

**Changing Patterns of Creditor Protection in the EU:
A Focus on Mandatory Disclosure**

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Contents

Summery

Preface

I Introduction

- 1. Background**
- 2. Influence of creditor protection in EU**
- 3. Purpose**
- 4 Specific questions**
- 5. Delimitation**
- 6. Structure**

II. Corporate creditors

- 1. Types of corporate creditors**
 - a. Voluntary creditors
 - b. Involuntary creditors
- 2. Types of corporate creditors risks**
 - a. Voluntary corporate creditors
 - aa. Initially inappropriate contract
 - bb. Ex post- devaluation of a claim
 - cc. Opportunistic behavior
 - b. Involuntary corporate creditors
- 3. Methods of creditor protection**
 - a. Legal capital
 - b. Limitation on distribution
 - c. Creditor self- help

- d. Mandatory disclosure
- aa. The entry strategy
- bb. Prerequisite for creditor self- help

. Current legal framework of creditor-protective mandatory disclosure

1. European Company Law Directives

2. ECJ case law

- a. Centros
- b. Überseering
- c. Inspire Art

3. Corporate governance code

4. The High Level Group Approach

IV. Analysis of the main creditor protection methods of corporate law

1. Legal Capital

2. Limitation of distribution

3. Mandatory disclosure

- a. The virtues of mandatory disclosure
 - aa. Market efficiency
 - bb. Market Failure
- b. Limits of creditor- protective mandatory disclosure
 - aa. Creditors
 - bb. Debtors
 - aaa. Criteria of dividing companies
 - bbb. Closely held companies lacking of access to data information from small companies
 - ccc. Limitations of small company disclosure

. Challenges to principles for efficient mandatory disclosure

1. Materiality

- a. Clear disclosure
- b. Current information
- c. Soft information
- d. Solvency test

2. Standardization

- a. Standardization with small companies
- b. Coordinating disclosure of corporate governance structures and practices

3. Comprehensibility

4. Timeliness

- a. The Company's website
- b. The need for electronic filing system

5. Enforcement

a. Liability for misreporting

b. Sanctions

c. Enforcement institutions

. Conclusion

Reference

Preface

I Introduction

1. Background

Corporate creditors usually provide loans to debtors under the assumption that they will return an equivalent amount of money and interest. A creditor is a party that could be a person, company or organization has a claim to the properties or services of a second party.

Law and regulations are very important means to protect corporate creditors. There is a relationship between the strength of legal protection and the extent of creditors' risk when creditors lend money. More strict legal protection means creditor suffering less risk of lending money, which leads to low interest for borrowers. So the fund could be used to make more profit with paying less interests, and investors could get more dividends.

Limited liability is a person's financial liability limited to a fixed sum, usually the value of a person's investment in a company or partnership with limited liability. Limited liability could protect shareholder' benefit, because detriments of creditors are not liable to their private assets.

Creditors of individual debtors and creditors of corporate debtors face the same forms of debtor misbehavior. And both of these risks could be exacerbated by limited liability. Debtors may not be truthful about their assets to obtain a loan before borrowing and may violate the terms of their agreements after borrowing. They either

pursue risky projects that shift the risk of failure to their creditors or dilute the assets available to satisfy their creditors.¹ For example, shareholders could claim that the firm holds title to assets that shareholders control but that actually belong to other entities or to shareholders themselves in their personal capacity. Then shareholders could take the money out of the corporate account so that creditors would suffer the costs if there project failed.

Is there any means of protection could fit all creditors in the company law? Company law can often provide a useful supplement and foundation for contractual protections. Standard legal protections are essential when parties cannot negotiate protections for themselves. In addition, it can define the parties' background expectations. Standard legal protections can save costs in some cases by offering ready-made terms and in other cases by inducing explicit negotiation when default terms do not suffice. When transactions are too small to support negotiation, when creditors are too naive to protect themselves, and when collective action problems prevent creditors from obtaining terms that might benefit all creditors ex ante, such as mandatory public disclosure or debtor registration of large corporate debts.² However, it not uncommon for formal legal measures under- protect or over-protect these interests. Adding the benefits of legal protections for creditors is supposed to reduce costs in theory, but they can also increase transaction costs when they are overly rigid and intrusive in practice.

2. Influence of creditor protection in EU

"Modernizing Company Law and Enhancing Corporate Governance in the European Union - A Plan to Move Forward" was published in 2003. The European Commission considers that the European regulatory framework for company law and corporate governance needs to be modernized. As an important participant of European market,

¹ See Lucian A. Bebchuk and Jesse M. Fried, *The Uneasy Case for the priority of Secured Claims in Bankruptcy*.

² John Armour, *Share Capital and Creditor Protection: Efficient Rules for a Modern Company Law*.

Modern Law Review (2000)

the issues of creditors become a hot topic. Protection of creditors is seemed as an important method to help the establishment of the internal market.

Different legal jurisdictions also give different answers to the question why a legal system would like to protect corporate creditors at all against the risk arising from limited liability. German law and British law have different company forms and supply different reasons to creditor protection. In Germany, some scholars perceive creditor protection by means of company law as an ethical necessity³, and the German Federal High Court may concur in view of some judgments rendered in recent years⁴. One British law⁵'s report on legal capital discusses desirable limits to the distribution of corporate assets to shareholders. And British law doesn't favor legal capital as a driving force to protect creditors. In the academic field, John Armour⁶, as well as Gerard Hertig and Hideki Kanda⁷ advocate an economic cost-benefit analysis.⁸

Legal capital which is stipulated in the Second Company Law Directive has been criticized to be a method of creditor protection. "The high Level Group of Company Law Experts" as an approach seeks to develop a conceptual framework for an efficient creditor protection regime with in a purely national setting⁹. A high- level framework has to start by identifying the risks.¹⁰ The High Level Group Experts also

³ H. Wiedemann, *Gesellschaftsrecht* in "A Synthetic view of Different Concepts of Creditor Protection or A high-level Framework for Corporate Creditor Protection"

⁴ A Synthetic view of Different Concepts of Creditor Protection or A high-level Framework for Corporate Creditor Protection

⁵ the British interdisciplinary Group on Capital Maintenance

⁶ J. Armour, 'Share Capital and Creditor Protection: Efficient Rules for a Modern Company Law', 63 *The MLR Modern Law Review* (2000) p. 355 et seq.

⁷ Oxford University Press, *The Anatomy of Corporate Law- A comparative and Functional Approach*

⁸ See Peter O. Mulbert, Center for German and International law of Financial Services and Faculty of Law, University of Mainz and ECGI, *A Synthetic view of Different Concepts of Creditor Protection*.

⁹ See Peter O. Mulbert, *A Synthetic view of Different Concepts of Creditor Protection*, Center for German and International law of Financial Services and Faculty of Law, University of Mainz and ECGI

¹⁰ Ibid

gave their view of point on legal capital. They think it couldn't protect creditors adequately effective. At the same time, the Group highly suggested corporate disclosure as a regulatory tool.¹¹

In the three landmark cases, *Centros*, *Überseeing* and *Inspire Art*, EC Treaty restricts minimum capital rules for private companies, and Member States also have the pressure by the trend of cross- border activity to reduce or get rid of minimum capital. The ECJ prefers to creditor protection through disclosure over merit regulation. Without adequate corporate disclosure of financial information, companies may suffer risks.

Mandatory disclosure is the entry strategy. Mandatory rules in company law could guarantee creditors' security by requiring companies to disclose some financial information, when they want to lend money to borrowers. So it is like an entry strategy that helps creditors set financial relationships with companies. Mandatory rules could make up the drawbacks of voluntary creditors' risks.¹² Usually voluntary creditors make a contract, such as about a debt due, to evade risks, which could be called exit strategy, contrary to the entry strategy of mandatory disclosure. For example, all jurisdictions require companies to file their charters in public registers, which makes available information about restrictions on director liability, legal capital, and the like-especially in the EU, where Member States must establish user-friendly registers. In addition, all jurisdictions require companies to keep appropriate accounting records.¹³

Legal capital, asset distribution and mandatory disclosure are important or used to important methods to protect creditors. Mandatory disclosure in current years

¹¹ The High Level Group, Page 33-35

¹² Oxford University Press, *The Anatomy of Corporate Law- A comparative and Functional Approach*, p 79-83

¹³ Ibid

becomes a more and more popular way. Its benefits and backdrops will be discussed in Chapter 4.

3. Purpose

Under the requirement of modernizing company law and enhancing corporate governance in EU, creditor protection becomes an important topic. Considering freedom of establishment, the traditional methods of creditor protection, such as legal capital and net assets distribution are no longer favored by the ECJ. At the same time, mandatory disclosure becomes an important mechanism to protect creditors.

First I will review the different methods of creditor protection generally, at the EU level. And then I will discuss why mandatory disclosure could protect creditors more efficiently, compared to other methods.

Mandatory disclosure is a universally-known way to protect creditors and has long been a highly debated issue among corporate lawyers. Corporate disclosure, on one hand, benefits creditor protection; on the other hand, it would infringe some companies' benefits and security. Enhancing market efficiency and avoiding market failure are pros of mandatory disclosure, but disclosure rules also have their own limitations. Also owing to the limitations of mandatory disclosure, so the extent of mandatory disclosure for different types of companies needs to discuss. Full mandatory disclosure to listed companies have been recognized by a lot of writers and suggested in the High Level Group of Company Law Experts, so in this article I focus on mandatory disclosure to closely- held and non- incorporated companies. After analysis, my proposal would be full mandatory disclosure to listed companies, partial mandatory disclosure to closely- held companies and no mandatory disclosure to non- incorporated companies. This article also considers what kinds of mechanisms could be used as information channels for corporate mandatory disclosure, and seeks for channels to mandatory disclosure.

4 Specific questions

After the above analysis of the importance of creditor protection for modernizing company law and enhancing corporate governance in EU, then there are some specific questions are going to solve in the following chapters.

Question 1: What are the types of creditors and risks of different creditors?

Question 2: How do different legislations explain the methods for creditor protection?

Question 3: Among the three methods- legal capital, net assets distribution and mandatory disclosure- what the pros and cons of them to protect creditors? Why does mandatory disclosure become most popular way to protect creditors?

Question 4: How to make mandatory disclosure more efficient to protect creditors?

5. Delimitation

This article discuss creditor protection at the whole EU level, and then focus on mandatory disclosure that the current most important means to protect creditors. So it doesn't focus on a specific country but review at the whole EU level. And this article doesn't involve in insolvency and tort law.

6. Structure

The structure is built to solve the above mentioned specific question step by step. The first chapter has introduced the background and the influence of creditor protection at the EU level. In the following content, the second chapter will start with some basic questions, like the types of creditors, the risks of different creditors and common methods of protecting creditors. The third chapter gives the current legal framework of creditor- protective mandatory disclosure, for example, the ECJ cases, Directives, corporate governance code and the High Level Group approach. The fourth chapter concludes three important ways of creditor protection and analysis their pros and cons. In the fifth chapter, the system of mandatory disclosure principles is set up by looking for and solving problems from the limitations of creditor- protective mandatory disclosure. The last chapter is the conclusion of the article and gives a charter of

connections between limitations of creditor- protective mandatory disclosure and principle of mandatory disclosure.

II. Corporate creditors

Creditors could be basic distinguished to two types: voluntary creditors and involuntary creditors. So owing to their different characters, so they also face different risks. Nowadays, legal protection, limitation on asset distribution, creditor self- help and mandatory disclosure are four common methods to protect creditors.

1. Types of corporate creditors

a. Voluntary creditors

Voluntary creditors are banks, suppliers and other (primarily contractual) creditors who know - in advance - that the corporation is going to have obligations to them. They can choose whether or not to do business with the corporation and can price the risk of limited liability – that is, the risk that the corporation will not be able to meet its obligations to them and that they will have no claim against the corporation’s investors – into the terms of their contracts. It's up to them. They can price creditor price goods and services supplied to the corporation to reflect the risk of the corporation's default. Limited liability is not controversial with respect to them. And, affirmative asset partitioning benefits them, because when deciding whether to deal with the corporation and, if so, on what terms, the voluntary creditor only has to evaluate the creditworthiness of the corporation and does not have to consider the creditworthiness of its investors. In fact, I think it is easiest to see traditional limited liability as the price that creditors pay in exchange for getting affirmative asset partitioning.

b. Involuntary creditors

Opposite to voluntary creditors, involuntary creditors, the state and public agencies, do not know in advance that a corporation they deal with will injure them, or they do

not know which corporation will injure them, and they do not choose to take the risk.

2. Types of corporate creditors risks

Corporate creditors could face different types of risks no matter if they voluntarily enter into a relationship with the corporation.

a. Voluntary corporate creditors

The risks of voluntary creditors could be caused respectively by initially inappropriate contract, ex post- devaluation of a claim and opportunistic behavior on the company's part.

aa. Initially inappropriate contract

If a contract couldn't reflect that the future risk caused by non- performance of the company, or that creditor's claim of net present value in this contract less than its nominal value, then creditors would face this risk caused by contract inappropriate initially.

bb. Ex post- devaluation of a claim

If a creditor claims his net present value actually no more than his nominal value, under this situation the contract is already at risks owing to inappropriate contract at the beginning. It caused either by debtor's misleading information or creditor himself inappropriate informing the risks. This risk could even increase if the company has any opportunistic behavior, i.e. if the company willingly takes on additional risk.¹⁴

cc. Opportunistic behavior

Opportunistic behavior could be done by either director or shareholders.

This action happens on one hand, when directors violate their duty to waste of

¹⁴ Peter O. Mulbert, Center for German and International law of Financial Services and Faculty of Law, University of Mainz and ECGI, A Synthetic view of Different Concepts of Creditor Protection, Page 12

company's assets; on another hand, the lack of personal liability of shareholder could cause company to act opportunistically, e.g. taking on riskier business projects, when a shareholder is a director at the same, issues a binding directive to the directors, or takes advantage of the influence of a dominant shareholder.¹⁵

b. Involuntary corporate creditors

Involuntary corporate creditors face similar risks as voluntary creditors. As a reason of initially inappropriate contracts, the situation of the net present value less than its nominal value already exists before the claim comes into existence.¹⁶ The only different could be the risk of future non- performance caused by company's being insolvent or bad financial situation, not like voluntary creditors caused by the debtor's misleading information or creditors' bounded rationality.

3. Methods of creditor protection

a. Legal capital

Legal capital has been an important means to protect creditors. There is a relationship between creditor protection and legal capital. Legal capital could guarantee creditors suffering less risk when they lending money, which leads to low interest from borrowers. So some debts could pay low interests, and investors could get more dividends and interests. It used to contribute the free movement of capital and harmonization of EU Member states law, which is a positive respect. However, the efforts have been weakened, owing to there measures, such as Second Company Law Directive doesn't apply to private companies.

b. Limitation on distribution

In the EU, limitation over the declaration of dividends or any other way of conveying corporate assets to shareholders are important in any legal capital regime. When net assets are no more than subscribed capital then there is no distribution to

¹⁵ Ibid page 13

¹⁶ Ibid page 14

shareholders¹⁷. Otherwise, companies still couldn't convey assets to shareholders if net assets get no more than the subscribed capital, unless shareholders vote to go through a capital reduction procedure which includes certain safeguards for creditors.¹⁸

c. Creditor self- help

Here I use P.O. Mülbart's idea in "A synthetic view" about creditor self- help. In the article, self- help is described and compared with mandatory rules to highlight the superiority of mandatory disclosure to protect creditors. He points that self- help is a very costly means to only protect contractual creditors. In the example of British law preferring self- help than mandatory, P.O. Mülbart denied it by saying "all four approaches¹⁹ to self- help do not act as a perfect substitute for creditor protection by mandatory law." If cheated by unreal financial situation, then self- help rule could cause problems when gathering information and providing information voluntarily. Contract as a means of self- help couldn't protect smaller creditor properly and suffers from "collective action problems", while mandatory rules don't exist these drawbacks.

d. Mandatory disclosure

aa. The entry strategy

Mandatory rules in company law could guarantee creditors' security by requiring companies to disclose some financial information, when they want to lend money to borrowers. So it is like an entry strategy that helps creditors set financial relationships with companies. Mandatory rules could make up the drawbacks of voluntary

¹⁷ The Second Directive, Article 15(1)

¹⁸ The Second Directive, Article 30-39.

¹⁹ The four approaches are collecting information on the intended party to the contract, taking out third-party credit insurance, inserting covenants into the contract, and obtaining collateral from the corporation and / or its directors and shareholders.

creditors' risks.²⁰ Usually voluntary creditors make a contract, such as about a debt due, to evade risks, which could be called exit strategy, contrary to the entry strategy of mandatory disclosure.

bb. Prerequisite for creditor self- help

As mentioned above, creditor self- help has some disadvantages compared to mandatory disclosure. Because self- help usually protect creditors by contracts, while corporate disclosure rules are usually stipulated in Company Law. But when disclosure rules already exist as a necessary prerequisite, self- help rules are added to strengthen creditor protection.

III. Current legal framework of creditor-protective mandatory disclosure

At EU level, the European Court of Justice has become a most powerful proponent of creditor protection²¹, and the ECJ's judgments in *Centros*, *Überseeing* and *Inspire Art* opened the way for an all- out competition between the different company forms provided for by national company laws.²² Many EU Member States have their own corporate governance code, which is voluntary with disclosure recommended. 1st Directive²³ truly was meant to protect the general public, and the 4th Directive²⁴ defined more precisely about the duty to disclose the annual accounts. For example, the concept of legal capital as written in the Second Directive is not stipulated in British company law but in German company law.²⁵

²⁰ Oxford University Press, *The Anatomy of Corporate Law- A comparative and Functional Approach*, p 79-83

²¹ See Hanno. Merkt, 'Creditor Protection through Mandatory Disclosure', *European Business Organization Law Review* 7: 95-122

²² See Peter O. Mulbert, Center for German and International law of Financial Services and Faculty of Law, University of Mainz and ECGI, *A Synthetic view of Different Concepts of Creditor Protection*.

²³ The First Company Law Directive, 1968

²⁴ The Fourth Company Law Directive, 1978

²⁵ See Peter O. Mulbert, *A Synthetic view of Different Concepts of Creditor Protection*, Center for German and International law of Financial Services and Faculty of Law, University of Mainz and ECGI

1. European Company Law Directives

Since the First Company law Directive of 1968 the EU law has been in the procedure of harmonization. According to the First company Law Directive which is one of the parties to protect the interest of corporate creditors, companies are required to disclose some financial information.

The Second Company Law Directive published in 1976. It co-ordinates national provision on the formation of public limited liability companies, minimum share capital requirements, distributions to shareholders and increases and reductions in capital. The Directive establishes the conditions to ensure that the capital of the company is maintained in the interest of creditors.²⁶ The Second Company Law Directive regulating predominantly the financial structure of the public limited company has been criticized.²⁷ The requirement of a minimum capital is not enough to enable companies to do business activities. Companies need more sufficient financial ways. On 15 December 2004, European Commission published Directive 2004/109/EC of the Council on minimum transparency requirements for listed companies, which proposes the simplification of capital maintenance rules to enhance creditor protection in the Second Directive. The aim is to improve the efficiency and competitiveness of companies.

The 4th Directives provide for a system of auditing under which companies must have their annual accounts audited by one or more persons authorized by national law to audit accounts. Such a person or persons must also verify that the annual report is consistent with the annual accounts for the same financial year.²⁸ This 7th Company

²⁶ [http://europa.eu/rapid/pressReleases](http://europa.eu/rapid/pressReleases>Action.do?reference=IP/06/312&format=HTML&aged=0&language=EN&guiLanguage=en)

²⁷ European Corporate Governance in Company Law and Codes, Report prepared for the European Corporate Governance, the Netherlands

²⁸ <http://www.europa.eu/scadplus/leg/en/lvb/126009.htm>

Law Directive coordinates national laws on consolidated (i.e. group) accounts. Together with the Fourth Directive on the annual accounts of public limited liability companies, it belongs to the family of "accounting directives" that form the arsenal of Community legal acts governing company accounts.²⁹

2. ECJ case law

From the following ECJ cases, we could find the Court prefer to creditor protection through disclosure over merit regulation. We also could find creditor are at risk, because EC Treaty restricts minimum capital rules for private companies, and Member States also have the pressure by the trend of cross- border activity to reduce or get rid of minimum capital. Minimum capital is a means to protect creditors. Without it, creditors will expose to the risk of less guarantee.

a. Centros³⁰

Centros Ltd is a private limited company registered in Great Britain and has a branch in Denmark. But the company has never done business since it was founded. Danish law refused Centros to register a branch in Denmark that does all business in the host country and asks for a minimum company capital. The court judged that Danish law violates the Article 52 and 58 of the Treaty.

The Danish board argues there are two objectives for private limited companies to pay a minimum capital. The first reason is that public creditors couldn't secure those debts by means of guarantees, so they face more risks than private creditors. Another reason is that creditors, both public and private, have the risks when companies are approaching bankruptcy.³¹ The board also added there is no less restrictive means of attaining this dual objective.³² But the Court points out the reasons are not consistent

²⁹ <http://www.europa.eu/scadplus/leg/en/lvb/l26010.htm>

³⁰ ECJ, Case C-212/97 *Centros Ltd. v. Erhvervs-og Selskabsstyrelsen* [1999] ECR I-1459.

³¹ ECJ, Case C-212/97 *Centros*, pp32

³² ECJ, Case C-212/97 *Centros*, pp33

with Article 56 of the Treaty, even though Danish creditors might have been exposed to risk.

The Court mentioned a certain rules of Community law to protect creditors are “on notice that it is covered by laws different from those which govern the formation of private limited companies in Denmark”, such as “the Fourth Council Directive 78/660/EEC of 25 July 1978 based on Article 54(3)(g)of the Treaty on the annual accounts of certain types of companies (OJ 1978 L 222, p. 11), and the Eleventh Council Directive 89/666/EEC of 21 December 1989 concerning disclosure requirements in respect of branches opened in a Member State by certain types of company governed by the law of another State (OJ 1989 L 395, p. 36).”³³

In Centres case, ECJ doesn’t favor minimum capital, but it gave two other methods for creditor protection: auditing annual accounts and disclosure requirements.

b. Überseering³⁴

Überseering BV is a company incorporated under Netherlands law and registered the company in Netherlands. It moved its center of business to Germany and was going to bring a legal proceeding against Nordic Construction Company Baumanagement GmbH (NCC) to defend rights of the contract. As a real seat country, Dutch law admits that the center of business is actually in Germany so that couldn’t bring legal proceedings. ECJ argues that according to Art. 43 and 48 of EC, companies have the right to choose the center of business, when they have their registered office, central administration within the EU³⁵. While Germany argues that the company set principle would hinder the freedom of establishment. ECJ argued that it is not inconceivable that overriding requirements relating to the general interest, such as protection of

³³ ECJ, Case C-212/97, para 36

³⁴ ECJ, Case C-208/00 Überseering BV v. Nordic Construction Company Baumanagement GmbH (NCC) [2002] ECR I-9919.

³⁵ ECJ, Case C-208/00 Überseering BV, pp 22

creditors. Actually Dutch law breaches Art. 43 and Art. 48 of EC. So Überseering could bring a legal proceeding. “The Netherlands and United Kingdom Governments, the Commission and the EFTA Surveillance Authority submit that the restriction in question is not justified. They point out in particular that the aim of protecting creditors was also invoked by the Danish authorities in *Centros* to justify the refusal to register in Denmark a branch of a company which had been validly incorporated in the United Kingdom and all of whose business was to be carried on in Denmark but which did not meet the requirements of Danish law regarding the provision and paying-up of a minimum amount of share capital. They add that it is not certain that requirements associated with a minimum amount of share capital are an effective way of protecting creditors.” The court holds the same idea in the previous case *Centros*, so it means that, on one hand, minimum capital couldn’t protect creditors effectively; on another hand, other methods of creditor protection mentioned in *Centros* also could be applied in this case, which includes the Fourth Directive on the annual accounts of certain types of companies and disclosure requirements in respect of branches opened in a Member State by certain types of company governed by the law of another State.

c. Inspire Art³⁶

Inspire Art Ltd. a private company limited by shares established in the UK and has a branch in the Netherlands. But it only does business in the Netherlands and had never had any business in the UK. According to Dutch law on pseudo foreign companies³⁷, Inspire Art Ltd. should comply with some disclosure requirements³⁸ and be up to a minimum capital.³⁹ “The list set out in Article 2 of the Eleventh Directive does not include the other disclosure obligations provided for by the WFBV, namely, recording

³⁶ ECJ, Case C- 167/01 *Kamer van Koophandel en Fabrieken voor Amsterdam v. Inspire Art Ltd.* [2003] ECR I- 10155.

³⁷ Dutch law on pseudo foreign companies is *Wet op de formeel buitenlandse vennootschappen* (WFBV) in Dutch.

³⁸ Article 2 to 5 WFBV, Article 178 *Burgerlijk Wetboek* (Dutch Civil Code)

³⁹ See Article 4 (1) WFB, also

in the commercial register the fact that the company is formally foreign (Articles 1 and 2(1) of the WFBV), recording in the business register of the host Member State the date of first registration in the foreign business register and information relating to sole members (Article 2(1) of the WFBV), and the compulsory filing of an auditor's certificate to the effect that the company satisfies the conditions as to minimum capital, subscribed capital and paid-up share capital (Article 4(3) of the WFBV). Similarly, mention of the company's status of a formally foreign company on all documents it produces (Article 3 of the WFBV) is not included in Article 6 of the Eleventh Directive.”⁴⁰ So the Court ruled that Dutch law about Dutch branches of pseudo-foreign companies must disclose the fact that they are pseudo-foreign companies was in breach of the 11th directive. Because the directive did not permit any disclosure rules going beyond the rules contained in it.⁴¹ The Court ruled that the Dutch law requires pseudo-foreign companies to have a minimum capital breach the freedom of establishment. The Court pointed out that Inspire Art held itself out to be a foreign and not a Dutch company. Therefore its creditors were sufficiently informed that it was subject to other provisions than a company with limited liability formed under Dutch law.⁴² ECJ states that, when different provisions apply altogether, it wouldn't be a sufficient protection of creditors because other provisions either expect minimum capital or the personal liability. In this case the Court favors the freedom of establishment and creditor protection by disclosure rules.

3. Corporate governance code

There are many corporate governance codes in Europe, with disclosure recommended. Some Member States have not just one but many of them. The means of corporate disclosure stipulated in Member States' codes could be different and conflict each other. German Corporate Governance Code stipulates strict and detailed rules. Such as

⁴⁰ ECJ, Case C- 167/01, para 65

⁴¹ ECJ, Case C- 167/01 *Kamer van Koophandel en Fabrieken voor Amsterdam v. Inspire Art Ltd.*

[2003] ECR I- 10155. pp 65-71

⁴² 15 ECJ Case C-167/01 (*supra* note 4), para. 135

the Management Board is required to disclose insider information without delay; “the reporting requirement relates to purchase and sale transaction exceeding 5,000 euros in a calendar year. The company must publish the disclosure without delay.”⁴³ From the stipulations of corporate disclosure in the German Corporate Governance Code and the Combined Code, we could find German law, in the respect of disclosure, is more restrict than British law. Jurisdictional differences in legal strategies really matter for the protection of creditors and they are less important than they might appear to be.⁴⁴ But these codes existing at the same time could bring problems by confusing investors, so the convergence of Member States’ codes, on the level of EU, still would a trend.

4. The High Level Group Approach

The High Level Group⁴⁵ seeks to develop an ideal framework for an efficient creditor protection regime. It brings out some good proposals but, at the same time, it also has problems. Enhancing corporate governance disclosure requirements is a way of the HLG recommendations to improve the EU framework for corporate governance. HLG proposed disclosure of information should be a very important regulatory tool in company law and recommended that “capital and control structures of listed companies should be disclosed comprehensively and that such disclosure should be updated continuously”.⁴⁶ The Group also notes that legal capital is criticized for failing to protect creditors when the capital is reduced to account for.

The High Level Group states: “Disclosure requirements can sometimes provide a more efficient regulatory tool than substantive regulation through more or less

⁴³ German Corporate Governance Code, Art. 6

⁴⁴ Oxford University Press, *The Anatomy of Corporate Law- A comparative and Functional Approach*, p 98

⁴⁵ Report of the High Level Group of Company Law Experts on a Modern Regulatory Framework for Company Law in Europe, Brussels, 4 November 2002

⁴⁶ Hanno Merkt in Report of the High Level Group of Company Law Experts on a Modern Regulatory Framework for Company Law in Europe, Brussels, 4 November 2002

detailed rules. According to the Group, such disclosure creates a lighter regulatory environment and allows for greater flexibility and adaptability. Moreover, although the regulatory effect may in theory be more indirect and remote than with substantive rules, in practice enforcement of disclosure requirements as such is normally easier.”⁴⁷ So EU should consider whether disclosure requirements are better suited to achieve the desired effects than substantive rules.

IV. Analysis of the main creditor protection methods of corporate law

1. Legal Capital

. Minimum capital was required in The Second Company Law Directive. “The laws of the Member States shall require that, in order that a company may be incorporated or obtain authorization to commence business, a minimum capital shall be subscribed the amount of which shall be not less than 25 000 European units of account.”⁴⁸ Actually Member States could decide the amount by themselves. For example, there is no minimum requirement for private companies in the UK, but the highest amount in Austria.⁴⁹

The concept of legal capital is seen as one of the cornerstones of European Company law.⁵⁰ The main function of legal capital is to protect creditors and shareholders by preventing unlawful transfers of dividends or other distributions from the company to its members when companies’ assets reducing below the legal capital.

But actually the merits of minimum capital requirements are not believed by The High Level Group. The rules on capital formation and maintenance are heavily influence the cost of capital and credit. The majority of the respondents do not think that legal

⁴⁷ High Level Report

⁴⁸ 2nd Directive, Art. 6

⁴⁹ See § 6(1) of the Law on Private Limited Companies (*Gesetz über Gesellschaften mit beschränkter Haftung*).

⁵⁰ HLG report, p78

capital could reflect capital adequacy and protects the interests of creditor and shareholders effectively. The strict rules of minimum capital in the 2nd Directive provide have often been criticized. Because they couldn't efficiently protect those creditors who are not interested in minimum capital much but have the ability to pay debts. European legal capital regime is usually not believed that it has either a competitive disadvantage or advantage.

Minimum capital is a tradition way to protect creditors written in the Second Company Law Directive, which is, however, conflict with the current judgements of the ECJ. According to the ECJ cases (*Centros, Inspire Art and Überseering*), the Court doesn't favor creditor protection through minimum capital requirements but other ways, such as mandatory disclosure over merit regulation, which is less capable of infringing upon the freedom of establishment.⁵¹ It seems that minimum capital requirements are impossible to be imposed on pseudo-foreign corporations any more. And some countries have already adopted some measures to be consistent with the decisions of the ECJ.⁵²

⁵¹ See H. Merkt, 'Creditor Protection through Mandatory Disclosure', *European Business Organization Law Review* p 106

⁵² Minimum capital has become the most important factor driving for the incorporation of continental businesses in the United Kingdom. This has arguably prompted some 'defensive regulatory competition': France effectively abolished minimum capital for private corporations, (See Art. 1, *Loi n° 2003-721 du 1er août 2003 pour l'initiative économique* [Law for Economic Initiative], *Journal officiel* n° 179 du 5 août 2003, p. 13449.) and even the German Ministry of Justice proposed a reduction from €25,000 to €10,000 in early 2005. (see *Entwurf eines Gesetzes zur Neuregelung des Mindestkapitals der GmbH (MindestkapG)* [Draft Law for a New Regulation of the Minimum Capital of Private Limited Companies], available at: <<http://www.bmj.de/media/archive/908.pdf>>, last accessed 28 May 2005. The proposal was rejected by the Federal Council (*Bundesrat*) with a view to the early 2005 elections, but new plans to facilitate the formation of start-up firms are currently emerging. See M. Miola, 'Legal Capital and Limited Liability Companies: The European Perspective', 2 *ECFR* (2005) p. 413 at p. 445. The final outcome of this process may be the practical elimination of minimum capital

The legal capital could protect creditors in theory, but it doesn't reflect "capital adequacy" so that it is failing to adequately protect creditors. The current regime is criticized by its inflexibility and costs. A large majority of The High Level Group experts think the current legal capital regime should be improved and new approaches to the reform of legal capital in the EU are needed.

The High Level Group Expert gives a suggestion about an alternative regime for creditors.⁵³ An adequate solvency test could better protect creditors. A proper test should be required for any payment of dividend or other distribution against repayment to shareholders. The solvency test should be based on at least two different tests: Balance Sheet test and Liquidity test. Also a solvency certificate should be required to make valid distribution with adequate sanctions for misleading certificates.

2. Limitation of distribution

Limitation of distribution is another main method to protect corporate creditors. It is a core element to reduce a company's probability of entering into financial distress, which means that the rules of distribution could be applied in the whole companies' life. Assets distribution, as other pre- insolvency rules, could cause the influence of regulatory competition in company law. Although efforts have been applied to harmonize these rules but haven't succeeded. But EC law supplies the possibility to harmonize limitation of asset distribution rules in different Member States.

Distribution rules are in order to "prevent shareholders from diluting the pool of assets that implicitly bonds a company's debts"⁵⁴. Dividends and share repurchases distribution are not allowed, according to company law. Member states have different distribution rules, but dividends- restriction is most widely used if the dividends could

requirements.)

⁵³ The Level Group, page 86

⁵⁴ Oxford University Press, *The Anatomy of Corporate Law- A comparative and Functional Approach*, page 83

influence the legal capital in this company. Dividend restrictions are better applied to countries that have conservative accounting practices, such as Germany.

EU law limits the distribution of corporate asset to shareholders. “(a) 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. (b) Where the uncalled part of the subscribed capital is not included in the assets shown in the balance sheet, this amount shall be deducted from the amount of subscribed capital referred to in paragraph (a). (c) The amount of a distribution to shareholders may not exceed the amount of the profits at the end of the last financial year plus any profits brought forward and sums drawn from reserves available for this purpose, less any losses brought forward and sums placed to reserve in accordance with the law or the statutes. (d) The expression ‘distribution’ used in subparagraphs (a) and (c) includes in particular the payment of dividends and of interest relating to shares.”⁵⁵ Usually it could protect creditors, but it is not when net assets are less than subscribed- capital. But sometimes capital reduction could help.⁵⁶

The Fourth Directive stipulates the extent of capital maintenance in accounting rules, which directs Member States to harmonize their national accounting rules. The recent IAS Regulation is about the application of international accounting standards⁵⁷, so Member States have to choose between an accounting system based on the Fourth Directive and one on a national law for individual accounts. As a practical matter, it is not totally clear to tell what kind of transactions the prohibitions limiting the distribution of assets apply to. Compared the term of “distribution” in the Second

⁵⁵ 2nd Company law Directive, Art. 15 (1)

⁵⁶ 2nd Company Law Directive, Art. 30- 39

⁵⁷ Regulation No. 1606/2002 of the European Parliament and of the Council of 19 July 2002

Directive, “Concealed distributions”⁵⁸ is a term from German law, which is also prohibited. By contrast, English Law on this subject does not seem that it has a connection with the Second Directive. So the British understanding on asset distribution of EC law is different.

The answer for whether the asset distributions should be limited stricter is no. These rules can only be effective when the distributions are admissible. The only possible effect of stricter limitation is to avoid company approaching bankrupt because of “an isolated exogenous shock”⁵⁹. Limitation on asset distribution could cause risks to shareholders who are in insolvency- approaching companies.

3. Mandatory disclosure

a. The virtues of mandatory disclosure

aa. Market efficiency

Mandatory disclosure helps market to be more efficient. It could protect the benefits of investors so that they would have more confidence to lend money to debtors. Transparency of the market could lower the rate of fraud happening. Some commentators suggested that “investor confidence and protection and prevention of fraud are of equal rank as functions of mandatory disclosure.”⁶⁰ These factors are also important proponents in an efficient market. Credit market is like securities markets and characterized by incomplete information, which causes the problems of adverse

⁵⁸ “*verdeckte Ausschüttungen* or *verdeckte Einlagenrückgewähr*” in German

⁵⁹ Peter O. Mulbert, A Synthetic view of Different Concepts of Creditor Protection or A high-level Framework for Corporate Creditor Protection. Center for German and International law of Financial Services and Faculty of Law, University of Mainz and ECGI, page 34

⁶⁰ N. Moloney, EC Securities Regulation (Oxford University Press 2002) p. 120 in “Creditor protection through Mandatory disclosure”

selection, moral hazard, and under production.⁶¹ Owing to behavior of securities prices has a deep effect on the efficiency of securities markets⁶² and it is probably also correct for debt pricing, so it safe to say that disclosure is critical to establishing a pricing mechanism. Owing to the fostering of market efficient through promotion of price accuracy, so disclosure is helpful for market efficient.

bb. Market Failure

Disclosure of information is a key factor of market securities regulation to avoid market failure. The High Level Group experts highly suggested disclosure of information as a regulatory tool.⁶³ Disclosure could be a powerful regulatory tool to enhance the transparency of the company's governance and its affairs. It creates an incentive to comply with best practice and it is also an important element to allow those who participate in companies or do business with companies to take necessary actions.

The question whether and to what extent the mere dissemination of issuer information should be mandatory disclosed.⁶⁴ Because mandatory disclosures rules like a tool, with out it information could cause a market failure by not being disseminated, or not sufficiently.⁶⁵

b. Limits of creditor- protective mandatory disclosure

A debt activity happens between a creditor and a borrower (debtor), so the limitations to creditor- protective mandatory disclosure could be distinguished from creditors to

⁶¹ Creditor Protection through mandatory disclosure, page 99

⁶² “J. C. Coffee, ‘market failure and the Economic Case for a Mandatory Disclosure System’, P717 at P714,” in “Creditor Protection through mandatory disclosure, page 100”

⁶³ Report of the High Level Group of Company Law Experts on a Modern Regulatory Framework for Company Law in Europe, Brussels, 4 November 2002. page33

⁶⁴ Creditor protection through Mandatory disclosure, page107

⁶⁵ See G. Hertig, R. Kraakman, and E. Rock, ‘issuers and Investor protection, in H. Merkt, Creditor protection through Mandatory Disclosure, page 100

debtors. Member States' different legislations about creditor- protective mandatory disclosure could be conflict to each other.

aa. Creditors

Creditors form a pretty “heterogeneous group”⁶⁶ from different fields (such as banks, institutions) and different size (hybrid, large, small). Owing to most of creditors lend money to several borrowers, and a debtor might borrow money from more than one creditors. So creditors and debtors form a sophisticated transaction net.

Hybrid creditors are also called insider- creditors and usually they are also shareholders, so they have a lot of internal information. The information mandatory disclosed is limited to some basic information but internal and important corporate information.

Large creditors grant credit only by contracts, because they could always find company's information without the assistance of law. Debtors have to supply any information creditors ask for, such as current financial situation. If they couldn't fulfill the requirements, creditors could decline granting credit. There is way in US of signing a loan contract as a safeguard that is already certified to be effective. But at the same time an increase transaction cost is caused.⁶⁷

Small creditors suffer more limitation compared to large ones. They don't have enough ability to negotiate a covenant, which needs large creditors to do it as a trustee. This way of protection for small creditors is not comprehensive, because they couldn't decide the important details of a contract, such as the decision of alteration or abolition of the contract.⁶⁸ It means protection of small creditors, to a large extent, depends on action of large creditors.

⁶⁶ Ibid, page 107

⁶⁷ Ibid page 108

⁶⁸ Ibid page 109

bb. Debtors

aaa. Criteria of dividing companies

In the 1960s and 1970s following the enactment of the 1st and 4th Directive, the legal relationship between public disclosure and limited liability is currently widely accepted within Europe and has recently been stressed by the European Commission again.⁶⁹

The High Level Report, in order to determine which companies are obliged to comply with mandatory disclosure, suggests dividing corporations into three types: listed companies, public- held companies and closely- held companies and for “public” or “closed” companies, no need for establishment of disclosure requirement at EU level.⁷⁰

Full disclosure for listed companies is well accepted. According to HLP, “For listed companies, a certain level of uniform, compulsory, substantive rules may be required to sufficiently protect both shareholders and creditors.” But then for “open” and “close” companies, the Group suggests no need to impose disclosure requirements on these two kinds of companies at EU level.⁷¹

Merkt thinks it’s formalistic and inflexible to distinguish disclosure for these three kinds of companies. Mandatory disclosure is a regulatory to protect creditors and calls for more flexible determination of both the scope and the content of disclosure⁷².

⁶⁹ European Commission, Communication from the Commission to the Council and the European Parliament: Modernizing Company Law and Enhancing Corporate Governance in the European Union – A Plan to Move Forward, (Brussels, 2003), para 3. 7., p.22

⁷⁰ High Level Report, page 45

⁷¹ Ibid

⁷² Merkt, Creditor Protection through Mandatory Disclosure, page 111

Creditor protection should be distinguished by varying criteria like size or public trading activities.⁷³

bbb. Closely held companies lacking of access to data information from small companies

Owing to most closely held companies don't disclose their financial statements and EU Member states freely use their power to simplify accounting requirements for smaller corporations⁷⁴, so creditors enjoy less access to financial data than it seems to promise. This situation would be even worse if these companies are allowed to not disclose. Corporate disclosure of European and domestic is gradually eroding. Creditors, who wish to extend or monitor loans handed out to limited liability, have a legitimate interest to know about the economic situation of their borrower and to find out whether funds have been diverted from the company to the shareholders or third parties. The question is whether this legitimate interest justifies public mandatory disclosure. The seemingly self-evident logic to combine limited liability with compulsory disclosure is far from convincing.⁷⁵ When lots of small creditors do not have enough bargaining power to put pressure on the debtor to reveal its financial data, there might be "collective action" problems⁷⁶, so that they would rather rely on mandatory legislation on disclosure. In cross- border situation, for foreign contract partners who seek information concerning limited liability companies, convenient access to a public register might reduce transaction cost.

ccc. Limitations of small company disclosure

Since a company's prospects and future plans have a much more significant bearing on its creditworthiness than does past financial performance. The use of accounts to

⁷³ Merkt, Creditor Protection through Mandatory Disclosure, page 111

⁷⁴ Art. 11 Fourth Company law Directive

⁷⁵ Brian Cheffins, Company Law – Theory, Structure and Operation, Clarendon Press, Oxford, 1997/2003

⁷⁶ Ibid

forecast insolvency is difficult. The information submitted suffers from important limitations is a key reason why many creditors do not assign a high priority to studying the publicly filed financial statements of smaller companies is that the accuracy of the accounts therefore ultimately depends on assertions by the directors that all of the company's transactions are reflected correctly in the records. Reliability is another problem. In a larger enterprise, controls built into the company's administrative system will provide assurance for those who study and depend on the accounts. In a smaller company, there is usually no enough staff to implement a system of controls.

cc. Legislations of different Member States

Within the EU, Member States have different systems of corporate governance and stipulate different rules of creditor- protection mandatory disclosure. Different legislations of mandatory disclosure in Member States may create uncertainty and costs for issuers, investors and creditors, which need to be addressed to promote an efficient integration of EU capital markets. The Commission's Action Plan⁷⁷ states: "In view of the growing integration of European capital markets, a common approach should be adopted at EU level with respect to a few essential rules and adequate coordination of corporate governance codes should be ensured."⁷⁸ Mandatory disclosure is one of the mentioned essential rules.

V. Challenges to principles for efficient mandatory disclosure

Owing to the limitations of Mandatory disclosure for creditor protection, they could bring creditors into risks. How to reduce or avoid these risks? The challenge of setting principles of mandatory disclosure rules could help. These principles also could be considered when making new mandatory disclosure rules to avoid facing same risks.

⁷⁷ European Commission, Communication from the Commission to the Council and the European Parliament: Modernizing Company Law and Enhancing Corporate Governance in the European Union – A Plan to Move Forward, (Brussels, 2003)

⁷⁸ Action Plan, page 12

1. Materiality

a. Clear disclosure

When setting a contract, ambiguous words and unclear explanations of mandatory disclosure rules could mislead creditors involved into risks. Small creditors could be in a worse situation owing to its weak bargaining power. They have to take any risk that larger creditors make when they originate covenants.⁷⁹

EC law requires that listing particulars present in formation in as easily analyzable and comprehensible a form as possible,⁸⁰ and would reinforce this requirement.⁸¹ But disclosure requirements should demand the detailed information and explain some hardly understandable or ambiguous elements, for example, data from the annual financial statements. It should be written or explain the specific data when they decide to disclose the information of an annual financial statement so that it wouldn't confuse people and become an excuse of companies to cause risks to creditors.

b. Current information

Considering the risks of weak bargaining power of small creditors as mentioned above, disclose the current information of debtor companies is a good way to help creditors noticing risks and taking action to protect their own benefit and avoid risks.

The German method of periodic report should be taken into action at the EU level. A periodic report should file and publish company's current significantly influencing information in shareholdings promptly.

Except for requirements of publishing periodic reports, the requirement of the period is also important for the extent of new information. According to German law,

⁷⁹ Merkt, *Creditor Protection through Mandatory Disclosure*, page 108-109

⁸⁰ EC Listin and Reporting Directive (2001/34/EC), Art. 22(1)

⁸¹ EC Prospectus Directive (COM (2001) 280 final), Art. 5(2)

consolidated financial statements must be submitted to the shareholders' meeting within 12 months after the end of the fiscal year,⁸² and be published within 12 months after the end of the fiscal year for which they are prepared.⁸³ But considering efficiency to have period report at the EU level, the German Corporate Governance Code gives good recommendations that the period for publication should be shorted to 90 days after the end of the fiscal year for which the financial statements are prepared, and for interim reports, it recommends a shorter term of 45 days.⁸⁴

c. Soft information

Information has a facilitating function. Demonstrable facts and statements that are not capable demonstration is soft information, such as management projections regarding business plans, can be material.⁸⁵

When potential creditors decide whether to grant credits to a debtor, they usually need to consider some soft information, such as “the customer’s willingness to meet credit obligations; the customer’s ability to meet credit obligations out of operating cash flows; and the customer’s financial reserves”⁸⁶. But so far none of these creditors’ consideration is stipulated by mandatory disclosure in current statutory law in EU. If some of these information could be mandatory disclosed, i.e. creditors could get more security, which means creditors will be more willingly to grant credits and lower the cost and interest of debt. Then investors could better take advantage of the asset and make more profit that give shareholders as dividends and interests. So it is benefit for the whole EU market.

d. Solvency test

⁸² §§ 337, 175(1) *Aktiengesetz* (Stock Corporation Act).

⁸³ § 325(3) *Handelsgesetzbuch* (Commercial Code).

⁸⁴ Corporate Governance Code

⁸⁵ See generally MERKT, UNTERNEHMENSPUBLIZITÄT 132 *et seq.* (2001). at 453 *et seq.*

⁸⁶ Merkt, Creditor Protection through Mandatory Disclosure, page 112

A solvency test could be helpful to provide creditors the required forward- looking “soft” information to be mandatory disclosed.⁸⁷ Some jurisdiction have already experienced using a solvency test, for example, Australia and new Zealand apply a liquidity test, Delaware and the Revised model Business Corporation Act apply a balance sheet test.⁸⁸ The High Level Group Suggests the protection of creditors could come by means of a solvency test applied to distributions and capital transactions between the company and its shareholders. A solvency test should be based on at least two different tests: liquidity test and balance sheet test. In a liquidity test, the criterion is whether the company, assuming that its operations continue, has sufficient cash available after making a distribution to be able to meet the debts which fall due in the come period as a result of its ordinary business operation.⁸⁹ In a balance sheet test, the criterion is whether after making a distribution the assets of the company are at least equal to its debts and provisions.⁹⁰ So solvency test could be considered to use at the whole EU level.

2. Standardization

a. Standardization with small companies

Disclosure calls for standardization. One requirement of standardization is that all issuers must present the required information in the same format for disclosure, which could facilitate comparison of the data disclosed.⁹¹ But as mention in Chapter 4 (3), smaller companies don’t have the ability to handle a lot of information, and most of them don’s disclose their financial information, so they apply to flexible disclosure

⁸⁷ Merkt, *Creditor Protection through Mandatory Disclosure*, page 113

⁸⁸ H.E. Boschma, M.L. Lennarts, and J.N. Schutte-Veenstra, *Alternative Systems for Capital Protection* (Groningen, Institute for Company Law 2005) op. cit. n. 36, at s. 4.2.2 in Merkt, *Creditor Protection through Mandatory Disclosure*, page 113

⁸⁹ The High Group Level Experts, page 88

⁹⁰ Ibid

⁹¹ Merkt, *Creditor Protection through Mandatory Disclosure*, page 115

regulations. Standardization seems conflict with the flexible rules. Company law provide for a framework for competitive business, this calls for flexible rules. However, there is a tendency to use the traditional field of company law to achieve all sorts of other regulatory purposes, for example to protect creditors. And as mentioned before, creditors hardly have access to financial data of small companies if they are not disclosed. For both the benefits of small companies and creditors, standards for small company disclosing are needed. One way to solve the problem would be re-divide companies by the criteria of size⁹² and limit standardization to a certain class of size of companies.⁹³

b. Coordinating disclosure of corporate governance structures and practices

As mentioned before,⁹⁴ the Commission Action Plan pursues a fully integrated approach. But the conflicts of different Member States' legislations cause problems of uncertainty and costs. In order to provide creditors better information, corporate governance structures and practices should be better disclosed and standardized.

First more disclosure should be put on corporate governance structures and practices of companies, such as shareholders rights and structures of companies. Transparency of information is good for creditors. Second, even though both Action Plan and High Level Group don't support EU Corporate Governance Code, but the Group suggests Member States should designate a reference code included an indication whether a certain corporate governance code is followed and where and why the code is not complied with.

3. Comprehensibility

⁹² Merkt, Creditor protection through Mandatory Disclosure, page 111

⁹³ Ibid page 115

⁹⁴ Chapter 4 (3) (b) (cc)

Comprehensibility is the ability to be understood; intelligible. When small creditors do not have enough bargaining power to put pressure on the debtor to reveal its financial data, so as mentioned before, they have to rely on the protection from large creditors exercise. However, sometimes this protection offered to smaller creditors is not comprehensive,⁹⁵ because they couldn't influence the result of a contract. So comprehensive- disclosure rules should be applied to protect small creditors. EC listing and Reporting Directive⁹⁶ requires that information should be presented in as easily analyzable and comprehensible a form as possible. Small creditors could get some guarantees through disclosure rules, and comprehensive disclosure rules enhance the function of such protection.

4. Timeliness

Timeliness is a very important factor to make mandatory disclosure efficiently. Current information of companies is important for creditors avoiding delayed information so that creditors could take advantage of mandatory rules to protect themselves. Periodic report is a good way to disclose corporate information, and it needs means to guarantee timeliness so that creditors could get current information timely.

In pursuing timeliness of information disclosure, modern technology probably is a very efficient way.

a. The Company's website

Company information is filed and disclosed at various places. It is costly and with too much effort to file and disclose information in traditional paper way. If the company would put the information is required to file and disclose the company's own website, the efficiency is for both companies and interested parties. Cost and effort could be saved at the same time. The company could be required to maintain a specific section on its website, and a link with the register about all legal and other information it is

⁹⁵ Merkt, Creditor protection through Mandatory Disclosure, page 109

⁹⁶ EC listing and Reporting Directive (2001/34/EC), Art. 22(1)

required to file and disclose.⁹⁷

b. The need for electronic filing system

In order to avoid obstacles to timely disclosure, both the High Level Group and the Action Plan give their suggestions in order to modernize corporate disclosure by electronic filing.

The High Level Group suggests a European central system,⁹⁸ which would benefit the markets in Europe. This system could be filled and updated efficiently by links with the websites of the companies on which they put and update their relevant information. In Action Plan,⁹⁹ shareholders of listed companies are suggested to provide electronic facilities to access the relevant information in advance of General Meetings, which is also stipulated in the EU Proposal for a Transparency Directive¹⁰⁰ and Disclosure requirements Directive.¹⁰¹

5. Enforcement

Finally in order to get efficient creditor- protective mandatory disclosure, effective enforcement is very important. Merkt points three ways to enforce mandatory disclosure.

⁹⁷ The High Level Group, page 38

⁹⁸ Ibid, page 40-41

⁹⁹ Action Plan, Page 13-14

¹⁰⁰ Directive 2004/109/EC of the European Parliament and of the Council of 15 December 2004 on the harmonisation of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market and amending Directive 2001/34/EC, *OJ* 2004 L 390/38-57.

¹⁰¹ Directive 2003/58/EC of the European Parliament and of the Council of 15 July 2003 amending Council Directive 68/151/EEC, as regards disclosure requirements in respect of certain types of companies, *OJ* 2003 L 221/13-16.

a. Liability for misreporting

If debtors have limited liability, on one hand, it could protect shareholder' benefit owing to detriments of creditors is not liable to their private assets; On the other hand, it could cause counterproductive to misreporting, which would impair company's solvency and brings a lot of damages to creditors. However, "imposing liability directly on those managers or on those individuals that are responsible for misreporting is for practical reasons not as effective as one expect."¹⁰² The reason is that most of misrepresentations are for a company's self- protection when the company is approaching fail.

b. Sanctions

Another way to cope with the problem of enforcement of disclosure duties is to impose personal liability or other civil or criminal sanctions on those individuals responsible for misrepresentations.¹⁰³

A solvency test could be better protect creditors by providing creditors the required forward- looking "soft" information to be mandatory disclosed., which also need sanctions as methods to enforce this test.

c. Enforcement institutions

The third way to for enforcement of disclosure is entrusting particular institutions with enforcement function, such as audit committees, intermediaries.¹⁰⁴

VI. Conclusion

Today creditors rely mainly on contacts not on the law, they need protection does not necessarily justify legal intervention that is merited only if the law protects creditors

¹⁰² Merket, Creditor Protection through Mandatory Disclosure, page 120

¹⁰³ Ibid

¹⁰⁴ Ibid

more efficiently than they might protect themselves by contract. Rigid creditor protections, historically, that involves something of comparative value for granting limited liability to shareholders, an argument that remains influential even today.¹⁰⁵ But commercial practice suggests that this argument is not believable. Today credit agencies and a host of other self-help measure to safeguard major business creditors' interests. According to economic and legal theory mandatory disclosure is an important instrument to improve market efficiency and prevent market failure. Old systems are overly costly and do not meet market needs or must be reformed with respect to comprehensibility, timeliness and enforcement. So disclosure requirements may well deserve improvements. It is critical to consider the possibility of making better use of information pools and information channels. A system of the mandatory disclosure principles is set and concluded according to the limitations of current legal framework, particular for creditor protection. It contains methods to solve current problems of mandatory disclosure and gives potential or new disclosure rules standards to find and avoid risks, so that it helps to build efficient EU market.

Limitation of Mandatory disclosure	Principle of mandatory disclosure (Methods to solve the problems)
Ambiguous words and unclear explanations of mandatory disclosure rules in a contract.	Principle of Materiality- Clearly disclosure of the content of a contract
The risks from weak bargaining power of small creditors	Principle of Materiality- Publishing current information of companies
EU mandatory disclosure rules don't cover creditors' consideration about whether to grant credits to a debtor.	Principle of Materiality-Need for soft information
providing creditors the required forward-	Principle of Materiality- Solvency test

¹⁰⁵ See Company Law Review Steering Group, Modern Company Law for a Competitive Economy: The Strategic Framework

looking “soft” information to be mandatory disclosed	
Mandatory disclosure rules of small companies are not standardized with other types of companies.	Principle of Standardization
The EU Commission Action Plan’s pursuit of a fully integrated approach conflicts with different from Member States’ legislations.	Principle of Standardization
Owing to small creditors’ weak situation, sometimes the protection from large creditors exercise is not comprehensive.	Principle of Comprehensibility.
The traditional way of information disclosure is at significant cost and with considerable effort.	Principle of Timeliness- company’s website.
Obstacles to timely disclosure	Principle of Timeliness- The need for electronic filing system
To get efficient creditor- protective mandatory disclosure	Principle of Enforcement- a. Liability for misreporting b. Sanctions c. Enforcement institutions

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