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Abstract

This paper gives a first analysis of the new directive amending the 2nd company law directive (dir 2006/68). The four changes are analysed and criticized. The rules doing away with an expert opinion in case of contributions in kind are useful, although their scope will appear quite limited. On buy back of shares the directive merely does away with the 10% ceiling, a historical error anyway. Instead comes a limitation to undistributable assets (capital + undistributable reserves). The hopes for relaxation of the regime on financial assiatence has not been achieved: the prohibition is abolished, but the procedures are heavy and the reservation requirement excessive. A missed chance !

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Reforming the Second Company Law Directive
Eddy Wymeersch[1]

1. The second company law directive[2] and the philosophy underlying this important chapter of European company law, has been the subject of an active debate in Europe over the last five to ten years[3]. The discussion was originally mainly an academic one, but over time legal practice seems to increasingly be paying attention to the subject while the legislators have been responsive to some of the burdens on business[4].

In the academic debate several tendencies can be distinguished
A minimalist approach concedes that the directive is up for updating and that improvements on specific provisions could be discussed. This analysis was underlying the amending directive that will be analysed in the third part of this paper. A maximalist approach proposes to do away with the use of capital as a legally relevant notion[5]. It points to the almost entire

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[2] Second Council Directive 77/91 of 13 December 1976, OJ L. 26 of 31 January 1977. For a detailed overview of the transposition of this directive in several Member States, see SCHUTTE-VEENSTRA, J.N., *Harmonisatie van het kapitaalbeschermingsrecht in de EEG*, Deventer, Kluwer, 1991, 348 p.

[3] See among many publications in Europe: KÜBLER, F., *Aktie, Unternehmensfinanzierung und Kapitalmarkt*, Köln, Ges. für Bankwissenschaftliche Forschung, 1989, p. 49 and 64; KÜBLER, F., "Aktienrechtsreform und Unternehmensverfassung", *AG* 1994, 141; KÜBLER, F., MENDELSON, M. AND MUNDHEIM, R., "Die Kosten des Bezugsrechts: Eine rechtsökonomische Analyse des amerikanischen Erfahrungsmaterials", *AG* 1990, 461; KÜBLER, F., "The rules of capital under pressure of the securities markets" in HOPT, K.J. and WYMEERSCH, E., *Capital Markets and Company Law*, Oxford University Press, 2003, 95. See also: ARMOUR, J., "Legal capital: an outdated concept?", *EBOR* 2006, 5; DAVIES, P., "Legal Capital in Private Companies in Great Britain", *AG* 1998, 346; ENRIQUES, L., "As simple as it may be: the case against the Second Company Law Directive Provisions on Legal Capital", Bologna 2000; ENRIQUES, L. and MACEY, J.R., "Creditors versus Capital Formation: the Case against the European Legal Capital Rules", *Cornell Law Review* 2001, 1165; FERRAN, E., "Legal Capital Rules and Modern Securities Markets - the Case for Reform, as Illustrated by the U.K. Equity Markets", in HOPT, K.J. and WYMEERSCH, E., *Capital Markets and Company Law*, Oxford University Press, 2003, 115; NAPIERA, J., SOJKA, T. and CEJMER, M. (eds), *Instytucje prawne dyrektywy kapitalowej*, European Centre for comparative commercial and company law, Krakow, Kluwer, 2005, 408 p.; Research Group on Listed Corporations, Real Colegio Complutense, 2006, www.realcolegiocomplutense.harvard.edu/; SCHÖN, W., "The future of legal capital", *EBOR* 2005, 429, defending "legal capital as the most efficient way of limiting distributions prior to insolvency, providing less room for manipulation than the ad hoc solvency tests used in the Anglo-American legal systems"; ECGI, "Modernising company law and enhancing corporate governance in the European Union - A plan to move forward", May 3, 2006, proposed an optional regime, allowing states to determine whether to maintain the legal capital rules, or to opt for an alternative regime not based on legal capital: www.ecgi.org/commission/

[4] Several legislators have reduced the minimum capital for the formation of a private company limited to one euro, following the example of the UK, for which the required minimum capital has been maintained at one pound sterling. For France see art. L. 223-2 C. Com., as amended by art. 1 of the "Loi pour l'initiave économique n° 2003-721 du 1er août 2003", Journal Officiel 5 août 2003. In the Netherlands see the project "Versoepeling van het BV-kapitaalbeschermingsrecht", Ambtelijk voorontwerp van Wet tot wijziging van Boek 2 van het Burgerlijk Wetboek in verband met de aanpassing van de regeling voor besloten vennootschappen met beperkte aansprakelijkheid - derde tranche: kapitaal en schuldeisersbescherming, June 26, 2006, available at http://www.minjus.nl/onderwerpen/wetgeving/bv%5Frecht/

[5] See L. ENRIQUES and J.R. MACEY, "Creditors versus Capital Formation: the Case against the European Legal Capital Rules", *Cornell Law Review* 2001, 1184; F. KÜBLER, "The rules of capital under pressure of the securities markets" in HOPT, K.J. and WYMEERSCH, E., *Capital Markets and Company Law*, Oxford University Press, 2003, 114; CEPS, "Repeal the Second EU Company Law Directive", Statement nr. 21, March 14, 2005, available at http://www.ceps.be/Article.php?article_id=414

absence of a similar notion in some major legal systems, such as the United States. Alternative creditor protection mechanisms have to be introduced, such as stronger liability of promoters and directors, disqualification of directors, …
An intermediate approach points to the significance of legal capital as a relatively simple regulatory technique, the objectives of which could not be achieved except by very complicated regulation or by using legal techniques that are relatively alien to the European legal tradition. A cost – benefit analysis is called for to determine whether it would be "cheaper" to deal with the "undesirable" conduct viewed by the legal capital rules along alternative legal concepts rather than by simply following the directive's concepts, however imperfect.

On this background, and taking into account the strong divisions in legal thinking, especially in Germany[6], the Commission has decided to launch a full scale research into the subject of alternative to creditor protection[7].

Part 1. The Second directive

A. Background remarks

2. Before discussing specific issues relating to the Second company law directive it is necessary to point to a number of general subjects against the background of which the specific discussion has to be viewed.

Much of the criticism addressed to the directive in fact relates to the rules that national legislators have adopted for the implementation of the directive. Often these national rules are stricter because the directive allowed for minimal harmonisation. National legislators have a tendency to behave in an overcautious way, especially as they agreed with the prevailing concept underlying the directive, i.e. that creditors did have to be strongly protected by putting up capital. It would be unfair to charge the directive with the goldplating of overzealous member states.

3. The company law harmonisation was conceived as addressing only the public companies limited by shares, i.e. the most important business firms at that time. As the use of that legal form is very different among the states, the practical impact of the directive was commensurate: in the Southern European states, the SA form is frequently used also for small

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[6] See the proceedings of the Munich Conference on Efficient Creditor Protection in European Company Law, *EBOR* 2006, Vol. 7:1, 471 p.; LUTTER M. (ed.), *Das Kapital der Aktiengesellschaft in Europa*, in *ZGR* 2006, Sonderheft 17, 807 p.; also available in English: LUTTER M. (ed.), *Legal Capital in Europe*, in *ECFR* 2006, special volume 1, 701 p.

[7] See Call for tender MARKT/2006/7/F, "Feasibility study on alternative to capital maintenance regime as established by the Second Company Law Directive 77/91/EEC of 13.12.1976 and the examination of the implications of the new EU accounting regime on profit distribution", second publication, March 14, 2006, www.ted.europa.eu/ojs/tender/en/51751-2006.html. Reform proposals were supported by the DTI: *Directive proposals on Company reporting, Capital maintenance and Transfer of the registered office of a company - a consultative document*, March 2005, www.dti.gov.uk/files/file14584.pdf

business firms, while in the UK or Germany, the SA form is still reserved to the larger entities. The private companies limited are not subject to the directive, but many legislators have extended the rules to these entities as well. As this was not governed by the directive's safeguards, the net outcome is quite diverse: in some jurisdictions, the same rules apply, in others only part of the rules apply to the private companies, offering interesting alternatives for avoiding the application to public companies, e.g. as shareholders of a private company limited. The consistency of the overall approach and the outcome in terms of harmonisation of company law were lost in the translation to the national legal order.

4. Several of the directive's rules are not anymore adapted to today's corporate finance concepts and techniques: they belong to the times that company financing was essentially ensured by bank financing, or by private shareholders. It seems relevant to point out that even today the defenders of the second directive mainly are rooted in jurisdictions where bank financing has remained very strong if not the dominant form of business financing. However, in practice, financing is increasingly achieved by using the public markets, by issuing shares, bonds, or similar instruments, or by heaving off part of the assets through securitisation techniques. Moreover, one has witnessed these last ten to fifteen years, an strengthening of the position of the shareholders to the detriment of creditors: the regained power of the shareholders is evidenced in take-over battles, the ongoing discussions about corporate governance, the role of the voting agencies and very recently the redefinition of shareholder rights. As a consequence of this fundamental shift in the legal paradigm, other needs and instruments of protection have been developed. These sometimes are at odds with the directive's provisions, that were rooted in another paradigm.

5. Critics often address criticism to the second directive not achieved its stated purpose, i.e. protecting creditors[8]. However, it should be stressed that many provisions of the directive aim at protecting, not only the creditors, but the shareholders, especially the minority shareholders. The equal treatment clause in art 43 of the directive contains a fundamental principle of company law that clearly aims at protecting shareholders against decisions, not so much of the board of directors but of the general meeting, in fact of the controlling shareholders. The same observation applies to the rules on share buy backs or on preferential subscription rights. The issue here is not whether these protective mechanisms are needed, but rather whether linking them to the legal capital rules is an effective and satisfactory approach.

6. Criticism often is addressed to the notion of capital: should we not simply do away with the concept in favour of the more economic but unregulated notion of shareholders' equity? It is true and has often been affirmed that capital does not play a first class role anymore in decisions by banks to grant credit: the future cash flows, the quality of management, the business model may be more important factors than the amount of capital stated. However, in smaller firms, banks often require capital to be increased to comfort their position as a creditor. The same indifference has been expressed by rating agencies that have often stated that capital is very low on their agenda for deciding on a rating.

Banking regulators however continue to invest in "capital" and "own funds" as a major prudential supervisory tool. The entire Basel II re-regulation is based on defining criteria for measuring risk against which sufficient amounts of own funds have to be produced. Recently, the Basel Committee has decided to start new work on "capital", it being understood that this refers not so much to traditional legal capital, as to alternative techniques allowing liabilities

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[8] See e.g. F. KÜBLER, "The rules of capital under pressure of the securities markets" in HOPT, K.J. and WYMEERSCH, E., *Capital Markets and Company Law*, Oxford University Press, 2003, 101.

to be qualified as own funds[9]. Although legal capital, or rather "core capital" is not absent of prudential supervisors' minds, it plays a minor role, except perhaps as a minimum threshold, in which case the bank should be discontinued if it did not reach anymore the level of the minimum capital as provided in the law.

7. A final introductory observation relates to the well known problem of measuring business assets, liabilities and results. The prevailing accounting system based on historical costs is more creditor oriented. Often the values attributed are conventional. The present drive for "fair value" accounting aims at better reflecting today's valuations, in part by substituting judgemental valuations[10]. Being more shareholder oriented, it reduced the value of the accounting system for creditor protection purposes. Hence the search for alternative techniques. In this respect also, times have changed.

To summarise: it would be an oversimplification to state that the legal capital rules as laid down in the directive are without value. Their usefulness has been undermined by strong evolutions in the markets. Moreover, one can question whether the directive is right in linking answers to the company's capital.

1 *Discussion of specific provisions of the Second company law directive*

8. The directive contains numerous provisions that prescribe specific conduct by linking this conduct to the legal capital as a yardstick for assessing specific behaviour. In fact these provisions contain instructions about the duties imposed on the addressees: by linking the rule to the legal capital, there where in fact these instructions relate to duties of the parties (promoters, board), the directive creates a confusion between two orders or reasoning, one affecting the capital, to other relating to the more general duties of care and of loyalty. By so doing the directive enacts rules that are often excessively strict, unmanageable, and may be prejudicial to business development.

In the following paragraphs a few examples will be given where the directive establishes a link with the company's capital, there where in fact other issues relating to the duties of care or loyalty are at stake. Most of these relate to the provisions of the directive that view the protection of the shareholders.

1. Share buy backs

9. The second directive contains stringent requirements relating to the buying back of shares. When the directive was enacted buy backs were frowned upon: they were analysed as a partial dissolution of the company and hence forbidden or at least required particular safeguards aimed at the protection of the creditors. If the shares were kept in treasury, a solution that was no favoured, the shares should be disposed of within 3 years, and if not the shares were automatically cancelled, with or without the reduction of the capital[11]. In order to protect the creditors it is required to constitute an undistributable reserve for the amount spent on the acquisition, establishing – contrary to usual accounting principles- a direct link between a

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[9] See Bank for International Settlement, , Basel Committee on Banking Supervision, see the work programme of the Policy Development Group

[10] See e.g. ICAEW, *Implications of IFRS for distributable profits*, ICAEW Briefing paper, July 20, 2005, www.icaew.co.uk/index.cfm?route=115488

[11] Art. 20 (3) Second directive.

designated "asset" and the corresponding liability. This technique is based on the idea that the shares held in portfolio are worthless, so that upon cancellation the company would suffer no harm. Also, there were fears that the controlling shareholders, buying back secretly, would use this technique for putting their hands on the company's cash at conditions that would be favourable to him. Equal treatment of shareholders was therefore imposed, with the exception of transactions on the public markets[12].

10. Since the enactment of this provision, much has changed: share buy backs belong to the standard paraphernalia of corporate finance, consisting of distributing excess cash to shareholders. The transaction is widely announced and implemented in the public markets. It contributes to support the market price of the shares, and hence improves the financing conditions for the company. Support of the market price also protects the company against potential take-over bids, while the management's options become more valuable[13]. Whether boards are acting in the company's interest will not be determined by the formal safeguards of the directive, but by the conditions in which the transactions have been executed. Buy-back authorisations – other than those serving to avert a grave and imminent danger, to which certain voting agents usually object as being an instrument for board entrenchment - are granted or renewed on a routine basis by the general meeting, as shareholders are the primary beneficiaries. The ten percent limitation does not effectively restrict the acquisition capacity, as often the transaction is spread over two accounting years – the rule being considered to apply on an annual basis – or if needed will result in a formal reduction of the capital. Conflict of interest issues[14] – and these are real - are not dealt with in the buy back regulations, but should be governed by general rules of company law.

Difficulties arose when companies started to grant options to their management, to their boards and to their personnel. In order to avoid a market risk for the company, it was good management to cover the position by acquiring shares in the market and keep them in treasury, if needed for the entire option period. Hence the directive and national laws allowed for greater freedom for buybacks aimed at distribution to employees, to be intervening within 12 months. But it did not deal with the most important case that of the management granting options to themselves.

11. The provisions of the directive, somewhat rendered more flexible in the amending directive, are obviously not adapted to the needs of companies with shares traded in the public markets. They were conceived to enable major shareholders to control the mechanism, or to avoid the management striking sweetheart deals with some of the major shareholders. Creditor protection was considered the first concern, considering the treasury shares as being worthless, even if the market held differently.

In summary, the directive's rules on share buy backs, however justified in times the directive was enacted, do not meet today's concerns. They contain rules that govern the board's and the management's conduct, some of which are certainly justified or at least understandable. However, these rules should not be stated in terms of restrictions on capital transactions, but

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[12] However, it often appears that buy back transactions are handled whether OTC or through the stock exchange mechanism that effectively confronts only one buyer and one seller at a pre-arranged price. See about the issue the position of the CBFA, Statement of April 14, 2005, ref. fmi. 2005-01; based i.a. on the company law provision.

[13] The directive only deals with buy backs that may be allowed to "prevent serious and imminent harm to the company (art. 19 (2) Second directive).

[14] Including questions on how the transactions are being executed, on the securities markets or not, and whether insider rules have been respected.

are specific applications of the duty of care or in some cases of the duty of loyalty, imposed on the company and its representatives. By stating these obligations in terms of restrictions to capital and share transactions, the directive has solved these problems in an "inappropriate" way, thereby avoiding the more difficult task of formulating the appropriate "conduct of business" rules.

2. Nominal Value, Accounting par value

12. According to article 8 of the Second directive "shares may not be issued at a price lower than their nominal value, or, where there is no nominal value, their accountable par"[15].

This provision allows for the issue of two classes of shares, those with and those "without" nominal value, but obviously forbids any other formula. It has been the basis for preventing the issue of shares that have no relationship to the capital but merely represent a percentage of the company. The nominal value is a technique that has been used in many member states for a long period of time. It stated a figure that bore some relationship to the contribution made to the company upon its formation or on later increases of the capital. However, the contribution could exceed the amount of the nominal value, the difference being booked on a reserve, which should have been undistributable, although national laws allowed distribution under specific conditions[16]. If additional shares have to be issued below the nominal value, this would in principle be forbidden: in practice a solution is found by reducing the nominal value of the existing shares, leading whether to the absorption of losses or the constitution of a reserve that could than be reincorporated in the capital after the issue of the new shares. A change of the nominal value is a quite burdensome operation, as share certificates have to be adapted – sometimes even reprinted - to mention the new nominal value. Another solution could be worked out by issuing a different class of shares, however with different voting rights.

13. Nominal value, although sometimes serving to identify different classes of shares, has no relationship to the actual value of the shares. In some markets there has been – a now abandoned tradition – to quote securities in the markets as a percentage of nominal value. By referring to the nominal value, the message conferred on the unsophisticated investor is misleading. In actual corporate life, no one except the legal specialists pays any attention to the nominal value, and the latter is likely to complicate corporate life without much added value.

14. Shares may also be issued without stated nominal value. However there might be a misunderstanding as these shares have still an "accountable par" ("pair comptable"). The practice has mainly been developed in Belgian company law, and amounts to determine the legal value of the shares by dividing the amount of the capital by the number of shares issued: as a result one becomes an amount that serves to a large extent the same function as the nominal value.

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[15] The second paragraph adds: "However, Member States may allow those who undertake to place shares in the exercise of their profession to pay less than the total price of the shares for which they subscribe in the course of this transaction".

[16] E.g. imposing a heavy taxation, leading in fact to making the reserve undustributable.

According to Belgian law, additional shares may be issued above accountable par, leading to attribute that part of the contribution to the capital account that corresponds to the accountable par, the remainder – "prime d'émission" – being booked to a separate reserve, the distribution of which is firmly prevented by taxation rules. Often this reserve is immediately incorporated into the capital, after the newly issued shares have been paid up. The technique therefore aims at safeguarding the equal treatment of old and new shareholders. But the capital increase could also be booked entirely to the capital account, creating shares with different contributions and possibly different voting rights. Issues below accountable par was once held to be subject to similar rules as applicable to the issue below nominal value, but since the law implementing the directive this may take place provided there is a separate decision of the general meeting, acting on the basis of special reports by the board [17].

Although the "accountable par" technique is more flexible than the nominal value technique, it still comports similar pitfalls. These are in part linked to the general principle that under Belgian law voting rights are proportional to the amount of the capital they represent. If new shares are issued at a different par values, one may wonder whether the new shares, for which a different amount has been paid up, would confer the same voting rights as the previous ones[18]. In companies with a long and complex history of capital increases and decreases, this question is particularly alarming, as it would render shareholder voting extremely complex and unmanageable. In practice, the question is solved by making the little detour over the "prime d'émission", so that the par value paid in is the same for all shares.

16. In both categories of shares the question should be raised why we need these complexities and whether they serve any real purpose. The value of the share is not related to the amount of capital, or even to the own funds of the company it represents. It is the result of offer and demand, where models for valuation, essentially based on future cash flows are followed. Whatever valuation technique financial analysts may follow, these have nothing to do with the nominal value or accountable par. Hence these notions should be held misleading.

Shares represent a fraction of the company, whether in terms of assets, or in terms of income streams. In the hypothesis that there is only one class of shares, it would be much easier to determine the value of the shares as a percentage of the company, e.g. if one million shares have been issued, each share represents one millionth of whatever basis one has chosen for valuation. If additional shares are issued, the denominator would be adapted: if an additional five hundred thousand are issued, each share represents one 1.500.000th. Defenders of the present system will object that this does not protect the shareholders against diluting their stake, e.g. if shares are issued below the market price. The observation is valid but does not refer to nominal value of accountable par, but to market value: it is the duty of the board, under the guidance of the general meeting, to decide upon dilution – or the opposite: relution. In both cases, the effect to be avoided consists of one group of shareholders losing to another. By changing to shares without stated value, the responsibilities would be laid there where they belong, this is with the board of directors.

17. To summarise, the technique of issuing shares at nominal value of accountable par is likely to make capital transactions more complex, more opaque without any perceivable justification. It would be advisable to allow companies to issue shares that merely represent a

[17] This is left to national company law; see e.g. the Belgian Companies Code, art. 582.
[18] See M. WYCKAERT, *Kapitaal in nv en bvba*, Kalmthout, Biblo, 1995, nr. 972 e.s.

fraction of the company, both in terms of voting power, and in terms of valuation[19]. It is regrettable that at the moment of the changeover to the euro legislators have not decided to allow this simplification.

3. Contributions in kind.

18. Contributions in kind have been strictly regulated in the second directive as a technique to secure that at the formation of the company, or later upon capital increases, the assets would at least reflect an amount equal to the capital. The main requirement relates to the expert valuation, although secondary requirements state that these contributions should be paid up in full, at least within five years[20], and that contributions can only consist of assets that are "capable of economic assessment"[21]. However, an undertaking to perform work or supply services may not form part of these assets"[22]. The expert valuation requirement has been somewhat loosened in the amending directive, analysed later in this paper.

By requiring an expert to value the assets contributed, the directive introduces a rule limiting the promoters' or the boards' freedom of judgment. As the rule has been framed, it serves the protection of creditors, but may also be beneficial to the old shareholders, who should not be diluted. The valuation does not, as one might have expected from a protection perspective, convey a message as to the effective value of the assets contributed but merely states " whether the values arrived at by the application of these methods correspond at least to the amount booked in the capital and the premium accounts". Overvaluation would hence be excluded, not undervaluation. But these valuations are not binding on the promoters or on the board: provided adequate information is disclosed, they may adopt another valuation, stating their reasons[23].

The concept of linking the value of the contributions in kind to the capital is an imperfect one. Not only are the valuations not binding, the expert value does not contain a reliable message about the value. Moreover, being a mere snapshot, the initial valuation will be rapidly outdated, and no further information is given to shareholders or creditors. Fair value valuation, applicable on a continuous basis, to all assets and liabilities, would be necessary to deal with this objective. The directive's provision might serve as a guidance for irresponsible promoters or boards: it would be better to address their responsibility, rather than burdening all parties with cumbersome, expensive and ineffective requirements.

4. Preferential or "pre-emptive" subscription rights

19. Article 29 provides: "Whenever the capital is increased by consideration in cash, the shares must be offered on a pre-emptive basis to shareholders in proportion to the capital represented by their shares.". This provision has a clear shareholder protection function, both with respect to the larger, non controlling blockholder and with respect to the financial investor. By having the shares first offered to the existing shareholders, the rule avoids any

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[19] See C. GALAN LOPEZ, *Classes of shares: differences between European and American law*, Real Colegio Complutense, August 2006, www.realcolegiocomplutense.harvard.edu/PresCarGal.pdf
[20] Art. 9 (2) Second directive.
[21] Art. 7 Second directive.
[22] Art. 7 Second directive.
[23] This subject is dealt with by national law.

tampering with control positions, while financial dilution will not have to be feared. It typically addresses the European ownership structure, where minority blocks exercise de facto control that might be at risk by a decision of the general meeting, or of the board acting pursuant to the authorisation to issue additional shares. The rule also plays a role in companies with dispersed ownership, in this case to avoid financial dilution as a consequence of an issue of shares considerably below the market price[24].

The directive starts from the assumption that new shares can only be issued pursuant to a decision of the general meeting, the board being a mere instrument of execution of that decision, a practice that was the prevalent one up to the 1970's[25]. "Nevertheless", states art 25(2), the articles may introduce a system of authorised capital, up to an - unlimited - maximum fixed in the articles. In this case, the preference rights still apply. However they can be waived by specific decision of the general meeting, stating the motives and the price. Oddly, the same article allow the issue of new shares by the board waiving any preference rights, and without specific decision of the general meeting[26]. A general authorisation for a five year period will be sufficient. Needless to say that the latter rule has widely undermined the safeguards that were intended in the previous provisions. In practice, at least in some member states, preference rights have become very rare to inexistent, and shares are issued by the board, waiving any preference right. The shareholders are called upon every five years to approve a new delegation to the board: they generally approve except if the authorisation allows for share issues aimed at fending off a takeover bid.

20. This rule has become futile in company practice in some Member states: shares are often issued at market, of slightly below, and in both cases there is no room for preference rights. But some of the doubtful practices the rule aimed to combat still persist, or have even become more frequent. In companies with minority controlling shareholders, boards may still feel tempted to tamper with control positions, what leads in practice that in these companies shareholders will refuse giving the board the power to issue shares. In other companies, boards feel tempted to issue shares, or options to themselves, or to friendly parties. Or issues may be placed at a discount favouring one or two privileged parties. In these cases the capital directive is respected, but fiduciary obligations will be violated.

5. Financial Assistance

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[24] See COURET, A., "Le développement du droit préferentiel de souscription de l'actionnaire en droit comparé", *Rev. Sociétés*, 1979, 505; BGH, Kali und Salz, *BGHZ* 71, 40, WM, 1978, 401; LUTTER, M., "Materielle und förmliche Erfordernisse eines Bezugsrechtsauschlusses", *ZGR* 1979, 401; LUTTER, M. in *Kölner Kommentar*, § 186, 60-64; LUTTER, M., "Anmerkung zu Deutsche Bankurteil", *BGH* 17 März 94, JZ, 1994, 914; HOMMELHOFF, 100 Bände BGHZ: Aktienrecht, *ZHR* 1987, 508; MARTENS, "Der Ausschluß des Bezugsrechts", *ZIP* 1992, 1977. See also BGH 20. Januar 1995, "Siemens AG", *AG* 1995, 227; and EuGH 19. November 1995, *AG* 1997, 36. A different opinion has been defended by H. HIRTE, "Gesellschaftsinteresse und Gleichbehandlung beim Bezugsrechtsausschluss", *ZHR* 1990, 375; HIRTE, H., "Einige Gedanken zur Entwicklung des Bezugsrechts in den Vereinigten Staaten", *AG* 1991, 166. Comp. EKKENGA, J., "Kapitalmarktrechtliche Aspekte des Bezugsrechts und Bezugsrechtsausschlußes", *AG* 1994, 59; WYMEERSCH, E., "Das Bezugsrecht der alten Aktionäre in der Europäische Gemeinschaft", *AG* 1998, 382.

[25] Art. 25(1) Second directive.

[26] Art. 29(4) and (5) Second directive.

21. The directive's provisions on financial assistance belong to the most difficult to situate in a directive dealing with the company's capital[27].

The directive forbids a public company to grant credit to anyone, if the purpose of the loan consists of acquiring shares of that company. The prohibition is extended to the company giving a guarantee to a third party, usually a bank. According to national law, the prohibition would lead to the transactions being held null and void, notwithstanding civil – or even criminal - liability of the directors[28].

The reasons for this prohibition are not very clear: according to some, it is unlawful to finance the acquisition of the shares and by extension of the company as a whole, by pulling out the cash: company acquisitions should be financed by sources other than the acquired company itself. Creditors may fear that the acquisition will lead to a loss of substance, as the new owner who is not able to finance the deal by himself, will have to take out the cash, or burden the company with excessive guarantees[29]. It is not sufficient that the company's board makes a well established assessment of the acquirer's creditworthiness, or determines that the loan would not endanger the company's future existence, the prohibition attaches as soon as the loan is granted with a view of acquiring the shares, whether these represent control, a mere minority stake, or even some small holding. One can understand that board should not grant loans imprudently, but that is a general principle, and bears no relationship with the acquisition of shares in that company. This is the more striking as the directive formulates no outright prohibition against other techniques for pulling out cash: distribution of dividends, reduction of capital, share buy backs are allowed, although under certain conditions. Also, the rule does not prevent the company to borrow heavily after the acquisition and to distribute the proceeds of the loan to the new shareholders, a frequent practice for private equity investors, and probably more detrimental to creditors' rights.

Especially if the acquisition of a company takes place against the will of its board, or some of its shareholders – typically in case of an aggressive take-over bid – one could understand that the bidder should not be allowed to make his bid dependent upon using the company's assets to finance his bid. In practice this aim is achieved by requiring that the bid consideration be produced straight from the bid's outset[30].

The financial assistance prohibition is a typical case of a rule addressing company conduct in terms of capital maintenance. One could identify different reasons why a board may not grant credit: it should determine the beneficiary's creditworthiness, it should not extend credit beyond it own financial capacity, it should avoid being conflicted, especially if the beneficiary is or is planning to become the controlling shareholder. All these are perfectly valid reasons, and belong to the general category of obligations rooted in the duties of care and loyalty. But the relationship to share acquisitions remains unexplainable.

Part 2 The Directive amending the Second Company Law Directive on Legal Capital.

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[27] For a more detailed analysis see WYMEERSCH, E., "Article 23 of the second company law directive: the prohibition on financial assistance to acquire shares of the company", in *Festschrift für Ulrich Drobnig*, Tübingen, Mohr, 1998, 725.

[28] These are governed by national company law.

[29] This is sometimes referred colloquially to in French as "se payer sur la bête".

[30] See art. 3, §1, e) Takeover bid directive, Directive 2004/25/EC of the European Parliament and of the Council of 21 April 2004 on takeover bids, O.J. L. 142, April 30, 2004, p. 12–23.

22. On 6 September 2006 the European Community adopted a directive ("the amending directive") whereby the member states henceforth are allowed to solve some of the most vexing problems of the Second company law directive[31]. It should be clear from the outset that the amending directive does not oblige the Member states to change their laws: as some of the issues discussed here continue to be very controversial, it will be interesting to see which states are sensitive to a more relaxed attitude towards the legal capital issues.

It is unlikely that this criticism referred to above has been at the basis of the Commission's decision to start work on a revision of the Second directive. It was only after revision work had been started that the Commission decided to engage in a full scale study on the general theory underlying he legal capital rules. Therefore, rather than theoretical arguments, the revision was of a more pragmatic nature, essentially to realise some deregulation.

The immediate cause for the revised directive stems from the initiative taken by the Commission in the late nineties to strive for simpler legislation, some type of deregulation. Under the acronym SLIM (Simpler Legislation for the Internal Market), the Commission, with the assistance of experts groups, scanned directives in a wide range of fields. In the company law field, the first and the second directive have been the subject of simplification proposals[32]. Some of these were than taken up by the High Level Company Law Experts' Group[33], what finally led to a proposal for amending only the second directive[34]. Obviously, the Commission did not take up proposals for simplifying the First directive[35].

As far as the second directive is concerned, almost all SLIM proposals finally were adopted in the revised directive. This does not mean that there were no other subjects that could usefully be further simplified, or adapted to today's practice. This applies on the use of the authorised capital for placing share in the market at the market price, or slightly below: for listed companies there is no need to pass through the cumbersome procedures flowing from the preferential subscription rights technique.

The amending directive has limited itself to four issues: expert valuation in case of contribution in kind, share buy backs, financial assistance, and capital reduction. Although these certainly were not the only difficulties raised by the 2nd directive, and other items have been mentioned, at least in an effort of prioritisation, these would come on top of the list.

§1. Expert valuations for contributions in kind

23. Based upon the idea that the assets to be contributed to the company should offer the creditor an effective recourse, the original directive provided that all contributions in kind

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[31] O.J. L. 264/32 of 25 September 2006.

[32] See the final report of the SLIM working party at www.law.ugent.be/fli/WP/SLIM.pdf; for comments see WYMEERSCH, E., "European Company Law: The Simpler Legislation for the Internal Market (SLIM) - Initiative of the EU Commission", *Nordisk Tidsskrift*, November 2000/2, 126-134 and http://www.law.ugent.be/fli/WP/WP2000-pdf/wp2000-09.pdf. For a critical analysis see SCHUTTE-VEENSTRA and GEPKEN-JAGER, "New Directions in European Company Law", *Ondernemingsrecht* 1999, 271.

[33] See for the report of the HLCLEG, http://ec.europa.eu/internal_market/company/docs/modern/report_en.pdf

[34] For the proposal, see: Com (2004) Final, 21 September 2004. The proposal also aimed at deregulating preference rights.

[35] These related to a more intensive use of information technology for the dissemination of company related information. The subject has been taken up in part in in the Transparency directive for listed companies. Other proposals related to the regime of the branches, subject of the 12th directive. The use of language was also proposed to be simplified.

should be the subject of an expert valuation. This rule pre-existed in some jurisdictions, e.g. in Belgium where it was introduced in the 1950's[36]. The rule offers some protection to creditors, but its protective function should not be overstated: the expert valuation is not binding on the promoters of the company; the expert's valuation does not necessarily reflect the full value of the asset contributed, but it suffices that the expert states that the value contributed is sufficient to cover the amount of the capital stated in exchange of the contribution[37]. The promoters can apply another valuation in which case they would have to state their reasons for not following the expert's opinion[38]. Any deviation from the expert's opinion will have to be disclosed, warning third parties that the valuation followed by the promoters may need a further qualification. In practice, most promoters follow the valuation, and a divergent pinion should act as a serious warning to creditors. On the other hand, if the real value would be higher, that would not harm the creditors.

One can question whether the directive offers effective protection to creditors. According to the accounting scheme adopted in the 4th directive, assets are valued at historical cost and hence any valuation is obsolete after time, even given the going concern hypothesis being met[39]. Creditors will not necessarily find the value they could attribute to the company's assets on the basis of the expert valuation. Only in an accounting system that fully reflects the "value" of the assets presented in the financial statements, would creditors find protection upon liquidation. But this value will rarely correspond to the original value at which the contribution has taken place. This limitation is not proper to the contribution issue, but underlies the entire accounting system: in the specific case of the safeguards introduced for valuing the contributions in kind, the directive's philosophy appears unconvincing.

24. According to the 2nd directive, the valuation of the contributions in kind is usually undertaken by an "independent expert, appointed or approved by an administrative or judicial authority"[40]. Usually it is an auditor, in case of the formation of a new company, the auditor will be an external auditor, designated by the promoters, or by an external body, e.g. a tribunal. In case of a capital increase the auditor will often be its statutory auditor. If the auditor is appointed by the promoters, there might be an issue of conflict of interests, as the auditor is unlikely to oppose an overvaluation if he is likely to be appointed statutory auditor afterwards. This was the reason why in some jurisdictions, the auditor is appointed by the tribunal. As to capital increases the conflict is less striking, as the auditor has to review all valuations.

The amending directive allows states to waive the expert valuation requirement in cases in which a valuation would not add much value. Three cases are mentioned.

A- Valuation of assets traded on regulated markets.

- the rationale

[36] See e.g. for Belgium, L. 30 June 1961; L. DABIN, "L'application de la loi du 30 juin 1961 organisant le nouveau régime des apports en nature", *RPS* 1962, 121.

[37] See art. 10(2) Second directive; comp. Belgian Companies Code art. 444, according to which the promoters have to state their reasons for derogating from the expert's valuation and disclose them.

[38] The directive does not impose the valuation to be followed by the promoters, nor does it impose any specific sanction: these issues are left to national law. See e.g. the Belgian Companies Code, art. 647, 4°.

[39] Art 31(1)(a) Fourth Company Law directive.

[40] Art. 10(1) Second directive.

25. The rules relating to the expert valuation on contributions in kind were often considered very burdensome and adding little value, in cases in which a reliable valuation was at hand, " a clear point of reference" as stated in the preamble. This is the case when the assets are traded on large liquid markets as it would be very hard for an expert to second guess the value of assets that are continuously traded among professional parties, and to substitute his own valuation techniques. The most typical case relates to the contribution of listed securities, e.g. in case of a share for share exchange offer. As in these transactions speed is often of the essence due to the rapidly flowing prices in the markets, the need to call for an expert to confirm that the market price corresponds to the value at which the securities can be contributed did not stand for much added value. In this case the new directive allows the assets to be contributed without valuation, but at a weighted average price and that during a sufficiently long preceding period of time. However the rule does not extend to other regularly traded assets, such as commodities[41]. As to derivatives, they would fall under the definition of transferable securities as set out in the MiFid.

- issues of interpretation

26. Questions of interpretation will be raised with respect to which securities the new rule applies, which prices have to be adopted in case of multiple trading venues, what will be the reference method.

As to the ambit, the new directive refers to the Mifid, where transferable securities[42], money market instruments[43], and regulated markets[44] have been defined. The regulated markets cover those markets that are subject to the strictest form of regulation and are defined by each of the member states; their list is officially published.

The valuation itself should take place at the price at which the securities have been trading during a certain period before the date of the contribution[45]. There is no discretion for the board to value even at a lower figure. As is usual in these matters, the valuation is to be

[41] But derivatives on commodities are covered.

[42] Art. 4 (18) 'Transferable securities' means those classes of securities which are negotiable on the capital market, with the exception of instruments of payment, such as:
(a) shares in companies and other securities equivalent to shares in companies, partnerships or other entities, and depositary receipts in respect of shares;
(b) bonds or other forms of securitised debt, including depositary receipts in respect of such securities;
(c) any other securities giving the right to acquire or sell any such transferable securities or giving rise to a cash settlement determined by reference to transferable securities, currencies, interest rates or yields, commodities or other indices or measures.

[43] Art. 4 (19) defines money market instruments as follows: "Money-market instruments' means those classes of instruments which are normally dealt in on the money market, such as treasury bills, certificates of deposit and commercial papers and excluding instruments of payment".

[44] Art. 4(14) 'Regulated market' means a multilateral system operated and/or managed by a market operator, which brings together or facilitates the bringing together of multiple third-party buying and selling interests in financial instruments – in the system and in accordance with its nondiscretionary rules – in a way that results in a contract, in respect of the financial instruments admitted to trading under its rules and/or systems, and which is authorised and functions regularly and in accordance with the provisions of Title III.

[45] To be determined by national law.

established upon the average market price during a certain period – usually 20 or 30 trading days – before the transaction, weighted in function of the volumes.

It is unclear whether according to the amending directive the contribution should necessarily take place at than the weighted average price and whether securities might be contributed at a lower value, benefiting the existing shareholders or in the opposite case benefiting the contributors.

The directive contains no provision for the contribution below the market value: the directive merely states that the contribution has to be "*valued* at the weighted average price"[46]. In accordance with the present system allowing promoters to apply another consideration, contributions below market do not prejudice actual shareholders nor creditors , and can be freely determined.

27. The directive contains a provision for the reverse case: in principal, it would not be allowed to value the securities above market? However, if exceptional circumstances might have significantly affected the price of the securities to be contributed, a valuation above market (called a "revaluation") can take place, but in this case the full expert valuation becomes obligatory[47]. The question arises what rule has to be followed if there are no "exceptional circumstances", or these have not "significantly affected" the price: could contributions slightly above the market price by realised without expert valuation? Reasoning a contrario, the answer would apparently be : yes. However this would be contrary to the philosophy that the contribution has to be valued at the "weighted average price" and although the contribution could be determined at a lower price, both creditors and shareholders should be protected against other cases of "revaluation". The provision has to be read in the sense that revaluation is not allowed except if "exceptional circumstances" appear, leading to have significantly affected the price. But even then, the rule remains puzzling because significant circumstances will normally affect the market price. A substantial difference could appear if due to sudden "circumstances" [48]the closing price on the day before the contribution was significantly higher that the average price during the last 20 or 30 days. The directive mentions the discount to value as a consequence of the illiquidity of the market: however, unless it is a sudden factor, the illiquidity will be reflected in the – lower – market price. However in all these cases, it will be a heavy responsibility for both the board and the expert to substitute its valuation to the market price.

28. The mentioning of restrictive conditions might be read as meaning that the board can in any case prefer to obtain an external expert valuation. This would be logical for a "simplifying" directive. The amending directive calls for clarification. Until such clarification comes forward, it would be advisable to follow the rationale of the directive, i.e. that valuation at the market may be followed, and that only exceptionally revaluation is allowed, while in any case parties may can call in an expert for an external valuation. One should also not lose out of sight that the directive does not impose the alternative regime, but only allows member states to adopt it.

B- valuation of assets already valued at fair value.

[46] Art. 10a (1) Amending directive.
[47] Art. 10a (1) § 2, Amending directive.
[48] E.g. a counterbid at a significant premium.

- the rationale

29. The rationale of the second case is in philosophy similar to that of the first one: both are based on the idea that when assets have been correctly valued, there is no need for a second valuation. Therefore, states the amending directive, Member states may extend the rule to other assets provided these have been the subject of a valuation at fair value, and provided that valuation has previously been subject to the opinion of a recognised independent expert. One could imagine the rule to be applicable to the case that a fair value opinion has been delivered by the expert in the context of another transaction, e.g. within the context of an intra-group transaction, in a tax assessment, in a litigation case. The expert has to stand behind his opinion as stating the fair value of the assets for all other purposes. One will have to determine in each case whether the opinion delivered has focused on determining the "fair value", what will require a fine analysis of the context in which the opinion has been delivered. So e.g. can one doubt whether a "fairness" opinion[49] delivered in the context of a parent- subsidiary take-over bid, or for a transaction among shareholders necessarily reflects the valuation basis as applicable for the purposes of the amended directive. But if assets, contributed to a company on the basis of an expert opinion, are contributed to another company, "fair value" in the second transaction may be expected.

30. The use of this alternative valuation method is predicated on a number of stringent conditions:

- The valuation should have taken place at "fair value", to be applied according to "the generally accepted valuation standards and principles in the Member State which are applicable to the kind of assets to be contributed". "Fair value valuation" is one of the building blocks of the International Financial Reporting Standards and one will logically admit that the valuation according to these standards would also meet the standards the directive is calling for. However, additional valuation techniques may have been adopted in certain member states, e.g. for the valuation of real estate; if generally accepted they would also be applicable for the present purposes.
- The valuation should be recent i.e. not older than six months before the asset contribution[50];
- The valuation has to been subject to a fair value opinion by a "recognised independent expert". Normally a valuation by the statutory auditor would not meet

[49] On fairness opinions, see among many publications: Y. Ohta & K.K. Yee, "The Fairness Opinion Puzzle: Board Incentives, Information Asymmetry, and Bidding Strategy", *Journal of Legal Studies*, vol. 37, 2007 ; D.J. Kisgen, J. Qian & W. Song, "Are Fairness Opinions Fair? The Case of Mergers and Acquisitions", ssrn.com/abstract=850804); S.M. Davidoff, "Fairness Opinions", *American University Law Review*, vol. 55, 2006, 1557 ssrn.com/abstract=881109); J.C. Coffee Jr., "The Attorney as Gatekeeper: An Agenda for the SEC", *Columbia Law Review*, vol. 103, 2003, 1293-1316 ; L.A. Bebchuk & M. Kahan, "Fairness Opinions: How Fair Are They and What Can Be Done about It?", *Duke Law Journal*, 1989, nr. 1, 27-53.

[50] The amending directive refers to the "effective date of the asset contribution": is this the date at which the agreement has been concluded, or the date at which the agreement has been executed (the closing date)? In legal terms it would depend on the date at which the risks are transferred to the company, which normally would be the second date, but parties could as well choose for the first. A more careful drafting might have avoided this interpretation difficulty.

this requirement, and creates a risk of self review. Hence the valuation by the statutory auditor who has to meet the independence requirements laid down in the 8th directive would normally not meet the independence requirement of the new 2nd directive [51].
Apart from the statutory auditor, other experts recognised as being independent could also be qualified to deliver this opinion. This could especially be the case for real estate valuations.

A similar rule relating to the revaluation of the asset between valuation date and contribution date - maximum six months, as in the previous case - has been provided for: there are however slight differences in formulation. In this case again, the full regime of the original directive applies.

The directive contains an additional safeguard for shareholders in case the assets are valued above the previous valuation: here shareholders owning 5% of more of the capital can apply for having the full valuation technique applied.

c- valuation of assets valued at fair value in annual accounts.

- the rationale

31. The third case in which a contribution in kind can be made without specific expert valuation is in fact a variety of the previous one, namely the case in which the asset has been valued at "fair value" as having been included in the annual accounts. The same conditions would apply as in the previous case. The asset has to be valued individually, included in the accounts of the previous financial year, which accounts have been audited in accordance with the eighth directive. The rule is likely to support the use of the IFRS or other fair value accounting systems, as these would allow transfers between companies without additional valuation[52]. One could even argue that for intra-group transactions the same valuation can be followed without requiring an additional valuation in the framework of conflicts of interest regulations between group companies.

In most states IFRS are only applied to consolidated accounts of listed companies. Hence arises the question whether the valuation referred to in the new directive includes valuations in the consolidated accounts or also in the solo accounts of the contributing company. As the directive makes no difference and as the IAS regulation allows the use of IAS both in consolidated and solo accounts, both should be considered acceptable as basis for fair value accounting for the purposes of the present directive.

The same restrictions in case of revaluation apply.

d – Common provisions

32. When a company accepts a contribution in kind without the expert valuation, the board of directors of that company will he held to additional obligations in terms of disclosure

[51] Art. 22; Directive 2006/43 of 17 May 2006, OJ L. 157/87 of 9 June 2006

[52] In case of historical cost accounting, the company will have to prove that the value of its assets in the accounts correspond to their fair value, which is not likely to be the case.

to third parties. These disclosures have to be made whether the capital increase has been decided by the general meeting or by the board of directors.

After the transaction has taken place, the company will publish according to the rules of the First company law directive, a document describing the assets contributed, their value, the source and method of valuation. A statement that no new qualifying circumstances have occurred that might have affected the original valuation is to be added. In addition, the board has to certify that the value of the assets contributed are at least sufficient to cover the value of the capital so constituted[53].

In general terms the new directive states that "adequate safeguards for ensuring compliance" with the new rules will have to be provided for in the state's legislation. One could analyse this provision as calling for liability of directors in case the requirements have not respected. The intervention of a notary or other public official will also contribute to that objective. However, the board should not be held accountable for differences in the valuation, the latter having been whether derived from the securities markets or certified by independent experts.

The independent experts that have certified valuations outside the capital formation procedures will incur an additional liability if it appears that their valuation has been used for a capital contribution. In principle, this extension of the scope of liability should not increase the expert's risks, as he should be able to stand behind the valuation that he has previously certified. But it remains useful to know that his liability may extend to contributions in kind, effectuated outside his knowledge.

33. The preamble to the directive adds in connection with the alternative valuation methods discussed in this section: "nonetheless, the right of minority shareholders to require such valuation should be guaranteed". This rather exceptional case could present itself in case revaluation is required[54]. The use of fair value can be open to challenge when due to "new qualifying circumstances" since the original valuation at fair value a revaluation has become necessary. This case could refer to rather volatile assets, which have increased in value considerably and that over a maximum six months period. For that case, there is an obligation to proceed to a revaluation at the request of the board; shareholders with a 5% stake could demand a revaluation. In both cases the full procedure of the Second directive will have to be followed. One wonders why shareholders would request the contributions to be valued at a higher price as this will result in an increased dilution of their position. In some detail the directive spells out that holders of 5% or more of the shares will qualify for this remedy.

The directive does not clarify whether the flexibility it introduces in case of contributions also applies to mergers[55] or divisions of companies: the Third and Sixth directive follow a similar approach, but do not directly refer to the second directive as to the valuation techniques. However, it seems difficult to state that a national legislator could derogate from these directives' strict conditions. Here again, a clarification would be useful.

Summarizing the provisions of the new directive in this field, one can expect member states to introduce the new rules on valuations of contributions in kind provided sufficient experience has been gathered with fair value accounting. This is likely to be case in states

[53] See art. 10 b, (1) c, reproducing the text of art. 10(2) of the amended directive.
[54] Se art 10(a) 2, third paragraph.
[55] Art. 11, Directive 78/855 of 9 October 1978; Art 8, Directive 82/891 of 17 December 1982.

with large capital markets, where IFRS is widely practised. However the directive texts contains some ambiguities that may reduce the usefulness of the simplified requirements.

Some of the rules of the amending directive indicate that the draftsmen were not very much at ease with the new approach followed in this directive and hence, confronted with their hesitation, introduced elements of uncertainty that are likely to hamper the practical benefits of the new regime.

§ 2 The acquisition of own shares

34. The rules on the acquisition of own shares were laid down in the second directive for several reasons: first to ensure that the creditors would be protected by avoiding that the assets be constituted of shares of the company itself, hence not representing any "outside" value. In terms of capital protection, the creditors would be misled if they found out that the assets had fled away in exchange for shares representing this capital on which the rely. The reason is not entirely convincing, as the own shares will be shown in the accounts, and moreover these shares are not worthless, especially if they are traded on a securities market.

But underlying is also the fear that share buy backs be used for illegitimate purposes, e.g. to grant one shareholder the right to leave the company, or for directors to be able to draw on the company's cash by offering their shares to be acquired. This motivation explains why the original directive adhered to an overly strict regime, attempting to protect both creditors and shareholders, by curtailing buy back transactions, even if these were based on good financial practice.

Under the influence of the financial markets the analysis of buy back transactions has considerably changed: from transactions affecting the capital of companies and hence the relative position of the shareholder, the new approach assimilates buy backs to dividends, whereby funds are returned to the shareholders. The difference with dividends is however considerable, especially in terms of taxes due. According to present thinking, to buy back shares and keep them in the company's treasury, often will be an act of good management.

35.The new directive does not free buy back transactions in general but only allows member states to lower some of the requirements at which buy backs can take place. The main difference consists of the abolition of the ten percent ceiling, obviously an haphazard figure[56]. Henceforth buy backs are allowed up to the amount of the distributable net assets, or in the wording of the directive "may not have the effect of reducing the net assets below the amount mentioned in art 15(1) (a) and (b)". This formula adheres to the directive's overall philosophy declaring all assets distributable under whatever form, provided the amounts corresponding to capital and undistributable reserves remain within the company.

The new directive allows to simplify in the following respects:

- The authorization by the general meeting can be given for a 5 year period, in stead of 18 months, avoiding ritual annual renewals of the authorisation, but at the same time strengthening the position of the controlling shareholders. The change is not without importance as many companies experience difficulties in having the authorization approved due to the opposition of institutional investors who analyse the authorization as an anti-takeover technique.

[56] See about the origin of this figure in German law, the revealing study by MALTSCHEW, referred to by J. OECHSLER, "Die Änderung der Kapitalrichtlinie und der Rückerwerb eigener Aktien", *ZHR* 2006, 72.

- The calculation base for the permissible amount to be used for acquisitions are the total amount of the own funds, minus capital and undistributable reserves; the previously acquired shares have to be included, i.e. the calculation is not per transaction, but on the basis of the stock of shares bought back. This limits the buy backs to the remaining distributable reserves, which will then have to be declared undistributable for the period of time during which the shares are kept in the company's portfolio.
- The calculation is based in reference to art 15 (1) (a) and (b) whereby according to (b) the amount of the uncalled part of the capital is to be deducted from the subscribed capital.

36. The amendment is halfhearted as the restrictions that previously applied are maintained but then on an optional basis: this applies to

- the limitation to 10% of the subscribed capital
- other conditions relating to the authorisation (duration, maximum amount, consideration)
- reporting and notification, in addition to the disclosure requirements of art. 22(2)
- obligation to cancel the shares, in addition to art 20 (2)
- no prejudice to creditors' claims, in which case the national law could impose the company to constitute a guarantee (comp. art 32 of the Second directive)

These additional requirements may be useful for unlisted companies, where buy backs affect not only the creditors' position, but also the relationship among shareholders. For listed ones, where buy backs normally take place on the markets, the applicable disclosure requirements will allow necessary transparency, while the other conditions are of less significance.

37. Unchanged are some of the flanking measures that were already part of the 2nd directive. These relate to

- the obligation to dispose of the shares referred to in art 20 (1) litt. b to g, unless these remain under the 10% threshold; and the shares not so disposed off must be cancelled[57]
- the suspension of voting rights attached to shares held by the issuer company in own portfolio
- the requirement to constitute an undistributable reserve for an amount equal to the purchase price of the shares
- the disclosure requirement in the annual report (amount, percentage, consideration, and reasons for acquisitions)

Issues of interpretation

38. The amending directive contains a general reference to principle of equal treatment[58]. This reference was not part of the Second directive, but could be linked to the general provision of article 42 stating "for the purposes of the implementation of this directive the laws of the member states shall ensure equal treatment to all shareholders who are in the

[57] See art. 20(2) Second amended directive

[58] Art. 19(1) as modified by the Amending directive.

same position”. Therefore the addition of this reference does not seem to change the purport of the provisions of the directive.

The directive also makes a reference to the Market Abuse directive and its implementing regulation[59]. Companies that repurchase their own shares very often will be in possession of inside information about their our own plans and developments. The regulation only exempts from the directive buy backs that are aimed at covering position flowing from convertibles or employee share options[60]. This limitation does not forbid companies to acquire their own shares but they will not be protected under the regulation, and hence have to fully respect all conditions laid down in the market abuse directive. The ambit of the limitation is therefore relatively limited.

39.Three cases are be distinguished in the Regulation: these relate to buy back programmes that are ‘time-scheduled”, i.e. when dates and quantities are set out at the time of public disclosure of the programme; secondly, when the programme is run by a bank or investment firm, independently of the issuer; and thirdly under the detailed conditions of the regulation relating to price, average daily volume and disclosure[61]. In any case, these companies will not be entitled to repurchase their shares during the so-called “closed periods”[62] during which according to national law, the company is in the possession of insider information. The regulation allows buy backs both on and outside the regulated market[63]: here other national provisions may intervene to ensure equal treatment of the shareholders by canalising the transactions to the main market[64]. OTC transactions will usually be considered to be contrary to the equal treatment requirement.

Summarizing

40. The regime for share buybacks has been made more rational by not further referring to the absolute threshold of 10% but – and in line with the general concepts of the capital protection – in reference to the distributable own funds. The change is therefore significant, although minimal.

The directive continues to contain some further restrictions that may usefully be pruned in a later revision. Here again, it would be preferable that some of these rules were applicable to listed companies only, where shareholders enjoy a better protection both in terms of financial conditions and of disclosure.

§ 3. Simplified regime for financial assistance.

The rationale

41. The 2nd directive’s provisions on financial assistance have been frequently criticised as being ill conceived, aimed at solving the wrong problem with inappropriate rules[65]. The practical effect of the rule has been that useful transactions, especially in the field

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[59] Art. 8 of directive 2003/6 of 28 January 2003 and Commission Regulation 2273/2003 of 22 December 2003, OJ. L. 336/33 of 23 December 2003.
[60] Art. 3 of the regulation.
[61] See articles 4 and 5 of the regulation.
[62] Art 6(1) (b) of the regulation referring to the closed period under the law of the state in which the trading takes place. It includes the cases of delayed publication, as mentioned in art. 6(2) of the directive.
[63] Art. 5(1) 2 of the regulation.
[64] See the interpretation by the Belgian CBFA, nt.12.
[65] See Wymeersch, nt. 27.

of management buy-outs and private equity transactions, have been rendered whether impossible, or at least much more difficult. Legal advise for finding ways to circumvent the prohibition has been much sought after. This was the more so as several member states had applied the prohibition only to public companies limited by shares, but introduced no, or considerably more flexible rules for the private companies limited.

Under the regime of the 2nd directive, there was an outright prohibition for a company to finance the acquisition of its own shares by any party. The prohibition related to both loans, credit advances and guarantees. Third parties, such as banks, could equally be held liable if they knowingly contributed to a forbidden transaction ("financial assistance"). Transactions that violated the rule were void, resulting in liability of the directors granting the loan, with often a criminal liability attached as well[66]. In practice, very few cases of violations have been reported but it is well known that a very considerable – and very lucrative – consultancy practice has sprung up dealing with the pitfalls of art. 23 and its national implementing provisions.

42. The prohibition of financial assistance was a mysterious one. Granting a loan to a third party should be judged on the basis of the solvency of that party, not so much on the use it would make of the loan money. Also, the loan – assuming the borrower solvent- would not put the company's assets in danger, as the loan would constitute an asset of the lender company. The rule was therefore more a rule addressing the conduct of the board of directors who, with the necessary prudence, should determine to whom to grant loans, and what guarantees to request. That by granting loans to insolvent future shareholders the company could be deprived of its substance, and hence put the creditors in danger, is certainly to be avoided, but not by imposing an outright prohibition of any transaction, but rather by addressing the board who should be held accountable for irresponsible conduct. Also, it should be reminded, creditors are not entitled to the assets of the company without more: a company can always distribute a large part of its assets to its shareholders, whether by way of dividends or of share buy backs. It is the responsibility of the directors and shareholders to determine whether a dividend distribution is likely to harm the creditors, and they may be held to account for all shortcomings. For all these reasons, it will not astonish that some have favoured an abolition of article 23 altogether. The amending directive has attempted to alleviate some of these concerns.

- the amending directive

43. The new directive offers some solutions to this vexing problem. It allows member states to do away with the wholesale prohibition of financial assistance, however allowing them to keep the prohibition unchanged[67]. If they allow it, the requirements of the directive will have to be complied with.

Basically it restates the rule in terms of conduct of the board and of related liabilities. The new directive repositions the subject in terms of rules of conduct both for the general meeting and for the board. The remaining restrictions are still quite burdensome and will continue to restrict certain transactions, or make them more costly.

Firstly the transaction has to be approved by the general meeting in advance. Approval has to be given with a supermajority of 66 % at least, depending on national law. The

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[66] E.g. under the Belgian Companies Code, art. 648, 7°.

[67] Differences in this respect may have a detrimental effect on cross border establishment and cross border capital flows. Hence compatibility with Treaty provisions should be further investigated.

requirement to submit the individual deal for prior approval[68] and to have the report of the board published will make it often impossible in listed companies to use financial assistance. The board has to present a report – to be published – with precise conditions of the transaction: conditions, risks in terms of liquidity and solvency, acquisition price of the shares, interest of the company. Moreover the board has to take responsibility for the fair market conditions, both with regards to remuneration to be received, guarantees to be constituted in favour of the company and the credit standing of the beneficiary of the loan. It is striking that notwithstanding the detailed prior approval by the general meeting, the directive still declares that "the transactions shall take place under the responsibility of the board"[69]. In practice, these transactions will often trigger the rules on conflict of interest and according to national law, similar disclosures or procedures may be applicable. A new article in the amending directive calls attention to this point, leaving it to the member states to decide how these conflicts have to be dealt with[70].

44. The directive adds a special rule in case the financial assistance is used for acquiring the shares from the company itself, whether by subscribing to newly issued shares, or by acquiring treasury shares that the company held in its portfolio: in both cases the price should be "fair"[71]. One can suppose that this requirement is imposed to ensure that the other shareholders will not be harmed, and this notwithstanding the approval of the general meeting[72]. For the creditor, the requirement has no meaning: funds are flowing out of the company under the form of a loan, and come back under the form of own funds. Creditors will not complain.

- evaluation

45. The substantive new condition introduced by the amending directive put "financial assistance" on the same footing as a share buyback or any other distribution. The reasoning is that notwithstanding the decisions of the general meeting and the board, the sums used for financial assistance are lost for the company, and should therefore be restricted to the distributable net assets[73], while a reserve unavailable for distribution has to be constituted.

The new regime is burdened by considerable restrictions and raises a number of serious questions: it is therefore unlikely to be received with enthusiasm[74]. The provisions remain based on the largely false premise that financial assistance is an unacceptable practice. Moreover, there is fundamental flaw in the way the company's organs intervene in these transactions.

C. Conclusion

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[68] Delegation to the board seems not allowed.

[69] Art. 23(1)(1) Amending directive.

[70] Art. 23a Amending directive: "member states shall ensure through adequate safeguards that such transaction does not conflict with the company's best interest".

[71] Art.23(1), paragraph 5, Amending directive; whether this provision relates of acquisition from the company itself is unclear, but seems likely due to the mention of a subscription of the shares.

[72] Would that mean that notwithstanding the approval by a supermajority of 2/3 or 3/4th, the individual shareholder could complain and state that the deal is null and void on the basis that the price was not fair. This reading would result in a very serious incursion in the functioning of the company .

[73] As defined in art. 15(1) a and b, Second Directive.

[74] A similar remark was formulated by E. FERRAN, in "Simplification of European Company Law on Financial Assistance", *EBOR* 2006, 93-99. The final directive has been improved but still continues to be overly restrictive.

46. The second directive attempts to deal with a number of real issues in terms that are unlikely to yield a valid answer. By linking a number of requirements to the notion of capital, it has introduced opacity in the reasoning, muddying the real issues and their answers.

Rules that would normally be considered as being addressed to the general meeting or to the board and often express their duties of care and loyalty are restated in strict limits that use capital as a yardstick. As a consequence, two lines of reasoning have been interwoven: capital protection and shareholder protection. This also explains the rigidity of the system: even bona fide transactions fall under the strict prohibitions as affecting legal capital.

Questions of an ethical nature, or fairness, of loyalty and correct behaviour cannot be dealt with in terms that take as their reference point the legal capital of a company. These issues have to be dealt with straight on, possibly by framing general principles of a higher level, relying on legal practice, on the judiciary and other instruments to secure their implementation. It is striking that many of the difficulties that have been described in the present paper could be considered as "corporate governance" issues, expressing duties of care and loyalty, dealing with conflicts of interest, while other issues will find a more adequate answer once more experience is gained with the fair value as an accounting base.

The revision of the Second company law directive has not even started.

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