UNIVERSITÀ
DEGLI STUDI
FIRENZE

FLORE
Repository istituzionale dell'Università degli Studi di Firenze

Director’s Duties and the Optimal Timing of Insolvency. A Reassessment of the ‘Recapitalize or Liquidate’ Rule

Questa è la Versione finale referata (Post print/Accepted manuscript) della seguente pubblicazione:

Original Citation:

Director’s Duties and the Optimal Timing of Insolvency. A Reassessment of the ‘Recapitalize or Liquidate’ Rule / Lorenzo Stanghellini. - STAMPA. - (2011), pp. 733-768.

Availability:

This version is available at: 2158/676908 since:

Publisher:

UTET

Terms of use:

Open Access

La pubblicazione è resa disponibile sotto le norme e i termini della licenza di deposito, secondo quanto stabilito dalla Policy per l'accesso aperto dell'Università degli Studi di Firenze (https://www.sba.unifi.it/upload/policy-oa-2016-1.pdf)

Publisher copyright claim:

(Article begins on next page)

19 April 2024

IL DIRITTO DELLE SOCIETÀ OGGI

INNOVAZIONI E PERSISTENZE

Diretto da
P. Benazzo - M. Cera - S. Patriarca

UTET
GIURIDICA

DIRECTORS' DUTIES AND THE OPTIMAL TIMING OF INSOLVENCY. A REASSESSMENT OF THE "RECAPITALIZE OR LIQUIDATE" RULE*

SOMMARIO: 1. *Introduction*. – 2. *The Role of Directors' Duties in the System of Creditor Protection*. – 3. *Duty to File for Insolvency Proceedings. Cash-flow v. Balance-sheet Insolvency*. – 4. *Wrongful Trading*. – 5. *Why Creditor Protection, and What*. – 6. *The "Vicinity of Insolvency" and its Consequences*. – 7. *Disclosure of the Downward Trajectory: Law and Contract*. – 8. *Firm Value Maximization: The Ambiguous Role of Fiduciary Duties*. – 9. *Creditor's Claims Value Maximization*. – 10. *The "Recapitalize or Liquidate" Rule (ROL): Structure and Operation*. – 11. *The Informational Value of ROL*. – 12. *Cost and Benefits of ROL*. – 13. *Conclusion*.

Several legal systems have in place rules which aim at reducing the loss that creditors may suffer from the unnecessary delay in the initiation of bankruptcy proceedings. The legal mechanisms that have this goal differ greatly, but they can be broadly divided in two categories: a strict duty for the directors to file for bankruptcy if the company is insolvent, and a more flexible approach, which simply requires them to minimize losses to creditors when insolvency proceedings appear inevitable. All mechanisms, many of which are discussed in this paper, share two elements: the expiration of the shareholders' call option as a consequence of a specific condition of the company, and the shareholders' right to pay off the creditors to prevent liquidation. This paper: (a) explains how the various legal mechanisms differ along these two dimensions; (b) argues that a dynamic approach, one which focuses on the trajectory of the company rather

* I wish to thank Régis Blazy, Walter Doralt, Luca Enriques, Ronald J. Gilson, Wolf-Georg Ringe, and several participants to a seminar at the Financial Law Discussion Group, Oxford University Faculty of Law, November 22nd, 2007, and to the European Association of Law & Economics Conference in Rome, September 18th, 2009, for many helpful comments. I am especially grateful to John Armour for his encouragement in writing this paper and for his perceptive suggestions.

than merely a snapshot of its balance sheet, is preferable; (c) analyses the so-called "recapitalize or liquidate" rule (ROL), which as a condition to continue trading demands a recapitalization if a company's net assets fall below zero. When the company is on a downward trajectory, ROL forces insiders to reveal their estimation of the true value of the firm. The negative effects of ROL on cash-constrained shareholders must be properly weighed against the benefits of its ability to reduce the information asymmetry between insiders and creditors. ROL, therefore, may play a role in making the shareholders' call option to expire at the appropriate time. The paper finally shows that ROL is independent of rules mandating minimum capital and of capital maintenance rules generally, and does not recommend the adoption of such rules.

1. *Introduction*

Bankruptcy is a necessary ingredient of a market economy, and the losses to creditors that derive from it are, to a certain extent, inevitable. However, it is important that creditors do not suffer *unnecessary* losses, *i.e.*, losses that are not the result of acceptable and socially productive risk-taking, but are the consequence of undue delay in the initiation of bankruptcy proceedings.

Indeed, once the equity cushion has been lost, the risk of further losses shifts from shareholders to creditors, who have become the residual claimants[1]. Yet, rational shareholders will normally postpone the time of reckoning, and instead pursue investments strategies that a normal investor would reject. In so doing, they are effectively extending the duration of their call option on the assets of the firm, therefore increasing the value of such an option. This phenomenon, made possible by shareholders' limited liability, is in fact a kind of overinvestment (which takes place when the the firm is investing in business projects that a rational investor would turn down as yielding too low a rate of return)[2], and it is a serious matter especially in times of economic downturn and widespread business failure.

[1] More precisely, the residual claimants are those creditors whose claims are not covered (or not fully covered) by the value of the assets. Therefore, the governance of insolvency proceedings and decisions regarding the assets should be left to them, provided that the creditors of the senior class(es) are paid in full as a consequence of such a choice. If more than one class of "submerged" creditors exists, the problem becomes complicated in practice, although the economic rationale (the residual claimants should decide) remains the same. For a description of this problem, and for an account of the most well-known solutions that have been devised to cope with it, see P. AGHION, *"Bankruptcy and its reform"*, in *The New Palgrave Dictionary of Economics and the Law*, Palgrave Macmillan, New York, 1998, volume 1, 145.

[2] See R. KRAAKMAN ET AL., *"The Anatomy of Corporate Law: A Comparative and Functional Approach"*, 2nd ed., Oxford University Press, 2009, at 116-21 (Chapter 5, par. 5.1.1).

Corporate law establishes directors' duties to shareholders of solvent companies. Insolvency law ensures that creditors' claims rank ahead of those of shareholders in insolvent companies[3]. However, in the transition between the two states entitlements are murkier, the allocation of decisionmaking authority is less clear, and creditors' rights are more vulnerable. How does law ensure that directors of insolvent or near-insolvent companies do not adopt value-destroying investment strategies in the interests of the shareholders? What "new" duties does corporate and/or insolvency law impose on them to ensure that, as the case may be, they either timely file for bankruptcy or attempt (in good faith and with adequate means and information) a workout?

This paper considers the range of legal techniques most commonly adopted to this end in a number of jurisdictions, which all share two common components: the expiration of the shareholders' call option as a consequence of a specific condition of the company, and the shareholders' right to pay off the creditors to prevent liquidation. We then derive the characteristics that might be possessed by an "optimal rule". From this perspective, it turns out that the "recapitalize or liquidate" rule adopted (although with some significant differences) in a number of legal systems has many of the characteristics of the optimal rule. We will see that its negative effects may have been overstated, and its positive effects, conversely, may have been understated. Moreover, its structure and operation have not been fully understood in the corporate law debate.

This paper is structured as follows: in the first part (sections 2-4) the legal techniques covering the directors' duties "in the vicinity of insolvency" will be reviewed, distinguishing between rules and standards. In the second part (sections 5-9) the structure of an optimal rule will be analysed and set against the uncertain background of directors' fiduciary duties to creditors. In the third part (sections 10-12) the "recapitalize or liquidate" rule will be assessed in the light of the preceding framework. The fourth part (section 13) concludes.

Part I

2. *The Role of Directors' Duties in the System of Creditor Protection*

Empowering the creditors of insolvent firms is, with various degrees and flavors, the goal of bankruptcy proceedings. Quite often, however, when

[3] J. Payne, *Legal Capital in the UK Following the Companies Act 2006*, in *"Rationality In Company Law: Essays In Honour Of D.D. Prentice"*, J. Armour and J. Payne, eds., Hart Publishing, 2008, also available at *www.ssrn.com* (Oxford Legal Studies Research Paper n. 13/2008) (citations refer to the paper).

such proceedings start, it becomes apparent that the company should have stopped trading much earlier and has suffered further losses in the interim. Yet, bankruptcy can start only if a petition is filed with the competent authority, which in turn requires that a claimant be both informed and sufficiently incentivized to make such a move.

Creditors do have strong incentives to restrain the firm from pursuing value-destroying investment strategies, if necessary by forcing it into bankruptcy (and all the more so if bankruptcy is efficient). However, they would be able to fend for themselves only if they were able to perfectly monitor the company and – as soon as it became insolvent or near-insolvent – to react immediately; in practice, this is not the case: their information mainly comes from the firm itself, and may be biased or even deliberately withheld[4]. The directors of the firm, on the other hand, have accurate information, but at the eve of bankruptcy they may have an incentive to pursue risk-increasing investment strategies (including the pure continuation of the business without any credible restructuring plan), given their loyalty to the shareholders who have elected them.

Several bodies of law step in when the company is in the "twilight" period, to redress the effect of the firm's distorted incentives and to ensure that it adopts the correct investment decisions. This is indeed the objective pursued by three different, and apparently unrelated, fields of law: the law of vulnerable transactions[5], the law of the subordination of creditors' claims[6],

[4] A bank that serves the firm in its relationship with suppliers and customers may have first-hand information. This special relationship, however, cannot be generalized, nor can we safely assume that, discovering that the firm is in crisis, such a bank will necessarily act as a champion for the general creditors' interests.

[5] The law of vulnerable transactions is conceptually very important [see R.C. Clark, *"The Duties of the Corporate Debtor to its Creditors"*, 90 *Harvard Law Review* (1976), 505], but taken alone does not allow creditors to sleep peacefully: by definition, its aim is to nullify contracts and transactions that may have been perfectly valid at the time at which they were entered. A "surgical" approach in attacking pre-insolvency transactions is advisable, lest spreading uncertainty in the market and, as a consequence, endangering a vital component of economic activity.

[6] Equally important are the rules (and judicial interpretations) that subordinate the claims of certain creditors (shareholders or other companies of the group that have financed the insolvent company, hence extending the expiration of their call option on the assets of the firm, banks that have interfered in the management) to those of the general creditors. Subordination must also be imposed with care, as it may discourage value-maximizing, albeit risky, loans. See, D.A. Skeel, Jr., G. Krause-Vilmar, *"Recharacterization and the Nonhindrance of Creditors"*, 7 *European Business Organization Law Review* 259 (2006). S.A. Muro, *"Economic Reasons for the Nonhindrance of Creditors Per Se Rule? A Reply"*, 8 *European Business Organization Law Review* 401 (2007), 401. A European rule concerning the subordination of insiders' claims has been recommended in the report by the High Level Group of Experts ("Winter Report", of 2002: *"Report of the High Level Group of Company Law Experts on a Modern Regulatory Framework for Com-*

and the law – at the border between corporate and insolvency law[7] – that specifies the duties of company directors in the vicinity of insolvency[8].

We are concerned with the latter, which has drawn particular attention at various levels. As we will see in paragraph 4, in its 2003 "Action Plan" for modernising corporate law and corporate governance the European Commission has recommended a rule that would force directors of near-insolvent companies to minimize losses, but strangely enough, such a rule is not explicitly codified in any corporate or insolvency statute. At best, it can be inferred by general principles of corporate law, and in any event it is extremely controversial.

Let us start reviewing the most well-known mechanisms that aim at making the initiation of bankruptcy proceedings timely.

3. *Duty to File for Insolvency Proceedings. Cash-flow v. Balance-sheet Insolvency*

A first approach to the problem of ensuring that the directors file in a timely fashion is, quite obviously, to put them under an obligation to file once the company is cash-flow insolvent, the presumption being that *cash-flow* insolvency is a good proxy for the excess of liabilities over assets, or *balance-sheet* insolvency. This is indeed the approach of several jurisdictions, among

pany Law in Europe", available at *http://ec.europa.eu/internal_market/company/docs/modern/report_en.pdf*).

[7] It is debated whether the subject of company's directors duties and responsibility in the case of insolvency is a matter of *corporate* or *insolvency* law. This could have practical consequences if there is a principle that insolvency law should be left to the the law of EU Member States and not to EU law. On this specific point, the report by the High Level Group of Experts explicitly rejected the position that the matter pertains to insolvency law (see par. 4.4 of the report). It also remains to be seen if, assuming that it pertains to insolvency law, any action by the European Union would therefore be barred.

To be sure, it is arguable that *EU Member States' action* aiming at imposing their domestic filing duty to companies of other member states could be barred under the *Centros* line of reasoning (see WOLF-GEORG RINGE, *Forum Shopping under the EU Insolvency Regulation*, in *9 European Business Organization Law Review* (2008) 579, and *University of Oxford Legal Research Papers No. 33/2008*, available at *www.ssrn.com*). Precisely applying the duty to file for insolvency proceedings when the company is insolvent to the directors of foreign companies is one of the goals of the recent German reform labelled MoMiG, that has moved such duty from the statutes on stock companies and limited liability companies (see *infra*, nt. 9) to the insolvency act (new Sec. 15a). On the interplay between freedom of establishment and insolvency regulation see generally HORST EIDENMÜLLER, "Abuse of Law in the Context of European Insolvency Law", *European Company and Financial Law Review* (forthcoming), available at *www.ssrn.com*.

[8] Criminal law is also, to some extent, a useful tool, in that it restrains the most egregious acts that may harm the creditors' interests at the eve of insolvency.

which, notably, are Germany, France, Austria, Spain and, indirectly, Italy[9]. There is no such a duty in the United States[10].

Typically, the law states that the directors must file within a certain period of time after having judged (or after they should have judged) the company insolvent, and holds them responsible for not doing so. The time frame varies, but it is usually quite short: a matter of weeks, if not days (two months in Spain, 45 and 21 days, respectively, in France and Germany, and without undue delay but in any case not later than 60 days in Austria). The type and measure of the liability also varies, ranging from the most common solution, a duty to compensate creditors for the losses that have been incurred in the delay, to the direct personal liability of the directors for the obligations incurred by the company, in Spain[11]. The amount of the compensation and its beneficiaries are also very complex matters[12].

A functional equivalent to a strict duty to file triggered by cash-flow insolvency is the prohibition on directors incurring new debts when the company is cash-flow insolvent, under penalty of being directly liable, not for the amount of the general losses to the creditors, but, for the loss or damage to the creditor(s) to whom the new debts are owed. This is the solution

[9] See, in Germany, Sec. 15a of the Insolvenzordnung, which also provides for criminal sanctions (prior to the recent reform, which introduced Sec 15a, the duty was established by Sec. 64 par. 1 of the GmbHGesetz Act on private limited liability companies and by Sec. 92 par. 2 of the Aktiengesetz on public limited liability companies); in France, Article L631-4 of de Code de Commerce; in Austria Sec. 69 par. 2 Konkursordnung (Insolvency Act), plus Sec. 159 par. 5.2 of the Criminal code (punishing directors that take exceptional risks when the company is in difficulty); in Spain, Article 5.1 of Bankruptcy Law. See also, in Italy, Article 217, par. 4, of the Bankruptcy Law (in combination with Article 224 and Article 240), which imposes civil and criminal liability on directors that negligently deepen insolvency.

[10] D.G. Baird, *"The initiation problem in bankruptcy"*, in 11 *International Review of Law and Economics* (1991) 223 (very skeptical about the enforceability of a duty to file by the managers, and relying more on incentives than on sanctions).

[11] The deterrence effect of this personal liability is compounded by a rebuttable presumption that all obligations have been incurred after the directors should have filed for insolvency: Art. 367 Ley de Sociedades de Capital, Real Decreto Legislativo 1/2010, of 2nd July 2010.

[12] In theory, not all creditors are equally harmed by a delay in filing: creditors whose claim existed at the time the directors should have filed suffer the damage (if any) from the delay (i.e., assuming that they would have recovered 60% of their claim, if they recover 10% they are entitled to a compensation for 50% of their claim); on the contrary, creditors whose claim has arisen *after* the critical moment should be compensated for the entire amount they are not able to recover from the company (they would not have become creditors if the company had timely entered into insolvency proceedings). How the compensation is divided among creditors depends on of who is the claimant: if it is the company (or the creditors, derivatively), all creditors usually receive the compensation in equal shares (through distribution of proceeds from the insolvency proceedings), if instead creditors have the right to sue the directors directly, then each creditor will (in theory) be compensated for its specific losses.

adopted, for instance, in Australia[13]. Indeed, it is difficult to imagine how the company could carry on without filing *and* without incurring new debts.

Such an approach has the virtue of clarity. It triggers the directors' duty as a consequence of a condition (the company's cash-flow insolvency) that is more or less easily ascertainable, and achieves the goal of sparing creditors from the further losses that usually (although not always) follow from running a business in insolvency, with the associated costs. If directors do not file for insolvency proceedings when the company is cash-flow insolvent, creditors, at least in theory, can recover such losses from the directors (in practice, for large insolvencies the recovery is almost nil).

The duty to file, however, entails two specific problems:

(1) a duty to file for insolvency proceedings within a certain time may prevent good faith attempts to restructure the company out of court, which can sometimes yield better results than insolvency proceedings. The relative preferability of workouts versus formal insolvency procedures depends, at the margin, on the debt concentration (the more dispersed the debt, the more difficult a workout)[14] and on the efficiency of judicial restructuring procedures in terms of time, flexibility, and costs (the less efficient the restructuring procedures, the more attractive a workout), but there will *always* be some cases in which a workout is preferable for creditors. Therefore, the shorter the time limit for filing, the more difficult it is to achieve an efficient workout;

(2) a duty to file for insolvency proceedings as soon as the company is cash-flow insolvent is for creditors a sort of stop-loss, but does help them in the "twilight" period. Its importance may even appear negligible, given that creditors that are not paid can easily and readily push the debtor into involuntary proceedings[15]. The company may have suffered losses for a con-

[13] Sec. 588G of the Australian Corporation Act 2001 prohibits directors from incurring a debt when they know or should have known that the company was insolvent or would become insolvent as a consequence of incurring that debt: see P. Davies, *Directors' Creditor-Regarding Duties in Respect of Trading Decisions Taken in the Vicinity of Insolvency*, in 7 *European Business Organization Law Review* (2006) 301, at 311. The consequence of violating the prohibition is that directors are liable to "the person to whom the debt is owed has suffered loss or damage in relation to the debt because of the company's insolvency": Sec. 588J (1)(c). According to P. Davies, *supra* note 13, 313-4, this provision "gives the directors slightly greater freedom of manoeuvre in deciding how to deal with the company's insolvency than does the German provision", but this appears debatable.

[14] J. Armour, S. Deakin, *"Norms in Private Insolvency: The 'London Approach' to the Resolution of Financial Distress"*, 21 *Journal of Corporate Law Studies* (2001), 1.

[15] If the company is cash-flow insolvent, by definition there are unpaid creditors. If they can obtain an instant petition for insolvency [as in the UK, when the debt is undisputed: see *Cornhill Cornhill Insurance Plc. v Improvement Services Ltd.*, (1986) 1 W.L.R. 114], the need for a directors' duty to file becomes less important. Its significance, in other words, is a function of the

siderable period before becoming cash-flow insolvent, without the directors being under an obligation to file, nor to modify the standards of management and the degree of riskiness of their decisions. During that period creditors were the residual claimants, or at the very least they were exposed to the downside of business decisions more than they would otherwise be in a company in normal conditions, but the directors will be accountable only for decisions that are not protected by the business judgment rule. For creditors, this is no great consolation.

In some jurisdictions, notably Germany and Austria, besides cash-flow insolvency, an alternative test for triggering the duty to file is established. Sec. 19 of German Insolvency Act (*Insolvenzordnung*), states that the company must be subjected to insolvency proceedings also when it is overindebted, i.e., when the value of its assets exceeds the value of its liabilities, and the same is stated by Sec. 67 par. 1 of Austrian Insolvency Act (*Konkursordnung*). This condition is termed *Überschuldung*, i.e., overindebtedness[16]. For this purpose, the assets must be valued at market value, which in turn is heavily influenced by the ability of the company to operate as a going concern. If the directors foresee that the company is *not* able to operate as a going concern, they must consider applying an appropriate discount to the value of the assets[17].

The directors of a German company, therefore, must also file within 21 days of realizing that the company is overindebted, even though it is not cash-flow insolvent (in Austria, 60 days). This has opposite effects on the two problems described above:

a) in theory, a continuous monitoring on the value of assets and a timely filing could keep creditor losses to a minimum, if not avoid them altogether. As long as there are sufficient assets to cover the existing liabilities, the directors need not file. Therefore, losses for creditors could derive only from the sudden reduction of value of such assets (e.g., an unexpected, negative outcome of an investment project), or from the change in perspective with respect to the ability of the company to operate as a going concern (e.g., a change induced by cash-flow insolvency), with the resulting depreciation of the assets. This appears to provide greater protection for creditors than a

obstacles (in terms of time and/or the risk of liability for filing frivolous bankruptcy petitions) that creditors face in forcing a cash-flow insolvent debtor into insolvency proceedings.

[16] Insolvenzordnung, § 19: "Overindebtedness – (1) When the debtor is a company, overindebtedness shall also be grounds to open insolvency proceedings. – (2) Overindebtedness shall exist if the assets of the debtor no longer cover its existing liabilities. In valuing the debtor's assets, the continuation of the entreprise shall be taken into account, if such continuation is reasonable according to the circumstances".

[17] Eberhard Braun (ed.), *Commentary on the German Insolvency Code*, IDW Verlag, Dusseldorf, 2006, 98-9.

mere duty to file when the company is cash-flow insolvent, since generally (albeit not always) cash flow insolvency emerges after overindebtedness;

b) putting the trigger signal at an earlier time, however, magnifies the risk of filing too soon, preventing the directors from exploring possible workouts that can maximize value also for creditors. This is usually solved in practice by allowing the directors to explore workout possibilities while preparing an *ad hoc* balance sheet (*Überschuldungsbilanz*) for the purpose of assessing the existence of *Überschuldung*, which may take several weeks. Admittedly, while this practical expedient mitigates the problem of filing too early, at the same time it reduces (albeit without nullifying) the attractiveness of *Überschuldung* as an effective device to protect creditors in the phase that precedes the emergence of cash-flow insolvency.

In the wake of the financial crisis of 2008, Germany temporarily amended the law on *Uberschuldung*. This change was intended to avoid unnecessary filings and uncertainty for directors, and therefore excluded *Uberschuldung*'s relevancy to insolvency law (and the related duty to file) when there is a positive forecast for the company to operate as a going concern.

The change is quite radical, as the test seems now more focused on the ability of the company to continue trading than on over-indebtedness itself. The directors of a company with excess liabilities but with either a) good prospects of profits, or b) the capability of reaching an agreement with its creditors, no longer seem under a duty to file for insolvency.

The amendment, originally due to expire in 2010, will be in force until December 31st, 2013. For this reason, in the rest of the paper we will refer to *Uberschuldung* in the original form.

4. *Wrongful Trading*

Instead of putting directors under an obligation to file, a more flexible and possibly more sophisticated approach sets them under an obligation to minimize losses for creditors when the company is insolvent (we will see later in what sense, whether cash-flow or balance sheet). This includes a duty to file for insolvency proceedings if no other solution is viable, but does not rule out the possibility of attempting a good faith effort to rescue the business, or to achieve a composition with the creditors (or with some of them) out of court. Indeed, it is even conceivable that filing for insolvency proceedings is a source of liability when a company's rescue was within reach[18].

[18] VANESSA FINCH, *Directors' duties: insolvency and the unsecured creditor*, in ALISON CLARKE, ed., *Current Issues in Insolvency Law*, Sweet & Maxwell, London, 1991, 96; R.J. Mo-

This flexible approach, in its best-known form, is codified in Sec. 214 of the UK Insolvency Act 1986, which states that directors are liable for losses incurred by the company after they "*knew or ought to have concluded that there was no reasonable prospect that the company would avoid going into insolvent liquidation*"; however, they are not liable if they took "*every step with a view to minimising the potential loss to the company's creditors as (...) [they] ought have taken*". The provision on wrongful trading received a significant endorsement in 2002, when the High Level Group of Experts, set up by the European Commission to advise on company law reform, wrote that the EU-wide introduction of this rule "*would be a considerable improvement in the functioning of companies and groups of companies*"[19].

On closer analysis, the very jurisdiction that has created the rule also sets several restrictions and conditions on its enforcement[20]. To begin with, for the provision on wrongful trading to be applicable the company must have gone into insolvent liquidation, and not have been subject to administration, the rescue procedure reformed in 2002[21]. Therefore, not in all cases of corporate insolvency can creditors recover the losses generated by the company having continued to trade at their expense.

The most important point that must not be overlooked, however, is the trigger condition for wrongful trading: the lack of *any* reasonable prospect of avoiding insolvent liquidation. This seems to be quite a high standard: on the one hand it is usually very difficult to rule out all prospect of, say, finding a buyer for the business or the whole company, on the other hand it is reasonable to assume that Sec. 214 does not impose a duty to protect creditors before the company is balance sheet insolvent, and, possibly, before it is also *cash flow* insolvent, because only then does liquidation become inevitable[22]. The

KAL, *"An agency cost analysis of the wrongful trading provisions: redistribution, perverse incentives and the creditors' bargain"*, 59 *Cambridge Law Journal* 335 (2000), at 365-6; P. DAVIES, *supra* note 13, at 314.

[19] *"Report of the High Level Group of Company Law Experts on a Modern Regulatory Framework for Company Law in Europe"*, par. 4.4, available at *http://ec.europa.eu/internal_market/company/docs/modern/report_en.pdf*.

[20] One of these relates to the difficulty of funding the high cost of an action for wrongful trading, which was a major problem up to 2006. It was only then that Sec. 176ZA was inserted in the Insolvency Act 1986, to clarify that the costs of the liquidation rank before the preferential creditors, therefore opening the path to wrongful trading actions even when all the available assets are encumbered. This (now solved) problem may partly explain the low level of enforcement of Sec. 214 to date, which we discuss immediately below.

[21] On which see J. ARMOUR, R.J. MOKAL, *"Reforming the Governance of Corporate Rescue: The Enterprise Act 2002"*, 2005 *Lloyds' Maritime and Commercial Law Quarterly*, 28.

[22] See *Rubin v. Gunner* [2004] B.C.L.C. 110: the company was balance-sheet insolvent and short of cash by February 1998, but up to October 1998 the directors reasonably believed that insolvent liquidation could be avoided [§ 79: "I find that, although RGO was insolvent by April

"inevitability" requirement is in fact so stringent that, although in theory the directors could be held liable for trading wrongfully when the company is still solvent (if it is clearly going off the cliff at a fast pace), in practice this never happens.

It follows, then, that the liability for wrongful trading triggers *not earlier* than the liability for not filing when the company is cash-flow insolvent (in the systems examined above), and *after* the liability for not filing in case of *Überschuldung* (in its original form: see par. 3) would have already kicked in[23]. Add to all this a healthy, benign attitude towards even unsuccessful attempts to rescue the company or simply to minimize the creditors' losses, and the net result is that reported cases that have held the directors responsible for wrongful trading are very rare in the United Kingdom[24].

1998, the respondents had a genuine and reasonable belief, during the period prior to 15 October 1998 (albeit diminishing substantially in reasonableness from the end of September 1998), that Mr Stables would provide sufficient funding for RGO to avoid the company going into insolvent liquidation"]. See also P. Davies, *supra* note 13, at 319.

[23] See T. Bachner, *"Wrongful trading before the English High Court. Re Continental Assurance Company of London plc (Singer v. Beckett)"*, 5 *European Business Organization Law Review* (2004) 195.

[24] V. Finch, *Corporate Insolvency Law. Perspectives and Principles*, Oxford, 2003, at 513, noting only a handful cases out of a total of 92,500 corporate insolvencies in England and Wales between 1989 and 1993. A total of 25 cases were recorded as of the year 2000 according to R.J. Mokal, *supra* note 18, at 355-57, most of which concerned closely-held firms. *See also* A. Walters, *"Wrongful Trading: Two Recent Cases"*, *Insolvency Lawyer* 2001, 211. In the well-known *Continental Assurance Co of London Plc* case (April 2001) the English High Court held that directors that had kept the business running for several months after it was insolvent were not responsible, as their attempts to sell the business as a going concern were not unreasonable. See in particular §§ 95-128 and §§ 280-298. In § 281, Justice Park said: «A decision to close down will almost certainly mean that the ensuing liquidation will be an insolvent one. Apart from anything else liquidations are expensive operations, and in addition debtors are commonly obstructive about paying their debts to a company which is in liquidation. Many creditors of the company from a time before the liquidation are likely to find that their debts do not get paid in full. They will complain bitterly that the directors shut down too soon; they will say that the directors ought to have had more courage and kept going (...). Ceasing to trade and liquidating too soon can be stigmatised as the cowards' way out». See also the cases *Re Oasis Merchandising* and *Rubin v. Gunner*.

To get a complete picture of Sec. 214 enforcement we must also add in directors' disqualification cases under the Company Directors Disqualification Act 1986. The CDDA contemplates, as a ground for disqualification, "any misfeasance or breach of any fiduciary or other duty", which the courts envisage also (but not only) in cases of "trading to the detriment of the creditors". A violation of Sec. 214 can easily fit the definition, but there is no coincidence between the two provisions, and «it appears that the courts are entitled to find a defendant unfit under s. 6 on the basis of trading to the detriment of the creditors *without* the claimant being required to make a case that satisfies all the elements of s. 214»: A. Walters, M. Davies-White, *Directors' disqualification & bankruptcy restrictions*, 2nd edn, London, Sweet & Maxwell, 2005, at 172; see also in *Re Bath Glass Limited* (1988) and on the importance of public enforce-

So we can argue that, at least in theory, wrongful trading is a good rule, because it embodies a dynamic test (the *prospects*) as opposed to a static one (cash-flow or balance-sheet insolvency), and because it provides flexibility to the management, thereby encouraging (or at least not discouraging) risk-taking[25]. However, it cannot be seen as a tool that protects creditors *in the vicinity* of insolvency, assuming, as we will discuss later, that this is a sensible goal.

This could be the reason why, in recommending the adoption of a rule on wrongful trading, the High Level Group appears to describe a rule slightly different from that of the UK[26]. In a sort of *crescendo*, the Report states:

> ... *if the directors ought to foresee that the company* ***cannot*** *continue to pay its debts, they must decide either to rescue the company (and ensure future payment of creditors) or to put it into liquidation. Otherwise, the directors will be liable fully or in part to creditors for their unpaid claims.*

Immediately after, it says that the rule

> ... *would hold company directors (including "shadow" directors) accountable for letting the company continue to do business when it should be foreseen that it* ***will not*** *be able to pay its debts,*

and, finally, that its benefits are that

> ... *[i]t would protect creditors without overly restricting companies and their directors, as they can and must make their own choice* ***in case of – foreseeable, not yet actually imminent – insolvency*** *whether to attempt to rescue the company or put it into liquidation* [emphasis added].

This latter proposition was included in the 2003 European Commission Action Plan for modernising company law and corporate governance in Europe[27].

ment J. ARMOUR, *"Enforcement Strategies in UK Corporate Governance: A Roadmap and Empirical Assessment"*, in *ECGI - Law Working Paper No. 106/2008*, available at *www.ssrn.com.*

[25] The argument that parties (creditors, shareholders, directors) would agree *ex ante* on a rule modelled after Sec. 214 of the Insolvency Act 1986 seems plausible: MOKAL, *supra* note 24. For a different view, see B. CHEFFINS, *Company Law: Theory, Structure, and Operation*, Clarendon Press, Oxford, 1997, 537-548, according to whom the parties would not agree, since the directors would be placed under the threat of an indefinite liability.

[26] T. BACHNER, *"Wrongful Trading - A New European Model for Creditor Protection?"*, 5 *European Business Organization Law Review* 293 (2004).

[27] In the Communication "Modernising Company Law and Enhancing Corporate Governance in the European Union - A Plan to Move Forward" (COM (2003) 284), the Commission proposed the "development of a wrongful trading rule, whereby directors would be held personally accountable for the consequences of the company's failure, if it is foreseeable that the company cannot continue to pay its debts and they don't decide either to rescue the company and ensure payment or to put it into liquidation". See the Action Plan at *http://ec.europa.eu/internal_market/company/modern/index_en.htm#communication.*

Other proposals, similarly aimed at adding bite to the rule on wrongful trading, move in the same direction. It has been suggested that the directors ought to take all reasonable steps to minimize the losses for creditors once that they foresee *a substantial probability* of an insolvent liquidation[28], or that insolvency *is more likely than not*[29]. Such approaches would trigger the obligation to minimize losses for creditors at a much earlier stage, but they rely on the directors' judgement about the probability of an event (insolvency) that depends on multiple, heterogeneous factors, and on the same uncertain grounds, to be judged *ex post*, impose a liability. They appear a step in the right direction, but the triggering point is quite difficult to pinpoint in time[30].

Part II

5. *Why Creditor Protection, and What*

One might wonder why creditors need to be protected at all. Creditors, or most of them, are able to contract on the terms of lending. They can impose restrictions on the projects that the company is permitted to undertake, they can provide for monitoring and information obligations, and may establish trigger clauses that allow them to call for immediate repayment in the case of the company not meeting certain ratios. Effectively, such terms are quite common in debt contracts. Where contracting is less common, creditors generally lend on a short term basis, which allows them to decide at any given moment whether to call the debt or not[31].

Apart from the fact that the firm might have creditors whose claims do not arise from contracts (e.g., tort obligations and, more frequently, taxes), the answer to this question is not clearcut, and goes beyond the scope of this paper. However, there is at least one argument for a legal rule being superior to indi-

[28] Final Report of the UK Company Law Steering Group. The proposal has been rejected as discouraging good faith rescue attempts (SECRETARY OF STATE FOR TRADE AND INDUSTRY, *"Modernising Company Law"*, Command Paper 5553-I, 2002, 28), but the "real issue is the fear that it is difficult to define such steps precisely *ex ante*": see H. EIDENMÜLLER, *"Trading in Times of Crisis: Formal Insolvency Proceedings, Workouts and the Incentives for Shareholders/Managers"*, in 7 *European Business Organization Law Review* 239 (2006), at 252.

[29] H. EIDENMÜLLER, *supra* note 28.

[30] This uncertainty would render more serious the threat of the indefinite liability, described by B. CHEFFINS, *supra* note 25, at 542-3, that currently (given the low level of enforcement and the fact that the courts seem very reluctant to condemn directors for their good-faith, if unsuccessful, attempts to save the company) appears somewhat overstated.

[31] Short term is to an extent a functional equivalent of contracting: see S.C. MYERS, *"Determinants of Corporate Borrowing"*, 5 *Journal of Financial Economics* (1977) 147, at 158-9.

vidual contracting: the collective action problem (and the associated costs), which makes contracting costly and not necessarily efficient for creditors as a group[32]. It is arguable that a legal protection for creditors, in terms that we will later explore, can reduce the costs of borrowing, and thereby offer some benefit notwithstanding the capacity of the main creditors to contract on the terms of lending[33]. This, in turn, suggests that the rules should be framed in terms as close as possible to those the parties themselves would accept[34].

If we assume that a set of rules that imposes a duty on the directors to protect creditors is advisable, then the question is how such a set should be construed, with respect to:

a) the moment at which the directors' duty to protect creditors triggers: when the company is (cash-flow or balance-sheet) insolvent, or before that;

b) what the directors should, or should not, do from the moment at which such a duty triggers.

This second point (directors' duties) can be broken down in three different directions:

(1) ensuring prompt and proper disclosure of the financial conditions of the company to the creditors, so as to give them the possibility to react according to their applicable statutory and/or contractual rights;

[32] P. DAVIES, *supra* note 13, at 307; P.O. MULBERT, *A Synthetic View of Different Concepts of Creditor Protection, or: A High-Level Framework for Corporate Creditor Protection*, 7 *European Business Organization Law Review* 357 (2006), at 375-7 (contracting costly; not true that covenants negotiated by some creditors benefit all); F. DENOZZA, *"Different Policies for Corporate Creditor Protection"*, 7 *European Business Organization Law Review* 409 (2006), at 413 (mandatory vs. contractual protection matter of fairness, not efficiency; contracting with creditors affected by collective action and managers' agency costs). W. SCHÖN, *The Future of Legal Capital*, 5 *European Business Organization Law Review* 429 (2004) (legal capital a minimum "contractual" offer to creditors).

[33] R.J. MOKAL, *supra* note 24, P. DAVIES, *supra* note 13, at 310. Rules establishing directors' duties (and liabilities) to creditors may have a different impact in different settings. In small-medium entreprises, where directors often offer personal guarantees (having effectively forgone limited liability), they may have less impact, in large firms with disperse ownership they may reduce risk-taking, and in large firms with concentrated ownership they may effectively constrain excessive risk-taking. There is indeed evidence of increased covenants in large firms with concentrated ownership and of different bank behaviour in firms where banks have personal guarantees. See J. FRANKS, O. SUSSMAN, *"Financial Distress and Bank Restructuring of Small to Medium Size UK Companies"*, 9 *Review of Finance* 65 (2005).

[34] The costs of such mandatory rules, much like the costs of borrowing that would result from a system relying on contracting alone, are ultimately borne by the shareholders, in the form of the additional compensation required by the directors to induce them to accept the increased risk: R.J. MOKAL, *supra* note 24. From this perspective the fact that under American substantive law there would be no fiduciary duties to creditors, recently advanced by H.T.C. HU, J.L. WESTBROOK, *"Abolition of the Corporate Duty to Creditors"*, 107 *Columbia Law Review* 1321 (2007), is irrelevant. See also the discussion in Section 8.

(2) ensuring that the directors' incentives are not distorted due to the fact that the equity cushion is thin or non-existent, i.e., ensuring that they select only investment strategies that have a positive net present value (NPV);

(3) ensuring that directors adopt a more conservative approach, i.e., select investment strategies that not only have a positive NPV on the whole, but *also* have a positive NPV for creditors (remember that creditors have a cap on positive returns, which may make an overall positive NPV project negative for them). The duty to minimize creditors' losses, that some jurisdictions affirm, appears close to a duty to adopt strategies that have a positive NPV for creditors.

While the first two propositions are less controversial, the latter is more or less accepted only once the company is insolvent (see Sec. 214 of UK Insolvency Act 1986 on wrongful trading, discussed above), and is subject to intense debate when this is not yet the case: in such a setting, in fact, applying the double-NPV requirement (on the whole *and* for creditors) could result in projects with an overall positive NPV being foregone, and underinvestment would follow.

6. *The "Vicinity of Insolvency" and its Consequences*

It has been argued that the incentives of shareholders start to shift not only when the equity cushion has been lost, but also when it "has been reduced to a very low level and there is no prospect of its being rebuilt through the company's established business model"[35]. This happens because, while shareholders bear *some* downside risk (equal to the amount of the equity cushion that is still existent), they do not bear *the entire* downside risk of investment projects that may wipe out the remaining equity entirely[36]. Therefore, it is important for creditors that when the equity cushion has become

[35] P. Davies, *supra* note 13, at 306.

[36] Let us suppose that the company has 300 in liquid assets and 250 in unexpired liabilities. The equity cushion is therefore 50, thin but still existent. Let us suppose that the directors are considering an investment project that requires 300, and that will yield 1,000 in 10% of cases, and will yield only 100 in 90% of cases. The project has a (negative) net present value (NPV) of -110:

*NPV: – 300 investment + 100 (1,000 *10%) + 90 (100*90%) = – 110.*

Notwithstanding this, the shareholders have an incentive to allow the company to go forward with the investment, as their returns are different from those of the creditors, thanks to the limited liability:

*NPV for the shareholders: – 50 + 75 (750 * 10%) + 0 (0 * 90%) = + 25 (positive NPV)*
*NPV for the creditors: – 250 + 25 (250 * 10%) + 10 (100 * 90%) = – 225 (negative NPV).*

particularly thin relative to the possible range of outcomes, the directors, at a minimum, do not start selecting investment strategies that are positive only for shareholders, who bet on the upside without fully bearing the cost of the downside.

The asymmetry of distribution of returns between shareholders and creditors, however, is embedded in company law and limited liability. Therefore, restraining the directors from pursuing the maximization of value for the shareholders in a solvent company calls for a distinguishing element that justifies a departure from this general principle. This justification, at least in theory, is provided by adding to the *snapshot* (of a company with a thin equity cushion) the *movement* (the prospect of such cushion being further reduced or lost altogether). In other words, its not enough that equity is thin, it is the fact that it is going to disappear that is important. True, we have seen above that providing for a dynamic assessment is the distinctive feature of wrongful trading (as opposed to the static tests of cash-flow or balance sheet insolvency), but we have also observed that, in practice, wrongful trading triggers when *both* static tests would already have been met.

In this light, let us examine the three points made earlier (disclosure to creditors, firm value maximization, creditor claims maximization).

It is worth noting that the need to anticipate the moment in which the directors must start considering the creditors' interests seems to be the implicit common denominator among a number of court rulings, provisions, and proposals for reform that have popped up quite independently in different jurisdictions. Let us look at several of them and try to extrapolate a coherent framework.

7. *Disclosure of the Downward Trajectory: Law and Contract*

Giving the shareholders and the various stakeholders notice of the company's downward trajectory appears to be the most sensible explanation of Article 17 of the Second Council Directive on harmonization of company law (77/91/EEC), which states:

> *1. In the case of a serious loss of the subscribed capital, a general meeting of shareholders must be called within the period laid down by the laws of the Member States, to consider whether the company should be wound up or any other measures taken.*
>
> *2. The amount of a loss deemed to be serious within the meaning of paragraph 1 may not be set by the laws of Member States at a figure higher than half the subscribed capital.*

The meaning of "loss" of capital is provided for by Article 15, which defines it as the situation in which "*the net assets as set out in the company's annual accounts are [...] lower than the amount of the subscribed capital plus those reserves which may not be distributed under the law or the statutes*". In short, the comparison is between the value of net assets at book value and the stated capital (plus non-distributable reserves)[37].

Therefore, the focus of this provision is not the snapshot (the equity cushion may still be positive), but the fact that the company has suffered losses. To be sure, the provision is designed as a governance mechanism aimed at informing the shareholders, but it could be a signal that goes beyond the closed walls of the company and reaches the creditors (good or bad as this may be).

In short, Article 17 of the Second Directive provides for:

a) a duty to monitor the affairs of the company on an ongoing basis;

b) a duty to report significant losses (the downward trajectory) to the shareholders.

Dissolution, however, is not mandated[38], nor is there any other mandatory consequence for the loss of capital, apart from limiting the distributions to shareholders[39]. Shareholders can therefore react to the directors' report as they will: they can simply wait, or they can decide to contribute funds. It is arguable that, in companies not listed in regulated markets [therefore not subject to the mandatory disclosure of inside information pursuant to article 6(1) of Directive 2003/6/EC on market abuse], shareholders can prevent the disclosure of the loss by contributing or committing funds up to half of the

[37] If (Assets – liabilities)/(stated capital + non-distributable reserves) < 1/2, then article is 17 triggered. For instance:

Balance Sheet

Assets	Liabilities and Sh. Equity
100 Receivables	100 Current Liabilities
100 Inventory	260 Bonds
200 Property, Plant & Equip.	100 *Capital*
	100 *Distributable Reserves*
	– 160 *Loss FY 2010* –
	40 *Shareh. Equity (< 1/2 Capital)*
400 TOTAL ASSETS	**400 TOTAL LIAB.**

[38] See, however, *infra* note 65 and accompanying text, with regard to the various scenarios following a loss of capital.

[39] Article 15, par. 1(a), of the Second Directive prohibits distributions to shareholders when "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." Losses, obviously, reduce the net assets and the distributable profits pursuant to par. 1(c) of the same article.

subscribed capital without going through a capital increase, thereby avoiding a shareholders' meeting[40].

One might argue about whether Article 17, and the EU Member States' implementation provisions (in some cases reducing the amount of losses deemed relevant to 1/3 of the capital, as in Italy), are effective[41], but clearly their goal is also reducing the information asymmetry between the directors and the other constituencies, shareholders and creditors alike[42]. The "price" for not disclosing the downward trajectory is, for the shareholders, committing funds to the company[43]. Indeed, a recapitalization may even not be a bad signal to send out, since it displays to the market the insiders' continuing confidence in the company.

Of course, creditors can contract for a similar (or even for a more direct) disclosure of losses. This leaves us with the same question: if creditors can obtain such disclosure by contract, is it efficient for the law to make it mandatory? A doubt comes from the American system, under which closely held companies are only required to keep the accounts, not to disclose them, so that all disclosure to creditors takes place via contractual arrangements. There are reasons to believe that a mandatory disclosure system, one that ob-

[40] Article 25 of the Second Directive, in fact, gives the shareholders the exclusive right to decide on capital increases, but does not stipulate that all contributions take the form of a capital increase. Therefore, if all shareholders, or even some of them, agree to inject funds in the company (e.g., forgoing reimbursement of debts it owes to them), they may do so without a shareholders' decision as long as this does not entail a new equity issue.

[41] Article 17 of the Second Directive is ineffective according to E. Ferran, *"The Place for Creditor Protection on the Agenda for Modernisation of Company Law in the European Union"*, 3 *European Company and Financial Law Review* 178 (2006), at 198, as it does not trigger for losses that can be covered through reserves (the paper is also available at *www.ssrn.com*). This could be justified, however, if the disclosure mechanism is aimed at alerting the shareholders with respect to an increase in the risk of losing control of the firm (and, even more, if the disclosure is indirectly aimed at the creditors).

[42] For instance, Sec. 656 of the UK Companies Act 2006 requires the directors to call the meeting "not later than 28 days from the earliest day on which that fact is known to a director of the company," and the meeting must be convened for a date not later than 56 days from that day. Under Italian law (Art. 2446 and Art. 2482-bis of the Civil Code) the shareholders' meeting must be called without undue delay from the the date when loss of capital is known (or should be known), and no precise date for the meeting to be held is specified (although a delay that is unjustified under the circumstances could be viewed as elusive and therefore sanctioned). Pursuant to Art. 2631 of the Civil Code, thirty days is the maximum time for a shareholders' meeting to be considered called without undue delay. See also, for Sweden, C. Norberg, *The Liability of Directors causing Loss of Capital in Companies, Mads Andenas & Nils Jareborg*, eds., *Anglo-Swedish Studies in Law*, Justus Forlag, Uppsala, 1999, 70 (stressing informational value for creditors and exploring the extent of the directors' liability for not disclosing a serious loss).

[43] One could argue as to whether demanding a "price" (the recapitalization) to be paid for not disclosing losses has significant *ex ante* negative effects, but it seems doubtful.

viously goes beyond the (indirect) disclosure mandated by Article 17, is more cost-effective, when properly balanced and scaled to the size of the company and its financial structure[44].

8. *Firm Value Maximization: The Ambiguous Role of Fiduciary Duties*

The notion that, in the vicinity of insolvency, directors owe a fiduciary duty to creditors is a contentious one. The Delaware Chancery Court, in *Production Resources Group, LLC v. NCTGroup, Inc.*, recently refused to endorse such a view in a case in which, to be honest, the company was clearly insolvent[45].

The court vigorously rejected the view that the directors owe a fiduciary duty to creditors "in the vicinity of insolvency" (a view that a famous footnote in the well-known 1992 case *Credit Lyonnais Bank Nederland, N.V. v. Pathe Communication Inc.* seemed to support), but went on to state, in an important footnote, that

> *... at all times, directors have an obligation to consider the legal duties of the firm and to avoid consciously placing the firm in a position when it will be unable to discharge those duties. Our statutory law reflects this aspect of director responsibility. (...) If this is accepted as a proposition, it seems to me even less plausible that directors' duties somehow change profoundly as the firm approaches insolvency. As the proportion of the firm's enterprise value that is comprised of debt increases, directors must obviously bear that in mind as a material consideration in determining what business decisions to make. I doubt, however, that there is a magic dividing line that should signal the end to some, most, or all risk-taking on behalf of stockholders or even on behalf of creditors, who are not homogenous and whose interests may not be*

[44] See, H. Merkt, *"Creditor Protection Through Mandatory Disclosure"*, in 7 *European Business Organization Law Review* (2006), 95.

[45] *Production Resources Group v. NCT Group, Inc.*, 863 A.2d 772, 790 (Del. Ch. 2004). NCT Group was both balance-sheet and cash flow insolvent, and was barely kept alive through secured credit extended by a single financier closely tied to a group of related persons and entities that, unlike other creditors, received hefty payments as consultants. Given that an exculpatory clause in the corporation's charter for the violation of the duty of care is effective also for claims in bankruptcy, lenders should accurately factor in (and price) such clause in their loan. See the recent case *Bridgeport Holdings Inc. Liquidating Trust v. Boyer Bridgeport Holdings Inc. Liquidating Trust v. Boyer (In re Bridgeport Holdings, Inc.)*, No. 07-51798, 2008 Bankr. LEXIS 1586 (Bankr. D. Del. May 30, 2008): exculpatory clauses in the corporate charter can be invoked by the directors, and they are a valid basis for dismissal of claims unless a separate violation of the duty of loyalty is established.

served by a board that refuses to undertake any further business activities that involve risk.

Therefore,

... [h]aving complied with all legal obligations owed to the firm's creditors, the board would, in that scenario, ordinarily be free to take economic risk for the benefit of the firm's equity owners, so long as the directors comply with their fiduciary duties to the firm by selecting and pursuing with fidelity and prudence a plausible strategy to maximize the firm's value.

Hence, what the court appears to be saying is that *at all times* the directors must select investment projects that have a positive net present value[46]. This is a statement that, while being very different from saying that when the company is insolvent (or near-insolvent) the directors owe a fiduciary duty to creditors, does not appear to differ greatly as to the consequences. It is even possible that creditors would be content with it[47].

In this light, the seemingly definitive elimination of fiduciary duties to creditors by the Delaware Supreme Court in 2007, with the *Gheewalla* decision[48], does not appear to change the landscape dramatically. The main consequence of this ruling, in fact, is that creditors do not have a direct claim against directors, and that the latter can engage in vigorous, adversarial negotiations with creditors, aiming (also) at restructuring the company's debt

[46] According to the court, this is also true when the company is insolvent, because «it is settled that under Delaware law, the firm's directors are said to owe fiduciary duties to the company's creditors. (...) The directors continue to have the task of attempting to maximize the economic value of the firm." This is because "the fact of insolvency does not change the primary object of the director's duties, which is the firm itself. The firm's insolvency simply makes the creditors the principal constituency injured by any fiduciary breaches that diminish the firm's value and logically gives them standing to pursue these claims to rectify that injury».

[47] This is what the creditors and the firm would agree not only in advance, but also when the company is in financial distress, if necessary through a renegotiation of the debt contract: see S.C. Myers, *supra* note 31, at 158. Such renegotiation, however, is costly. Insolvency proceedings can be viewed as forums where such costs can sometimes be reduced (through judicial oversight, monitoring, and the majority rule for creditors' decisions).

[48] *North American Catholic Educational Programming Foundation v. Gheewalla*, Delaware Supreme Court, 2007 WL 1453705. *See*, for a general discussion, J.C. Lipson, *"The Expressive Function of Directors' Duties to Creditors"*, 12 *Stanford Journal of Business, Law & Finance* (2007), 224 (also available at *www.ssrn.com*), with an acute description of the declining trajectory of fiduciary duties to creditors in US corporate law. For a more radical view against any corporate duty to creditors see H.T.C. Hu, J.L. Westbrook, *supra* note 34, who critically observe (at 1344) that in *Gheewalla* the Delaware Supreme Court has «accepted duty shifting for the first time and prescribed [insolvency as] the financial trigger for its application». See also D.C. Thompson, *"A Critique of 'Deepening Insolvency,' New Bankruptcy Tort Theory"*, 12 *Stanford Journal of Business, Law & Finance* (2007), 536 (also available at *www.ssrn.com*), describing the history of the doctrine and criticizing it over several grounds.

in the interests of the shareholders, which they arguably could not do if they owed a fiduciary duty to creditors[49]. Nor does a direct impact on our specific problem derive from the fact that, pursuant to other recent decisions, deepening insolvency of an insolvent company does not give rise to a specific cause of action under Delaware law[50]: the consequence is that the directors are liable derivatively and are protected by the business judgement rule, but may still be held accountable for negligent decisions that destroy the value of the firm, therefore harming (also) creditors.

All we can infer is that, under Delaware law, the directors of an insolvent company (and, even more, the directors of a company *in the vicinity* of insolvency) do not have a duty to stop trading, nor have they a specific obligation to minimize losses. Nonetheless, they are not allowed to pursue value-destroying projects that may be rational only for shareholders that enjoy limited liability.

The doctrine of fiduciary duties to creditors has apparently received a warmer acceptance in other common law jurisdictions. In a well-known Australian case, for instance, the court ruled that

> *... [i]n a solvent company the proprietary interests of the shareholders entitle them as a general body to be regarded as the company when questions of the duty of directors arise. If, as a general body, they authorise or ratify a particular action of the directors, there can be no challenge to the validity of what the directors have done. But where a company is insolvent the interests of the creditors intrude. They become prospectively entitled, through the*

[49] See, for a discussion, J.C. LIPSON, *supra* note 48.

[50] *Trenwick America Litigation Trust v. Billet* (2006), affirmed by the Delaware Supreme Court with a two page order on 14 August 2007. The Chancery Court stated: «The fact that the residual claimants of the firm at that time are creditors does not mean that the directors cannot choose to continue the firm's operations in the hope that they can expand the inadequate pie such that the firm's creditors get a greater recovery. By doing so, the directors do not become a guarantor of success. Put simply, under Delaware law, deepening insolvency is no more of a cause of action when a firm is insolvent than a cause of action for 'shallowing profitability' would be when a firm is solvent. Existing equitable causes of action for breach of fiduciary duty, and existing legal causes of action for fraud, fraudulent conveyance, and breach of contract are the appropriate means by which to challenge the actions of boards of insolvent corporations. (...) If the board of an insolvent corporation, acting with due diligence and good faith, pursues a business strategy that it believes will increase the corporation's value, but that also involves the incurrence of additional debt, it does not become a guarantor of that strategy's success. That the strategy results in continued insolvency and an even more insolvent entity does not in itself give rise to a cause of action. Rather, in such a scenario the directors are protected by the business judgment rule». In the later case *In re The Brown Schools*, 2008 WL 1849790 (Bankr. D. Del. 24 April 2008) the cause of action based on deepening insolvency was sustained, but only as a basis for damages arising from a breach of the duty of loyalty.

mechanism of liquidation, to displace the power of the shareholders and directors to deal with the company's assets. It is in a practical sense their assets and not the shareholders' assets that, through the medium of the company, are under the management of the directors pending either liquidation, return to solvency, or the imposition of some alternative administration[51].

In the United Kingdom and in other common law jurisdictions, several cases have recognised that, in discharging their duties, directors should have regard to creditors' interests where the company is balance-sheet insolvent, although not cash-flow insolvent[52]. If this is true, then fiduciary duties to creditors would trigger earlier than the liability for trading wrongfully, which, as we have seen, *de facto* requires cash flow insolvency and can be affirmed only in a liquidation (and not in a rescue) procedure[53].

The breadth of this principle, however, cannot – and should not – be overstated. Saying that directors' fiduciary duties shift to creditors when the company is insolvent is not substantially different from saying that they owe a duty to the company. Creditors, in fact, do not have a direct claim against the directors, and their claims can be enforced only through the company, which eliminates problems of double recovery and is consistent with the *pari passu* principle according to which all creditors in like situations must be treated equally[54].

In short, the practical consequences of fiduciary duties owed to creditors of insolvent companies are twofold:

(1) on the one hand, the shareholders no longer have the power to ratify and approve directors' acts that harm creditors, since they have no interest in the matter of which they are disposing (possible claims against the directors)[55];

[51] *Kinsela & Anor. v. Russell Kinsela Pty. Ltd. (in liq.)* [1986] 4 N.S.W.L.R. 722, at 730 (favourable lease to directors when company factually insolvent deemed void on demand by liquidator). For a detailed account of the development of constraints to shareholder value maximization in insolvent companies in several common law countries see R. Grantham. *"The Judicial Extension of Directors' Duties to Creditors"*, *Journal of Business Law*, 1991, 1; for a general (and critical) discussion about widening directors' duties see also L.S. Sealy, *"Directors' 'Wider' Responsibilities"*, 13 *Monash University Law Review* 164 (1987).

[52] *West Mercia Safetywear Ltd v Dodd*, [1988] BCLC 250; *Facia Footwear Ltd (In Administration) v Hinchcliffe*, [1998] 1 B.C.L.C. 218; *Colin Gwyer & Associates Ltd v London Wharf (Limehouse) Ltd*, [2003] 2 B.C.L.C. 153. See A. Keay, *"Directors taking into account creditors' interests"*, 2003 *Company Lawyer* 300.

[53] P. Davies, *supra* note 13, at 329.

[54] D.D. Prentice, *"Creditor's Interests and Director's Duties"*, 10 *Oxford Journal of Legal Studies* (1990), 265, at 275-6; P. Davies, *supra* note 13, at 328-9.

[55] D.D. Prentice, *supra* note 54, at 277; P. Davies, *supra* note 13, at 329. Instead, given the

(2) on the other hand, under this doctrine the preferential treatment of a creditor can give rise to a claim against the directors, as they have a duty to treat all creditors equally once they are the residual claimants[56].

These, though, are mere refinements to the doctrine of directors' fiduciary duties owed to the company. They do not seem to require any subversion in established company law principles. Fiduciary duties to creditors, if so defined, appear the product of *dicta* more than of substance[57], and the gap with Delaware which has declared them non-existent is not as wide as it appears.

separate personality of the company [*Salomon v. A. Salomon* & Co Ltd (1897) AC 22, at 57], when the company is solvent, the shareholders' unanimous consent will suffice to validate a corporate transaction against all subsequent challenge not only by the company, but also by those claiming in its right: J. ARMOUR, *"Avoidance of Transactions as a 'Fraud on Creditors' at Common Law"*, in John Armour & Howard Bennett, eds., *Vulnerable Transactions in Insolvency*, Hart Publishing, Oxford-Portland, 2003, 281, at 316. See *Colin Gwyer & Associates Ltd v London Wharf (Limehouse) Ltd* (release of claim against a party related to a director at the eve of insolvency deemed void, because the directors had not "properly considered the interests of the company's creditors when passing the resolution" [§ 80]). For a discussion of the validity of an exculpatory clause (which is not a ratification, given that it operates *ex ante*) see *supra* note 45.

[56] *West Mercia Safetywear Ltd v Dodd*, [1988] BCLC 250 (director held liable for having preferentially paid a creditor out of a personal interest); see D.D. PRENTICE, *supra* note 54, at 275. This particular situation brings to light how closely related the law on vulnerable transactions, the law on subordination and the law concerning directors' duties in insolvency are.

[57] «If these judicial utterances [obiter dicta declaring that directors owe duties towards their company's creditors] are examined in their context, it will be seen that in most cases they are nothing more than extraneous words of censure directed at conduct that anyway comes within some well-established rule of law»: L.S. SEALY, *"Directors' duties - an unnecessary gloss"*, 47 *The Cambridge Law Journal* 175 (1988), commenting *West Mercia Safetywear* and its wording. The case analysis seems to confirm Professor Sealy's view. On the one hand, in *Kinsela (supra* note 51), the court was presented with an interested transaction that seemed fishy, and not dissimilar were the facts in *Colin Gwyer & Associates Ltd (supra* note 55). On the other hand, in *Re Welfab Engineers Ltd* [1990] B.C.L.C. 833, the court deemed that the directors' decision to sell the business under time pressure, which eventually led the company to insolvency, could not be reviewed by the same standard as a liquidator seeking to obtain the best price for the creditors (the facts of the case, however, show that they probably *had* obtained the best possible price under the circumstances).

This appears to confirm Professor Sealy's opinion that «[i]t would be absurd (...) to allow a body of rules to develop which allowed directors to do X when their company had divisible profits, Y when there were profits which were not divisible, Z when there were no profits but the funds at risk were notionally the shareholders' capital contributions, and something else again when what they were hazarding was "creditors" money'. The question both for the directors at the time, and for the court sitting in review, is whether the directors are behaving responsibly or irresponsibly within the proper limits of business judgment» (L.S. SEALY, *supra* note 51, at 178-9). Obviously, if we believe that *ex ante* deterrents against directors' opportunistic behavior when the company is insolvent are optimal, and that *ex post* enforcement of their liability is sufficient, this position would hardly be disputable.

9. *Creditor's Claims Value Maximization*

The key point on which jurisdictions diverge, then, is whether or not the directors have a duty to maximize the value of creditors' claims and, if so, at what point in time it triggers. Let us first clarify the issue.

a) As we have seen, a duty to maximize the value of creditors' claims coincides with a duty to maximize the value of the firm when the value of the assets is less than that of the liabilities, *i.e.*, when the company is balance sheet insolvent[58]. In this sense, the duty to minimize creditors' losses arising from the wrongful trading provision is equivalent to the duty to adopt strategies that maximize the value of the firm, as are the so-called fiduciary duties;

b) However, a duty to maximize the value of creditors' claims does *not* coincide with a duty to maximize the value of the firm when the company is balance sheet solvent[59].

Again, a duty of this sweeping magnitude cannot be generally affirmed, as it would impede the essential function of the directors of solvent firms, which is to make judgements about business risks, and to take those risks[60]. One might wonder, however, if this freedom can (or should) be limited in cases in which a threat to the creditors' claims is envisaged as a real and serious possibility, and creditors are not able to observe that threat and to react promptly to it.

This leads us to the questions we were discussing at the beginning of this paper: are there cases in which it is reasonable to impose on the directors a duty to adopt a more conservative approach, i.e., a duty to minimize the losses for creditors? Given that insolvency is *always* a possibility, even for sound companies (under the Basel framework this is expressed in terms of "PD", or probability of default)[61], what would be the appropriate triggering point for such a duty?

[58] In theory this is no longer true if the upside outcomes of the investment strategy of the firm would bring the value of the assets higher than the liabilities. Admittedly, this is not something that happens frequently. Moreover, maximizing the value of the firm should also take into account value-producing contracts that have not yet been performed: A. CHAVER, J.M. FRIED, *"Managers' Fiduciary Duty upon the Firm's Insolvency: Accounting for Performance Creditors"*, 55 *Vand. L. Review* 1813 (2002).

[59] «While the company is solvent the creditors' interests do not need to be separated from those of the shareholders. There is no conflict between the two at this point - broadly what is good for the shareholders will also be good for the creditors»: J. PAYNE, *supra* note 3, at 6.

[60] L.S. SEALY, *Cases and Materials in Company Law*, 7th edn., London, Butterworths, 2001, 267. On the same line of reasoning, CHEFFINS, *supra* note 25, at 541; DAVIES, *supra* note 13, at 330.

[61] "International Convergence of Capital Measurement and Capital Standards. A Revised Framework", and "Basel III: A global regulatory framework for more resilient banks and bank-

I believe that the fact that the company is on a downward trajectory is a proper triggering point. Firms that have seen their equity cushion become thinner are not a random sample of firms: they have suffered losses for a considerable time, and more likely than not they will incur *further* losses, also due to the added costs of financial distress that may be associated with the losses (management time, market interpretation of financial distress as a proxy for economic failure, counterparts' fear of falling into the net of the claw-back provisions if the company they are dealing with later fails)[62]. While this situation does not necessitate a filing for insolvency (the management may be able to conduct a successful turnaround, or the losses may be part of a sound business plan that the shareholders have approved and have committed funds to), it does require a more conservative approach by the management. Losses are not necessarily a death knell, but may call for attention from creditors (as we have seen *supra*) and a cautious approach by the directors.

Again, an optimal rule would impose on the directors a duty to act conservatively contingent on a probability judgement: that the company, although at present still balance sheet solvent, is very likely, or more likely than not, to become balance sheet insolvent. This is, apparently, the economic rationale behind the proposals aimed at introducing a probability factor to the UK-style wrongful trading provision (see above, section 4). However, as this probability judgment is difficult to make *ex ante* and to review *ex post*, the enforcement of a modified wrongful trading rule risks of being noisy, yielding false positives and false negatives. Creditors would not reduce the costs of lending and directors would be discouraged from healthy risk-taking.

Part III

10. *The "Recapitalize or Liquidate" Rule (ROL): Structure and Operation*

I have previously mentioned the so-called "recapitalize or liquidate" rule (hereinafter, "***ROL***"), criticized in the law & economics literature but very little known in its operational mechanisms and in its effects. This rule is part of company law in Italy, France, Spain and Sweden, although with one sig-

ing systems", available at *www.bis.org*). The probability of default, together with other indicators (mainly, loss given default, or LGD), is necessary to evaluate the riskiness for each specific counterpart.

[62] EIDENMÜLLER, *supra* note 28, at 243, stresses the second point in particular.

nificant difference between Italy and the remaining three countries that we will examine. It is now time to put this rule into the preceding framework.

In its basic terms, ROL states that, if as a consequence of the losses, the net assets, at book value, fall *below* the minimum capital required by each jurisdiction, then the company is dissolved and liquidated in a *solvent* liquidation (i.e., with appointment of liquidators by the shareholders) unless such losses are covered (through subsequent income or shareholder contribution) within a certain period. Therefore, shareholders hold a call option to pay off the debt and take back the role of residual owners[63].

It is important to note that, in the interim period between when the directors realize (or should have realized) that the company is in a ROL condition and the completion of the recapitalization, the directors are under a duty to act conservatively, i.e., to minimize the potential losses for creditors[64]. France and Spain have a sort of "super-ROL", one that triggers irrespective of the residual amount of net assets, which can induce serious distortions[65]. This paper examines only ROL triggering when the net assets fall below the minimum capital (which, as we will see, is zero or very close to zero), *i.e.*, the Italian, less extreme version of the rule.

The hasty and disparaging negative judgment of ROL is intrinsically bound up with its being linked to the intensely criticized capital maintenance system[66]. ROL, however, is not an inevitable consequence of such a system

[63] Shareholders may, however, prevent the dissolution not only by committing funds, but also by transforming the company backwards into a partnership. For the sake of completeness, the shareholders of a stock company can also maintain limited liability by transforming the company backward into a limited liability company, provided that the value of the net assets is not less than the minimum capital for this form. See, *infra*, in the text, for the minimum amounts in the jurisdictions that have ROL. It follows therefore that if the net assets are less than zero the only option is the transformation of the company into a partnership.

[64] See, e.g., Articles 2485-2486 of Italian Civil Code.

[65] The company laws of France and Spain require that, if the net assets fall below half of the stated capital, the company be dissolved unless a capital decrease is *decided* by the shareholders (Code de Commerce, Art. L. 225-248 for stock companies and Art. L. 223-242 for limited liability companies; Ley de Sociedades de Capital, Art. 363). Italian corporate law, instead, does not trigger ROL unless net assets fall *below the minimum capital*, and if this is not the case (as the losses, heavy as they may be, still leave the company with positive net assets), the directors have the power and the duty to amend the charter, reducing the capital to the value of the net assets by order of the court (Civil Code, Art. 2446 for stock companies and Art. 2482-bis for limited liability companies). If the shareholders are deadlocked, or are in any case incapable of or unwilling to decide on a capital decrease, the French and Spanish super-ROL can make a substantial difference. See MASSIMO MIOLA, "Legal Capital and Limited Liability Companies: the European Perspective", 4 *European Company and Financial Law* Review (2004), 413, at 427-8, note 72. Super-ROL can lead to companies adopting low levels of capital: MÜLBERT, *supra* note 32, at 387 (not noting the Italian variant).

[66] See LUCA ENRIQUES & JONATHAN MACEY, "Creditors Versus Capital Formation: The

(Germany, for instance, has capital maintenance but does not have any form of ROL, instead having *Überschuldung* which is different in operation and tied to market values rather than accounting values), and could well exist outside such a system (measurement of the net assets at book values being more or less mechanical in all systems that require the company to prepare periodical financial statements).

Minimum capital is (rightly) judged as unable *per se* to protect creditors, both voluntary and involuntary, and may discourage entrepreneurship[67]. However, since here we are concerned with minimum capital not in a startup phase, but at a later stage, we should test the following two hypotheses:

(1) following various reforms in national jurisdictions, minimum capital for starting a business while enjoying limited liability is getting close to zero; and

(2) zero (or very low) minimum capital, if coupled with ROL, may play a role in making the shareholders' call option expire at the right time, in terms which we will see.

Article 6 of the Second Directive sets a minimum capital of only € 25,000 for public companies; there is no EU-mandated minimum capital for other corporate forms. The Member States that have ROL in their company law have minimum capital requirements that range from € 37,000 in France to € 120,000 in Italy for public companies (Sweden has € 50,000, and Spain has € 60,000), and from *zero* in France to € 10,000 in Sweden for private companies (Spain has € 3,000 and Italy has € 10,000)[68].

The adoption of the public company form, however, is not mandatory except for specific kinds of businesses (e.g., Italian banks cannot operate as private companies); moreover, stock companies can transform backwards into limited liability companies. This means that minimum capital, while impeding *some* new ventures when higher than zero for any possible corporate

Case Against the European Capital Rules", in 86 *Cornell Law Review* 1165 (2001); for a more balanced but nonetheless critical view, JOHN ARMOUR, "Legal Capital: An Outdated Concept?", in 7 *European Business Organization Law Review* (2006), 5; for a cautiously positive judgement on legal capital (but not minimum capital) see SCHÖN, *supra* note 32. After the directive 2006/68/EC, relaxing the rules of the Second Directive on share buy-backs, contributions in kind, financial assistance and reduction of capital, such criticism is now less grounded: see the position of the General Directorate Internal Market and Services at *http://ec.europa.eu/internal_market/company/docs/capital/feasbility/markt-position en.pdf.*

[67] JOHN ARMOUR & DOUGLAS CUMMING, "Bankruptcy Law and Entrepreneurship" (2008), available at *www.ssrn.com.*

[68] The Swedish minimum capitals amounts expressed in the text derive from the conversion from Swedish kronas to euros (at an exchange rate of 1 SEK = 0.1 €). Under Swedish law they amount to SEK 500,000 and 100,000 respectively for stock companies and limited liability companies.

form (which makes it advisable to introduce at least one corporate form with zero minimum capital, as France and Germany did recently), are indeed practically negligible as far as creditor protection *ex ante* is concerned. The amount of debts that the company may incur, in fact, is not limited by the level of its stated capital[69].

However, the level of minimum capital, whatever it is (even zero), becomes non-trivial if it is accompanied by a provision that assigns the directors the task of ensuring that net assets do not fall below this level as a condition for the company to operate normally. If minimum capital is "the entry price for limited liability"[70], ROL can be seen as the price for maintaining it. And, as the difference between € 10,000 (the minimum capital for an LLC in Italy and Sweden), € 3,000 (the minimum for an LLC in Spain) and zero is not much, and in France the minimum capital for a LLC *is* actually zero, it is fair to say that in France, Italy, Spain and Sweden the price for operating a company while maintaining limited liability is to have net assets, at accounting values, *higher than zero*[71].

As a consequence of ROL, if the directors detect a net assets imbalance, they must not only call a shareholders meeting, but also call for a recapitalization. This puts the shareholders in a position in which they have to express themselves about the real values and prospects of the company (and

[69] MIOLA, *supra* note 65, at 429. Attempts to impose limits on companies' "undercapitalization" have rightly failed. In 2008 Germany introduced the "Unternehmergesellschaft", which in a sort of Gmbh with no minimum capital and limits on profit distributions until it reaches € 25,000 capital: see JESSICA SCHMIDT, "The New *Unternehmergesellschaft* (Entrepreneurial Company) and the Limited - A Comparison", 9 *German Law Journal* 1093 (2008), ULRICH NOACK & MICHAEL BEURSKENS, "Modernizing the German GmbH - Mere Window Dressing or Fundamental Redesign?", 9 *European Business Organization Law Review* 97 (2008). The 14 May 2008 draft for a EU regulation concerning a Statute for a European Private Company provides for € 1 minimum capital (see it at *http://ec.europa.eu/internal_market/company/docs/epc/proposal_en. pdf*). It is unclear, however, if such draft will ever become EU law.

[70] DANIEL D. PRENTICE, "Corporate Personality, Limited Liability and the Protection of Creditors", in R. Grantham & C. Ricketts, eds., *Corporate Personality in the Twentieth Century*, Oxford, Hart Publishing, 1998, at 99.

[71] Critics of ROL stress that the yardstick for assessing the impact of ROL should not be the minimum capital for limited liability companies, but be the minimum capital for the *stock* company, since limited liability companies have more limitations on accessing external financing (ENRIQUES & MACEY, supra note 66, at 1201-2). On closer scrutiny, once we get into the details of external financing by LLCs in the relevant company laws, it is possible to note that (a) for listed companies the difference between having zero assets (at which ROL also blocks the existence of LLC) and having the minimum capital required by the law and the listing rules (e.g., € 225,000 in France) is arguably negligible and (b) LLCs generally have ready access to all sorts of external financing, except equity markets and public bond financing. On the second point, for Italian LLC, see especially GIUSEPPE ZANARONE, *Introduzione alla nuova società a responsabilità limitata*, in *Riv. soc.*, 2003, 58, at 88.

the directors must give the shareholders the information they need to make such a judgement). They must show readiness to invest in the company, if they share the directors' confidence in the bright future of the business.

11. *The Informational Value of ROL*

In a sense, limited liability appears weakened by ROL. Although the shareholders are not *obliged* to make new contributions, in order to retain a share of a normally operating company they have to do so, and the contribution must be made within a limited period of time (the time it takes to complete a capital increase, usually between one and four months). Critics of ROL place particular emphasis on this point, stressing it can have an *ex ante* discouraging effect on entrepreneurship, as potential entrepreneurs may fear being forced to make unnecessary capital contributions along the way[72]. This is only partly true, and must also be balanced against other countervailing effects.

Firstly, on the point that ROL requires unnecessary capital contributions, two clarifications are necessary: *a*) at least part of the new capital required by ROL can be simply *committed*, not necessarily paid up immediately, the directors being free to call for the payment when they think it is necessary; *b*) if it later emerges that the capital contribution is excessive, because the company makes a profit, such contributions can be returned to the shareholders via dividends as long as net assets are above zero (or the applicable minimum capital)[73]; *c*) at least when the company is in financial distress, raising the stakes can force insiders to make a capital contribution that spares the company the costs associated with it. This is not to say that constraints on shareholders deriving from ROL do not exist, but merely that they are less serious than usually stated.

[72] ENRIQUES, MACEY, *supra* note 66, at 1202. The problem may be serious if some shareholders are cash-constrained and other are not, as Enriques and Macey point out. However, there is nothing to prevent the shareholders from contracting on a supermajority requirement for recapitalizations (and indeed, this frequently happens). The case of a correctly triggered ROL must be distinguished from the case in which ROL is triggered through manipulation of financial accounts (see *infra*, note 78 and accompanying text).

[73] Funds can be (mostly or entirely, depending on what the minimum capital is in the applicable jurisdiction) injected into the company as paid-in surplus and not as capital, which makes them available for later distribution. The distribution of "excessive" contributions is limited in jurisdictions, such as the UK, where the definition of "capital" includes share premiums and capital redemption reserves: see J. PAYNE, *supra* note 3, at 7. This is not, however, a consequence either of the Second Directive or of the net asset system, and indeed appears hardly justified: see E. FERRAN, *Principles of Corporate Finance Law*, Oxford University Press, 2008, at 116-7.

Secondly, the allegedly discouraging effects of ROL must be weighed against its benefits, which – as far as I am aware – tend to be ignored by its critics. ROL, as I said above, is triggered by an asset imbalance measured at accounting values, which may be different from real values (we will discuss this point below). Such values are usually lower than real, market values. Therefore, a company in a ROL condition may be neither cash-flow insolvent, nor balance-sheet insolvent (in the generally accepted sense, i.e., balance-sheet insolvent at market values)[74]. It is thus safe to assume that ROL usually triggers earlier than both the duty to file and wrongful trading.

As a matter of fact, quite often (I would hazard to say, more often than not) shareholders contribute to the company when it is in ROL conditions[75]. The fact that they *do not* contribute may signal the fact that they have concluded that the company is not worth their money. If this is effectively the case, ROL could have the effect of anticipating the closure of a business that, even according to the insiders, is heading for insolvency, therefore limiting the loss for the creditors. True, there might be another explanation: that the company is worth saving, but its shareholders are both wealth con-

[74] Let us assume that the minimum capital according to the applicable company law is 10. A company has an outstanding bond due in two years, and property, plant & equipment (PP&E) that have a market value 50% higher than book value.

Balance Sheet

Assets	Liabilities and Sh. Equity
100 Receivables	100 Current Liabilities
100 Inventory	350 Bonds
200 Property, Plant & Equip.	100 *Capital (Statutory Minimum: 10)*
	100 *Distributable Reserves*
	– 250 *Loss FY 2010* –
	– 50 *Shareh. Equity (<0)*
400 TOTAL ASSETS	**400 TOTAL LIAB.**

The company is in ROL condition while being neither cash-flow insolvent (receivables match current liabilities) nor balance-sheet insolvent (the market value of PP&E is 300, which leads to a shareholders equity in real values of plus 50).

[75] Continuing the hypothesis of the preceding footnote, the shareholders will contribute 60 in cash (50 to eliminate the imbalance, plus 10 as minimum capital), that will most probably go to reduce the amount of current liabilities. Therefore, after the recapitalization the balance sheet will appear as follows:

Balance Sheet

Assets	Liabilities and Sh. Equity
100 Receivables	40 Current Liabilities
100 Inventory	350 Bonds
200 Property, Plant & Equip.	10 *Capital (Statutory Minimum)*
	0 *Distributable Reserves*
	10 *Shareh. Equity*
400 TOTAL ASSETS	**400 TOTAL LIAB.**

strained (e.g., they have pledged all their assets as guarantees for the banks), and unable to sell equity. In this case, the signal would not be accurate, and this element must be factored into the cost-benefit analysis of ROL.

We can therefore conceive ROL as a mechanism that forces the insiders to reveal information about the value and the prospects of the company, under penalty of losing control on it. Except in the case where the shareholders are wealth-constrained, this information-revealing mechanism is quite accurate, and creditors may well steer clear of a company that the insiders have refused to recapitalize.

Could ROL be adopted on an "opt-in" basis? Yes, although with non-negligible transaction costs. ROL should be a non-amendable part of the corporate charter[76]. I doubt, however, that in the absence of standardization and widespread knowledge of its operations, the benefits for shareholders (in terms of reduced cost of debt) would outweigh its costs. Therefore, the value of ROL, whatever it is, appears to derive from the fact that it is part of corporate law. However, corporate law should allow companies to opt out (prospectively) from ROL, and creditors, or those among them who are able to adjust the cost of the loan to the risk, would probably anticipate the consequences of such a choice when making the loan.

12. *Cost and Benefits of ROL*

The relative costs and benefits of the ROL can be then stated as follows:

a) ROL is costly, both *ex post* and *ex ante*, when the company is worth saving, its shareholders cannot contribute fresh funds, *and* they are not able to sell their shares (or their preemptive rights to recapitalize the company) at market value.

b) ROL is irrelevant whenever:

b1) the shareholders would have contributed to the company anyway (e.g., in a startup with a business plan that envisages losses for the first years of activity); or

b2) the company is worth saving, the shareholders cannot contribute funds, but they *are* able to sell their shares (or options to recapitalize) at market value[77]; or

b3) the company is *not* is worth saving, the shareholders do not contribute,

[76] This is possible only where the applicable corporate law so permits. Otherwise any enforcement of a contractual ROL seems problematic to say the least.

[77] True, ROL may be costly in this case too, if the shareholders attach a non-monetary value to retaining control. This, however, does not appear to be of great importance.

and creditors would have promptly stopped the company from operating anyway, e.g., by calling for immediate repayment.

c) ROL is beneficial when the company is *not* worth saving, its shareholders do not contribute fresh funds, and creditors would not have promptly stopped the company from operating, *i.e.*, there would have been losses, or more losses, than there are after ROL has triggered liquidation.

There is another cost that could be quite significant, although it is only associated with ROL and is not strictly a consequence of it. Let us assume that a majority shareholder wants to squeeze out a minority shareholder. A way of doing this is to create a ROL situation (by inducing the directors to prepare overly pessimistic financial statements), hence offering the minority shareholder the unattractive alternative of either contributing to the company or being squeezed out without compensation. This is a cost that, rather than being than attributable to ROL alone, implies a violation of the directors' duty to prepare true and fair financial statements[78].

If we believe that creditor monitoring is perfect, then ROL is obviously either irrelevant or costly (but under this assumption there would be very few insolvent companies, if any). Instead, if we believe that creditor monitoring is not perfect, either for collective action problems or for information asymmetries (or both), then ROL has some value that might be worth considering.

Among the arguments in favor of ROL we can mention:

(1) in comparison with other techniques that rely on probability judgments, the triggering point of ROL is easier to pinpoint in time, both for the directors *ex ante* and for the courts *ex post*;

(2) the consequence of the directors having realized that the company is in a ROL condition is not catastrophic: they must call a shareholders' meeting and, in the meantime, minimize the risk of losses for creditors. Quite often, as mentioned above in the paragraph concerning article 17 of the Second Directive (section 7), in closely held companies shareholders can contribute capital as equity without resorting to a formal capital increase;

(3) the triggering point of ROL is not unreasonable, since there is a strong statistic correlation (albeit mainly unidirectional and not bullet-proof) between losses and insolvency, in the sense that almost all insolvent companies have suffered losses some time prior to formal insolvency. Plus, quite importantly, the moment at which the directors are in a position to judge that the company has suffered losses usually comes earlier than the moment the company becomes insolvent;

[78] The minority shareholder has the right to ask a court to protect his right *not* to be unnecessarily and unfairly put in the ROL situation. Obviously, the greater the discretion in valuations under accounting standards, the greater the risk of ROL being used strategically.

(4) in short, ROL is triggered by a rule (net asset less than zero), but does leave directors flexibility in the interim period before the shareholders have decided whether to contribute or not[79].

The consequence of the shareholders not having recapitalized is that the company goes through a *solvent* liquidation. While this certainly does not *increase* asset values, it does allow leeway for a going-concern sale of the business or, in case of asset imbalance, an out-of-court restructuring, if technically feasible. Insolvency proceedings may begin as a consequence of the factual situation in which the company finds itself, and are not the effect of a duty *per se*. The fact that, under the applicable corporate law, *solvent* liquidation may be inefficiently structured (e.g., because it forces a shut-down of the business when it still has going concern value) is a different problem and not a problem of ROL as such[80].

In this light, the fact that ROL triggers at accounting values, far from being a problem, is precisely the only reason why it is relevant as an information-revealing mechanism. If ROL were to trigger at real values, it would be only a stop-loss mechanism much like *Überschuldung*. Shareholders would never agree to recapitalize the company. Therefore, ROL would optimally be activated when there is still *some* value, which is arguably a consequence of the "prudence" principle that underpins, admittedly with variations, both the traditional accounting system based on the Fourth Directive and the new, gradually spreading, IFRS system[81].

Therefore, let us put ROL in context, summarizing the features, the costs and the benefits of the various creditor protection mechanisms that depend on directors' duties.

(See table on following page)

[79] See, for competing views on rules v. standards, F. DENOZZA, *supra* note 32, at 414-5 (rules superior to standards), and P. DAVIES, *supra* note 3 (standards superior to rules). I believe that difference between the two opinions is less wide than it appears: what Denozza is in fact saying is that it is better to have duties that trigger after an objective event rather than following a subjective valuation, not that such duties should leave the directors with no discretion whatsoever.

[80] Arguably, an efficient solvent liquidation would be structured so as to allow the liquidators in charge to maximize asset values. Keeping the firm as a going concern while finding a buyer seems sensible so long as going concern value is higher than asset value in a piecemeal liquidation. This is much the same well-known problem of efficiency that bankruptcy law tries to address.

[81] On the different significance of prudence in the IFRS, see E. FERRAN, *supra* note 41, at 210 (prudence not irrelevant, but downgraded). Under the IASB framework, prudence is understood to be "the inclusion of a degree of caution in the exercise of the judgements needed in making the estimates required under conditions of uncertainty, such that assets or income are not overstated and liabilities or expenses are not understated". The IFRS system is being tested (and fine-tuned) as a consequence of the 2008 financial crisis.

	Timing	Consequences	Notes
Duty to file	Cash-flow insolvency	File for insolvency proceedings	Too late, may impede out-of-court restructuring
Überschuldung (not considering the temporary amendment 2008-2013: see par. 3)	Balance-sheet insolvency	File for insolvency proceedings	Requires costly valuations; may impede out-of-court restructuring
Wrongful trading	No reasonable prospects of avoiding insolvent liquidation (cash-flow insolvency)	Minimize creditors' losses	Somewhat late, difficult to enforce
"Modified" wrongful trading	Insolvency likely (or more likely than not)	Minimize creditors' losses	Timely, but difficult to assess *ex ante* and *ex post*
Fiduciary duties	Balance-sheet insolvency Also "vicinity of insolvency"?	Maximize the value of the firm	Timely, impact not very significant (the doctrine prevents value-destroying acts that may be illegal anyhow)
Recapitalize or liquidate	Assets imbalance at accounting values	Minimize creditors' losses, request funds from shareholders	Timely; may sort bad debtors from the good; may create false positives if shareholders are cash-constrained; may facilitate expropriation of minority shareholders

Part IV

13. *Conclusion*

Creditors are not perfectly informed on the conditions of the firm, and they are therefore not able to react immediately to a significant increase in the risk of losses. Contracting, it is arguable, is not sufficient. This is why a rule concerning the directors' duties with respect to the time that precedes a formal declaration of insolvency is advisable.

An optimal rule should have the following features:

a) it should trigger before cash flow insolvency, and also before balance

sheet insolvency, if insolvency is foreseeable as a real and serious possibility (i.e., when there is still some equity but it is predictable that it will shortly vanish);

b) it should leave directors freedom as to the appropriate steps to be taken to prevent or minimize losses to creditors. Those steps would include either out-of-court restructuring or filing for insolvency proceedings;

c) it should be tied to a factual situation that the directors can readily ascertain without resorting to complex valuations, and that the court can assess *ex post* with reasonable accuracy.

In short, an optimal rule should be specific as to the moment at which it triggers, but flexible as to the consequences[82]. In this light, the "recapitalize or liquidate" rule, the costs of which, in my opinion, have generally been overstated, displays some interesting attributes.

Such a rule can exist independently of rules mandating minimum capital, and independently of capital maintenance rules altogether. Therefore, it is not the goal of this paper to recommend or defend the capital maintenance system. First, it is worth noting that, at least in Europe, following the 2006 reform of the Second Directive on Company law (by the directive 2006/68/EC), this criticized system is little more than a limitation on profit distributions based on a positive net asset test[83]. Moreover, to the extent that the EU Member States allow (or require) companies to use International Financial Reporting Standards (IFRS), the role of legal capital may be changing significantly, as companies start using valuation standards that could yield more volatile results. An increase in the importance of debt covenants, and legal reforms explicitly introducing a solvency test for profit distributions, may follow[84].

[82] On the second point (flexibility concerning what directors should do), see P. DAVIES, *supra* note 13, at 315-6.

[83] See P. SANTELLA, R. TURRINI, *"Capital Maintenance in the EU: Is the Second Company Law Directive Really That Restrictive?"*, 9 *European Business Organization Law Review* 427 (2008) (Second Company Law Directive very flexible after the 2006 reform and allowing great freedom to EU Member States to be more restrictive and/or to introduce solvency test). See also L. ENRIQUES, *"EC Company Law Directives And Regulations: How Trivial Are They?"*, 27 *University of Pennsylvania Journal of International Economic Law* 1 (2006) (EC Company Law Directives are not particularly relevant).

[84] See E. FERRAN, *supra* note 41, at 204 (stressing increased use of cash flow data in debt covenants); W. SCHÖN, *"Balance Sheet Tests or Solvency Tests - or Both?"*, 7 *European Business Organization Law Review* 181 (2006) (solvency test will become important in addition to balance sheet test), and P. SANTELLA, R. TURRINI, *supra* note 83 (reviewing the limits introduced to the distribution of unrealized profits). Regarding IFRS and solvency test for distributions, some countries, such as Germany, oblige the company to use traditional accounting for the purpose of capital maintenance and for calculating profits for tax purposes (approach confirmed by the 2009 accounting reform termed "Bilanzrechtsmodernisierungsgesetz - BilMoG"), while others,

As we have seen, on the basis of a negative assets test ROL does more than limit the distribution of profits: it calls on insiders to reveal their estimation of the true value of the firm, under penalty of liquidation (solvent or insolvent liquidation, as the case may be). In so doing, ROL shares the goal of the many legal techniques aimed at disciplining directors during the twilight period: the time during which shareholders have not yet been displaced but directors ought to consider creditor interests.

such as Italy, allow the companies to prepare only one set of accounts, but the surplus resulting from the adoption of "fair value" ends up in a non-distributable reserve (such reserve, however, can be used to cover losses, which delays the trigger of the "recapitalize or liquidate" rule). Many EU Member States have already in place an explicit or implicit solvency test for profit distribution: see respectively Sweden ("prudence rule") and Italy (laid down by Art. 2433-bis for interim dividends, but deemed of general applicability). Moreover, insolvency is generally perceived as an important deterrent in profit distributions: see, e.g., "Feasibility study on an alternative to the capital maintenance 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", by KPMG, January 2008, at 149, available at *http://ec.europa.eu/internal_market/company/capital/index_en.htm.*

AUTORI

ABBADESSA PIETRO - Ordinario di diritto dell'economia nell'Università Cattolica del Sacro Cuore di Milano

ABRIANI NICCOLÒ - Ordinario di diritto commerciale nell'Università di Firenze

BENAZZO PAOLO - Ordinario di diritto commerciale nell'Università di Pavia

BENUSSI ALESSANDRO - Ricercatore di diritto commerciale nell'Università di Pavia

BIANCHI LUIGI ARTURO - Ordinario di diritto commerciale nell'Università "L. Bocconi" di Milano

BIONE MASSIMO - Ordinario di diritto commerciale a ri. dell'Università di Modena e Reggio Emilia

BORDIGA FRANCESCO - Assegnista di ricerca nell'Università di Bergamo

CAGNASSO ORESTE - Ordinario di diritto commerciale nell'Università di Torino

CALANDRA BUONAURA VINCENZO - Ordinario di diritto commerciale nell'Università di Bologna

CAMPIGLIO CRISTINA - Ordinario di diritto internazionale nell'Università di Pavia

CAPELLI ILARIA - Ricercatore di diritto commerciale nell'Università dell'Insubria - Varese

CERA MARIO - Ordinario di diritto commerciale nell'Università di Pavia

COSTI RENZO - Ordinario di diritto commerciale a ri. dell'Università di Bologna

CUSA EMANUELE - Associato di diritto commerciale nell'Università di Trento

DI CATALDO VINCENZO - Ordinario di diritto commerciale nell'Università di Catania

IBBA CARLO - Ordinario di diritto commerciale nell'Università di Sassari

JORIO ALBERTO - Ordinario di diritto commerciale a ri. dell'Università di Torino

LIBERTINI MARIO - Ordinario di diritto commerciale nell'Università di Roma "La Sapienza"

MAUGERI ALDO - Assistente Ordinario di diritto commerciale nell'Università di Pavia

MONTALENTI PAOLO - Ordinario di diritto commerciale nell'Università di Torino

MOSCONI FRANCO - Ordinario di diritto internazionale a ri. dell'Università di Pavia

OLIVIERI GUSTAVO - Ordinario di diritto commerciale nell'Università LUISS "Guido Carli" di Roma

PATRIARCA SERGIO - Ordinario di diritto commerciale nell'Università dell'Insubria - Varese

PORTALE GIUSEPPE BENEDETTO - Ordinario di diritto commerciale a ri. dell'Università Cattolica del Sacro Cuore di Milano

PRESTI GAETANO - Ordinario di diritto commerciale nell'Università Cattolica del Sacro Cuore di Milano

SACCHI ROBERTO - Ordinario di diritto commerciale nell'Università di Milano

SEMINARA SERGIO - Ordinario di diritto penale nell'Università di Pavia

SPADA PAOLO - Ordinario di diritto commerciale a ri. dell'Università La Sapienza di Roma

STANGHELLINI LORENZO - Ordinario di diritto commerciale nell'Università di Firenze