Alternative systems for protection of company creditors

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1. On cost effectiveness of protecting creditors

The current system used for protection of company creditors used in most EU member states is widely criticised for many years. It is seen as ineffective, as it is based almost exclusively on guaranteeing some level of share capital, which does not actually provide any real protection to the creditors and is quite restrictive for the company.

The goal of modern systems of company creditor protections should by complete opposite – granting the creditors adequate protection without imposing any unnecessary restrictions on the company itself. In other words we wish to achieve a solid level of creditor protection for the lowest price possible. The logic behind this principle is simple – any money allocated to creditor protection can't be used for business purposes and therefore harm the company, the market and become competitive disadvantage compared to foreign companies which are not subject to such regulation.

The protective instruments are mostly supposed to shield the creditor from danger that the company assets may be distributed among the shareholders without regard to company or shareholder risks and from risks connected to company insolvency – inability to pay its debts – due to economical reasons. The possibility that your debtor will not be able to pay you back is part of the business risk of the creditor and any protection offered by state might only "cushion" the risk, but can't exclude it completely. Therefore the legislative protection should focus on maintaining a transparent environment and effective protection from frauds on creditors (this, however, is a matter for criminal law as much as for commercial law).

2. Share capital systems

If we project abovementioned principles to share capital systems, we can clearly see that capital systems are fundamentally wrong. The only way, how a capital system can offer any real protection is by creating an insolvency barrier of the capital funds or their part – to do this, at least part of the capital should be treated as a kind of reserve fund which is prohibited to be used for business purposes.

This however makes the company deposit a significant portion of its resources instead of using them. This money are therefore an additional business cost that occurs due to legal reasons, which is economically undesirable as it drains the company resources for formal reasons (and one of the greatest challenges the company law has been up to in the recent year is reducing the formal barriers of business).

No wonder that EU law and most national legislations rather use capital systems based on guaranteeing that a certain level of share capital had been reached during the establishment of the company and do not limit the company in its later use. This, on the other hand, provides almost no protection to the creditors, it is just a historical record shoving that the company received some kind of investment to start its enterprise and may or may not still possess some of this property. The only real meaning of share capital is in that case to quantify the rights of shareholders. The same effect can of course be reached without prescribing the shareholders to commit certain amount of property to the company – setting other rules quantification of shareholders and shares in Articles of Association is free.

Should I shortly summarize my opinion on share capital systems it would sound somewhat like this – Protection of creditors by share capital may never work, any true guarantee is so costly that it is economically impossible to achieve and without it the share capital is useless.

Most governments, however, do not have the will and courage needed to get rid of the share capital as a useless and broken tool it really is an build another system as this would mean total overhaul of their company law, because many company law provisions are linked to share capital or these countries may not abandon share capital because they are bound by EU legislation (which in the area of company law is lately becoming more of a shackle than platform for unified way to modern company law which it should be – to reach uniformity in uselessness is not a particularly desirable goal in my opinion). Among most criticized EU company legislative acts is actually probably the second EU directive on companies[1] setting the basic rules for share capital.

Therefore, most of EU countries are currently choosing a more conservative way (and a way that does not contradict the second EU directive on companies) and allow[2] or are going to allow[3] private limited companies to be established with only symbolic level of share capital – mostly 1 unit of national currency (1 EUR companies). While this certainly is a much needed improvement, it does not go far enough. Why to have share capital at all if it has only symbolic meaning and serves no real purpose? Also, this is applicable only for private limited companies, public limited companies (which are in this case often not only companies traded on registered markets but all companies issuing shares as securities) still have to respect minimal share capital limits.

Furthermore, this development negates one argument for having share capital that I have not mentioned yet – that having a minimum level of share capital works as a "seriousness test" and reduces the amount of completely unrealistic business projects by requiring the shareholders to contribute a certain amount of start-up resources. While some authors still use this argument.[4]

[1] Schutte-Veenstra, H., Boschma, H., Lennarts, M.L., Alternative systems for capital protection, Groningen 2005, publisher: Kluwer, ISBN 90-411-2543-4, pg. 4.

[2] For example Germany, Great Britain, Finland, etc.

[3] For example Czech legislation, that is going to adopt new Corporation Act allowing establishment of 1 CZK companies.

[4] Eidenmüller, H., Grunewald, B., Noack, U., Minimum Capital in the System of Legal Capital in Lutter M., Legal Capital in Europe, Company and Financial law rewiev, special volume 1, 2006, ISBN 13:978-3-89949-339, pg. 25–26.

3. Reserve funds

Connected to share capital are reserve funds, which are often derived from the amount of share capital of the company, but actually are not a part of capital. Usually only the required level of these funds is calculated as a percentage of company share capital, but money transferred to reserve fund come from company earnings rather than shareholder investments. Therefore the link to share capital is very weak and another indicator can easily be used to determine the amount of money required for the reserve fund. This would actually often provide better results, because share capital has no relation to the size of company enterprise and therefore does not really shows what reserve should the company keep. It would probably be better to tie the size of reserve funds to company turnover shown in accounting balance.

Reserve funds are double-sided instruments; they bring some undeniable advantages, but also cause several problems. While they can certainly bring some creditor protection by creating a money barrier between a company and insolvency, their main disadvantage is that as they are created from company earnings and work only in relatively healthy companies that just had a bad year after several years of profit. Unfortunately, this is often not the case we will be dealing with.

4. Informational instruments

Informed creditor is a prepared creditor – another level of creditor protection is constituted by informational instruments. These are built on different principles and bring another kind of protection to company creditors. While they do not actually grant the creditors any additional rights, they bring them information, which a perceptive creditor might use. This reflects a more modern approach to creditor protection which could be summarized as "we do not offer you help, we give you instruments to help yourself".

Let's mention the mandatory disclosure first. This is quite a traditional and widely used instrument as it is quite cheap and provides the creditors with vital information. It is generally perceived that basic economical information about companies should be made public, so that anyone who intends to enter commercial relations with the company might check these out before decides. The forms of such mandatory disclosure differ; most often we encounter a duty to file accounting documents and other files to Commercial Register, where they are made freely accessible. The main points of critics of disclosure are that the mandatory disclosed information does not include information most needed by creditors (ability to fulfil obligations, financial reserves, expected economical results in future, etc.),[5] but rather a lot of less useful data[6] and are

[5] Nellisen Grade, J. M., Wauters, M., Reforming Legal Capital: Harmonisation or Fragmentation of Creditor Protection?, in The European Company Law Action Plan Revisired, Leuven 2010, Leuven University Press, ISBN 978 90 5867 805 8, pg. 37.

[6] Merkt, H., Creditor Protection through Mandatory Disclosure, in Eidenmüller, H., Schön, W. (editors), The Law and Economics of Creditor Protection. A transatlantic Perspective, T. M. C. Asser Press, 2008, ISBN 10 906 70 426 33, pg. 95.

not up to date (accounting documents are being published annually with delay of more than half year)[7] . On the other hand, the companies often criticise that they have to disclose inside information at all and that such information may be used against them in competition.

Another of the often used instrument is debtor registers. These might be kept both by state authority or by some private organization. Mostly we encounter state registers dealing with insolvency proceedings. Such registers show information on which companies are subject to insolvency proceedings, what is the current state of the proceeding and often allow third persons to access relevant documents. Easily accessible information (via web) on insolvency is a great resource for creditors, but we should not overestimate its impact. Only the most severely dysfunctional companies would already be brought to insolvency proceedings and careful creditor would probably know about that anyway.

There are many more instruments based on providing information to the creditor or investor, most of them private. Among those with widest use are rating agencies and rating information systems which provide the creditor information on the financial stability of the debtor. These instruments carry much weight in case of larger investments or for professional investors, while for small creditors they are too expensive, as the costs in this case has to bear the creditor (who purchases a service) and not the company. Ratings are not really a guaranteed instrument of creditor protection as we know it, for they are a privately provided paid service. Also, the last years have shown that the dependability of ratings is quite questionable, especially in times of economic turmoil.

It is said that providing creditor with information is a nice thing, but there is one major problem with it – it won't pay the debt. This might be a little exaggerated but the main point is valid / creditor needs information on the company mainly before they conclude their contract. Afterwards it has only limited value, because the creditor might not be able to do anything even if he knows very well that his investment is in danger[8].

5. Other alternative instruments of protection

Among other methods of creditor protection belong systems of mandatory insurance, which shift the risk from creditor to the insurance company (for a price). While this provides the creditor with a very solid protection (maybe even too solid), it is not completely trouble-free. Such systems are incredibly costly and therefore not suitable for general use (despite they might work well in some specific areas of business). Another issue would be how to calculate the proper cost of insurance for different companies[9] – this should somehow reflect

[7] Schutte-Veenstra, H., Boschma, H., Lennarts, M. L., Alternative systems for capital protection, Groningen 2005, publisher: Kluwer, ISBN 90-411-2543-4, pg. 57.

[8] Schutte-Veenstra, H., Boschma, H., Lennarts, M.L., Alternative systems for capital protection, Groningen 2005, publisher: Kluwer, ISBN 90-411-2543-4, pg. 57.

[9] Nellisen Grade, J.M., Wauters, M., Reforming Legal Capital: Harmonisation or Fragmentation of Creditor Protection?, in The European Company Law Action Plan Revisited, Leuven 2010, Leuven University Press, ISBN 978 90 5867 805 8, pg. 38.

company size and credibility, otherwise it would be just plain unfair. It may also be seen as too harsh for the debtor company, because mandatory insurance actually takes away creditors risk and makes the company pay for it.

One of the greatest risks a creditor has to cope with is that the company will transfer its property to third persons at unreasonably low price to deprive the creditors of their rights. The need to deal with this is currently widely discussed. So far the preferred solution has been to introduce some kind of liability of counterparties of such transaction (in addition to liability of company executive officers).

It is also discussed, that there should be a special liability of company executives for company contracts concluded when a company is nearing insolvency. This reflects growing opinion of the need to restrict company trade while the company is becoming unable to fulfil its obligations to creditors to prevent attempts to transfer assets out the company in order to send it empty into insolvency proceedings. Insolvency protection is insufficient in these cases because it simply applies to late. This would also as a side effect prohibit risky „last-ditch“ transactions that aim to either save company by making huge profit or sent it into insolvency with a sizeable debt (thus causing damage to company creditors).

Such liability would be wise to use in cases where the transaction clearly harms existing creditors. This would not be that common, we should expect, that more of transactions will be somewhere in the “shadow zone”. To deal with such cases it would be better to introduce voidability of such contracts or at least granting priority rights to previous company creditors. This of course means that not all company creditors would enjoy the same rights, but it can be reasoned that creditors that entered business relations with company on the brink of insolvency must or should have known and therefore do not deserve such level of protection (they knew of the coming insolvency and took that into account when they were deciding about signing contract).

6. Conclusions

The view on the system of creditor protection is currently in a process of transition from the traditional static paradigm based on share capital to dynamic modern approach. This approach will be based upon active role of the creditor who will have to participate in protection of his right. The role of state will probably focus on granting rights to creditors in special cases where it is required (companies nearing insolvency or transfer of company property to harm creditor rights, etc.), setting limits for distribution of company property among shareholders and on providing creditors with necessary information. However, as European countries display tendency to adopt conservative solutions and are bound by EU legislation, we can’t expect a distinct overhaul of the system anytime soon, we shall probably have to get along with share capital for a while longer.