Articles

The Future of European Creditor Protection and Capital Maintenance from a German Perspective

By Andreas Haaker[*]

A. Introduction

The one-sided focus on shareholders' interests inherent in shareholder value-orientated corporate policies presupposes that there is a functioning system to protect the economic interests of the other stakeholder groups (creditors, employees, customers, suppliers, etc.).[1] This is an important constraint on the maximization of the market value of equity,[2] which as a target variable cannot be equated with a market price on the stock exchange, or with a short-term profit or yield target, and certainly not with a pending bonus payment sum.[3] Conversely, the postulation that the primary focus must be on shareholders' interests loses its validity as a guiding operational principle if neither individual contractual agreements nor protective statutory rules can safeguard a minimum level of protection for individual stakeholder groups. Given the incompleteness of contracts, it is not sufficient to refer to the possibility of self-protection in contracts—this loophole must be closed by regulations and by corporate governance.[4]

In continental Europe, creditor protection is considered very important. More specifically, the potential dividend payouts of limited liability corporations are restricted by financial capital maintenance regulations, so it is not possible to shift the bulk of corporate liability into the liability-free sphere of the shareholders, to the disadvantage of creditors. Even

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[1] *See, e.g.*, Roland Bénabou & Jean Tirole, *Individual and Corporate Social Responsibility*, 77 ECONOMICA 1 (2010).

[2] Christoph Kuhner, *Unternehmensinteresse vs. Shareholder Value als Leitmaxime kapitalmarktorientierter Aktiengesellschaften,* 33 ZEITSCHRIFT FÜR UNTERNEHMENS-UND GESELLSCHAFTSRECHT 244, 254 (2004). Given certain conditions, maximising the market value of equity capital can be equated to protecting shareholders' interests by optimising income flow from companies in terms of breadth, temporal structure, and the degree of uncertainty, and thus operationalising those interests. *See* Reinhard H. Schmidt & Eva Terberger, *in* GRUNDZÜGE DER INVESTITIONS-UND FINANZIERUNGSTHEORIE 50, 50–57 (4th ed. 1997).

[3] *See Shareholder v Stakeholders: A New Idolatry*, ECONOMIST, Apr. 22, 2010, at 58.

[4] *See* Wolfgang Ballwieser, *Shareholder Value am Ende?*, 62 DIE WIRTSCHAFTSPRÜFUNG NO. 11, I (2009).

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with cautious accounting methods, shareholders' dividend entitlements are taken into account by well-understood rules that protect them from yield reductions, although creditor protection takes precedence if there is any doubt.[5] The relevant protective rules are based on the Second EC Capital Directive, which follows the accounting principles of the Fourth EC Accounting Directive. Both of these directives are applied to non-consolidated financial statements in Germany.[6]

This capital protection system is henceforth on trial and has already been criticized for lacking flexibility, effectiveness, and efficiency; but primarily, it has proved to be an impediment to the comprehensive application of International Financial Reporting Standards (IFRS) to non-consolidated financial statements,[7] as demanded by certain interest groups. Moreover, the lack of flexibility in the system seems to have less to do with the effectiveness of creditor protection than with the maximization of market value.[8] This shows that one does not appreciate, that the HGB (German Commercial Code) financial statement functions as a necessary constraint on the pursuit of shareholder-orientated goals, which must limit the single-minded pursuit of these goals in order to ensure a minimum level of creditor protection: "Hence, this mechanism is not intended to safeguard dividend policies which maximize company value, but merely to compensate for the disadvantages faced by creditors because of the owners' exemption from liability."[9]

This paper aims to discuss the potential consequences of a reform of the European creditor protection and capital maintenance system from an economic, legal, and political perspective. One major objective is to convey the German view on this subject.

The remainder of this paper is organized as follows: Section B criticizes the (political) targets of the capital maintenance reform in general. Section C gives an overview of the "accounting worlds" of limited liability corporations in Germany, which is important for understanding the interest in changing the capital maintenance system. Against this background, Section D specifically defines the goal of creditor protection as a basis for

[5] *See* Adolf Moxter, *Anlegerschutz durch Rechnungslegung bei Kapitalgesellschaften*, *in* ÖFFENTLICHE FINANZEN UND MONETÄRE ÖKONOMIE: FESTSCHRIFT FÜR KARL HÄUSER 257, 257–72 (Wolfgang Gebauer ed., 1985).

[6] *See* Hanno Merkt, *Creditor Protection and Capital Maintenance from a German Perspective*, 15 EUR. BUS. L. REV. 1045 (2004). With regard to the capital maintenance function of the German Commercial Code non-consolidated financial statement, see JÖRG BAETGE, HANS-JÜRGEN KIRSCH & STEFAN THIELE, BILANZEN (11th ed. 2011).

[7] *See*, *e.g.*, Stefan Rammert, *Der Solvenztest—eine unausgereifte Alternative zur Kapitalerhaltung*, *in* WIRTSCHAFTSPRÜFUNG IM WANDEL: HERAUSFORDERUNGEN AN WIRTSCHAFTSPRÜFUNG, STEUERBERATUNG, CONSULTING UND CORPORATE FINANCE 429, 429–48 (Wolfgang Ballwieser & Wolfgang Grewe eds., 2008).

[8] *See, e.g.*, Georg Lanfermann & Marc Richard, *Ausschüttungen auf Basis der IFRS: Bleibt die deutsche Bundesregierung zu zögerlich?*, 61 DER BETRIEB 1928–32 (2008).

[9] Jens Wüstemann, Jannis Bischof & Sonja Kierzek, *Internationale Gläubigerschutzkonzeptionen*, 17 BETRIEBS-BERATER SPECIAL NO. 5, 13, 17 (2007) (quotation has been translated into English).

assessing the (potential) capital maintenance instruments described in Section E. Section F points out the limits of possible reforms of the capital maintenance system. Finally, Section G concludes the paper by highlighting the problems with this reform.

B. Targeting Capital Maintenance Reform: Modernization and Feasibility Versus Suitability

As part of its intended modernization of the 2nd EC Capital Directive, the European Commission ordered a feasibility study from the "big four" audit firm, KPMG.[10] This oft-quoted study primarily investigated "the advantages from the company's point of view" regarding costs and "avoided quantifying the costs or benefits, for instance, regarding the effects on creditor protection."[11] Although the issue of the effects on creditor protection was disregarded, the author of the feasibility study advocated credit maintenance reform with the slogan: "IFRS plus a solvency test are qualified for dividend payout purposes."[12]

In Germany, this conclusion, somewhat "hasty" at best, was also accepted by the IDW (Institute of Public Auditors in Germany),[13] as well as by the German Accounting Standards Board (GASB) in a draft of a GASB white paper on the future of European creditor protection that was presented at its 127th meeting.[14] Taking note, however, of Professor Dieter Schneider's postulation that "the accounting purpose determines its content by means of its target,"[15] one must carry out an economic analysis concerning the goal of

[10] *See* KPMG, *Feasibility Study on an Alternative to the Capital Maintenance Regime* (2008), *available at* http://ec.europa.eu/internal_market/company/docs/capital/feasbility/study_en.pdf (last visited Apr. 27, 2012).

[11] Wienand Schruff & Georg Lanfermann, *EU-Machbarkeitsstudie für ein alternatives Kapitalschutzsystem*, 23 DIE WIRTSCHAFTSPRÜFUNG 1099, 1100 (2008) (quotation has been translated into English).

[12] Press Release, KPMG, IFRS mit Solvenztest für Ausschüttungszwecke geeignet: KPMG—Studie im Auftrag der EU-Kommission zur Kapitalerhaltung, (Feb. 1, 2008), http://www.kpmg.de/Presse/6378.htm (last visited Apr. 30, 2012) (quotation has been translated into English).

[13] *See* Press Release, Institut der Wirtschaftsprüfer, Vorschläge des IDW zur Neukonzeption der Kapitalerhaltung und zur Ausschüttungsbemessung (Sept. 11, 2006), *available at* http://www.idw.de/idw/generator/id=412914.html (last visited Apr. 23 2012).

[14] *See* GASB, *DSR-Thesenpapier: Zukunft des europäischen Gläubigerschutzes*, http://www.standardsetter.de/v4/docs/sitzungen/dsr/127/127_07a_Kapitalerhaltung_Entwurf-Thesenpapier.pdf (2009) (last visited Apr. 27, 2012). For a critical response, see Andreas Haaker, *A Critical View of the GASB (German Accounting Standards Board) Draft "White Paper" on the Future of European Creditor Protection* (Deutscher Genossenschafts- und Raiffeisenverband e.V. Working Paper No. 2/2010, 2010); Andreas Haaker, *Ein kritischer Blick auf den Entwurf eines* DSR-*Thesenpapiers zur Zukunft des europäischen Gläubigerschutzes: Eine ökonomische Analyse hinsichtlich der Zielsetzung eines hinreichenden Gläubigerschutzes,* 39 ZEITSCHRIFT FÜR UNTERNEHMENS- UND GESELLSCHAFTSRECHT 1055 (2010).

[15] DIETER SCHNEIDER, BETRIEBSWIRTSCHAFTSLEHRE, BAND 2: RECHNUNGSWESEN 45 (2nd ed. 1997) (quotation has been translated into English).

adequate creditor protection in order to reach an adequate judgment. The results of the study certainly do not prove that IFRS is appropriate for dividend purposes and that the findings concerning the legal situations in specific EU states do not change anything with regard to permitting dividend payouts on the basis of IFRS.[16] Here, one can also see the problems which arise when arguments refer to empty political terms as though they were actual objectives: Neither the term *modern* (conforming to contemporary fashion, part of the present, or in accordance with contemporary thought), nor the term *feasible* (able to be done or dealt with), means that something is actually *appropriate* (fit for purpose or well suited). Only the latter attribute can be used to assess the need for reform or the relative merits of the alternative systems.[17]

C. Overview of the "Accounting Worlds" of Limited Liability Corporations in Germany

If one wishes to understand the interest in changing the capital maintenance system, it helps to have an insight into the accounting domains of German limited liability corporations. Here, one must distinguish between the accounting domains of capital market-orientated companies, and those of non-capital market-orientated companies.[18] The accounting domains of capital market-orientated companies are the following: (1) The HGB non-consolidated financial statement–dividend calculation; (2) tax balance sheet–tax calculation, which is essentially based on the HGB non-consolidated financial statement; (3) IFRS consolidated financial statement, which is primarily for shareholder information; and (4) a so-called *package* according to IFRS. The accounting domains of non-capital market-orientated companies are the following: (1) The HGB non-consolidated financial statement–dividend calculation; (2) tax balance sheet–tax calculation, which, according to the so-called *Maßgeblichkeitsprinzip* (authoritative principle), is essentially based on the HGB non-consolidated financial statement; (3) if necessary, the HGB consolidated financial statement (stakeholder information, option: IFRS instead of the HGB); and (4) *Handelsbilanz II* (commercial balance sheet) generally according to the HGB.

From the point of view of capital market-orientated companies (of which there are far fewer than non-capital market-orientated companies), producing an HGB non-consolidated financial statement is perceived as more burdensome. Admittedly, for their subsidiaries, which produce HGB financial statements and must also each produce an additional IFRS *Handelsbilanz II* (a *package*), the argument that the HGB statement is burdensome might

[16] *See* Joachim Hennrichs, *IFRS—Eignung für Ausschüttungszweck*, 60 BETRIEBSWIRTSCHAFTLICHE FORSCHUNG UND PRAXIS 415, 423 (2008).

[17] Regarding appropriateness as a measure of value, see Hannes Streim, *Die Vermittlung von entscheidungsnützlichen Informationen durch Bilanz und GuV: Ein nicht einlösbares Versprechen der internationalen Standardsetter*, 52 BETRIEBSWIRTSCHAFTLICHE FORSCHUNG UND PRAXIS 111 (2000).

[18] *See* BERNHARD PELLENS, ROLF UWE FÜLBIER, JOACHIM GASSEN & THORSTEN SELLHORN, INTERNATIONALE RECHNUNGSLEGUNG 51–53 (8th ed. 2011).

carry some weight.[19] However, for the parent companies, the parallel use of two accounting systems would seem to be an acceptable price to pay for the advantages of capital market orientation, and this inconvenience certainly does not outweigh the disadvantages of an IFRS obligation for small and medium-sized businesses.[20] Above all, however, expected dividend payouts are based on IFRS consolidated profit, which is why capital market-orientated companies see the HGB non-consolidated financial statement as an irritating constraint on their dividend policies.[21] Hence, producing it is perceived as an unnecessary hindrance, which has led to calls, at least from representatives of capital market-orientated companies, for dividend calculations to be interlinked with the IFRS consolidated financial statement. As Pellens, Gassen, and Richard note, "The corporate representatives seem to think that it is not a problem to base dividend payouts on a fair value assessment, that is, on profits which have not yet been realized."[22] Accordingly, (large) banks have invented sector-specific *principles of proper bank accounting* in commercial accounting practice, which are contrary both to creditor protection and to statutory formulations—not deductive in any way and, if need be, purely inductive. Accordingly, a value-at-risk-adjusted fair value assessment, including unrealized valuation gains, is practised, which thus increases potential dividends at the expense of creditors.[23] In this case, banks and their auditors are trifling with the law. Regrettably, the BilMoG (Balance Sheet Law Modernization Act) legalized this procedure for future fiscal years, according to § 340e HGB (German Commercial Code) and supported by an additional special item endowment.[24]

As will be discussed in more detail below, the application of the IFRS in non-consolidated financial statements is highly questionable as regards creditor protection, and is also undesirable for a large number of small and medium-sized businesses.[25] Moreover, its

[19] *See* Wolf-Dieter Hoffmann, *Die Dreifachbilanzierer vor und nach BilMoG*, 10 STEUERN UND BILANZEN 367 (2009).

[20] *See* Wolfgang Schön, *Gesellschafter-, Gläubiger-und Anlegerschutz im Europäischen Bilanzrecht,* 29 ZEITSCHRIFT FÜR UNTERNEHMENS-UND GESELLSCHAFTSRECHT 706, 733 (2000).

[21] On this subject, see Bernhard Pellens, Joachim Gassen & Marc Richard, *Ausschüttungspolitik börsennotierter Unternehmen in Deutschland*, 63 DIE BETRIEBSWIRTSCHAFT 309, 326 (2003).

[22] *Id.* at 329 (quotation has been translated into English).

[23] Ulf Jessen & Andreas Haaker, *Zur Fair Value-Bewertung im "modernisierten" Handelsbilanzrecht: Ein Plädoyer für einen hinreichenden Gläubigerschutz*, 47 DEUTSCHES STEUERRECHT 499, 505 (2009).

[24] It is doubtful that the additional special item endowment amounts to an obstruction to the distribution of unrealized profits. Ironically, it is intended to have an anticyclical effect, DEUTSCHER BUNDESTAG: BESCHLUSSEMPFEHLUNG UND BERICHT DES RECHTSAUSSCHUSSES (6. AUSSCHUSS) ZU DEM GESETZENTWURF DER BUNDESREGIERUNG (BILANZRECHTSMODERNISIERUNGSGESETZ—BILMOG) [BT] 16/9737 (Ger.), while the (pro-)cyclical effect which has to be counterbalanced is actually a result of the introduction of fair value assessments.

[25] *See* DEUTSCHER BUNDESTAG: GESETZENTWURF DER BUNDESREGIERUNG—ENTWURF EINES GESETZES ZUR MODERNISIERUNG DES BILANZRECHTS (BILANZRECHTSMODERNISIERUNGSGESEZT—BILMOG) [BT] 16/12407 (Ger.).

legitimacy according to European law has not yet been definitively clarified.[26] In addition, the following has been overlooked: The maxim of shareholder orientation is to be followed within the scope of external governance by the capital market by using IFRS, and internally with the management control system.[27] The IFRS financial statement must, therefore, be characterized as an instrument of shareholder value.[28] However, because such a one-sided focus seems acceptable only if sufficient creditor protection is guaranteed, the IFRS financial statement no longer has any right to exist if creditor protection is weakened by the abolition of the HGB financial statement, as the regulatory framework can no longer guarantee a minimum level of creditor protection. Hence, it also appears shortsighted to regard the HGB financial statement solely as a foil for the shareholder-orientated IFRS.[29] Put simply: Without the HGB, no IFRS! Paradoxically, the IFRS financial statement is to be allocated the role of an instrument of shareholder value in the HGB as a condition of its own existence.

D. Specifically Defining the Goal of Creditor Protection

I. Basic Problems Regarding Incentive and the Necessity of Creditor Protection

While creditors' entitlement is limited to the agreed servicing of debt via repayments with interest, shareholders in limited liability companies benefit from profits without limitation, while enjoying a limited risk of loss.[30] Therefore, there is a limited incentive to pursue a high-risk corporate policy in which the risk can, in effect, be transferred to the creditors.[31] Equity value increases—such as a purchase option—as the expected results become more volatile. The readiness of shareholders to take risks can be counteracted by increasing equity distribution, as this makes them bear a greater proportion of the risk as guarantors.[32] In this context, a minimum capital level can also play a significant role as a

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[26] Regarding the impairment-only approach, see Joachim Hennrichs, *Zur normativen Reichweite der IFRS,* 8 Neue Zeitschrift für Gesellschaftsrecht 785 (2005) and Jens Wüstemann & Sonja Kierzek, *True and Fair View Revisited: A Reply to Alexander and Nobes*, 3 ACCT. IN EUR. 91, 102 (2006).

[27] *See* Hans Dirrigl, *Wertorientierung und Konvergenz in der Unternehmensrechnung*, 50 BETRIEBSWIRTSCHAFTLICHE FORSCHUNG UND PRAXIS 540–79 (1998); ANDREAS HAAKER, POTENTIAL DER GOODWILL-BILANZIERUNG NACH IFRS FÜR EINE KONVERGENZ IM WERTORIENTIERTEN RECHNUNGSWESEN ch. 5 (2008).

[28] *See* Rudolf J. Niehus, *Farewell to Fair Value—Zurück zum Unternehmensinteresse*, 62 DER BETRIEB No. 18, I (2009); *see also* Werner Bohl, *Verändert die Finanzkrise das IASB*, 62 DER BETRIEB NO. 22, I (2009).

[29] *But see* Niehus, *supra* note 28.

[30] *See* Ross L. Watts, *Conservatism* in *Accounting, Part I: Explanations and Implications,* 17 ACCT. HORIZONS 207, 212 (2003).

[31] *See* Frank H. Easterbrook & Daniel H. Fischel, *Limited Liability and the Corporation*, 52 U. CHI. L. REV. 89, 103 (1985); *see also* Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 334 (1976).

seriousness threshold. Admittedly, it is hard to standardize an optimum threshold level as the risks depend on the nature and quantity of the means being used, but such a level can take on a selective regulatory function concerning the foundation of limited liability companies with questionable business models.[33]

The unrestricted transfer of liability from the corporate sphere to the liability-free sphere of shareholders redistributes assets to the detriment of creditors, which runs contrary to creditor protection and can be associated with an avoidable waste of assets known as *efficiency losses*.[34] As it is possible that investment policy damaging to creditors will be pursued, or that the borrowing level will be increased, it is at least worth limiting the scope of externally financed and liquidation-financed dividend payouts. Moreover, corresponding asset transfers prior to insolvency must be prevented if the latter is caused primarily by corporate policy. Of course, a dividend payout cannot be allowed if it is certain to lead to insolvency. On the other hand, shareholders cannot be denied their dividend rights solely because of an increased risk of insolvency, since every dividend payout necessarily increases this risk.[35]

As certainty only exists in the model, however, and because there is always a certain risk of insolvency even if dividends are not paid out, it is necessary to determine an acceptable probability threshold.[36] Hence, one must agree with Jungmann that credit protection should at least be required to prevent companies from becoming insolvent as a direct and more or less certain consequence of a dividend payout; however, it does not follow that creditor protection cannot be required to do any more than this.[37] Dividend payouts ultimately also increase the probability of insolvency caused primarily by other main factors and, in the event of insolvency, they reduce the conditional probability that creditors' entitlements will be fulfilled—in other words, the insolvency quota. In effect, insolvency probability is always linked to dividend payout decisions. Imagine an enormous

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[32] *See* WERNER NEUS, EINFÜHRUNG IN DIE BETRIEBSWIRTSCHAFTSLEHRE 319 (5th ed. 2007).

[33] *See, e.g.*, Bernhard Pellens, Dirk Jödicke & André Schmidt, *Mindestkapital und bilanzielle Kapitalerhaltung versus Solvenztest: Alternativen zur Reform des deutschen Gläubigerschutzsystems*, *in* BILANZ ALS INFORMATIONS— UND KONTROLLINSTRUMENT 11 (Karlheinz Küting, Norbert Pfitzer & Claus-Peter Weber eds., 2008).

[34] *See* SCHNEIDER, *supra* note 15, at 110; Lucian A. Bebchuk, *Federalism and the Corporation: The Desirable Limits on State Competition* in *Corporate Law*, 105 HARV. L. REV. 1437, 1489 (1992).

[35] *See* Bernhard Pellens, Nils Crasselt & Thorsten Sellhorn, *Solvenztest zur Ausschüttungsbemessung—Berücksichtigung unsicherer Zukunftserwartungen*, 59 ZEITSCHRIFT FÜR BETRIEBSWIRTSCHAFTLICHE FORSCHUNG 264, 270 (2007).

[36] *See id.*; *see also* James B. Heaton III, *Solvency Tests,* 62 BUS. LAW. 983, 990 (2007).

[37] Carsten Jungmann, *Solvenztest versus Kapitalschutzregeln—Zwei Systeme im Spannungsfeld von Gläubigerschutz und Finanzierungsfreiheit der Kapitalgesellschaft*, 35 ZEITSCHRIFT FÜR UNTERNEHMENS-UND GESELLSCHAFTSRECHT 638, 648 (2006). For a critical approach, see Pellens, Crasselt & Sellhorn, *supra* note 35.

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decision tree: Interdependent investment and financing decisions must be made in conjunction with the dividend payout decision and these all affect the probability of possible insolvency scenarios on every branch of the decision tree, as well as the associated conditional probability that entitlements will be fulfilled in the event of insolvency. Hence, the value of creditors' entitlements is affected in many ways by the value of dividend payouts. This clearly illustrates that creditor protection is a highly complex phenomenon, and that its implementation is beset by major measurement problems.[38] Thus, the highest tolerable probability of insolvency after a dividend payout should be calculated individually in a retrograde way using a complex evaluation equation and taking into account the effects of time and repayment, with the creditor entitlement or various entitlements whose value is, or whose values are, to be maintained. For multiple periods, this depends on future dividend payouts that must be harmonized with business policy. Hence, the future is "not just uncertain but, before a decision to do this and not to do that, no future in fact exists."[39] This shows that, irrespective of impressive theoretical partial model analyses that imply a certain procedure, depending on the creditor protection purpose,[40] only one standardized solution is worth considering. It seems plausible that this solution must ultimately amount to the principle of careful balancing.[41]

II. Protecting Creditors by Limiting Dividend Payouts

Creditor protection involves ensuring that creditors' entitlements to debt service claims are fulfilled.[42] The measure of creditor protection is the maintenance of the economic value of a creditor's entitlement. The possibility of (total) loss in the event of insolvency must only be an extreme scenario, which should be reflected in the cash value of the creditor's entitlement, weighted with a specific probability.[43] This is to prevent the probability of insolvency from rising to an inappropriately high level, which would consequently result in the value of the creditor's entitlement falling to an inappropriately low level. Hence,

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[38] *See* Heaton III, *supra* note 36, at 989.

[39] Dieter Schneider, *Marktwertorientierte Unternehmensrechnung: Pegasus mit Klumpfuß*, 30 DER BETRIEB 1473, 1478 (1998) (quotation has been translated into English).

[40] *See* ALFRED WAGENHOFER & RALF EWERT, EXTERNE UNTERNEHMENSRECHNUNG ch. 5 (2nd ed. 2007).

[41] *See generally* Thomas Schildbach, *Dunkle Seiten der Vorsicht bei Licht besehen*, 60 BETRIEBSWIRTSCHAFTLICHE FORSCHUNG UND PRAXIS 449, 463 (2008).

[42] *See* Dieter Schneider, *Bilanztheorien, analytische*, *in* HANDWÖRTERBUCH DER RECHNUNGSLEGUNG UND PRÜFUNG 427, 430 (Wolfgang Ballwieser, Adolf G. Coenenberg & Klaus von Wysocki eds., 2002).

[43] Jessen & Haaker, *supra* note 23, at 503.

creditor protection is a matter of "safeguarding the net present value of an initial investment"[44], while taking into account the effects of time and repayments.

Every dividend payout intrinsically increases the risk of insolvency, as liquid assets are taken away from recoverable assets and the relationship between debt capital and recoverable assets deteriorates.[45] In this context, one faces the question of when it is appropriate for the risk of insolvency to be increased by making a dividend payout. Essentially, an acceptable risk increase can be factored into the interest rate when credit is granted.[46] This must, however, be estimated correctly, which is why it is necessary to set a limit for an acceptable increased risk of insolvency.[47] But a dividend payout suspension function must also be limited, as shareholders' interests must also be taken into account when deciding on an appropriate dividend payout and, also, because this increases the chances of improving equity as a recoverable funding source in the future.[48]

Careful limitations for balance sheet dividend payouts represent a standardized, transaction cost-saving substitute for contracts.[49] They seem imperative, as certain creditor groups cannot protect themselves in individual contracts because of prohibitively high costs, because they lack negotiating power, or because some are injured parties who have unwillingly been allocated the roles of creditors.[50] It is also apparent that the existence of an alternative path for developing the creditor protection system cannot be equated with a higher level of development,[51] as the "modern" Anglo-American model inevitably transfers creditor protection into the sphere of civil law. This creates a two-tiered system in which certain groups of creditors are exposed to exploitation,[52] which is

[44] Wolfgang Schön, *Internationalisierung der Rechnungslegung und Gläubigerschutz*, 54 DIE WIRTSCHAFTSPRÜFUNG SONDERHEFT 74, 75 (2001) (quotation has been translated into English).

[45] *See* Pellens, Crasselt & Sellhorn, *supra* note 35, at 267.

[46] *See* FRANK H. EASTERBROOK & DANIEL H. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 51 (1991); Bebchuk, *supra* note 34, at 1489.

[47] *See* Pellens, Crasselt & Sellhorn, *supra* note 35, at 267.

[48] *See* Schneider, *supra* note 42, at 431.

[49] *See, e.g.*, Yaxuan Qi & John Wald, *State Laws and Debt Covenants*, 51 J.L. & ECON. 179, 203 (2008).

[50] *See* Christian Kirchner, *Bilanzrecht und neue Institutionenökonomik: Interdisziplinäre Überlegungen*, *in* HANDELSBILANZEN UND STEUERBILANZEN: FESTSCHRIFT FÜR HEINRICH BEISSE 267, 279 (1997); Lucian A. Bebchuk & Jesse M. Fried, *The Uneasy Case for the Priority of Secured Claims* in *Bankruptcy*, 105 YALE L.J. 857, 891 (1996).

[51] *See* Christoph Kuhner, *Zur Zukunft der Kapitalerhaltung durch bilanzielle Ausschüttungssperren im Gesellschaftsrecht der Staaten Europas*, 34 ZEITSCHRIFT FÜR UNTERNEHMENS-UND GESELLSCHAFTSRECHT 753, 782 (2005); *see also* Mark J. Roe, *Chaos and Evolution* in *Law and Economics*, 109 HARV. L. REV. 641, 643 (1996).

[52] Holger Kahle, *Bilanzieller Gläubigerschutz und internationale Rechnungslegungsstandards*, 7 ZEITSCHRIFT FÜR BETRIEBSWIRTSCHAFT 695, 705 (2002).

not compatible with continental European economic philosophy and must be considered in light of path dependence.[53]

E. (Potential) Capital Maintenance Instruments

I. A "Modernized" HGB (German Commercial Code) Financial Statement

Although its informative function may gradually become more important because of the Balance Sheet Law Modernization Act (BilMoG), the dominant purpose of the annual financial statement required by the German Commercial Code for limited liability corporations is still the calculation of dividend payouts.[54] This dominant purpose is seemingly required, as the non-consolidated financial statement has a less significant informative role than the consolidated financial statement and also because, for the bulk of non-capital market-orientated companies, the consolidated financial statement must follow the basic principles of the non-consolidated financial statement for reasons of simplicity.[55] This necessitates prudent estimation and evaluation: For an item to be capitalized, it must obviously be realizable, and no gain can be payable as a dividend before the act of realization, while unrealized losses must be anticipated.[56] In places where these regulations are partially breached in the interests of information provision via the BilMoG, or where there is a suspicion of potential uncertainty, dividend payout suspensions take effect in accordance with § 268 Section 8 of the HGB in order to preserve "dividend payout neutrality."[57]

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[53] *See, e.g.*, Merkt, *supra* note 6, at 1057 (2004); Friedrich Kübler, *The Rules on Capital Under the Pressure of the Securities Markets*, *in* CAPITAL MARKETS AND COMPANY LAW 95 (Klaus J. Hopt & Eddy Wymeersch, eds., 2003). According to Professor Hopt, "Institutions, ownership structures, company and capital market system, language, and cultural background will not become the same." Klaus J. Hopt, *Comparative Company Law*, *in* THE OXFORD HANDBOOK OF COMPARATIVE LAW 1161, 1189 (2006).

[54] *See* Marcus Bieker, *HGB Reloaded: Die Bewertungskonzeption des BilMoG—fine tuning oder Paradigmenwechsel?*, 4 PRAXIS DER INTERNATIONALEN RECHNUNGSLEGUNG 365, 367 (2008).

[55] For a view on the consultation to reform the European Accounting Directives, which advocates that the 4th and 7th EC Accounting Directives should be endorsed, see DEUTSCHER GENOSSENSCHAFTS-UND RAIFFEISENVERBAND E.V., KONSULTATION ZUR ÜBERARBEITUNG DER RECHNUNGSLEGUNGSRICHTLINIEN 11 (2009), *available at* http://www.dgrv.de/webde.nsf/7d5e59ec98e72442c1256e5200432395/6eb776b345f721a3c12575ac00256a86/$FILE/DGRV_Stellungnahme_4_7_RL.pdf (last visited Apr. 30, 2012). If, on the other hand, one had wished to extend the use of IFRS in the corporation one would have had to advocate a greater separation of the two directives in order to enable the disconnection of credit maintenance. Hence, there is more to this apparently minor issue of detail than initially meets the eye.

[56] *See* Adolf Moxter, *Standort Deutschland: Zur Überlegenheit des deutschen Rechnungslegungsrechts*, *in* STANDORT DEUTSCHLAND: FESTSCHRIFT FÜR ANTON HEIGL 31, 32 (Volker Peemöller & Peter Uecker eds., 1995).

[57] Andreas Haaker, *Keine (weitere) Abkehr vom Gläubigerschutz im BilMoG—keine nur einjährige Ausschüttungssperre*, 46 DEUTSCHES STEUERRECHT 1750, 1754 (2008) (quotation has been translated into English).

Here, one has gone down the path "from the principle of caution to dividend payout suspensions."[58] These suspensions always come to nothing, however, for unlimited liability companies.[59] Along with this, creditor protection is primarily provided by compelling the prudent tradesman to disclose its own information.[60] The problem of hidden reserves—concealing losses by liquidating hidden reserves, a questionable practice from an informational point of view—would be mitigated by the elimination of numerous voting rights.

II. IFRS Financial Statement

As a global standard setter, the IASB necessarily provides an abstraction from the peculiarities of individual nation states, which is why IFRS can hardly be made legally binding.[61] It is explicitly stated that tax and dividend calculations are not the intended use.[62] The IFRS financial statement's sole function is to provide information to (potential) shareholders in order to help them make investment decisions concerning the purchase, retention, and sale of shares in reporting companies.[63] Because non-capital market-orientated companies do not generally represent objects for purchase or sale, the purpose of IFRS is completely irrelevant to their needs. Hence, IFRS are designed solely for accounting in capital market-orientated companies. Internationally comparable information is only significant for them—and even then, only for the consolidated financial report intended as an instrument of information.[64] Representatives of small and medium-sized businesses consider globally comparable information to be "massively overrated."[65]

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[58] Peter Hommelhoff, *Modernisiertes HGB-Bilanzrecht im Wettbewerb der Regelungssysteme*, 37 ZEITSCHRIFT FÜR UNTERNEHMENS-UND GESELLSCHAFTSRECHT 250, 258 (2008) (quotation has been translated into English).

[59] *See* Schneider, *supra* note 42, at 430.

[60] *See* Wolfgang Stützel, *Bemerkungen zur Bilanztheorie*, 37 ZEITSCHRIFT FÜR BETRIEBSWIRTSCHAFT 314, 323 (1967). This "nudge" for unlimited liability companies is a form of "libertarian paternalism." *See* RICHARD H. THALER & CASS R. SUNSTEIN, NUDGE: IMPROVING DECISIONS ABOUT HEALTH, WEALTH, AND HAPPINESS 5 (2008).

[61] *See* Joachim Gassen, *Finanzkrise: Die Rolle der Rechnungslegung*, 78 VIERTELJAHRESHEFTE ZUR WIRTSCHAFTSFORSCHUNG 83, 85 (2009).

[62] *See* International Accounting Standards Board, *IFRS Framework No. 6*.

[63] *See* International Accounting Standards Board, *IFRS Framework No. 9* in association with *IFRS Framework No. 12*.

[64] *See* Schön, *supra* note 20, at 730.

[65] Arnold Kawlath, *IFRS versus HGB—Polemik eines Betroffenen*, *in* RECHNUNGSLEGUNG UND WIRTSCHAFTSPRÜFUNG, FESTSCHRIFT FÜR JÖRG BAETGE 312 (Hans-Jürgen Kirsch & Stefan Thiele eds., 2007) (quotation has been translated into English).

With regard to the information provided in the balance sheet, IFRS permit an income-related fair value assessment that includes unrealized valuation gains. Apart from the fact that the purpose of providing information cannot be fulfilled without capitalizing the internally generated goodwill,[66] this is contrary to the concept in the German Commercial Code of providing a balance for calculating dividends.

If the conflict between these different purposes cannot be resolved, capital market-orientated companies must also remain under an obligation to create HGB financial statements precisely so that their narrow pursuit of a single goal can be counterbalanced. The obligation to employ two accounting systems in parallel does not appear to be an unreasonable price to pay for the advantages of capital market orientation, especially compared to the economic costs that would be borne by small and medium-sized businesses if they had an IFRS reporting obligation.[67] The creation of HGB financial statements also appears to be essential for creditor protection, as creditors would otherwise have to rely on costly civil lawsuits. Moreover, the discontinuation of the standard balance sheet and the imposition of a compulsory additional solvency test (as and when required) prevent the possible savings permitted by previous IFRS accounting. It is also unclear whether it is possible to synergize auxiliary IFRS accounting, such as IAS 36, and the solvency test.[68]

If cost considerations alone are not the main reason why there are calls for IFRS to be misused for dividend payout calculations, one must suspect that the main motivation for the calls for IFRS to be approved for non-consolidated financial statements is the importance of IFRS for dividend policies.[69] This is because, if necessary, it could enable the fulfillment of IFRS-related dividend expectations at the expense of creditor protection.[70]

III. Forecast-Orientated (Ability-to-Pay) Solvency Test

A solvency test is intended to measure directly the effects on solvency of a dividend payout by means of a financial schedule rather than an objective dividend payout indicator.[71] In the literature, however, it is unclear how actual behavior—for example, paying out nothing

[66] *See* Adolf Moxter, *Rechnungslegungsmythen*, 42 BETRIEBS-BERATER 2143 (2000). According to International Accounting Standard (IAS) 38.48, internally generated goodwill shall not be recognized as an asset.

[67] *See* Schön, *supra* note 20, at 733.

[68] *See* Bernhard Pellens, Thomas Kemper & Andre Schmidt, *Geplante Reformen im Recht der GmbH: Konsequenzen für den Gläubigerschutz*, 37 ZEITSCHRIFT FÜR UNTERNEHMENS- UND GESELLSCHAFTSRECHT 381, 426-430 (2008).

[69] *See* Pellens, Gassen & Richard, *supra note 21, at* 326.

[70] For a critical view, see Jessen & Haaker, *supra* note 23, at 504.

[71] Wüstemann, Bischof & Kierzek, *supra* note 9.

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or paying out one million euros less than scheduled—is intended to be linked to the calculation.[72] Ultimately, the dividend payout decision must take into account a maximum acceptable probability of insolvency. It is claimed that, conceptually, the forecast-orientated solvency test is very well suited to assessing solvency because it refers to the future and it uses payment sizes. Apart from the fact that the financial statement also contains forecasts (estimated duration of use, provision evaluation) and that, ultimately, the solvency test's forecasts amount to a "look in the rear-view mirror to assess the road layout up ahead," accrual accounting enables better "fine-tuning" in the light of risk-relevant events and transactions.[73] The necessary standardizations and objectifications, such as limiting the forecast horizon or excluding additional investments that have not been instigated, could, however, make the solvency test degenerate into a mere indicator of dividend payout potential in spite of its focus on forecasting. Moreover, the solvency test remains a vague concept, the precise details of which remain wholly unclear.[74] It appears to be of debatable value whether, at best, it can provide an addition to a balance sheet test. In any event, the solvency test is far from being the ideal way toward appropriate creditor protection referred to in the literature,[75] particularly as a testing obligation could only improve plausibility and, at best, prevent "gross distortions."[76] The dangers associated with this tend to become more acute if responsible company representatives are subject to the (self-) assessment "that specifying debts due on the schedule's horizon and the accruing liquid resources would not cause any significant difficulties, and also that the result forecasted would be adequately secure."[77] It is hard to

[72] *See, e.g.*, Heaton III, *supra* note 36, at 989. You can find pointers, which are very well-founded compared to the majority of contributions but still somewhat basic in Pellens, Crasselt & Sellhorn, *supra* note 35, at 270. These remarks do, however, illustrate the high, indeed, barely manageable, level of complexity that would be required of a well-founded solvency test.

[73] *See generally* Christian Leuz, *The Role of Accrual Accounting in Restricting Dividends to Shareholders*, 7 EUR. ACCT. REV. 579, 585 (1998); *see also* Dieter Ordelheide, *Kaufmännischer Periodengewinn als ökonomischer Gewinn*, *in* UNTERNEHMENSERFOLG: PLANUNG, ERMITTLUNG, KONTROLLE 275, 275–302 (Michael Domsch et al. eds., 1988).

[74] Concerning its inadequate level of development, see Wüstemann, Bischof & Kierzek, *supra* note 9, at 13. Concerning the numerous problems and "adjusting screws," see Rammert, *supra* note 7. *See also* the admission in the Ministry of Justice's draft on the Accounting Law Modernisation Act, BUNDESMINISTERIUM DER JUSTIZ, REFERENTENENTWURF EINES GESETZES ZUR MODERNISIERUNG DES BILANZRECHTS (BILANZRECHTSMODERNISIERUNGSGESETZ—BILMOG) 219 (2007), *available at* http://www.der-betrieb.de/content/pdfft,227,344380 (last visited Apr. 30, 2012), which seems to have gone missing as a result of the political process in the Draft Law on the Accounting Law Modernisation Act. *See* DEUTSCHER BUNDESTAG: GESETZENTWURF DER BUNDESREGIERUNG—ENTWURF EINES GESETZES ZUR MODERNISIERUNG DES BILANZRECHTS (BILANZRECHTSMODERNISIERUNGSGESEZT—BILMOG) [BT] 16/12407 (Ger.).

[75] Jungmann, *supra* note 37.

[76] Concerning these limitations, see Institut der Wirtschaftsprüfer, *supra* note 13.

[77] DELOITTE, GLÄUBIGERSCHUTZ DURCH BILANZIELLE KAPITALERHALTUNG 14 (2008), *available at* http://www.deloitte.com/assets/Dcom-Germany/Local%20Assets/Documents/05_Wirtschaftspruefung/2010/DE_WP_Studie_Glaeubigerschutz_210108.pdf (last visited Apr. 30, 2012) (quotation has been translated into English).

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understand how a form of deobjectivization, which has, up to now, not been acceptable even for purely informative purposes should be acceptable for dividend payout purposes.

F. Possible Reforms of the Capital Maintenance System

I. "Hindrances to Modernization"

Assessing the appropriateness of increasing the risk of insolvency by making a dividend payout, and the measurement of this risk, are not trivial matters, nor can they be value-free. Yet the framework conditions are stated in policy: Capital maintenance must be reformed "without reducing the protection offered to shareholders and creditors."[78] Hence, any reform must meet the Pareto criterion for the two interest groups: The existing protection can be changed only if neither creditors nor shareholders are any worse off, and at least one of them is better off as a result.[79]

The reform is intended to make dividend payouts more upwardly flexible, which is meant to optimize dividend payout policies to the benefit of shareholders.[80] In the light of this assumption, and ignoring the bureaucratic costs of (potential) capital maintenance instruments, safeguarding the existing level of creditor protection proves to be a "hindrance to modernization," while the benefits to shareholders can be assumed. Subject to this condition, however, dividend payout potential cannot be systematically increased.

The path-dependent way in which the law has developed represents another "hindrance to modernization." The capital protection system has developed within a specific legal, economic and cultural context.[81] The Anglo-Saxon system, which represents a template for modernization, has followed a different developmental path that can in no way be equated to reach a higher level of development.[82] The difference between these paths supports the

[78] Directive 2006/68, of the European Parliament and of the Council of 6 September 2006 on amending Council Directive 77/91/EEC as regards the Formation of Public Limited Liability Companies and the Maintenance and Alteration of their Capital, recital 2, 2006 O.J. (L 264) 32. On this subject, see also the Draft Law for the Accounting Law Modernisation Act. DEUTSCHER BUNDESTAG: GESETZENTWURF DER BUNDESREGIERUNG—ENTWURF EINES GESETZES ZUR MODERNISIERUNG DES BILANZRECHTS (BILANZRECHTSMODERNISIERUNGSGESEZT—BILMOG) [BT] 16/12407 at 75, 108 (Ger.).

[79] *See generally* HORST EIDENMÜLLER, EFFIZIENZ ALS RECHTSPRINZIP 48 (3rd ed. 2005).

[80] *See generally* Lanfermann & Richard, *supra* note 8.

[81] *See, e.g.*, Kübler, *supra* note 53.

[82] *See* Kuhner, *supra* note 51, at 782 (2005); Roe, *supra* note 51, at 643; Lucian A. Bebchuk & Mark J. Roe, *A Theory on Path Dependence in Corporate Ownership and Governance*, 52 STAN. L. REV. 127 (1999); Reinhard H. Schmidt & Gerald Spindler, *Path Dependence, Corporate Governance and Complementary,* 5 INT'L FIN. 311 (2002).

view that if there are any doubts about the advantages of a modernization measure that is foreign to the current system, one should retain the existing capital maintenance system as it fits within the existing legal framework.[83] With their overview of corporate law as a whole, legal experts are correspondingly critical of any reform of capital maintenance, whereas there seem to be more supporters among increasingly specialized economists familiar with the instruments of partial analysis.

In any event, it must be noted that any (potential) new system must prove that it fulfills the Pareto criterion.

II. IFRS Financial Statement

The IFRS financial statement seems to be an unsuitable basis for dividend payout calculations, as it is intended solely to assist shareholders with their investment decisions. Such purpose is diametrically opposed to that of protecting creditors by limiting dividend payouts. Nor is this negative finding improved by the fact that IFRS are not fit for purpose[84] or by the casuistic presence of careful regulation[85] in the IFRS system. In fact, primarily in the context of the income-related fair value assessment, unrealized gains are included, and, if paid out as dividends, endanger creditor protection (on this subject, see *Section D* in particular). Hence, the statutory provision for dividend payout suspensions cannot offer any compromise, as the speed with which IFRS change would force legislators to continually update the law.[86] The BilMoG (Balance Sheet Law Modernization Act) solution of maintaining dividend payout neutrality while taking deferred taxation effects into account[87] seems, in any event, to be unworkable for IFRS and, quite apart from constitutional law considerations, it could cause a range of legal compliance problems. A decision would also have to be made as to whether the absence of any systematic amortization of the goodwill obtained to determine dividend payout potential could be imitated in a secondary calculation. Overall, IFRS also provides too many additional degrees of freedom in creating balance sheets, and "freedom in calculating profits also

[83] *See* High Level Group of German Experts on Corporate Law, *Zur Entwicklung des Europäischen Gesellschaftsrechts*, 24 ZEITSCHRIFT FÜR WIRTSCHAFTSRECHT 863, 872 (2003). Because an annual financial statement has numerous legal implications, the possibility of creating only a solvency test was disregarded.

[84] For a detailed discussion of this point, see HAAKER, *supra* note 27, at 161–326.

[85] *See, e.g.*, Rolf Uwe Fülbier, Joachim Gassen & Thorsten Sellhorn, *Vorsichtige Rechnungslegung: Theoretische Erklärung und empirische Evidenz*, 12 ZEITSCHRIFT FÜR BETRIEBSWIRTSCHAFT 1317–42 (2008).

[86] For critical views, see Wüstemann, Bischof & Kierzek, *supra* note 9, at 13, 16. But see also the model of Joachim Hennrichs, *supra* note 19, at 425 .

[87] *See generally* Haaker, *supra* note 57, at 1753.

means freedom in paying out dividends."[88] Hence, it is at least questionable whether the IFRS weaknesses can be counterbalanced by an additional solvency test.[89]

III. Combination of IFRS Financial Statement and Solvency Test (Double Safeguarding?)

German advocates of approving the IFRS for dividend payout purposes at least admit that there is a fair value assessment problem with the IFRS financial statement as discussed above. However, instead of giving this greater recognition, they try to deduce from it that "only" additional safeguarding measures are required.[90]

Even if expert advocates cannot be accused of needless folly, their actions can at least be boldly compared to the well-known pranks of Max and Moritz (Wilhelm Busch): "*Dieses war der erste Streich, Doch der zweite folgt sogleich.*" ("This was the bad boys' first trick, but the second follows quick").

After the "first trick" of permitting IFRS to be used for dividend payout purposes, which will probably be mandatory in the long term, as there are calls for a forecast-orientated solvency test which would have to "support" the IFRS financial statement "as part of an effective creditor protection system"[91]—this is the "second trick." Here, one cannot help feeling as though a less-than-entirely-selfless doctor wants to drop a reasonably priced and pleasant medicine, and prescribe an expensive alternative that has unpleasant side effects. And the side effects, which he knows about, and which are not kept secret,[92] are to be mitigated by a costly remedy, which has not yet been clinically proven. Quite apart from the fact that, in any event, this cannot be seen by the "patient" as the well-attested ideal pathway, it would have to be verified whether this detour could achieve the goal of creditor protection as effectively as the direct HGB route. One would have to assume the opposite if the "side effects" of including unrealized gains cannot be counteracted in this way.

It would seem, however, that it is impossible for the distribution of unrealized gains to be counterbalanced, and thus for this "protection loophole" in the IFRS financial statement to be systematically closed, using a payment-based solvency test. This is because, by its very

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[88] Moxter, *supra* note 5, at 263 (quotation has been translated into English).

[89] *See* Klaus-Peter Naumann, *Neukonzeption der Kapitalerhaltung und IFRS-Anwendung im Jahresabschluss?*, *in* RECHNUNGSLEGUNG UND WIRTSCHAFTSPRÜFUNG: FESTSCHRIFT FÜR JÖRG BAETGE, 419, 438 (Hans-Jürgen Kirsch & Stefan Thiele eds., 2007).

[90] *See* KPMG, *supra* note 12; Institut der Wirtschaftsprüfer, *supra* note 13; and GASB, *supra* note 14.

[91] Institut der Wirtschaftsprüfer, *supra* note 13 (quotation has been translated into English).

[92] There is "a ready response, subject to a charge" to this. *See* Kawlath, *supra* note 65, at 315 (quotation has been translated into English).

nature, the IFRS financial statement is simply not geared towards this.[93] Hence, a combination of IFRS and a solvency test is not a system of "*double safeguarding*"[94], but of *double non-safeguarding*. Moreover, because of the limited period covered by the forecast, a whole range of long-term obligations is not taken into account.[95] Hence, because dividend payout potential is systematically increased compared to that of the HGB by including elements that may not actually be realizable, the level of creditor protection is reduced, which is undesirable for the distribution policy. Furthermore, even in crisis situations, in which it could potentially have a protective effect, the solvency test can provide no additional protection, as proper company management already involves a solvency forecast—an ability-to-pay solvency test on a where-circumstances-dictate approach.

IV. Effects on the Existing Balance of Interests Between Creditors and Shareholders (Examination of the Pareto Criterion)

Up until now, the balance of interests between creditors and shareholders has been put in terms of the typified hypothesis[96] according to which a dividend payout does not increase the risk of insolvency for creditors to an unreasonable degree (this is the consequence of the hypothesis). This assumes that, on the balance sheet date, at least the nominal minimum capital and all debts are covered by the assets, which, in turn, have been valued conservatively (this is the condition of the hypothesis).[97] Using this typified balance of interests as a starting point, according to which—in light of the historic lessons learnt from the founder crisis ("*Gründerkrise*") at the end of the 19th century[98]—a "significantly increased risk" for creditors resulting from limited liability is to be compensated for "by a strict limitation of dividend payouts"[99], neither the level of creditor protection nor that of shareholder protection can be reduced according to the political conditions of the Pareto criterion. In the context of the standard balance of interests, shareholders are also adequately protected against dividend reductions by a highly developed protective legal

[93] *See* Hennrichs, *supra* note 16; Andreas Haaker, *Einfache Solvenztests statt aufwendige Ausschüttungssperren zur Gewährleistung eines hinreichenden Gläubigerschutzniveaus?*, 13 DEUTSCHES STEUERRECHT 663, 667 (2010).

[94] Pellens, Kemper & Schmidt, *supra* note 68, at 423.

[95] *See* Rammert, *supra* note 7, at 440.

[96] Pellens, Jödicke & Schmidt, *supra* note 23, at 12.

[97] *See* Schneider, *supra* note 42, at 431.

[98] *See* Patrick Velte & Andreas Haaker, *Entwicklung der Zeitwertbilanzierung im Handels- und Steuerrecht – Anmerkungen zur Bewertung von Finanzinstrumenten des Handelsbestands zum beizulegenden Zeitwert bei Kredit-und Finanzdienstleistungsinstituten*, 88 STEUER UND WIRTSCHAFT 56, 59 (2012).

[99] ADOLF MOXTER, BILANZLEHRE 51 (1974) (quotations have been translated into English).

system.[100] The systematic increase of dividend payout potential has the implied consequence of weakened creditor protection, and vice versa. For shareholders, on the other hand, increasing dividend payout potential is advantageous, and reducing it is disadvantageous. This shows that there is very limited scope for reform, because, if in doubt, one must assume that the Pareto criterion is not being fulfilled.[101]

The following simplified numerical example, taken from Jessen and Haaker, may help to illustrate the balance of interests. It does not have the level of complexity necessary for a model, as this would not serve any illustrative purpose:

> A limited liability company has year-end cash assets of 120 monetary units (MU), whilst facing liabilities amounting to the same value. Because the price of a security on the active market has risen from 90 MU to 100 MU and a further increase is expected, the company purchases the security on 29.12.x. As expected, the price of the security rises to 120 MU, which is shown in the annual financial statement on 31.12.x at its fair value of 120 MU, including an unrealized gain of 20 MU. Because the price follows its upward trend further, reaching 130 MU, a dividend payout of 15 MU (after a risk deduction) is made.
>
> Hence, cash assets of 5 MU and the potential liquidity of selling the security are left to cover the liabilities. But before the liabilities are due, the price of the security falls to 110 MU, the price at which it can (still) be sold before a further drop to 105 MU. The 'new' cash assets now amount to 115 MU (=5+110), and the company still faces liabilities of 120 MU. Ignoring transaction costs, the creditor makes an economic loss of 5 MU, whilst the shareholder was able to make a gain of 15 MU, thanks to the dividend payout, at the creditor's expense. Hence, creditors can be disadvantaged by fair value balancing, as (realization) risks are transferred to them. Hence, the insolvency

[100] *See* ADOLF MOXTER, GRUNDSÄTZE ORDNUNGSMÄßIGER RECHNUNGSLEGUNG 3 (2003).

[101] For a graphical analysis, see Andreas Haaker, *A Critical View of the GASB (German Accounting Standards Board) Draft "White Paper" on the Future of European Creditor Protection*, *supra* note 14; Andreas Haaker, *Ein kritischer Blick auf den Entwurf eines DSR-Thesenpapiers zur Zukunft des europäischen Gläubigerschutzes—Eine ökonomische Analyse hinsichtlich der Zielsetzung eines hinreichenden Gläubigerschutzes*, *supra* note 14, at 1087.

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> risk increases for creditors, leading to a reduction in the economic value of their entitlements and thus going against their interests. In contrast, by taking the realization principle into account it is worth waiting for the situation to be clarified. If the security is sold, the shareholders make a gain of 10 MU which has definitely been realized, whilst creditor entitlements can be completely fulfilled.[102]

As this example illustrates, compared to a purchase cost evaluation which takes the realization principle into account, a fair value assessment shifts the proven balance of interests to the disadvantage of creditors, as the significant increase in the risk which they bear is not given as much weight.[103]

By contrast, the gain-reducing effects of reductions in value must be taken into account before realization. If it subsequently emerges, when there is a sale or a discontinuation of a reduction in value, that too much has been written off, this "error" is corrected by increasing gain.[104] Here, the payout of dividends to shareholders is postponed until the situation has been clarified. This seems to be acceptable, as a dividend payout cannot be claimed back—in other words, in the event of an excessively high valuation, the mistake cannot automatically correct itself over time. Hence, the only way of countering the risk of loss for creditors is to postpone shareholders' gain entitlements.[105] In plain language: "[C]onservative accounting is nothing more than a natural complement to the rule that legally paid dividends can never be forced back to the company's funds."[106]

For dividend payout purposes, IFRS would ignore this distinction in risk scenarios, as unrealized gains would be included in dividend payouts, a fact which cannot be corrected by a solvency test because of the very nature of IFRS. In this event, agreements under civil law would have to close the resulting protection loophole, and these would, in practice at

[102] *See* Jessen & Haaker, *supra* note 23, at 503.

[103] This increased risk always exists, though it may not lead to such a dramatic scenario if an active market is available as a necessary, but by no means sufficient, condition of realisability at any time. Until clarification, realization is nothing more than a sometimes believable promise.

[104] If appreciation over and above purchase costs is treated differently from appreciation up to purchase costs (appreciation ban versus appreciation obligation), this is because the latter is to protect shareholders within the context of the standard compromise.

[105] *See* WAGENHOFER & EWERT, *supra* note 40, at 185.

[106] Wolfgang Schön, *Balance Sheet Tests or Solvency Tests—or Both?*, 7 EUR. BUS. ORG. L. REV. 181, 187 (2006); *see also* Wolfgang Schön, *supra* note 20, at 713.

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any rate, exclude certain creditor groups.[107] Even leaving aside the wisdom of balancing interests according to the German Commercial Code, the weakening of creditor protection—caused by the IFRS alternative—is contrary to the politically stipulated Pareto criterion, and hence it must be regarded as unacceptable. Moreover, damage to creditors implies a waste of assets, which cannot unconditionally be (mathematically) compensated for by the increased benefits to shareholders of a flexible dividend payout policy. Or, to put it another way, even the Kaldor/Hicks criterion[108] cannot be fulfilled as a kind of "watered-down" Pareto criterion.

G. Conclusion

The "need to modernize" credit maintenance, let alone any creditor protection superiority of IFRS and a solvency test compared to the HGB financial statement, has certainly not been proven. Professor Moxter anticipated these developments more than fifteen years ago and assessed the accounting system prescribed by the German Commercial Code as being an advantage for Germany as a commercial location.[109] This seems compelling, as the system's advantageousness depends on the specific properties of the economic region that has characterized its development.[110] But he also said that one cannot assume "that no one will dare to attack it," as "it is confronted by the basic Anglo-Saxon concept, which has stubborn and probably not always entirely selfless advocates."[111] Since then, European regulations on capital maintenance and thus the non-consolidated financial statement in the German Commercial Code have been under scrutiny as the basis for dividend calculations. IFRS are meant to take over this task from them, and the intention is to compensate for IFRS weaknesses—the fact that unrealized gains can be paid out as dividends—by means of a complex solvency test. The present investigation illustrates why

[107] *See* Kahle, *supra* note 52. Information-orientated creditor protection is also of no use to these groups, nor is it compensation for the ineffectiveness of credit maintenance. *See* Gerrit Brösel & Anikke Wittko, *Gläubigerschutzorientierte Rechnungslegung—Auf internationalen Pfaden oder am seidenen Faden?*, *in* CONTROLLING UND MEDIEN: FESTSCHRIFT FÜR ROLF DINTNER 237, 237–52 (Gerrit Brösel & Frank Keuper eds., 2009). Or, to put it another way: A craftsman does not employ a tax accountant to draw up his balance sheet so that he can have more time to analyze customer balance sheets. But for corresponding objections and the view that "the true and fair view provides optimum creditor protection," see Wolf-Dieter Hoffmann, *Eignung der IFRS für Ausschüttungszwecke?—Pro*, 5 PRAXIS DER INTERNATIONALEN RECHNUNGSLEGUNG 172, 173 (2009).

[108] According to this criterion, it would suffice if the lost benefits to creditors could potentially be counter-balanced by the increased benefits to shareholders (but they do not have to be). *See* HORST EIDENMÜLLER, *supra* note 79, at 51.

[109] *See* Moxter, *supra* note 56, at 31–41. Regarding the selection criteria used by companies in choosing economic locations in which to establish themselves, see Jürgen Bloech, *Industrieller Standort*, *in* INDUSTRIEBETRIEBSLEHRE 63 (Marcell Schweitzer ed., 2nd ed. 1994).

[110] *See* Kuhner, *supra* note 51, at 782.

[111] Adolf Moxter, *supra* note 56 (quotation has been translated into English).

this cannot work. Moreover, it seems problematic that the large number of non-capital market-orientated companies should be burdened with the obligation to produce an IFRS financial statement and a solvency test in order to serve the dividend payout interests of capital market-orientated companies. Nevertheless, certain interest groups regard the creation of a financial statement according to the German Commercial Code for dividend payout purposes as being superfluous. "For us this is not the case. Compared to some other countries, it is advantageous for us."[112] An advantage of this kind promises to be relatively beneficial in terms of costs, and it could also ultimately benefit other freely trading states. This point was expressed by Professor Coase as follows:

> The welfare of a human society depends on the flow of goods and services, and this in turn depends on the productivity of the economic system. Adam Smith explained that the productivity of the economic system depends on specialization (he says the division of labor), but specialization is only possible if there is exchange—and the lower the costs of exchange (transaction costs if you will), the more specialization there will be and the greater the productivity of the system. But the costs of exchange depend on the institutions of a country: its legal system, its educational system, its culture, and so on. In effect it is the institutions that govern the performance of an economy.[113]

But this hypothesis is based on a different understanding of competitive advantages than is the case with regard to the predominant understanding in the capital maintenance reform debate.[114]

Besides, the "shareholder value revolution" is, in effect, "eating" its children. While it started as a sensible attempt to introduce a long-term approach to corporate management, it is now in danger of losing its reason to exist by focusing entirely on one interest. If dividends were determined by IFRS and a solvency test instead of the HGB financial statement, creditor protection would fall below the existing minimum protection level. The exclusion of justified, but not automatically guaranteed creditor interests from

[112] Marcus Lutter, *Kontinuität und Seriosität: Weites Blickfeld der Ausschüttungspolitik, enge Grenzen durch die HGB-Einzelbilanz*, 62 STATUS: RECHT 89 (2009) (quotation has been translated into English).

[113] Ronald Coase, *The New Institutional Economics*, 88 AM. ECON. REV. 72, 73 (1998).

[114] *See* Franz Hörmann, *Kapitalerhaltung und die Grenzen der Doppik*, *in* JAHRBUCH FÜR CONTROLLING UND RECHNUNGSWESEN 291, 292 (Gerhard Seicht ed., 2008).

shareholder value-orientated corporate policy would be unjustified, as would the shareholder value principle and the IFRS financial statement geared towards it. Put simply: Without the HGB, no IFRS.

Nevertheless, if IFRS are approved for calculating dividends, this "modernization" will make dividend payouts more flexible, but it will also lead to a politically undesirable lowering of the creditor protection level and thus an abrupt departure from the proven balance of interests. As well as the normative investigations necessary for reform considerations, (additional) empirical studies[115] could be used to support theoretical insights.[116] For instance, if dividend payouts just before insolvency were not observed, this would indicate the effectiveness of financial dividend payout suspensions,[117] and would not mean that they were expendable. Moreover, the similarity of agreements in civil law to the institutional substitute of financial capital maintenance should be regarded as an indicator of its usefulness. By contrast, conducting a survey of CFOs to find out what they want, or looking at legal systems that have developed in a completely different way, excludes the issue of creditor protection quite unacceptably. "One must urge the revolutionary reformers to be cautious in their attempts to replace conservative balance sheet dividend payout suspensions with alternatives that appear to be more appropriate."[118]

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[115] This relativisation contrasts with the mainstream of American accounting research (which, *pars pro toto*, is representative of international research), which utterly rejects normative research as unscientific and focuses on empirical studies. For a critical view, see Rolf Uwe Fülbier & Manuel Weller, *Normative Rechnungslegungsforschung im Abseits? Einige wissenschaftstheoretische Anmerkungen*, 39 J. GEN. PHIL. SCI. 351 (2009).

[116] *See, e.g.*, Kuhner, *supra* note 51, at 783.

[117] Or, according to Schildbach, free cashflow is over. *See* Schildbach, *supra* note 41, at 456.

[118] *Id.* (quotation has been translated into English).