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EFFECTIVE PROTECTION OF CREDITORS' INTERESTS IN PRIVATE COMPANIES: OBLIGATORY MINIMUM CAPITAL RULES *VERSUS* CONTRACTUAL AND OTHER EX POST MECHANISMS

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Abstract. *This article reveals arguments for and against the initial minimum capital of private companies. It explains that the initial minimum capital rule, which was entrenched in the Second Company Directive as of 13 December 1976, provides for little meaningful benefit in terms of creditors' protection in private companies. Furthermore, the present paper reviews possible alternative mechanisms for creditors' protection that could achieve the same effects as the minimum capital rule, although more efficiently and at lower costs. Finally, the author evaluates the legislation on the initial capital of private companies in Lithuania and proposes some potential future trends in this field.*

Keywords: *authorized capital of a public limited liability company, limited liability, creditors' protection in a private company, considerable capital reduction, capital sufficiency, capital maintenance.*

Introduction

It is traditionally believed that the rules governing legal capital¹ are efficient means for creditors' protection in private companies. What is more, the legal capital rules are deemed to be a price to pay for the shareholders' limited liability. It is regarded that legal capital rules, as *ex ante* mechanism, could prevent the creation of undercapitalized companies that would shift the risk of a firm to the creditors.² The primary purpose of these rules is to regulate the conflict that exists between creditors and shareholders regarding the allocation of the company's capital. This conflict is obvious once the company appears to be insolvent—has insufficient money to meet all its financial obligations.³

At the European Community level, for the first time, the rules for maintaining capital in public limited liability companies were entrenched in the Second Council Directive of 13 December 1976⁴ (the Second Directive). Accordingly, it does not apply to private companies. The regulation of such companies is entirely within the national legislation of each Member State. However, the majority of the EU countries' legislators have incorporated the Second Directive capital rules into the private companies' legislation. In Lithuania, the majority of the legal capital provisions of the Second Directive have been integrated into the Law on Companies of the Republic of Lithuania⁵ (the Law on Companies), which is also entirely applied to private limited companies (Lith. *uždariusios akcinės bendrovės, UAB*).

However, capital rules applied to private companies are nowadays argued a lot. Recent debates, in continental Europe and internationally, in relation to reforming the legal capital regime demonstrate that the current legal capital rules do not do much in protecting creditors; thus, alternative regulatory strategies should be employed in order

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- 1 The core of the *Legal Capital Rules* is the limited liability of private companies' shareholders. Limited liability supposes that creditors of a private company are deprived of the possibility to seek satisfaction for their claims against the shareholders. Thus, the basic reasoning for the necessity of *Legal Capital Rules* is creditor protection. At the statutory level the *Legal Capital Rules* were stated in the so-called Second Directive, which dates from 1976. It co-ordinates national provisions on the (i) formation of public limited liability companies and minimum share capital requirements, (ii) distributions to shareholders and (iii) increases and deductions in capital to insure that the capital is maintained in the interests of creditors. Accordingly, the below mentioned (i)-(iii) provisions comprise the traditional *Legal Capital Rules*.
 - 2 Machado, F. S. *Mandatory Minimum Capital Rules or Ex Post Mechanisms?* [interactive]. [accessed 10-07-2010]. <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1568731>.
 - 3 Payne, J. *Legal Capital in the UK Following the Companies Act 2006* [interactive]. *Oxford Legal Studies Research Paper*. No. 13/2008 [accessed 10-07-2010]. <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1118367>.
 - 4 Second Council Directive 77/91/EEC of 13 December 1976 on coordination of safeguards which, for the protection of the interests of members and others, are required by Member States of companies within the meaning of the second paragraph of Article 58 of the Treaty, in respect of the formation of public limited liability companies and the maintenance and alteration of their capital, with a view to making such safeguards equivalent [interactive]. [accessed 10-7-2010]. <<http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=DD:17:01:31977L0091:LT:PDF>>.
Article 6 of the Second Directive provides that the laws of the Member States require that, in order for a company to be incorporated or obtain authorization to commence business, a minimum capital (the amount of which should be not less than EUR 25,000) should be subscribed.
 - 5 Law on Companies of the Republic of Lithuania. *Official Gazette*. 2000, No. 64-1914.

to address creditors' interests.⁶ It should be also noted that in France (2003) and in Germany (2008) major reforms abolishing the minimum capital rule have taken place.

This article reviews the pros and cons of private companies' legal capital rules and, specifically, the Second Directive's minimum capital requirement⁷ when the former is applied to private companies. After proving that minimum capital rules do not offer an effective protection to creditors and that these rules are regarded as an unjustified restriction to the private company, the author analyzes the alternative contractual and other (so-called *ex post*) creditors' protection mechanisms, which could be deemed an efficient sub-institute of the minimum capital mechanism.

Until now, the Lithuanian legal doctrine has not paid much attention to the analysis of the minimum capital rules in private companies.

Research object: minimum capital requirements in private companies, contractual and other (so-called *ex post*) creditors' protection mechanisms.

Primary objective of this publication: to analyze whether the minimum capital rule provides for an efficient or illusory protection to private companies' creditors against the corporate failure and shareholders' limited liability. *Tasks* for attaining the objective:

(1) to disclose arguments for the minimum capital requirement for private companies;

(2) to disclose arguments against the minimum capital requirement for private companies and demonstrate the insufficiency of the mandatory minimum capital requirement as a creditors' protection mechanism;

(3) to analyze the alternative, the so-called *ex post* mechanisms of creditors' protection;

(4) to evaluate the legislation on the initial capital of private companies in Lithuania and propose some future trends in this field.

Research methods. In the present article, the author applies a systematic analysis, comparative, logical, document analysis methods and other general research methods.

1. Arguments for a Minimum Capital Requirement

Before probing into the reasons for the reform of the minimum capital requirement, it is necessary to analyze what the minimum capital rule has originally aimed to achieve.

1.1. Creditor Protection

As mentioned before, the main objective of the minimum capital requirement is to protect creditors. Generally speaking, the minimum capital requirement is a rule that requires incorporators to contribute assets of at least the specified minimum value to

6 Ewang, F. *An Analysis and Critique of the EU's Minimum Capitalization Requirement*. *EU Minimum Capitalization Requirement* [interactive]. [accessed 10-07-2010]. <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1015708>.

7 The Second Directive requires a minimum capital of EUR 25,000 only for public companies.

their company before its registration is allowed.⁸ Due to the business liberalization in the nineteenth century, entrepreneurs were finally able to form their own companies and limit their liability. Actually, limited liability has been said to be one of the most—if not the most—important achievements in commercial law, for it permitted all kinds of enterprises to be undertaken. Hence, because shareholders were able to limit their liability to the capital actually invested even in small firms, minimum capital rules started to be viewed as a way to protect creditors.⁹

Historically it was deemed that the limited liability of shareholders is a privilege given by the state rather than an original right of shareholders. To obtain this benefit, shareholders have to make some contributions. Accordingly, the aim of setting the minimum capital requirement, as an imposition of 'an entrance fee', is to make sure that such a privilege is enjoyed by the entrepreneurs who are serious and responsible.

The basic idea is that through limited liability shareholders confine their losses only to the amount invested; however, may gain unlimited profits. That means that a great part of business risks is shifted to creditors. Shareholders may benefit from dividends distribution and share capitalization, whereas creditors can only pursue the company's assets. What is more, shareholders can divert assets from the company by means of distribution of dividends, salaries, etc. Therefore, as generally shareholders are protected more than creditors, there are some costs imposed on shareholders in order to decrease the disparity in risks and benefits between shareholders and creditors of a limited liability company.

It is further assumed that creditors look at the minimum capital as a 'guarantee fund', as security, and as a source for the collection of payment of their claims in a situation of an early insolvency.¹⁰ According to this concept, the larger minimum capital is required by the legal act, the larger level of protection creditors can enjoy.

It is typically agreed that legal capital rules substantially advantage (protect) involuntary creditors and creditors who are technically voluntary but do not have the bargaining power to protect themselves through covenants, securities and similar instruments.¹¹

1.2. Prevention of Frivolous Incorporation

By acting as a barrier to formation, the minimum capital requirement may also serve as a tool to prevent the abuse of the privilege of limited liability. Also, the minimum legal capital rule is deemed to serve as a test of entrepreneurs' seriousness and determination to start commercial activities and gain the limited liability. In addition, the rule screens out opportunists who try to use empty companies to perpetrate frauds or engage

8 Gordon, Y. M. C. *Why does China not Abolish the Minimum Capital Requirement for the Limited Liability Companies?* [interactive]. [accessed 04-06-2010]. <<http://ssrn.com/abstract=1442791>>.

9 Machado, F. S., *supra* note 2, p. 9.

10 *Ibid.*

11 Ewang, F., *supra* note 6, p. 10.

in purely speculative activities. In that way, the minimum capital rule benefits creditors by maintaining an orderly market.¹²

Furthermore, the minimum paid-in capital is also assumed to be a response to certain perceived abuses associated with the formation of ‘\$2 companies’. ‘\$2 companies’ is a term used to describe limited liability companies in certain common law jurisdictions like Australia and New Zealand, which do not impose the minimum capital requirement. There, companies operate and commence business with the share capital as low as \$2.¹³

1.3. Material Basis for the Company’s Operation

This function is also known as a means of ensuring the adequacy of a company’s asset for its activities (‘capital adequacy’). According to this, the minimum paid-in capital is deemed to furnish the company with a material basis for its commercial activities. Some proponents of the minimum capitalization requirement assume that it presents a capital adequacy requirement in the sense that it would protect those creditors who have no market power. In other words, it is useful in order to protect the ‘weakest creditors’, e.g. such as trade creditors, employees, other involuntary creditors—those with little or no bargaining power.

Minimum initial amount contributed should enable a company to have a chance to survive in a competitive market or even facilitate borrowing soon after incorporation. It is assumed that creditors, to a certain extent, do check the initially paid-in capital before contracting and concluding any covenants with the company.

Other explanation is that the purpose of the paid-in capital is that a company should have sufficient funds to meet its initial needs after incorporation so that the risk of the early insolvency is minimized.¹⁴

The imposition of the minimum initial share capital requirement on limited liability companies is much related to the capital maintenance principle—by serving as a minimum initial level for the capital that is to be maintained. Capital adequacy is further stated in Article 17 of the Second Directive. The effect of this provision was that it required directors of a public company which has suffered a serious loss of capital (i.e. its asset are half or less of its paid-in authorized capital¹⁵) to call an extraordinary general meeting to consider what steps should be taken to maintain a specified level of its asset. The ‘capital adequacy’ analogy is reinforced by the so-called ‘re-capitalized’ rules adopted by most EU Member States.¹⁶ In Lithuania, as in the great majority of other EU Member States, this rule is also applied to private companies.¹⁷

12 Gordon, Y. M. C., *supra* note 8, p. 25.

13 Ewang, F., *supra* note 6, p. 15.

14 Gordon, Y. M. C., *supra* note 8, p. 25.

15 The national laws of the Member States have to define considerable loss of the capital within the meaning of the Second Directive; however, its limits may not exceed half of the authorized capital.

16 *Ibid.*

17 Article 38(3) of the Law on Companies (Lith. *Akcinių bendrovių įstatymas*) sets forth that if the equity capital of a company falls to less than ½ of the amount of the authorized capital referred to in the statute, the

Considering the abovementioned reasons, it is apparent that historically the minimum capital requirement was adopted to play a significant role of securing creditors' rights and guarding the limited liability from potential abuses of shareholders.

Now let us consider the arguments revealing that the initial capital requirement provides for an illusory protection of creditors against corporate failure and limited liability.

2. Arguments against a Minimum Capital Requirement

The proponents of the abolition of the minimum initial capital rule see the prevalence of creditor self help through contractual covenants, personal securities of shareholders, and other *ex post* creditor protection mechanisms. It is argued that the minimum capital requirement in private companies in Europe not only fails to efficiently fulfil its abovementioned functions but also is costly and unjustified.

2.1. Minimum Capital Does Not Efficiently Protect Creditors

An initial capital requirement operates when the company commences its commercial activity. However, in practice (in the EU, Lithuania as well), a company may totally deplete its initial legal capital by incurring substantial losses,¹⁸ it can reach a point where equity is lost and the risk of business is entirely shifted to creditors.¹⁹ In the author's opinion, the most the minimum capital can offer to creditors' rights is a limited protection to prevent early insolvency soon after the incorporation.

Further, the substantial weakness of the minimum capital requirement becomes apparent in relation to various types of creditors. As far as voluntary creditors are concerned, minimum capital requirements are not necessary. As pointed out by the European Court of Justice²⁰, such creditors are able to negotiate on the terms of their contracts.²¹ The proponents of the minimum capital imposition view another group of creditors, i.e. involuntary creditors, as a weak party to be protected by such a requirement. Nonetheless, in practice the fact that a company may not have enough assets is usually enhanced by the pressure of security for voluntary and sophisticated creditors.²² Accordingly, involuntary and weak creditors are in a bad position because the few assets that the com-

board (the manager of the company if the board is not formed) shall convene the general meeting of shareholders within 3 months after the day on which it learned or should have learned about the existing situation.

18 As it has already been mentioned, the majority of EU jurisdictions (Lithuania as well) provide for stricter legal capital rules by imposing a 're-capitalize' approach when half of the legal capital is lost; however, usually it is solely required to call a general meeting to debate on this target issue.

19 Machado, F. S., *supra* note 2, p. 20.

20 Judgement of the European Court of 5 November 2002, *Überseering BV v. Nordic Construction Company Baumangement GmbH (NCC)*, Case 208/00; Judgement of the European Court of 9 March 1999, *Centros Ltd v. Erhvervs- og Selskabsstyrelsen*, Case C-212/97; Judgement of the European Court of 30 September 2003, *Kamer van Koophandel en Fabrieken voor Amsterdam v. Inspire Art Ltd*, Case C-167/01.

21 Ewang, F., *supra* note 6, p. 20.

22 Machado, F. S., *supra* note 2, p. 20.

pany owns are used to satisfy the creditors' claim. However, in the author's opinion, it is obvious that the minimum capital requirement is not related to the securities gained by voluntary creditors and the risk shifted to involuntary creditors.

What is more, some authors²³ argue that involuntary creditors can even benefit from the covenants binding upon the company and concluded with sophisticated creditors. It is claimed that weaker creditors can 'free-ride' on the covenants and agreements of sophisticated creditors because the benefits of restrictions on the managerial autonomy of the company (e.g. to sell a significant part of the real estate owned by the company) imposed on it will flow to all creditors. Even if only one sophisticated creditor has imposed such covenants on a corporate debtor, all the creditors of that company will gain protection from wrongdoing.²⁴ On the other hand, very restrictive covenants for the benefit of a sophisticated creditor may impede the company's operation to such an extent that the company cannot meet its obligation under the agreement concluded with a weak (e.g. trade) creditor. In the author's opinion, the abovementioned 'free-ride' theory has a little positive effect for the benefit of weak creditors; however, it is usual that a particular covenant is designed to protect the individual interests of the creditor who/that is a party to the relevant covenant rather than the collective interests of all the creditors.

In fact, the main reason revealing the lack of the protection of creditors by the minimum capital rule is that the initial minimum capital is the same for all private companies (in particular, within a Member State), notwithstanding the commercial activity the private company is commencing. If the minimum capital requirement was to afford substantial protection to creditors, it should relate to the type of business, the actual size of the company and, more importantly, its riskiness. The point is that each company has its own 'entrepreneurial, organizational and financial characteristics' and needs.²⁵ However, the Second Directive as well as national legal acts implementing the Second Directive set a 'one-size-fit-all' standard to all companies, although the capital needs of individual companies are so diverse and different.²⁶

Of course, in practice for the incorporators of a company it would be impossible to measure the risks of all types of business the company is engaged in. Further, those risks would also have to be re-measured every time when a new agreement is concluded or a new investment is pursued. However, this additionally reveals that the sums required to cover the company's future liabilities and amounts of future creditors' claims are actually not estimated *ex ante*.

Considering the above arguments, the author draws a conclusion that the minimum capital requirement lacks an economic rationale; consequently, it is obvious that it does not sufficiently protect creditors, i.e. it fails to properly serve as creditors' protection.

23 Enriques, L.; Macey, J. Creditors versus capital formation: the case against the European legal capital rules [interactive]. *Cornell Law Review*. 2001, 86(6) [accessed 04-06-2010]. <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=291471>.

24 *Ibid.*

25 Machado, F. S., *supra* note 2, p. 25.

26 The exceptions to this rule are financial institutions and insurance companies which are not free to pursue their risky activities with an amount of capital chosen by their incorporators.

2.2. Minimum Capital Misleads the Creditors

The proponents of the minimum capital requirement further assume that the fixed amount of a company's initial capital should inform its potential creditors on the assets the company possesses. The concept of the authorized capital can be seriously misleading as a company's initial capital gives no indication of the finance and creditability of the company. Although the minimum capital requirement has been recognized by the law as the price for the advantage of limited liability to shareholders, taking into consideration the net worth of the company, it may not be easy to maintain a constant equilibrium between the nominal capital of the company and the net value.²⁷

It is obvious that the value of the assets contributed to the company at the moment of its incorporation in time can depreciate or appreciate in value. That is why the author agrees with the opponents of the minimum capital requirement: 'any monetary pricing introduced as a signal to the market of the value of the shares in the equity of the company is almost a fiction and may not only be misleading but also meaningless'²⁸.

For instance, a Lithuanian private limited company formed with a minimum initial capital of LTL 10,000 may purchase a new computer for LTL 10,000, which immediately after the beginning of its use will be worth LTL 9,000 just because it is not new anymore. Accordingly, creditors would be mistaken because the initial capital contributed by the shareholders was LTL 10,000 and the company's assets should correspond to this amount. However, if the company is in default, creditors will only be able to satisfy their claims over an asset worth LTL 9,000. Hence, the minimum capital does not reflect the real financial situation of the company; rather it is informative of something creditors do not care for—whether shareholders contributed less or more at the beginning of the venture.

2.3. Minimum Capital Creates an Unnecessary Barrier to Incorporations

The imposition of the minimum capital requirement usually creates undesirable barriers to the incorporation of small private companies. It is common for scholars to argue that the minimum capital creates barriers in jurisdictions where it is set at a high value.²⁹ Hence, there is a group of Member States' jurisdictions that set a relatively low minimum capital requirement (e.g. EUR 2,896 for Lithuanian UAB; EUR 2,560 for Estonian OU; EUR 2,863 for Latvian SIA; EUR 3,005 for Spanish S.L.; EUR 1,164 for Maltese Ltd.). However, in the author's opinion, even a relatively low sum of the estimated initial capital has created barriers due to the financial crisis as of 2007. For instance, according to the official data from the Company Register of the Republic of Lithuania, the amounts of incorporations of private companies in the fourth quarter of

27 Ewang, F., *supra* note 6, p. 30.

28 *Ibid.*

29 Machado, F. S., *supra* note 2, p. 27.

2008 and the first quarter of 2009 decreased by approximately 25 per cent compared with the first quarters of 2008.³⁰

As mentioned above, this requirement is a particular barrier to small firms the incorporators of which may ‘find it difficult to gather the required initial capital’³¹.

In summary, it is quite obvious that the minimum paid-in capital rules are no longer very useful and, despite the shareholders’ costs incurred due to this rule, cannot efficiently protect creditors. Let us now consider some alternative methods/mechanisms (in the absence of the minimum capital rule) that could achieve the same effects as the minimum capital rule is supposed to achieve, although more efficiently and at lower costs.

3. Alternative Mechanisms

3.1. Contractual Creditors’ Protection Mechanisms

When considering contractual creditors’ protection mechanisms, it is obvious that they can be applied only to voluntary creditors (i.e. all of the creditors who contracted with the company at their own will). Indeed, voluntary creditors usually have stronger negotiating skills and more experience, and they can easily rely on the agreement concluded with the company.

First of all, creditors usually charge adequate interest rates. Secondly, agreements may generally restrict the freedom of a company, e.g. a debtor is usually not entitled to invest, purchase or acquire assets of a particular value, to borrow or to lend particular sums, to mortgage or pledge real property, etc. without a prior written consent of the creditors. Thirdly, sophisticated loan/credit and other similar commercial agreements usually prohibit any distributions to shareholders. Another traditional contractual mechanism to limit the company’s asset decrease is subordinating shareholders’ loan agreements concluded with the target company for the benefit of creditors, which means that upon signing a particular financial agreement with the creditor, the company undertakes neither to pay nor to settle off any obligations for the benefit of the shareholder who has provided a loan to the company, unless the company has fulfilled its obligation under the creditor’s agreement. The latter subordination agreements are now becoming more frequent in the Lithuanian commercial market as well.

Moreover, creditors, when concluding an agreement, may ask for additional securities from the company, i.e. real estate mortgage, pledge, bank guarantee, etc. Recently, under the current conditions of economic recession, creditors also ask for personal securities of shareholders for the obligations of the company. In such cases, creditors ‘contract out of the doctrine of limited liability’³². Logically that would mean that the

30 Company Register of the Republic of Lithuania [interactive]. [accessed 15-07-2010]. <<http://www.registrucentras.lt/jar/stat/kap.php?kap=IKI10K&fok=310>>.

31 Machado, F. S., *supra* note 2, p. 28.

32 *Ibid.*

shareholder, once having paid for its limited liability by contributing the initial capital, 'pays' for the second time when personally securing the company's obligations.

It is undeniable that the abovementioned contractual mechanisms place the secured creditors in a better position than the unsecured creditors in regard to pursuing their claims. However, as it has already been stated, the benefits of some of the restrictions and securities imposed by sophisticated creditors also accrue to weak or involuntary creditors.³³ Besides, it is arguable whether a weak or involuntary creditor could gain any benefits and protection from the statutory minimum capital requirement in such a case when a sophisticated voluntary creditor has evaluated the low credibility of the company and decided to require additional securities from it. Therefore, the legal acts should include some other *ex post* mechanisms that protect all types of creditors and do not impose significant costs on the incorporators as the minimum capital requirement does. In the next sections the author reveals a few mechanisms which are used in some of EU Member States.

3.2. Piercing the Corporate Veil

This *ex post* mechanism is lifting the corporate veil. Accordingly, if a company sets up an inadequate capital structure and/or because of the default of shareholders the company cannot fulfil its obligation, debts incurred by such a company may be satisfied over the personal assets of the shareholder or of the parent company.³⁴ Therefore, courts may allow creditors to reach the assets of shareholders.

It should be noted that, although not to the same extent as in the U.S., courts in Great Britain and Ireland, where the legislator sets no minimum capital requirement to private companies at all,³⁵ apply the abovementioned rule more frequently than courts in other Member States where historically a mandatory minimum capital is relatively high.³⁶ What is more, almost every case in Great Britain concerning the disregarding of legal personality relates to private companies. In the author's opinion, the case-law of the courts to interpret the doctrine of piercing the corporate veil as an effective means for creditors' protection obviously has contributed a lot to the decreasing of the importance of the minimum capital requirement at the moment of incorporation.

The Civil Code of the Republic of Lithuania³⁷ has actually introduced the doctrine of 'piercing the corporate veil' as a legal measure to contend against the problem of shareholders abusing the benefit of limited liability. However, there are few cases³⁸

33 Machado, F. S., *supra* note 2, p. 28.

34 *Ibid.*

35 For instance, in Great Britain the incorporator is free to establish a private company (*Ltd*) of 1 pence.

36 EUR 25,000 for German GmbH; EUR 35,000 for Austrian GesmbH.

37 Article 2.50 (3) of the Civil Code of the Republic of Lithuania states: 'where a legal person fails to perform his obligations due to acts in bad faith of a member of the legal person, the member of a legal person shall, in a subsidiary manner, be liable for the obligations of a legal person by his property'.

38 For instance, judgments of the Supreme Court of Lithuania as of 18 February 2004, Case 3K-3-124/2004; 3 February 2004, Case 2K-23/2004; 28 November 2006, Case 3K-3-604/2006; 14 June 2006, Case 3K-3-383/2006; 12 December 2007, Case 3K-3-572/2007; 12 March 2008, Case 3K-3-163/2008; 9 July 2009, Case 3K-3-329/2009.

when the Lithuanian courts have applied this rule and pierced the shareholders' limited liability. Concerning particular circumstances when the doctrine of 'piercing the corporate veil' can be applied and the complication of proving the 'bad faith' of a shareholder according to the Lithuanian legal acts and case-law, it is not clear whether creditors in Lithuania can rely on such protection. In spite of that, such an *ex post* mechanism, even not usual in the Lithuanian jurisdiction, may protect creditors' rights not burdening the incorporation.

Hence, the judicial doctrine of 'piercing the corporate veil' in the cases of unreasonably low capitalization would most likely be cheaper in terms of administrative costs than the general minimum capital requirement.³⁹

3.3. Other *ex post* Mechanisms

Some authors⁴⁰ state that the application of 'liability or mandatory insurance' might be used to mitigate the risk shifted on the creditors' side in limited liability companies. However, in the author's opinion, such an alternative may be possible; however, in terms of the insurance sum that is to be fixed, the same difficulties as with the minimum capital requirement are to be faced. Not a single insurance sum would be satisfactory across industries, firms of different sizes or even production technologies.⁴¹ What is more, it would also be very costly and difficult to properly evaluate and distribute various companies according to their commercial activities and potential harm and losses their creditors may incur.

Finally, it should also be noted that once an insurance company becomes a contract creditor, it itself gets a very high risk of liability. The question is: who will insure the insurer? Besides, the price of mandatory liability insurance might be very high and the insurance requirement would be an even more burdening rule than the minimum capital requirement.

Another mechanism that could be applied is the equitable subordination of shareholders' loans or restructuring according to equity. When a company is in financial distress, its shareholders and directors may decide to award the company some additional financial aid or to continue their business rather than to initiate insolvency procedure. If the shareholders make such a decision, they can either make capital contributions or lend the required sums to the company as a loan. As shareholders hope to recover at least a part of additional investments, they are more likely to provide some loan than to contribute the investments to the equity.

In Germany, the mentioned doctrine of the equitable subordination of shareholder loans has been developed by courts on the basis of 'equity substitution law' (*Eigenka-*

39 Armour, J. *Share Capital and Creditor Protection – Efficient Rules for a Modern Company Law* [interactive]. 2000 [accessed 04-06-2010]. <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=234518>.

40 Gabaldon, T. The lemonade stand: feminist and other reflections on the limited liability of corporate shareholders. *Wanderbilt Law Review*. 1992, 63; Cheffins, B. R. *Company Law: Theory, Structure and Operation*. Oxford: Oxford University Press, 1997; Freedman, J. Limited liability: large company theory and small firms. *Modern Law Review*. 2000, 63(3): 317–354.

41 Ewang, F., *supra* note 6, p. 38.

pitalersatz). In 1980 the doctrine was codified.⁴² The main idea of the target doctrine is that when a company is in financial distress, the shareholder's loan is converted into equity if 'under similar conditions a reasonable creditor does not give the same loan'⁴³.

In the author's opinion, if such an *ex post* mechanism is established by law and applied by courts, it may be more efficient, and it is obvious that such a creditor protection mechanism cannot be considered as additionally burdening the incorporators.

4. The Minimum Capital Requirement in Lithuania

The Law on Companies⁴⁴ applicable in Lithuania since 2001 has provided for the amount of the initial authorized capital in a private company equal to LTL 10,000 (EUR 2,896). As it has been mentioned, Lithuania belongs to the Member States that have chosen a relatively low rate of the initial authorized capital for private companies. However, it should be noted that no analyses on the efficiency of initial capital or studies have been made yet. The Lithuanian legislator simply adopted the Second Directive's initial capital rule for private and public companies, although it is originally obligatory for public companies only.

It should be noted that in December 2009 the amendment to the Draft Law on Companies⁴⁵ was submitted to the Parliament of the Republic of Lithuania. Among other amendments of and supplements to the Law on Companies, it was proposed to decrease the initial capital for private companies to LTL 1,000 (approximately EUR 290). It was argued that a decrease of the initial capital requirement would facilitate the incorporation of limited liability companies; thus, it would stimulate the establishment of private companies which could be regarded as the best legal form for promoting small and medium business in Lithuania. However, the main argument against the abovementioned decrease was that private companies would be used for 'one-time projects' and frivolous incorporations would be motivated.⁴⁶ As a result, when a new wording of the Law on Companies of the Republic of Lithuania as of 15 December 2009 was adopted, the amount of the initial authorized capital in a private company was not reduced. In the author's opinion, there are more effective means for monitoring a frivolous incorporation, i.e. it could be supervised according to the financial annual reports of companies submitted to the Register of Legal Persons, by various means of tax law, etc. It would be fair and proportional to justify the higher initial capital requirement only as a mechanism to prevent the establishment of frivolous companies.

42 Machado, F. S., *supra* note 2, p. 28.

43 *Ibid.*

44 Law on Companies of the Republic of Lithuania. *Official Gazette*. 2000, No. 64-1914.

45 Draft Law on Companies of the Republic of Lithuania [interactive]. [accessed 07-07-2010]. <http://www3.lrs.lt/pls/inter3/dokpaieska.showdoc_l?p_id=360117&p_query=&p_tr2>.

46 Conclusions of the Committee on Economics of the Parliament of the Republic of Lithuania [interactive]. [accessed 07-07-2010]. <http://www3.lrs.lt/pls/inter3/dokpaieska.showdoc_l?p_id=360908&p_query=&p_tr2>.

On the other hand, it is true that a number of *ex post* mechanisms analyzed in this article (such as sophisticated and conscious creditors' self-help means, 'piercing the corporate veil' doctrine, etc.) are really efficient and would protect creditors if the financial markets and legal systems are mature. However, the market economy of Lithuania is still in its development stage. In the author's opinion, Lithuania simply lacks an adequate analysis and other prerequisite conditions for decreasing the initial capital of private companies.

In the author's opinion, the future protection of creditors in private companies will depend on the development of *ex post* mechanisms and, especially, contractual creditor protection mechanisms rather than mandatory rules on initial capital. This is the reason why in terms of private companies in the future Lithuanian Law on Companies it is necessary to weaken those costly and non-effective requirements imposed on the authorized capital and strengthen the alternative methods focused on the protection of creditors.

Conclusions

1. The minimum initial capital requirement remains deeply rooted in the company law of the majority of the EU Member States' as well as Lithuania. Although the Second Directive imposes this requirement on public companies only, private companies are also unnecessarily burdened (in Lithuania as well). The purpose of this rule is firstly to protect creditors' rights.

2. In this article, the author reviewed the pros of the initial capital rule and argued that the initial capital neither provides sufficient protection to creditors nor is a guarantee fund or an adequate capital for the commencement of all the commercial activities, despite the company's size, the kind of activities and the level of its potential liability.

3. In order to prove such a conclusion, not only arguments against the minimum capital requirement were analyzed—some more efficient mechanisms for the protection of creditors' interests in private companies were reviewed. Further, it was demonstrated that creditors are able to protect themselves through contractual and other *ex post* mechanisms (e.g. piercing the corporate veil, subordination of shareholders loans).

4. The author suggests that the Lithuanian legislator, which has simply adopted the Second Directive's initial capital rule for private and public companies, even though it is originally obligatory only for public companies, should in the future decrease the sum required for the initial capital and afterwards completely abolish the minimum capital requirement. Therefore, what regards private companies in the future, the costly and non-effective requirements on the authorized capital should be reduced and the application of alternative methods for creditor protection should be encouraged.

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EFEKTYVI UŽDARŪJŲ AKCINIŲ BENDROVIŲ KREDITORIŲ INTERESŲ APSAUGA: ĮSTATINIO KAPITALO REIKALAVIMAS AR SUTARTINĖS BEI KITOS KREDITORIŲ TEISIŲ APSAUGOS PRIEMONĖS?

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Santrauka. *Europos Sąjungos bendrovių teisės sistemoje kapitalo palaikymo doktrina, kuriai istoriškai priskiriama kreditorių apsaugos funkcija, o ypač reikalavimai įstatiniam kapitalui, užima ypač svarbią vietą. Įstatinio kapitalo apmokėjimo reikalavimas yra kapitalo pakankamumo doktrinos, kitaip vadinamos kapitalo doktrinos, elementas. Teisinėje literatūroje šio instituto svarba siejama su ribota juridinių asmenų dalyvių atsakomybe prieš kreditorius ir šių dviejų asmenų grupių interesų konfliktu.*

Nepaisant to, kad įstatinio kapitalo instituto pagrindinė paskirtis ir funkcija, kaip jau minėta, yra kreditorių interesų apsauga, pastaruoju metu Europos Sąjungos ir tarptautiniu mastu vyko nemažai diskusijų, ar iš tikrųjų įstatinio kapitalo reikalavimas uždarojo tipo bendrovėms yra efektyvi kreditorių interesų apsaugos priemonė? Tokias diskusijas dar labiau paaštrina Europos Teisingumo Teismo (toliau – ETT) formuojama Europos Sąjungos įmonių laisvo steigimosi praktika. ETT yra tiesiogiai nurodęs, kad įstatinis kapitalas vargu ar gali apsaugoti kreditorių interesus. Dauguma Europos Sąjungos bendrovių teisės specialistų laikosi nuomonės, kad uždarujų bendrovių įstatinio kapitalo reikalavimas yra silpniausia grandis visoje kapitalo palaikymo doktrinoje; be to, nemažai autorių yra tos nuomonės, kad kreditorių (ypač tų, kurių ekonominė ir derybinė galia yra didesnė) interesai galėtų būti efektyviau apsaugoti alternatyviomis priemonėmis, o ypač sutartinėmis.

Šiuo metu visame pasaulyje daugėjant ekonominio sunkmečio sukeltų problemų ir padarinių bendrovių teisėje minėti klausimai tampa dar aktualesni. Lietuvos teisės doktrinoje kol kas nėra skirta daug dėmesio bendrovių kapitalo palaikymo taisyklių, taip pat ir įstatinio kapitalo reikalavimo, analizei.

Šio straipsnio autorė siekia išanalizuoti įstatinio kapitalo reikšmę uždarujų akcinių

bendrovių kreditorių apsaugos sričiai ir išsiaiškinti, ar įstatinio kapitalo institutui istoriškai priskiriamos funkcijos iš tikrųjų yra veiksmingos. Autorė straipsnyje prieina prie išvados, kad uždaryjū akcinių bendrovių kreditorių teisės gali būti apsaugotos kitomis priemonėmis, kurios yra veiksmingesnės ir reikalaujančios mažiau sąnaudų nei įstatyminė įstatinio kapitalo taisyklė. Autorė taip pat apžvelgia Lietuvos įstatymo leidėjo poziciją dėl įstatinio kapitalo.

Reikšminiai žodžiai: *įstatinis uždarosios akcinės bendrovės kapitalas; ribota bendrovių atsakomybė, bendrovės kreditorių teisių apsauga, kapitalo reikšmingas sumažėjimas, kapitalo pakankamumas; kapitalo palaikymo doktrina.*

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