

# **SOLVENT FIRMS - PROTECTION OF CREDITORS**

In solvent firms, creditor protection relies primarily on ex ante mechanisms such as disclosure and standardized rules. These mechanisms aim to mitigate shareholder-creditor agency conflicts before financial distress emerges

**A) AFFILIATION STRATEGY/MANDATORY DISCLOSURE are common strategies**

Creditors usually receive information about the debtor company before borrowing

Creditors generally do not contract without obtaining basic financial information, unless they can rely on reputation or publicly available data. Larger lenders, in particular, routinely negotiate acceleration clauses and security interests to protect their position in case of covenant violations.

Creditors seek exit strategies: acceleration clauses, securities

Corporate law requires the disclosure of certain information:


- suffix (inc., ltd, GmbH, spa, etc.)
- charters to be filed in public registers

The mandatory disclosure is used mainly for the benefit of public small investors (market debt finance) as big lenders (banks) have incentives to screen and monitor the debtor. Banks are also well equipped to assess the credit risk associated to each corporate debtor and therefore they can tailor the terms of the lending.

Mandatory disclosure obligations typically benefit market-based creditors more than bank lenders. Because banks can privately gather information about borrowers, mandatory disclosure functions as a substitute for dispersed investors who cannot monitor the firm directly.

Banks can obtain financial information not generally available to the public investors so establishing a strong relationship with the borrower.

Banks engage in relationship lending, enabling continuous monitoring of debtor behavior and allowing them to renegotiate terms. By contrast, market creditors each hold small stakes and face high coordination costs, making mandatory disclosure an essential complement in public debt markets.

Public investors cannot avail sensitive financial information  risk of insider trading

## **A CLOSELY HELD CORPORATIONS**

- Such corporations are unable to receive financing by public investors, therefore their principal source of support comes from banks. Because banks supply most external financing to closely held firms, disclosure obligations are generally lighter. However, some jurisdictions, including the EU and Japan, still require filing of financial statements, although the level of detail may be reduced for smaller firms.**
- That is the reason why closely held corporations are not subject to mandatory disclosure**
- In US - no filing of financial statements, disclosure only for benefit of shareholders**
- In EU+Japan just filing of financial statements**
- US corporations can voluntarily submit financial statements to private credit bureaus**
- accounting methodology (GAAP or IFRS) not always used**

## **A2) PUBLICLY HELD CORPORATIONS**

- mandatory disclosure of all material information regarding securities issued and issuer. Publicly traded firms must comply with extensive initial and periodic disclosure rules, including prospectus filings, financial statements, and ongoing reporting of material events that may affect the value of securities. Over the past two decades, GAAP/IFRS convergence has strengthened comparability across jurisdictions.**
- US, Japan, Brazil and EU accounting standards (GAAP/IFRS) and other disclosure requirements are converging**

### **A3) GROUPS**

**- creditors of groups companies are more vulnerable, hence visible convergence in account standards**



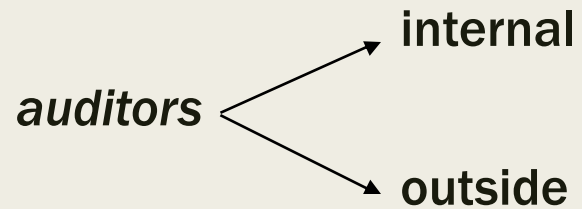
**consolidated accounts**

**Group accounting increases transparency regarding intra-group transactions, which are often used to shift assets, liabilities, or profits across entities. In most jurisdictions, listed groups must prepare consolidated accounts, though rules for closely held groups vary—Germany, for example, provides only summary-level reporting for dependent firms.**

**- EU: generally consolidation requirements are used also for closely held groups (excepted Germany)**

#### A4) ROLE OF GATEKEEPERS

- verify the quality of mandated disclosures



Gatekeepers enhance the reliability of mandated disclosures by verifying financial information and reducing information asymmetries. Their reputational capital acts as a form of assurance for creditors, potentially reducing the firm's cost of debt

- the functions of credit rating agencies (CRA) and private bureaus

The reputation and reliability of auditors and CRA can lower the cost of debt capital

- CRA and auditors: independence and licensing requirements, rating standards and ex post liability

**- Concerns about independence of audit firms:**

- a) Limits on non-audit services supplied by a statutory audit firm**
- b) Mandatory rotation of audit partners and firms**

**Following major scandals such as Enron and Parmalat, jurisdictions introduced restrictions on non-audit services, mandatory auditor rotation, and liability regimes aimed at reducing conflicts of interest and improving audit quality.**

**- The problem of the increasing liability of gatekeepers after big scandals (Enron, Parmalat, subprime, Lehman Brothers, etc.)**

**- The risk of conflicted rating released by the CRAs**

**CRAs' failure to properly rate mortgage-backed securities before the financial crisis triggered regulatory reforms, including licensing requirements, transparency obligations, and limits on the use of ratings for regulatory purposes. Policymakers increasingly aim to reduce overreliance on private ratings.**

## **B) RULES STRATEGY: LEGAL CAPITAL**

**-strategies which requires high coordination among creditors, that is the reason why it is not used in US where the main lenders are the public investors**

**Legal capital rules operate as standardized creditor-protection mechanisms, setting minimum equity thresholds, restricting distributions, and imposing actions when capital falls below statutory levels. These rules are more effective where creditors are homogeneous and capable of coordinating, such as in bank-dominated systems.**

## B1) MINIMUM CAPITAL

- Threshold for having access to the corporate form
- It is not a relevant barrier to gain limited liability, nor satisfy the equity needs of a business activity
- Current legal approach is to consent formation of corporations without any minimum capital requirement. Minimum capital is a weak predictor of a firm's long-term solvency. Empirical evidence shows that entrepreneurs typically invest some capital even when no minimum is imposed, suggesting that capital acts more as a signal of seriousness than as a genuine creditor safeguard.

EU public companies = > € 25.000

US+JAPAN no minimum capital requirements

-the meaning of providing a company with adequate capital: commitment and seriousness of the venture

## B2) DISTRIBUTION of profits RESTRICTIONS

- constraint sets in order to prevent asset dilution. Distribution restrictions generally prohibit payments to shareholders that would impair legal capital. Many systems also recharacterize undervalued transfers as “disguised distributions,” ensuring that shareholders cannot extract value through non-transparent transactions.

- The rule limit distribution of dividends, share repurchase and like operations with shareholders

- legal capital exceeding the statutory minimum is an “opt in” set of standard terms



- however legal capital cannot offer a sufficient protection for creditors



- need of covenant protection!

- UK and Germany extend distribution restrictions to undervalued transactions between the company and its shareholders

- US=reduction of legal capital (which sometime can be decided by directors) does not need creditors approval/consent by creditors

- EU+Japan=reduction of legal capital needs adequate protection for existing creditors (i.e. third parties' guarantees or veto rights)

- Efficacy of distribution restrictions relies on accounting methods (conservative vs. "true and fair view")

Conservative accounting tends to favor creditor protection by understating distributable profits, whereas fair-value accounting may reduce the reliability of distribution constraints by incorporating unrealized gains.

- Are the legal capital maintenance rules still useful when corporations use the *mark to market* (fair value) accounting methodology instead of the historical cost accounting?

### B3) LOSS OF CAPITAL

EU definition: net assets falling below half the company's legal capital

Loss of capital rules often require management to call a shareholders' meeting to consider recapitalization, dissolution, or other remedial measures. These obligations aim to shorten the "twilight period" in which shareholder opportunism is most harmful to creditors.

In France, liquidation becomes mandatory when net assets fall below half of legal capital and shareholders fail to act. In Germany, insolvency must be declared when net assets fall below zero. These strict triggers promote early intervention but may lead to premature filings if applied mechanically.

- Actions to be taken following a serious loss of capital: call a shareholders meeting for liquidation - fresh equity - stop trading - bankruptcy

- definition of *serious loss of capital*

- Recapitalize or liquidate rule

- Legal capital can be seen as a financial cushion for creditors
- Given the low minimum capital thresholds, loss of capital rules promote early filing for bankruptcy
- capital requirements more to promote early bankruptcy filing than a true capital adequacy !
- cost of bankruptcy / renegotiation of debts!

Overall, the legal framework for solvent firms relies on ex ante tools—disclosure, gatekeepers, and legal capital—to mitigate shareholder opportunism. Their effectiveness varies significantly across jurisdictions depending on creditor composition, accounting practices, and enforcement intensity.