

The creditor protection law within corporate debt financing

Abstract

In this paper I have dealt with the protection of a creditor in debt corporate financing, where the debtor is a capital company. In this case, there are relatively specific conflicts of interest between creditors on one hand and shareholders on the other. This is due, in particular, to the characteristics of a capital company where the shareholders are not liable for the liabilities of the company (or they are limited in their liability) and are not responsible for their decisions, while the assets of the company are separated from the assets of the shareholders. Shareholders and creditors thus make competition for company assets. While the shareholders want to realize their investment as quickly as possible, they stand in an imaginary queue as residual creditors of the company at the end. This may lead to their attempt to overtake fixed creditors. This motivation culminates especially in situations where the company is in financial difficulties. Shareholders are aware of the fact that in case of insolvency, no company assets will be distributed to them.

In this thesis, I focus on protection of creditors of companies from opportunistic behaviour of shareholders, who may withdraw the company's assets at the expense of its creditors, i.e. they overtake creditors in the queue on the assets, or cash flows, of a company. In this analysis, I assume that the bank is the lender, whereas it is not secured creditor. The reason is that a bank is highly professional creditor who is able to enforce and negotiate very effective safeguards under the contractual relationship. In this analysis I focus on various tools within legal regulation protecting company's creditors and I critically evaluate this legal framework. Afterwards, I proceed to analyse such legal tools from the point of view of a bank and assess whether such regulation for a bank as a lender is beneficial or such a bank can protect itself more effectively by contractual arrangements and finally, what is the impact of unsecured bank financing on other company's creditors.

At first, I analyse regulation of profit distribution. Legislator must carefully find a compromise between interests of creditors on the one hand and interests of shareholders on the other. While creditors would prefer that financed company does not distribute dividends before their claims have been paid because it increases the risk of payment default, shareholders would prefer dividend distribution in maximum amount without any limitation. As part of this analysis, I find the doctrine of capital maintenance as totally inoperable and ineffective. On the other hand, I believe that, apart from the application of this doctrine, the existing legislation is sufficient. Bank will usually determine sophisticated financial covenants and liabilities

regulating distribution of the company's assets. However, some parts of this legal regulation will be irreplaceable for the bank. This is especially insolvency test, legal responsibility imposed on members of statutory body and consequences of unduly distributed dividends.

I also analysed regulation of financial assistance. While it is also related to the doctrine of capital maintenance, it goes far beyond it, regulating cases without influence on the company's share capital. I have come to the conclusion that this regulation is not appropriate from a creditor protection point of view when it regulates a number of transactions which do not reduce company's assets and which, by nature, correspond to transactions that the company may conclude with third parties without such restrictions. I believe that the risks associated with financial assistance are properly addressed by corporate law outside this specific regulation with sufficient means of creditor protection, and there is no reason for a specific legal regime different from that for other transactions between shareholders and the company. However, any assistance the cause of which is donation should be not permitted because of breaching or circumventing the law (blanket dividend distribution). In my opinion, this regulation has no benefit for a bank, rather it is the opposite, it makes acquisition financing more difficult and generates inefficient costs.

In addition, I analysed protection of a lender of a company against distributions mimicking dividends, when shareholder tries to obtain company's property at the expense of creditors of such a company, or also shareholders, through the transactions with the company where consideration is determined to the detriment of such company, i.e. the company receives or provides the performance at a non-market price, for benefit of its shareholder. The main instrument of creditor protection in this regard is fraudulent transfer law. However, identified inefficiency of current legal regulation is that only valid legal act can be challenged, which reduces effectiveness of this instrument. Given that this institute interferes with the rights of third parties, it is an instrument that the bank is not able to negotiate on a contractual basis, and this legal protection will therefore also be fundamental to it as part of its protection. On the contrary, I find the regulation of the so-called internal trading according to Sec. 255 of Business Corporate Act completely inoperable and redundant.

In some cases, creditor of a company may also claim to satisfy its claim against the company against another person, namely member of a statutory body or shareholder - influential person. In certain cases, these persons are responsible for the company's liabilities. This is a very appropriate addition to the creditor protection system affecting persons taking part in such

transaction being made to the detriment of the company's creditors, which will be beneficial also for a bank.

Insolvency law plays a crucial role in company's creditor protection, in particular, through the insolvency fraudulent transfer law. Since insolvency law is a public and mandatory law that addresses the problem of collective satisfaction of the creditors of an insolvent company and provides a mandatory distribution system for its creditors, there is hardly any room for contractual protection negotiated by the bank.

A very important role in the protection of the creditor in connection with the bankruptcy of a company is played by regulation in Sec. 68 of Business Corporate Act establishing the so-called "wrongful trading" tort, which ensures that a member of the statutory body resists pressure of shareholders and motivation to behave opportunistically in a situation which is the most risky for creditors, and in order to avert the imminent bankruptcy he does everything necessary and reasonably foreseeable. In my opinion, however, it is contrary to the principles of insolvency proceedings that the breach of this obligation by such a member of the statutory body results in the incurrance of a liability for individual debts instead of obligation to contribute to the bankruptcy estate.

I have also analysed instruments of foreign legal regulation such as doctrine of so-called piercing of corporate veil, debt subordination, and debt recharacterization to equity. I did not find these tools as appropriate in general and what is more, Czech law addresses respective risks with other legal instruments.

Finally, I analysed contractual mechanisms used by banks to eliminate or address opportunistic behaviour of debtors and their shareholders, namely the risk of distributing the company's assets at expense of banks. Banks in this regard impose on funded companies a number of obligations in credit agreement regarding limitation of dividend and asset distributions, creation of other debts and provision of security, pursuing investments, mergers, etc. that are tailored to the specific credit case and hence, financial position of the funded company. Under the threat of credit acceleration (early repayment), funded companies have a great incentive to fulfil their obligations arising out of credit agreement and this motivation can be further strengthened by inclusion of a shareholder into the credit case (by his securing the credit etc.).

I concluded that analysed Czech legal regulation is set functionally and rationally except for three conceptual shortcomings, namely the part of legal regulation based on legal capital maintenance doctrine including regulation of financial assistance and internal shopping pursuant to Sec. 255 of Business Corporate Act and furthermore, preference of invalidity of

juridical act over relative inefficiency of judiciary acts and the liability of a member or a former member of a statutory body for the fulfilment of all its obligations towards particular creditors pursuant to Sec. 68 of Business Corporate Act, while the remaining legal regulation shows also certain partial shortcomings, however, without any need to implement a new legal tool to protect company's creditors. Furthermore, I concluded that the bank is indeed able to apply a number of sophisticated contractual mechanisms which provide it with effective protection against credit risks of a particular borrower. However, in many areas, a bank will benefit from the protection provided by the statutory law, which cannot be replaced by contractual arrangements. Moreover, the presence of the bank thus has a very positive effect on other creditors of the company and the contractual protective mechanism applied by the bank constitutes a specific mechanism protecting other company's creditors.

Key words: debt, creditor, corporate