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Legal Capital: A Navigation System for Corporate Law Scholarship

Holger Fleischer*

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* Professor of Law, Director of the Institute for Commercial and Economic Law, University of Bonn.

1. CREDITOR PROTECTION LAW AND LEGAL CAPITAL

I would like to use (or abuse) my comment on John Armour's thoughtful paper to sketch out a conceptual approach towards legal capital with an emphasis on *structure* rather than on *substantive regulation*.

1.1 Morphology of creditor protection law

1.1.1 *Creditor protection law as a cross-section subject*

At the outset, one should accentuate that creditor protection is dealt with in different areas of law. It touches *company law* as well as *insolvency law*, and it is also deeply rooted in *accounting law* and *contract law* – to mention just the most important fields.[1] To put it differently, creditor protection law is a *cross-section subject* with all the challenges, pitfalls and misunderstandings of legal frontier regions this entails.

1.1.2 *Creditor protection law as a 'movable system'*

Moreover, creditor protection law offers fertile ground for a methodological approach associated with the Austrian legal scholar Walter Wilburg: the idea of a *movable system* according to which an area of law is often structured and shaped by different and frequently competing principles which set more or less realisable standards.[2] I might add that Wilburg received the inspiration for his conceptual approach from comparative law studies.[3] In the area of creditor protection law, the underlying principles might be (1) transparency of creditors' risks; (2) self-responsibility of creditors; (3) equal treatment of creditors; and (4) barriers to *ex post* risk shifting. Within this framework, legislators and courts are confronted with the Herculean task[4] of harmonising these principles, finding consistent

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[1] Similarly G. Hertig and H. Kanda, 'Creditor Protection', in R. Kraakman, et al., *The Anatomy of Corporate Law* (Oxford, Oxford University Press 2004) p. 71: 'The need to protect corporate creditors, however, does not necessarily imply that *corporate* law must do the protecting: the job could be left entirely to contracting between the parties or to the general law of debtor-creditor relations.'

[2] See W. Wilburg, *Entwicklung eines beweglichen Systems im geltenden Recht* (Graz, Verlag Jos. A. Kienreich 1950).

[3] See W. Posch, 'Die Bedeutung des Beweglichen Systems für die Rechtsvergleichung und das Einheitsprivatrecht', in F. Bydlinski, H. Krejci, B. Schilcher and V. Steininger, eds., *Das Bewegliche System im geltenden und künftigen Recht* (Vienna/New York, Springer 1986) p. 253 at p. 254 et seq.

[4] The metaphor is taken from R.M. Dworkin, *Law's Empire* (Cambridge, Harvard University Press 1986) p. 239.

compromises between them and restricting none of them more than necessary by the furtherance of counter-principles. This *optimising task* has, by its nature, *several* possible solutions.

1.2 Competing designs of creditor protection

Analysed through the lens of a movable system,[5] it is thus not surprising that we find competing institutional designs of creditor protection: legal capital on the continent and alternative approaches in the United States and – more and more – in the United Kingdom. An additional insight to be gained from viewing creditor protection law via Wilburg's way of thinking is this: a movable system in his sense consists of *various* elements that can *substitute* each other to a certain degree.[6] To give two examples in our context: a *minus* of directors' personal liability may be compensated by a *plus* of shareholder liability via veil piercing, and *vice versa*,[7] while a reduction of *initial* capital requirements can be balanced out by *late-stage* equitable subordination of shareholders' loans.

2. Anatomy of legal capital

This leads me to some *less abstract* remarks on the anatomy of legal capital.

2.1 Protective dimensions of legal capital

2.1.1 *Shareholder protection*

The anatomy lessons should begin with a basic insight. The Second Company Law Directive[8] reminds us in the second recital of its preamble that rules on legal capital are designed to ensure protection for both creditors *and* shareholders of

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[5] This approach is suggested by H. Fleischer, 'Kapitalschutz und Durchgriffshaftung bei Auslandsgesellschaften', in M. Lutter, ed., *Europäische Auslandsgesellschaften in Deutschland* (Cologne, Otto Schmidt 2005) p. 49 at p. 107 et seq.

[6] See F. Bydlinski, 'Die "Elemente" des Beweglichen Systems: Beschaffenheit, Verwendung und Ermittlung', in B. Schilcher, P. Koller and B.-C. Funk, eds., *Regeln, Prinzipien und Elemente im System des Rechts* (Vienna, Verlag Österreich 2000) p. 9 et seq.

[7] See L.C.B. Gower and P.L. Davies, *Principles of Modern Company Law*, 7th edn. (London, Sweet & Maxwell 2003) p. 190: 'British law has approached that problem [i.e., inadequate capitalisation] through the statutory doctrine of wrongful trading rather than through lifting the veil.'

[8] Second Council Directive of 13 December 1976, *OJ* 1977 L 26/1.

public companies.[9] Scholarly analysis focusing only on the creditor dimension thus does not fully appreciate the range and ratio of legal capital rules.[10] An alternative system which abolishes legal capital altogether has to resort to functional substitutes in order to maintain the appropriate amount of shareholder protection, the most plausible candidate being the principle of equal treatment for all shareholders.[11] Having said this, I will leave aside the issue of shareholder protection through legal capital, since our conference is entitled 'Efficient *Creditor* Protection in European Company Law'.

2.1.2 *Creditor protection: voluntary and involuntary creditors*

As far as creditor protection is concerned, law and economics orthodoxy tells us to differentiate between sophisticated and unsophisticated, voluntary and involuntary, and adjusting and non-adjusting creditors.[12] While voluntary creditors can fend for themselves,[13] involuntary creditors cannot, and the discussion soon centres around alternative venues of protection for this second group of creditors. In my view, two aspects should be considered more closely.

First, involuntary creditors are far from being a homogenous group. Unlike John Armour, I would not exaggerate the protective need of the State as a tax creditor. Comparative law shows how the State interferes in its own interest by introducing liability provisions for directors into tax laws, for example, section 69 of the German General Tax Code (*Abgabenordnung*) or Article 266 of the French *Livre des procedures fiscales.*[14] More troubling is the legal protection of consumer creditors in cases where small claim problems arise and non-financial

[9] The second recital states: 'Whereas in order to ensure minimum equivalent protection *for both shareholders and creditors* of public limited liability companies, the coordination of national provisions relating to their formation and to the maintenance, increase or reduction of their capital is particularly important.'

[10] See H. Fleischer, 'Systematische Darstellung 6: Die Finanzierung der GmbH', in L. Michalski, *GmbH-Gesetz* (Munich, C.H. Beck 2002) n. 7.

[11] See Art. 42 of the Second Council Directive: '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 same position.'

[12] See F.H. Easterbrook and D.R. Fischel, *The Economic Structure of Corporate Law* (Cambridge, Harvard University Press 1991) p. 50 et seq.; H. Fleischer, 'Grundfragen der ökonomischen Theorie im Gesellschafts- und Kapitalmarktrecht', 30 *Zeitschrift für Unternehmens- und Gesellschaftsrecht* (2001) p. 1 at p. 19.

[13] In analogy to the famous formulation aimed at investors in *SEC* v. *Ralston Purina Co.*, 346 US 119 at 125 (1953).

[14] See H. Fleischer, 'Erweiterte Außenhaftung der Organmitglieder im Europäischen Gesellschafts- und Kapitalmarktrecht', 33 *Zeitschrift für Unternehmens- und Gesellschaftsrecht* (2004) p. 437 at p. 445 et seq.

creditors, for instance trade creditors and small subcontractors, that may lack bargaining and informational resources.[15]

Second, critics of legal capital rules usually point to alternative means of protection for involuntary creditors: piercing the corporate veil for tort victims,[16] mandatory insurance for hazardous activities[17] and personal tort liability for directors.[18] I would like to add a supplementary proposal that has almost fallen into oblivion but was recently reanimated by scholars on both sides of the Atlantic: *preferential* treatment for tort creditors in the case of insolvency of the company.[19] I do not want to take a firm position here as to whether this is the cure for involuntary creditors or whether it leads to the outbreak of just another illness, but I think it is worth discussing.

2.2 **Types of companies**

2.2.1 *Private and public companies*

A second dividing line in our discussion should separate private and public companies – for a variety of reasons. First of all, as John Armour mentions in passing, the principle of limited liability is much easier to justify for publicly traded companies.[20] Moreover, some instruments from the creditor protection toolbox are well suited to *private* companies and ill suited to *public* companies: veil piercing is one example,[21] the doctrine of equitable subordination another. Conversely, the protective power of mandatory disclosure and market forces is – for obvious reasons – the domain of publicly held and listed companies. Finally, it should not escape notice that some arguments for and against legal capital have force only in a particular setting. By way of illustration, the advantage that a

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15 See P. Mankowski, 'Does Contract Suffice to Protect the Interests of the Creditors of a Company Properly?', in M. Lutter, ed., *Legal Capital* (Berlin, De Gruyter 2006, forthcoming).

16 Most prominently, H. Hansmann and R. Kraakman, 'Toward Unlimited Shareholder Liability for Corporate Torts', 100 *Yale L.J.* (1991) p. 1879.

17 See Easterbrook and Fischel, op. cit. n. 12, at p. 47 et seq.

18 See Hertig and Kanda, loc. cit. n. 1, at p. 88 et seq.

19 See L.M. LoPucki, 'The Unsecured Creditor's Bargain', 80 *Va. L. Rev.* (1994) p. 1987; G. Wagner, 'Deliktshaftung und Insolvenzrecht', in E. Schilken, et al., eds., *Festschrift für Walter Gerhardt* (Cologne, RWS Verlag 2004) p. 1043 at p. 1067 et seq.

20 See S.M. Bainbridge, *Corporation Law and Economics* (New York, Foundation Press 2002) p. 132 et seq.; Fleischer, loc. cit. n. 12, at p. 16 et seq.

21 See R.B. Thompson, 'Piercing the Corporate Veil: An Empirical Study', 76 *Cornell L.J.* (1991) p. 1036, showing that veil piercing almost always takes place in close corporations; for a similar result, see C. Mitchell, 'Lifting the Corporate Veil in the English Courts: An Empirical Study', 3 *Company, Financial and Insolvency Law Review* (1999) p. 15 at p. 21: 'No case was found in which the English courts have even been asked to fix the shareholders of a public company with liability for its obligations.'

balance-sheet-oriented distribution rule makes it easier for managers to withstand pressure from shareholders in times of crisis is convincing in a *Berle/Means*-type of public company but looses its thrust in a manager-owned private company.

2.2.2 *Groups of companies*

I can only mention in passing the complex legal capital world of corporate groups, which gives rise to special problems. The most intriguing question is whether Article 15(1) of the Second Company Law Directive[22] also covers so-called *hidden distributions*,[23] which would have a major impact on the judicial review of *intra-group transactions*.

3. ANALYTICAL FRAMEWORK FOR LEGAL CAPITAL

3.1 **Levels of reasoning: theoretical arguments and empirical evidence**

The first wave of scholarship on legal capital began by *collecting* arguments for and against the established regime of the Second Company Law Directive.[24] The arguments are largely derived from and couched in terms of traditional or neo-institutional law and economics. We identify asymmetrical information between the participants in the corporate contract, we point to transaction costs and possible cost savings by interpreting legal capital as a collective offer to creditors[25] and we sometimes view legal capital as a signalling device.[26] This is all extremely valuable, but only at an intermediate stage of our discussion. The next step must be to *test* our arguments and theories against the empirical evidence. In this respect, German *legal scholars* – or should we blame our colleagues from the *business school?* – are lagging behind, and John Armour's paper is particularly

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[22] Article 15(1)(a) states: 'Except for cases of reductions of subscribed capital, no distribution to shareholders may be made when on the closing date of the last financial year the net assets as set out in the company's annual accounts are, or following such a distribution would become, lower than the amount of the subscribed capital plus those reserves which may not be distributed under the law or the statutes.'

[23] See P.O. Mülbert and M. Birke, 'Legal Capital – Is There a Case against the European Legal Capital Rules?', 3 *EBOR* (2002) p. 695 at p. 705 et seq.; H. Fleischer, 'Hidden Distributions and the Capital Directive', in Lutter, op. cit. n. 15.

[24] Beginning with J.R. Macey and L. Enriques, 'Creditors Versus Capital Formation: The Case Against the European Legal Capital Rules', 86 *Cornell L. Rev.* (2001) p. 1165.

[25] See W. Schön, 'The Future of Legal Capital', 5 *EBOR* (2004) p. 429 at p. 438 et seq.

[26] See K. Heine and K. Röpke, 'Die Rolle von Qualitätssignalen – eine ökonomische und juristische Analyse am Beispiel der deutschen Kapitalschutzregeln', 70 *Rabels Zeitschrift* (2006) p. 138.

promising. Some authors conjecture that information costs might be an insurmountable barrier for the self-help of small trade creditors; John Armour provides us with statistics.[27] Some authors theorise that trade creditors are unable to discriminate between borrowers on the basis of creditworthiness; John Armour cites studies which test and contest the validity of this claim.[28]

Several of these studies, however, are disputed. A recently published bankruptcy business study documents the presence of substantial numbers of creditors who have little meaningful opportunity to negotiate with their debtors or adjust their prices to reflect risk.[29] Despite this contradictory evidence, it remains true in creditor protection law that the *practical* often informs the *theoretical*, and that efficiency gains by a particular rule must be demonstrated, not merely presumed or asserted.

3.2 Underlying assumptions: rational corporate actors and cognitive deficiencies

A further and oft-neglected aspect of the legal capital debate concerns the underlying assumptions of our reasoning. Conventional economic wisdom teaches us to model the different actors in the corporate setting as fully *rational* players.[30] As a starting point and working hypothesis, this was and still is indispensable. On the other hand, we are increasingly confronted with experimental evidence of cognitive deficiencies.[31] A well-known example in our context is the over-optimism of top management throughout a company's lifespan and especially in times of crisis.[32] English company law has coined the phrase 'sunshine doctrine', referring to directors who in stormy weathers still hope that the clouds will go away and the sun will shine again.[33] If corroborated by further evidence,

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27 See M.A. Petersen and R.G. Rajan, 'Does Distance Still Matter? The Information Revolution in Small Business Lending', 57 *Journal of Finance* (2002) p. 533.

28 See M.A. Petersen and R.G. Rajan, 'Trade Credit: Theories and Evidence', 10 *Review of Financial Studies* (1997) p. 661.

29 See E. Warren and J.L. Westbrook, 'Contracting out of Bankruptcy: An Empirical Intervention', 118 *Harv. L. Rev.* (2005) p. 1197.

30 See Bainbridge, op. cit. n. 20, at p. 23 et seq.

31 See C.R. Sunstein, ed., *Behavioral Law and Economics* (Cambridge, Cambridge University Press 2000); H. Fleischer, 'Behavioral Law and Economics im Gesellschafts- und Kapitalmarktrecht – ein Werkstattbericht', in A. Fuchs, et al., *Festschrift für Ulrich Immenga* (Munich, C.H. Beck 2004) p. 575.

32 See D.C. Langevoort, 'Organized Illusions: A Behavioral Theory of Why Corporations Mislead Stock Market Investors (and Cause Other Social Harm)', 146 *U. Pa. L. Rev.* (1996) p. 101 at p. 161; Fleischer, loc. cit. n. 14, at p. 459 et seq.

33 See *Re White & Osmond (Parkstone) Ltd.*, unpublished but cited in *R.* v. *Grantham* [1984] 2 *All ER* 166 at 170.

these and other anomalies must be taken into account when designing legal rules in the vicinity of insolvency and when shaping a timely trigger for company insolvency. This is not to say that creditor protection law has to be completely rewritten from a behavioural law and economics perspective. Often, we can explain a certain pattern of behaviour from different perspectives. The seemingly irrational over-optimism of company directors, for example, may turn out to be a fully rational gamble for resurrection in the vicinity of insolvency.[34]

3.3 Categories of legal norms

We reach the next intellectual junction when we try to mould our results into legal norms. Here, attention should be paid to different techniques that have long been underexposed in the manuals of good corporate law-making.

3.3.1 *Mandatory and default provisions*

A key point in John Armour's paper and in the whole debate on legal capital is the respective place we assign to mandatory and default provisions.[35] John Armour favours default provisions with respect to distribution rules. I would like to ask whether the logic behind that also applies to insolvency law, which is generally understood as a mandatory system, and whether a bankruptcy regime negotiated in the marketplace will be more efficient than the standardised contract provided by our insolvency codes.[36]

3.3.2 *Rules and standards*

A second differentiation recently rediscovered in accounting and corporate law is the rules-standards distinction.[37] It plays an important role in designing distribution provisions. A rules-based regime coupled with the company's commercial

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[34] See R.A. Brealey and S.C. Myers, 'How Much Should a Firm Borrow', *Principles of Corporate Finance*, 7th edn. (New York, McGraw 2003) p. 489.

[35] For a recent survey of the rich literature, see H. Fleischer, 'Gesetz und Vertrags als alternative Problemlösungsmodelle im Gesellschaftsrecht', 168 *Zeitschrift für das gesamte Handels- und Wirtschaftsrecht* (2004) p. 673 at p. 886 et seq.

[36] See B.A. Adler, 'Financial and Political Theories of American Corporate Bankruptcy', 45 *Stan L. Rev.* (1993) p. 311; R.K. Rasmussen, 'Debtor's Choice: A Menu Approach to Corporate Bankruptcy', 71 *Tex. L. Rev*. (1992) p. 51; A. Schwartz, 'A Contract Theory Approach to Business Bankruptcy', 107 *Yale L.J*. (1998) p. 1807; contra: S. Block-Lieb, 'The Logic and Limits of Contract Bankruptcy', *U. Ill. L. Rev*. (2001) p. 503; L.M. LoPucki, 'Contract Bankruptcy: A Reply to Alan Schwartz', 109 *Yale L.J*. (1999) p. 317.

[37] For a key contribution, see L. Kaplow, 'Rules Versus Standards: An Economic Analysis', 42 *Duke L.J.* (1992) p. 557.

balance sheet promises to be less vulnerable *vis-à-vis* manipulative manoeuvres and overly optimistic projections by managers than an open-ended standard. This higher degree of objectivity, though, comes at a price: the loss of flexibility in corporate finance. One issue in this respect is whether legal uncertainty created by *vague* standards can nevertheless induce a *cautious* distribution policy by management on the grounds that there is always a certain probability that courts will regard specific projections or forward-looking statements as unacceptable. This depends largely on the willingness of courts to qualify solvency statements as decisions based on business judgment.

3.4 **Legal and social environment**

3.4.1 *National preferences and legal culture*

In an overall picture of creditor protection, we must finally not forget that different jurisdictions have different preferences and different attitudes towards entrepreneurship and management control. English *contract law*, for example, is largely based on the tenets of self-responsibility and *caveat emptor*,[38] whereas German *contract law* stresses the virtues of cooperation and good faith.[39] *Similar* value judgments may explain *some* of the divergences of *creditor protection* law in both countries.[40]

Moreover, when deciding which creditor protection instruments are suitable in a particular legal environment, much can be learned from the rich literature on *legal transplants*.[41] The key concepts are micro-fit and macro-fit. *Micro-fit* is how well a new rule complements the pre-existing legal infrastructure in a certain country; *macro-fit* is how well a new rule complements the pre-existing institutions of the political economy in that country.[42] It may well turn out that some

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38 Most prominently *Walford* v. *Miles* [1992] 2 A.C. 128 at 138.

39 See H. Fleischer, *Informationsasymmetrie im Vertragsrecht* (Munich, C.H. Beck 2001) p. 567 et seq.

40 On this point with respect to German and US law, see H. Fleischer, 'Der Gläubigerschutz im Recht der Delaware Corporation', 51 *Recht der Internationalen Wirtschaft* (2004) p. 92; see also Gower and Davies, op. cit. n. 7, at p. 190: 'Indeed, at a more general level, the approach of British law to regulation of the abuse of limited liability is a combination of facilitating self-help and statutory constraints.'

41 See generally A. Watson, *Legal transplants. An Approach in Comparative Law*, 2nd edn. (Athens/London, The University of Georgia Press 1993); with a view to company law, see H. Fleischer, 'Legal Transplants im deutschen Aktienrecht', *Neue Zeitschrift für Gesellschaftsrecht* (2004) p. 1129 with further references.

42 See H. Kanda and C.J. Milhaupt, *Re-examining Legal Transplants: The Director's Fiduciary Duty in Japanese Corporate Law*, Columbia Law and Economics Working Paper No. 219 (2003) p. 9, available at: <http://ssrn.com/abstract=391821>.

instruments which are highly efficient in their home country will not succeed at all in their new environment and suffer from a 'transplant shock'.[43]

3.4.2 *Switching costs and path dependence*

A last point to be considered in an economic calculus when comparing different creditor protection systems has emerged in the ongoing corporate governance discussion. It is the phenomenon of *switching costs* and path *dependence*.[44] Jurists, after all, prefer *incremental* rather than *radical* reform steps,[45] and a malicious tongue has argued that this also mirrors the legal academy's reward structure.[46]

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[43] D. Berkowitz, K. Pistor and J.F. Richard, 'The Transplant Effect', 51 *Am. J. Comp. L.* (2003) p. 163.

[44] See M.J. Roe, 'Path Dependence, Political Options, and Governance Systems', in K.J. Hopt and E. Wymeersch, eds., *Comparative Corporate Governance – Essays and Materials* (Berlin, de Gruyter 1997) p. 165.

[45] See H. Fleischer, 'Legal Transplants in European Company Law – The Case of Fiduciary Duties', *European Company and Financial Law Review* (2005) p. 378 at p. 393; see also M. Bors, 'Recht und Autorität', in P. Tercier, ed., *Festschrift für Peter Gauch* (Zürich, Schulthess 2004) p. 37 at p. 42 et seq.

[46] See M. Tushnet, '"Everything Old is New Again": Early Reflections on the "New Chicago School"', *Wis. L. Rev.* (1998) p. 579 at p. 581: 'Ambitious younger scholars, of whom there is rarely an undersupply, have obvious incentives to discover some novel approach. In general, however, the legal academy's reward structure requires that novel approaches be one that the younger scholars' elders can appreciate as continuing a tradition with which the elders are associated.'