created, the best interpretation seemed to be that there was no increase in the level of distributable reserves of a company formed under the law of a Member State that took advantage of the option to revaluate assets[51]. Unrealised profits could not enhance distributable reserves. This position was also valid for unrealised losses. In Member States that permitted revaluations, the effect of the net assets would be to reduce the profits available for distributions

[48] Jonathan Rickford, *supra* note 45, 147.
[49] V. Edwards, "EC Company Law", OUP, 1999, 117-121.
[50] Jonathan Rickford, *supra* note 45, 147.
[51] Jonathan Rickford, *supra* note 45, 149-153.

for companies suffering such losses whether or not they had a surplus in the revaluation reserve[52].

As a consequence, under the 1978 version of the Fourth Directive there were two possible balance sheet tests. For companies that were not allowed to engage in revaluations or that were allowed but did not do so, net assets were calculated considering only realised profits and losses. For companies that were allowed to engage in revaluations and actually used this possibility, net assets were calculated net of unrealised losses but not enhanced by unrealised profits.

The Modernised Fourth Directive remains largely optional for Member States, which are free to decide whether or not to permit or require companies or specific types of companies to apply most of the changes made. As a result, the two balance sheet tests under the 1978 version of the Fourth Directive remain at the disposal of EU companies[53].

B. *The Modernised Fourth Directive and the IAS Regulation*

Both the Modernised Fourth Directive[54] and the IAS Regulation represented a stark departure from the two 1978 versions of the Fourth Directive. They introduced modern accounting policies based on the idea of giving a realistic or "fair value" picture of the reporting activity. The IAS Regulation made the IFRS applicable to the consolidated accounts of listed companies, but Member States have the option to permit or require the use of IFRS in the accounts of individual companies. In its study KPMG found that the IFRS were already applied to the distribution of dividends in 17 of the 27 Member States, though 7 of these 17 Members States did so with some restrictions[55]. In addition to that, Eilís Ferran points out that it is likely that the IFRS will become relevant in relation to individual company accounts via "bottom up" convergence whereby national accounting standard setters bring their domestic requirements more in line with the IFRS[56]. When Member States do adopt the IFRS for individual accounts, the Fourth Directive regime is replaced and the relevant accounts for distribution purposes become the IFRS accounts.

[52] Jonathan Rickford, *supra* note 45, 152.
[53] Jonathan Rickford, *supra* note 45, 155.
[54] It should be recalled that this article treats the changes introduced by the Fair Value Directive and the Modernisation Directive together.
[55] KPMG, *supra* note 12, 318-320.
[56] Eilís Ferran, *supra* note 8, 201-202.

The resulting difference in the accounting basis on which EU companies report is dealt with by the Modernisation Directive, which amends the Fourth Directive. The Commission asserts that its effect "is to align the position of companies which continue to report in accordance with that Directive entirely with that of companies reporting under IFRS"[57]. As will be shown, this alignment is not as perfect as the Commission presents it.

It is commonly said that the Modernised Fourth Directive brought two main developments. First, the extent to which unrealised profits and losses are recognised through the fair value regime was greatly increased. Not only were certain financial instruments and hedging arrangements permitted to be valued in this way, but also "any assets other than financial instruments" with or without profit and loss account treatment[58]. Secondly, some or all of the differences revealed by a fair valuation can now be considered distributable, since they do not fall into the revaluation reserve. This is due to Articles 42A and 42E of the modernised version of the Fourth Directive that are in derogation from Article 32 of the Fourth Directive, which applies the old historic cost valuation rules in Articles 34 to 42 of the Fourth Directive[59].

As previously stated, despite the Commission's assertion there are in fact some differences between the Modernised Fourth Directive and the IFRS accounts. The first one is related to the accounting philosophies. The essence of the Modernised Fourth Directive's approach is the provision of the T&FV of assets, liabilities and financial position and the profit or loss for the year, while the objective of IFRS accounts is, according to IAS 1 (Presentation of Financial Statements), "to provide information about the financial position, financial performance and cash flows of an entity that is useful to a wide range of users in making economic decisions"[60]. The goal of the IFRS is to facilitate decision making by users of accounting standards. There are also differences between the Modernised Fourth Directive and the IFRS regarding accounting statements. Instead of the balance sheet and profit and loss account that characterise the Fourth Directive regime, the IFRS comprise a balance sheet, an income statement, a statement of changes and a cash flow statement. The cash flow statement, for example, is considered a fundamental device for

[57] Commission, Explanatory Memorandum on the Proposal for the Modernisation Directive, COM (2002) 259/2 final, Brussels, July 2002, 3-4.

[58] See Article 42E of the Fourth Directive in the modernised version.

[59] Jonathan Rickford, *supra* note 45, 156-159.

[60] The texts of the relevant IAS, that are part of EU law, are annexed to Regulation (EC) No 1126/2008 of 3 November 2008 adopting certain international accounting standards in accordance with Regulation (EC) No 1606/2002, OJ L 320.

assessing performance at cash level and future net cash inflows. This comes from the recognition that a simple index of performance is neither feasible nor appropriate and that financial performance is multidimensional and various indicators need to be used. Another important difference is related to the treatment of pension liabilities. Under the Modernised Fourth Directive, if provision is made for pension liabilities distributable profits will be reduced in the same measure. Under the IFRS, while on initial application a full provision is required, a "corridor and spreading" approach is permitted, requiring only losses or gains that represent more than 10% of the fund value to be considered and allowing these to be spread over the average fund life. Thus, companies that adopt the Modernised Fourth Directive accounts have to register actual deficiencies in full and those adopting the IFRS are free to pursue the more relaxed spreading approach. These divergent approaches could have major impacts and create entirely false incentives for Modernised Fourth Directive or IFRS regimes depending on the circumstances[61]. Without anticipating arguments that will be developed in Section D, it must be said that it is unacceptable that the decision whether or not to adopt the IFRS could have such a tremendous impact on the results of a company with all that it implies.

Having presented the different accounting regimes in force in the European Union, it is now time to turn to the general and specific problems associated with them.

C. *General problems with balance sheet tests*

Apart from the specific problems of the four balance sheet tests, which will be outlined in Section D, there are two criticisms that can be made against balance sheet tests in general. The first one is related to the limitations of the balance sheet as a set of comparable numbers, while the second, which complements the previous one, is concerned with the time horizon of its analysis. In other words, it has to do with the inability of balance sheets to provide indicators about a company's prospects and future cash flows.

Concerning the first criticism, it should be emphasised that accounts are a single selective snapshot of a number of financial indicators. They do not and cannot summarise the infinite diversity of a business in the format in which they have to be produced. Even the approaches that in the past established the most rigid and mechanical systems were designed to generate figures to be read and appreciated in the light of information which was not reflected on the face of the accounts. This criticism cannot be reversed by the increasing

[61] Jonathan Rickford, *supra* note 45, 163-164.

importance given to contingent liabilities, forward-looking and cash flows information in the modern accounting approaches, because these changes are mostly reflected in accounting statements other than the balance sheet, while the rules, particularly Article 15 of the Second Directive, continue to attach almost all the importance of distribution decisions to balance sheet figures.

The second criticism complements the first one and has to do with the fact that accounts are also designed as a snapshot of a point in time, together with a limited account of the progression to that point over the preceding year. A snapshot like this one, that is history as soon as it is taken, would always be an inaccurate indicator of solvency and solvency is what really matters for creditors in a distribution decision. Solvency focuses on the future and not on the past. It is a function of the availability of cash to a business over time. Recent attempts to improve the quality of accounts have been able to give greater economic reality and validity to them, but have done little to change the basic nature of the balance sheet component of the accounts. As the balance sheet continues to inspire the main test of Article 15 of the Second Directive, one can only agree with Jonathan Rickford when he says "that single static frame in the movie may be better focused and made more complete, but for other frames in the dynamic we need to look elsewhere"[62].

D. *Specific problems with the four balance sheet tests*

The overall effect of what was stated in Sections A and B is that within the European Union and within Member States the following accounting treatments are now possible and the balance sheet test will be capable of being drawn from accounts based on any them:

i) The traditional historic cost 1978-style Fourth Directive accounts;
ii) Such accounts with revaluations;
iii) Accounts based on some or all of the accounting changes introduced as company or Member State options under the Modernised Fourth Directive;
iv) IFRS accounts, i.e. accounts which comply directly with the IFRS under the European Union's IAS Regulation[63].

Some of the problems associated with the various versions of the test are already evident from what was stated above. Regarding the pure historic cost

[62] Jonathan Rickford, *supra* note 45, 167.
[63] Jonathan Rickford, *supra* note 45, 155.

version of the Fourth Directive, it is clear that the absence of current values, the failure to include contingent liabilities and the inclusion of liabilities and provisions at full value give a clearly inadequate basis for assessing the real economic situation of a company or its ongoing cash generating prospects. As seen in Section A, the second version of the Fourth Directive permits valuations of various assets to be reflected in the accounts. However, the only practical effect of these valuations is the reduction of the sums available for distribution where unrealised losses arise, in a way that can be considered asymmetric and biased. All the other criticisms against the pure historic cost version of the Fourth Directive can also be drawn against this version.

The Modernised Fourth Directive now allows fair valuation of all types of assets, considering the profits obtained distributable. These valuations can be done by directors when market values are not available. This is a major move in the direction of the less rigid balance sheet tests that are offered in the other side of the Atlantic and could be viewed as a relaxation of the Second Directive rules. However, the number of issues that is left to Member States and/or companies in the implementation of this system makes its test unreliable as a basis for company regulation[64]. Furthermore, with the introduction of fair value assessment comes the potential for very subjective decision making on accounting statements which may be reflected in irresponsible distributions of dividends. It is also widely recognised that fair value accounting can lead to results that are highly volatile. The calculation of the pension deficits mentioned above is just one of several examples that could be given. Overall, when facing indications of future cash flows obtained from the Modernised Fourth Directive one should bear mind that these indications could well be less reliable than the ones obtained from the traditional historic cost accounts. In Jonathan Rickford's view, the Modernised Fourth Directive also does not make provision for fair valuation of liabilities and provisions[65].

Many of the weaknesses identified for the Modernised Fourth Directive are also applicable to IFRS accounts. However, there are some differences and additional criticisms that need to be addressed.

The way in which IFRS accounts address the creditors' interests is a crucial element in understanding the impact of the transition to the IFRS. To assess this impact one should look to the conceptual framework that underpins the IFRS. This framework is set out in the "Conceptual Framework for Financial Reporting 2010 ("IFRS Framework") approved by the International

[64] Jonathan Rickford, *supra* note 45, 168.
[65] Jonathan Rickford, *supra* note 45, 168.

Accounting Standards Board ("IASB")[66]. The IFRS Framework serves as a guide to the IASB in developing future accounting standards and as a guide to resolve accounting issues that are not directly addressed in an International Accounting Standard or International Financial Reporting Standard or Interpretation. It is stated in the Framework that "the primary users of general purpose financial reporting are present and potential investors, lenders and other creditors, who use that information to make decisions about buying, selling or holding equity or debt instruments and providing or settling loans or other forms of credit"[67]. The accounting firm Ernst & Young analysed the previous version of the IFRS Framework, whose main principles remain unchanged in the 2010 version, and concluded that it narrowed the conceptual framework down to serving the needs of investors[68]. In addition to that, Ernst & Young's interpretation of the fact that financial statements serve the purpose of supporting investors assessing whether a company would pay dividends is that "the objective of financial statements, therefore, becomes to predict future cash flows"[69]. This focus on investors seems to mean that financial statements are increasingly being driven by the needs of capital markets. Thus, there are increasing reasons to cast doubts on the reliability of IFRS accounts as a creditor protection device and as an adequate yardstick for distributions.

Regarding pension liabilities, it is not evident that the "corridor" approach is better than the requirement that deficits are to be taken direct to the accounts. Wolfgang Schön, for example, points to the AEG and General Motors/Delphi cases to warn about the dangers of the IFRS discounted value approach[70]. Nevertheless, none of these approaches take account of the true issue for solvency determination purposes, i.e. the prospects of the business to finance staff cost over time. Here the perspective has to be the same as for any other future payroll charge and a number of factors will need to be considered if this issue is to be properly assessed[71].

Pension liabilities also give a good example of the delusion of comparability which even a sophisticated IFRS-based approach provides[72]. As they are treated

[66] IASB, Conceptual Framework for Financial Reporting 2010. http://www.iasplus.com/en/standards/standard4.

[67] IASB, *supra* note 50, para. 1 of Chapter 1.

[68] Ernst & Young, "International GAAP 2005 – Generally Accepted Accounting Practice under International Financial Reporting Standards", LexisNexis, 2004, 100.

[69] Ernst & Young, *supra* note 52, 100.

[70] Wolfgang Schön, "Balance Sheet Tests or Solvency Tests – or Both?", European Business Organization Law Review 7, 2006, 191-193.

[71] Jonathan Rickford, *supra* note 45, 168.

[72] Jonathan Rickford, *supra* note 45, 168-169.

as existing liabilities, those companies that rely on pension funds to provide defined benefits for retiring employees deteriorate their distribution capacity and thus their cost of capital. Yet in some Member States a relatively generous pension arrangement is provided through mandatory state funding via high levels of payroll taxes. This inflates the companies' future liabilities for staff costs. Nevertheless, they are not existing liabilities and will not appear on the balance sheet. Hence, the economic position of such companies could well be worse than those in countries that do not provide these pension arrangements, but their cost of capital will be lower. Similarly, where a company opts for defined contributions instead of defined benefits, future contributions, as future and not accrued liabilities, will not appear on the balance sheet. They will be treated in the same way as any other future staff cost and will be registered in the accounts at the time of payment. Again, this distorts comparability. From this discussion, it becomes clear that accounts are not an accurate indicator of prospects and the inappropriateness of balance sheet tests as a criteria for allowing or prohibiting business decisions that affect company funding.

It should finally be added that even prudential regulators do not seem to trust the IFRS as a basis for prudential decisions. According to the Basel Committee "prudential supervisors need to consider whether financial statement information is suitable for their purposes and, when it is not, to make suitable adjustments" and "certain IAS treatments should be excluded or overridden by supervisors' judgements"[73]. By the same token, the UK Financial Services Authority has overruled a number of IAS, having stated for example that "we do not believe that defined benefit pensions should be treated as if they were current liabilities which would have to be funded over the next 12 months"[74]. This means that, in practice, companies subject to these regulators must have two sets of accounts. Hence the question: "If IAS accounts are, on the highest authority, not a sound basis for regulators to assess the solvency of banks, what can justify their mandatory use to determine the prudence of company distributions, including distributions by those very banks?"[75].

[73] See Basel Committee, "Supervisory Guidance on the Use of the Fair Value Option by Banks under IFRS", July 2005, paras. 7 (general prudential override), 38 (overriding certain fair value gains and losses), 39 (excluding the own credit risk rule).
[74] Financial Services Authority, Policy Statement 05/05 of April 2005.
[75] Jonathan Rickford, *supra* note 45, 170.

IV. **Proposals to reform the Second Directive regime**

In Part III, it became clear that accounting standards further undermine the already weak arguments in favour of retaining the Second Directive[76]. Indeed, not only are balance sheet tests an inappropriate form of assessing the real economic situation of a company and an ineffective form of protecting creditors' interests, but the four versions of the balance sheet in force in the European Union also pose serious problems that affect reliance on them. The increasing awareness of these difficulties, coupled with the drivers mentioned above, has paved the way for several reform proposals.

Of all these proposals, four gained more notoriety: the Winter Group proposal[77], the Rickford Group proposal[78], the Dutch Group proposal[79] and the Lutter Group proposal[80]. The solutions they suggest vary in content and in the level of details provided.

Due to limitations on the size of this article, only a brief reference will be made to the proposals of the Winter, Dutch and Lutter Groups. A more detailed analysis will be dedicated to the Rickford Group proposal, the most complete and supported of all of them. Hence, this part will be divided into two sections. Section A will briefly describe the suggestions of the Winter, Dutch and Lutter Groups and Section B will address the Rickford Group proposal.

A. ***The proposals of the Winter, Dutch and Lutter Groups***

As the proposal of the Lutter Group involves fewer changes to the current regime, it is probably easier to start with it. The Lutter Group came to the conclusion that the abolition of the legal capital regime was not recommendable until the function and effectiveness of the proposed alternative regimes were properly tested. They, nevertheless, proposed the repeal of Article 15 of the Second Directive. The Lutter Group recognised the problem of identification of profits according to the IFRS and therefore proposed a dual solution: the company either produces a balance sheet based on commercial accounting principles that is reviewed and certified or a balance sheet based on the IFRS which is reviewed by an auditor and certified by the management plus a

[76] Eilís Ferran, *supra* note 8, 183.

[77] High Level Group of Company Law Experts, *supra* note 10.

[78] Jonathan Rickford (ed.), *supra* note 15.

[79] Boschma/Lennarts/Schutte-Veenstra, "Alternative Systems for Capital Protection", Final Report, 2005.

[80] Lutter (ed.), "Legal Capital in Europe", ECFR Special Volume I, 2006.

solvency test. This solvency test should be based on the information summarised in a financial budget and on a longer-term capital budget document that assures that the proposed distribution will likely leave the company with enough funds to meet liabilities as they become due for one to two years. The management should be liable for the test.

The proposals from the Winter and Dutch Groups are more ambitious. They both recommend the repeal of several provisions on the raising of capital and the introduction of true no-par value shares. However, as the scope of this article is the capital maintenance rules these suggestions will not be addressed. The core element of these proposals is common and consists of a two-stage distribution test which serves as a means to determine the maximum amount available for distribution. Distribution in this context means all forms of distributions, i.e. dividends, share buy-backs and distributions as part of capital reduction. This two-stage distribution test includes a balance sheet test and a liquidity test. Company assets may only be distributed when that distribution complies with both tests and the members of the management board issue a solvency certificate assuring that compliance. None of these proposals require an auditor's certificate. Regarding the balance sheet test, both proposals declare a distribution permissible if the assets fully cover or exceed liabilities after the proposed distribution[81]. While under the Dutch Group's proposal only national GAAP or IFRS are admitted[82], under the Winter Group's proposal the accounts forming the basis of the balance sheet test do not need to be drawn up in accordance with a generally accepted accounting method[83]. More differences can be found in the content of the liquidity test. While the details of the liquidity test are not defined in the Dutch Group's proposal[84], according to the Winter Group this test would only be passed if a company has sufficient liquid assets to pay liabilities as they fall due in the following period, e.g. the forthcoming twelve months[85]. As the management board has to consider balance sheet figures, this test is an objective one. Finally, while the Dutch Group's proposal does not contain specifications about personal liability of directors or complementary insolvency measures, the Winter Group proposes a comprehensive system

[81] Here it is worth noting that the Winter Group suggests that a further study should consider the possibility of introducing a solvency margin. See High Level Group of Company Law Experts, *supra* note 10, 88.

[82] Boschma/Lennarts/Schutte-Veenstra, *supra* note 79, 71.

[83] High Level Group of Company Law Experts, *supra* note 10, 87-88.

[84] The Dutch Group thinks that they should be established in consultation with accounting organisations. See Boschma/Lennarts/Schutte-Veenstra, supra note 79, 71.

[85] High Level Group of Company Law Experts, *supra* note 10, 88.

of sanctions, ranging from personal liability of directors to directors' disqualification, and the implementation at European level of a wrongful trading rule and the concept of subordination of insiders' claims[86].

B. *The proposal of the Rickford Group*

Like the Winter and Dutch Group's proposals, that of the Rickford Group also suggests several changes to the capital raising rules of the Second Directive. The minimum capital requirement, the prohibition to issue true no-par value shares and the valuation requirements in which shares are issued for a consideration other than in cash are among the aspects criticised by the Rickford Group. However, the main focus of its report is, as in this article, the capital maintenance and distribution rules of the Second Directive.

In this regard, the Rickford Group proposes a system in which all forms of distributions to shareholders – i.e. dividends, share buy-backs and distributions as part of a capital reduction – may only take place if they comply with a solvency test. This solvency test is, however, substantially different from the ones proposed by the other groups. Indeed, this solvency test comprises: (i) a short-term liquidity assurance and (ii) an indefinite assurance of the company's viability. Only the solvency test serves as a substantive restriction on distributions and only the combination of a strict short-term liquidity requirement and the assurance of the company's positive prospects for the longer term is deemed to be of real value for creditors. In this proposal the balance sheet test is not a substantive distribution requirement. It will only be relevant if the proposed distribution is not covered by net assets. In this case the management is still allowed to proceed with the distribution, provided it states the reasons why it is of the opinion that a distribution is nevertheless justified. The balance sheet test is thus downgraded to a "comply or explain" basis. The reason for this change is that a mere mechanical application of a crude balance sheet test is not thought to make proper allowances for the quality of the company's assets and liabilities, their volatility and linkage over time and the quality of the company's performance[87].

The short-term liquidity requirement of the solvency test is cash-flow based. To make a lawful distribution the directors would need to certify that, having regard to their intentions and the resources in their view likely to be available, for the year immediately following the distribution the company will be able in the ordinary course of business to meet all its debts as they

[86] High Level Group of Company Law Experts, *supra* note 10, 88.
[87] Jonathan Rickford (ed.), *supra* note 15, 975.

fall due as a going concern throughout the year. Contingent and prospective liabilities and future and contingent assets should be taken into account in this assessment[88].

The indefinite assurance of the company's viability is also cash-flow based. Here to make a lawful distribution the directors would need to certify that, in their view, for the reasonably foreseeable future, taking into account the company's expected prospects in the ordinary course of business, it can reasonably be expected to meet its liabilities. Again contingent and prospective liabilities and future and contingent assets should be considered in the assessment[89].

According to the Rickford Group's proposal a mandatory auditor's certificate is not required. However, in respect of large companies whose accounts must be audited, the proposal follows an audit-based approach insofar as the audit report for the financial year in which the distribution has taken place must consider the legality of the distribution and the directors' "going concern" assurances. In cases in which there are doubts as to the legality of distributions, directors exercising normal standards of care will also consult an auditor prior to the distribution. In respect of small companies whose accounts need not to be audited, such requirements are not applicable[90].

To support this test the Rickford Group recommends that a comprehensive system of remedies and sanctions should be attached to the solvency certificate to be issued by the management board. These remedies and sanctions should comprise at least the personal liability of directors and directors' disqualification. It emphasises that the efficiency of the alternative regime depends in part on directors' fiduciary duties. To the extent that such fiduciary duties do not exist in EU Member States, they should be implemented. Furthermore, it is recommended that the alternative regime should be supplemented by insolvency legislation measures, particularly by a wrongful trading rule at EU level[91].

V. **The KPMG study and the position of the EU Commission**

As previously mentioned, in the context of these proposals the EU Commission hired KPMG to conduct a study on the feasibility of an alternative to the capital maintenance regime of the Second Directive and to examine the

[88] Jonathan Rickford (ed.), *supra* note 15, 979-980.
[89] Jonathan Rickford (ed.), *supra* note 15, 979.
[90] Jonathan Rickford (ed.), *supra* note 15, 981.
[91] Jonathan Rickford (ed.), *supra* note 15, 980 and 984.

impact of the adoption of IFRS on profit distribution. The study was intended to "help the European Commission to evaluate whether an alternative regime would better support the efficiency and competitiveness of EU businesses"[92]. The accounting giant was clearly aware of the problems above identified and of the reform proposals. For instance, it is stated in the executive summary of the report that "under the IAS Regulation (1606/2002), EU Member States may permit or require companies to use IFRS for their individual financial statements. This instantly raises the question whether IFRS as an accounting framework is adequate to be used as the basis for profit distribution under the current capital regime of the 2nd CLD when IFRS are not primarily designed for this purpose"[93].

The results, however, did not confirm many of the problems identified in the proposals and essentially cut any momentum there was for reform. As noted by Ferran "for those who favour radical reform, the findings of the KPMG study – published in February 2008 – that the Second Directive is a flexible instrument, that compliance costs associated with it are limited, and that it does not cause significant operational problems for companies, and the Commission's decision, in response to the study, not to propose any follow-up measures of further changes, will come as a disappointment"[94].

The Commission's reaction to the conclusions of the KPMG study was released as a communication from its DG Internal Market and Services ("Commission's Position")[95]. In this communication the results of the KPMG study were summarised in two main findings: i) the current minimum legal capital requirements and rules on capital maintenance do not constitute a major obstacle to dividend distribution; and ii) regarding the impact of the IFRS on dividend distribution, several Member States have required or permitted the application of the IFRS for individual accounts without any apparent difficulty for the distribution of dividends[96]. As a consequence of these findings, the Commission decided that no follow-up measures or changes to the Second Directive should be implemented in the near future[97].

[92] KPMG, *supra* note 12, 1.
[93] KPMG, *supra* note 12, 1.
[94] Eilís Ferran, "Principles of Corporate Finance Law", OUP, 2008, 263.
[95] Communication from the Commission, *supra* note 13.
[96] Communication from the Commission, *supra* note 13, 1-2.
[97] Communication from the Commission, *supra* note 13, 2.

VI. **The case for reform after the KPMG study**

This article has now come to the answer to the question posed in its title. As stated above, the KPMG study had a major impact on the burgeoning debate that was taking place before its results were published. Due to the Commission's reliance on the KPMG study, the analysis of the current situation has to start with an enquiry about its conclusions and methodology and only after this exercise can the actual strength of the arguments for reform described above be assessed. This Part will then be divided into two sections: Section A will deal with KPMG study and the way in which it was interpreted by the Commission and Section B will assess whether the arguments for reform were affected by the study and evaluate its present force.

A. ***Criticism of the KPMG study and its interpretation by the EU Commission***

As a significant part of the relevance of the KPMG study came from the reliance the Commission placed on it, some of the criticisms made against the study will refer to the Commission's Position.

According to the Commission, the first finding of the KPMG study was that the current minimum legal capital requirements and rules on capital maintenance do not constitute a major obstacle to dividend distribution. Regarding the second part of this finding, the Commission stressed that the only constraint that the current regime imposes is that it restricts distributions in the cases in which the balance sheet test is negative. This could raise the question whether a solvency test is a more appropriate and flexible solution. However, the study showed that balance sheet tests are also required by most of the non-EU countries that apply solvency tests and that EU Member States are presently at liberty to introduce an additional solvency test, if they so wish.

With all due respect, both these arguments missed the point. Firstly, the fact that other countries add a balance sheet test to the solvency test would never be a decisive argument against having just a solvency test, as proposed by the Rickford Group. In addition, those other countries apply the balance sheet test in a totally different way. They do not include a share capital or undistributable reserves "cushion" in the test and they allow directors to use valuation methods that are reasonable in the circumstances. Secondly, the main reform proposal, that of the Rickford Group, only considers a balance sheet test in a "comply or explain" basis. So the point is not to add a solvency test to the existing balance sheet test, reason why it is completely irrelevant that Member States are currently at liberty to add this solvency test. What is intended is the replacement of the current balance sheet test by a solvency test.

On the other hand, there seems to be a serious methodological misgiving associated with the KPMG study. The study based its assertion that the compliance costs associated with the capital regime of the Second Directive are not burdensome on interviews and CFO questionnaires. However, if we delve into the 424 page report, we will find that only 35 interviews were conducted and that only 157 of the 3,578 questionnaires that were sent out were answered, i.e. 4.39 per cent of the total number of questionnaires[98]. Moreover, as the tables on pages 311 and 312 of the report clearly attest, KPMG was not able to collect information about significant aspects. Again with all due respect for the authors of this study, this empirical evidence does not seem to be sufficient to draw such firm conclusions.

However, even if one accepts that the compliance costs analysed by KPMG are low or not burdensome, that would never mean that a solvency test is not a better solution than the current balance sheet test. KPMG basically picked some processes (capital increase, distribution, acquisition of own shares, etc.) and summed the administrative costs of these processes by reference to the data collected in the above-mentioned interviews and questionnaires. This method is able to assess those administrative costs and nothing else. It would always struggle to assess costs that are not included in that calculation and are not so easily calculated, for example the costs that will arise if a company distributes unrealised profits and six months later is declared insolvent. Thus, this method is completely incapable of evaluating the coherence and completeness of a certain legal system and its results should be analysed within this limited scope.

Concerning the second finding that the Commission identified in the KPMG study, it should be stated that on none of the 424 pages of the report is it said that "several Member States have required or permitted the application of IFRS for individual accounts without any apparent difficulty for the distribution of dividends". This conclusion is never drawn by KPMG. The mere fact that 19 of the 27 EU Member States already apply the IFRS, though 8 of these 17 Member States with some modifications regarding the distribution of dividends, cannot and does not mean that this transition is taking place without any difficulties.

On the contrary, the study persistently alerts to the difficulties involved in this transition. On the conclusions of the detailed analyses for selected EU Member States for example, it states that "if the current distribution regime model of the 2nd CLD which is exclusively based on a balance sheet test is to be maintained, there needs to be a solution for significant differences between accounting profits under IFRS and «realised» profits/losses for distribution

[98] KPMG, *supra* note 12, 2 and 14-16.

purposes"[99]. If it is said that at the end of those very same conclusions a solvency test is presented as one and apparently the preferable remedy for overcoming these difficulties, one can see how misleading the Commission's interpretation of this study is[100].

However, the main point of the KPMG study regarding the accounting regime of profit distributions is its lack of harmonisation. This lack of harmonisation occurs not only among the Member States that still apply the Fourth Directive, in any of its versions, but also among the Member States that already apply the IFRS, as the several modifications to the application of these standards attest[101]. Again, this is a very strong argument against the link between profit distribution and accounts and in favour of reform.

Overall, the enormous effort made by KPMG should be praised, but the results that the Commission is trying to extract cannot be obtained from that study. On the one hand, the data on which the first finding was based seem to be insufficient and could never lead to a conclusion that balance sheet tests are a better creditor protection technique than solvency tests. On the other hand, the best that can be said about the second finding that was extracted by the Commission is that it is misleading. Not only does the study warn about the problems of the transition to the IFRS, but it also presents solvency tests as one and apparently the preferable solution to overcome them.

B. *Strength of the arguments for reform after the KPMG study*

From the analysis of the previous section it is now possible to say that the impact that the KPMG study had on the debate about the Second Directive was probably unfounded. Indeed, the only aspect in which that study could affect the arguments in favour of reform is the administrative costs associated with some particular processes. Even here there are serious grounds to cast doubt on the conclusion reached by KPMG as the empirical evidence collected seems to be scarce. Thus, after passing the careful scrutiny of KPMG one could say that the arguments for reform are stronger than ever.

First of all, the implementation of a solvency test in place of the current balance sheet test would greatly simplify the system. In the United Kingdom, for instance, more than 90 sections were needed to implement the balance sheet

[99] KPMG, *supra* note 12, 394.
[100] KPMG, *supra* note 12, 394. Another relevant passage for this purpose can be found on the third paragraph of page 395, in the introduction of the alternative regimes.
[101] KPMG, *supra* note 12, 317-334.

test based distribution regime[102]. This is a cost in itself with no corresponding benefits. It would also permit the replacement of the current schizophrenic regime, by means of which EU companies can produce their accounts based on four different balance sheet tests with very diverse results, by a much simpler and straightforward test[103]. Last but not the least, this change would allow that all forms of distributions, i.e. dividends, share buy-backs and distributions as part of capital reduction, to finally be treated uniformly, as examples of the same economic transaction, that is, the return of assets to shareholders[104].

Secondly, by breaking the linkage between distributions and accounts the reform would allow companies to reflect their true financial situation in distribution decisions. As persistently argued before, this type of decision calls a variety of factors that go well beyond the figures contained in the balance sheet or profit and loss account. The solvency test has the virtue of providing directors with a flexible and far-reaching tool for this assessment. At this point it is worth noting that the replacement of the balance sheet test by a solvency test does not imply the abolition of the capital maintenance regime in its broadest sense. The aim of the solvency test is the same as that of traditional capital maintenance: to make sure that a company remains solvent. This requires a margin of capital as the company must maintain sufficient resources to assure the necessary cash flows in the face of inevitable risks over time and might be described as a surplus of assets[105]. Hence, while creditors do not lose their current guarantees, companies will be provided with a more flexible and adequate device that will benefit all stakeholders in the end.

Regarding this particular advantage, it should be stressed that any rational system would add a behavioural test to the balance sheet test to make sure that distributions are not made when the test fails. Behavioural regulation is to some extent inevitable and the balance sheet approach is demonstrably defective[106]. In addition, "civil law judges may be much more adept at after-the-event moulding of broad concepts to fit new situations than is sometimes assumed. Differences in legal culture alone do not provide a compelling argument for retaining an otherwise discredited legal strategy"[107]. New Zealand's successful experience in changing from a traditional capital maintenance regime to a solvency test regime could well work as an inspiring example in this regard.

[102] Jonathan Rickford, *supra* note 45, 170.
[103] Jonathan Rickford, *supra* note 45, 165.
[104] Jonathan Rickford, *supra* note 45, 144.
[105] Jonathan Rickford, *supra* note 45, 145.
[106] Jonathan Rickford, *supra* note 45, 177.
[107] Eilís Ferran, *supra* note 8, 199-200.

Lastly, the solvency test could end the lack of harmonisation that has been characterising the balance sheet test regime and avoid the increasing tendency for regulatory arbitrage by companies that want to avoid the IFRS or just take advantage of the rules of jurisdictions that allow distribution of unrealised profits[108]. Diversity is a source of complexity and that matters in an international marketplace. In addition, harmonisation is one of the basic goals of EU intervention and that intervention should be reconsidered when it is not achieved. On the other hand, a major benefit of the internationalisation of accounting standards (convergence and the avoidance of the expense of maintaining different sets of books) is being frustrated by the European distribution rules and the regulatory arbitrage it permits[109].

Conclusion

This article started with a question: where do we stand now in the debate about the capital maintenance and distribution rules of the Second Directive? It was noted that the KPMG study had a chilling effect on the burgeoning discussion that was taking place in Europe at that time. Whether this silence is justified by the acceptance of the KPMG arguments or because the Commission's position effectively dismissed the practical possibility of a reform in the near future nobody can say. However, after considering the global regime imposed by the Second Directive, its problems in theory and in practice, the accountability regime that underpins its distribution rules and the findings of the KPMG study that lie beyond the executive summary of its report or the Commission's position about it, one can only conclude that the arguments in favour of reform remain solid, persuasive and stronger than ever after one more demanding test.

As Jonathan Rickford points out, the main objection to change may be summed up in the old English adage: "always keep ahold of nurse, for fear of finding something worse"[110]. However, no convincing criticisms have been made against the most complete and supported of all the reform proposals, the one of the Rickford Group. The experiences of other developed economies that have adopted solvency tests long ago can only further encourage reform. While some of them combine a solvency test with a balance sheet test, the truth is that this balance sheet test is drawn in such flexible terms that it always

[108] Jonathan Rickford, *supra* note 45, 170.
[109] Jonathan Rickford, *supra* note 45, 171.
[110] Jonathan Rickford, *supra* note 45, 171

grants management the necessary leeway to take into account the different aspects called by this type of decision.

Hence, there is no reason for so many precautions and the reform procedure should be immediately resumed. Although details regarding the civil liability of directors or the return of unlawful distributions by shareholders seem to need further consideration in order to achieve a good level of harmonisation among EU Member States, it has to be recognized that the Rickford Group's proposal constitutes a very solid and workable basis.

As has been made clear in this article, a complete reform of the legal capital regime would be preferable from a strict efficiency oriented perspective. Yet the current political context may be particularly adverse to deep reforms. Thus, a "think small first" approach could be followed and proposals like the "two-step approach" suggested by the Winter Group should be taken into account[111]. In addition to that, measures that encourage Member States to remove "gold--plating" of the Second Directive or to adopt the proposals of the Rickford Group for private companies should be analysed.

Like all patients, European company law does not seem to be interested in getting rid of this nurse that has been assisting it for such a long time. However, the time has come to turn the page and implement a system that is again relied on by creditors, prudential regulators and courts. The proposal by the Rickford Group is already a promising alternative and appears to be talented enough to achieve this ambitious goal and to bring the European capital maintenance regime in line with the regime of the world's other developed economies.

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