European Business Organization Law Review 7: 95-122
© 2006 T.M.C.ASSER PRESS DOI10.1017/S1566752906000954

Creditor Protection Through Mandatory Disclosure

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Abstract
Creditor protection through mandatory disclosure has long been a highly debated issue among corporate lawyers. This paper considers whether the legal system should compel corporations to disclose information publicly in order to better protect their creditors. First, the paper elaborates on the various economic rationales of mandatory disclosure advanced by proponents of that approach. Second, it reviews the theoretical framework of mandatory disclosure. Third, it gives a brief overview of the law on those mandatory disclosure requirements that primarily – or at least partially – focus on corporate creditor protection. Fourth, it outlines limitations of mandatory disclosure with respect to creditors and debtor companies. Fifth, it briefly surveys several important challenges to mandatory disclosure regulation with respect to materiality, standardization, comprehensibility and timeliness. Finally, this paper deals with various legislative options to enforce creditor-protective mandatory disclosure.

Keywords: creditor protection, mandatory disclosure, *Inspire Art*, materiality of information, soft information, Basel II, standardization, comprehensibility, timeliness, enforcement of disclosure duties.

1. INTRODUCTION

1.1 A classic debate

It is almost self-evident that those who lend money or advance credit can benefit from having reliable financial information pertaining to the corporations with

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whom they deal. This is true for virtually any type of creditor, be it a bank, an institutional investor, a commercial creditor in supply industries, or the proverbial small tradesman rendering services to the corporation. In dealing with the prospective debtor, all of these creditors will thus be able to carry out in a more effective fashion the process of "screening" to determine whether it is worthwhile to transact. Also, with an ongoing debt contract, a creditor can assess on a periodic basis the debtor's creditworthiness and determine whether corrective action is required.[1] It is, therefore, perfectly plausible that corporations do provide their various creditors to a very large extent with information regarding their financial status. In addition, many jurisdictions require corporations to publicly disclose certain basic information before starting business or borrowing funds. For example, virtually all important jurisdictions require corporations to file their charters with state officials or public registers, giving access to information about the incorporators, the directors, the legal capital, restrictions on director liability, and the like. Many jurisdictions have improved their public registers in recent years in order to present such information in a more user-friendly fashion. Furthermore, all jurisdictions require corporations to keep proper accounting, and many of those jurisdictions, in addition to that, require certified auditing and subsequent disclosure of accounts.[2]

And still, after almost a century of fierce legislative, judicial, and academic debate, disclosure stands right in the center of the debate over the best and most efficient ways to organize company activities *vis-à-vis* shareholders, creditors, and other market participants. Regulators literally all over the world, from New Zealand[3] and Australia[4] to the United States[5] and Europe, are in the process of addressing whether their domestic disclosure rules are rigorous enough in the light of the problems and implications thrown up by recent corporate collapses –

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[1] L.C.B. Gower and P.L. Davies, *Principles of Modern Company Law*, 7th edn. (London, Sweet & Maxwell 2003) p. 531.

[2] G. Hertig and H. Kanda, 'Creditor Protection', in R. Kraakman, et al., eds., *The Anatomy of Corporate Law – A Comparative and Functional Approach* (Oxford, Oxford University Press 2005) p. 71 at p. 79.

[3] See, e.g., the establishment of a Working Group for Improved Product and Investment Advisor Disclosure of the Securities Commission of New Zealand.

[4] See, e.g., the recent establishment of a roundtable by the Australian SEC examining proposals for better protecting investors by reforming financial disclosure and auditor oversight.

[5] See, e.g., SEC Regulation FD (Fair Disclosure) of 24 August 2000, Release No. 33-7881, analyzed by S.E. Bochner and S. Bukhari, 'The Duty to Update and Disclosure Reform: The Impact of Regulation FD and Current Disclosure Initiatives', 7 *Stan. J.L. Bus. & Fin.* (2002) p. 225; M. Steinberg and J. Myers, 'Lurking in the Shadows: The Hidden Issues of the Securities and Exchange Commission's Regulation FD', 27 *J. Corp. L.* (2002) p. 173; M. Morano, 'Reg FD: Its Effects on the Role of Analysts, Market Volatility on Wall Street, and Information Flow from Issuers', 54 *Rutgers L. Rev.* (2002) p. 535.

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such as HIH and One.Tel in Australia, Enron and Worldcom in the United States, and Ahold, Comroad and Parmalat in Europe to name only few of the most spectacular ones – and the risks associated with inadequate disclosure.

1.2 The HLG approach to disclosure

Completely in line with these developments, the High Level Group of Company Law Experts in its Final Report from 2002 strongly advocated disclosure of information as a regulatory instrument.[6] According to the Report, requiring disclosure of information can be a powerful regulatory tool in company law. It enhances the accountability for and the transparency of the company's governance and its affairs. Therefore, the Group recommends that capital and control structures of listed companies should be disclosed comprehensively and that such disclosure should be updated continuously. However, the Report goes one important step further in stating: "Disclosure requirements can sometimes provide a more efficient regulatory tool than substantive regulation through more or less 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."[7] Hence, the Reports suggests that the European Union, in considering new – and amending existing – regulation of company law, should carefully consider whether disclosure requirements are better suited to achieve the desired effects than substantive rules.

It is that concept of superiority of mandatory disclosure over merit regulation that deserves particular attention, since it bluntly challenges firm convictions of company regulators as well as academics in many Member States of the European Union. Especially in the context of modernization of the current EU regime of creditor protection, the concept of "disclosure-over-merit-regulation" deserves attention. This paper considers whether the legal system should compel corporations to disclose information publicly in order to better protect its creditors. Part 1 of this paper elaborates on the various economic rationales of mandatory disclosure advanced by proponents of that approach. Part 2 rehearses the theoretical framework of mandatory disclosure. Part 3 gives a brief overview of the law on those mandatory disclosure requirements that primarily or at least in part aim at corporate creditor protection. Part 4 outlines limitations of mandatory disclosure

[6] *Report of the High Level Group of Company Law Experts on a Modern Regulatory Framework for Company Law in Europe* (hereinafter cited as 'High Level Report'), Brussels, 4 November 2002, pp. 33-35, 45-47, 95-96.

[7] High Level Report, op. cit. n. 6, at p.34.

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with respect to creditors and debtor companies. Part 5 briefly surveys several important challenges to mandatory disclosure regulation with respect to materiality, standardization, comprehensibility and timeliness. Finally, part 6 deals with various legislative options to enforce creditor-protective mandatory disclosure.

2. THEORY: VIRTUES OF CREDITOR-PROTECTIVE MANDATORY DISCLOSURE

2.1 **Protective function of mandatory disclosure**

Looking somewhat closer at the economic rationale for mandatory disclosure, two basic types of justifications can be identified. First, there are various protective functions of mandatory disclosure, which in general are hardly contested today. According to one early analysis, investor confidence (in a broad sense of share and debt capital investors) in the capital market can be regarded as an overriding aim of disclosure, while investor protection, the monitoring of company law, the transparency of the market operations, and sales promotion can be regarded as subsidiary aims.[8] Other commentators have suggested that investor confidence and protection (and thereby the promotion of investor confidence) and prevention of fraud are of equal rank as functions of mandatory disclosure.[9] Still other commentators emphasize investor or individual protection and market protection (protection of the functioning of the market) as the two main protective aims of disclosure with a couple of further protective functions subordinated to each of them.[10]

2.2 **Market failure**

The second type of justification circles around market efficiency and market failure, as already mentioned, and still is far less uncontested among economists and legal academics.[11] It is well accepted that credit markets like securities markets are characterized by incomplete information, which gives rise to problems of adverse selection, moral hazard, and underproduction of information. Mandating disclosure

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[8] E. Wymeersch, *Control of Securities Markets in the European Economic Community*, Collection Studies, Competition – Approximation of Legislation Series No. 31 (Brussels 1977) pp. 139-142; cf. also OECD Principles of Corporate Governance, SG/CG (99) 5 sub IV.

[9] N. Moloney, *EC Securities Regulation* (Oxford, Oxford University Press 2002) p. 120.

[10] K.J. Hopt, *Der Kapitalanlegerschutz im Recht der Banken* (Munich, Beck 1975); H. Merkt, *Unternehmenspublizität – Die Offenlegung von Unternehmensdaten als Korrelat der Marktteilnahme* (Tübingen, Mohr Siebeck 2001).

[11] T. Baums, 'Changing Patterns of Corporate Disclosure in Continental Europe: The Example of Germany', 30 *Giurisprudenza Commerciale* (2003) pp. 53-69.

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is expected to reduce the cost of capital.[12] Therefore, it is pretty safe to say that mandatory disclosure today is not a matter of principle (disclosure does have beneficial effects),[13] but a matter of counterbalancing its positive and negative effects (is disclosure too costly in the light of its beneficial effects?). With respect to the fostering of market efficiency through promotion of price accuracy, it is argued that, where markets are efficient, in that information is reflected in prices, disclosure serves to ensure that securities or debt instruments are correctly priced, in that they reflect the intrinsic value of the issuer, and, in turn, given the role of financial markets in allocating capital, that capital is efficiently allocated. Investment or capital-allocation decisions are therefore made not on the basis of speculation or advertising but in an efficient manner, based on the value of the security. The role of disclosure in establishing a pricing mechanism has been emphasized as critical, in that behavior of securities prices has a deep effect on the efficiency of securities markets.[14] This is probably also correct for debt pricing.

At the center of the law and economics debate over disclosure as a regulatory tool stands, as already mentioned, the question whether and to what extent the mere dissemination of issuer information should be mandatory and managed by public rules or left to market forces and the incentives given to companies and other suppliers of information to provide adequate disclosure. The market-failure doctrine teaches that regulation should be imposed on the market only in order to correct a market failure. It operates on the assumption that a perfect market exists which will allocate resources efficiently and that regulation is a corrective to an imperfect market. Information may represent a market failure in this area in that, in the absence of public control, it will not be disseminated, or not sufficiently,[15] as a result of its public good nature,[16] and the efficient allocation of resources will accordingly be prejudiced.[17] Mandatory disclosure regimes can thus be viewed as

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[12] F. Allen and D. Gale, *Comparing Financial Systems* (Cambridge, MA, The MIT Press 2000).

[13] See R. Kraakman, 'Disclosure and Corporate Governance: An Overview Essay', in G. Ferrarini, et al., eds., *Reforming Company and Takeover Law in Europe* (Oxford, Oxford University Press 2004) p. 95 at p. 96.

[14] J.C. Coffee, 'Market Failure and the Economic Case for a Mandatory Disclosure System', 70 *Va. L. Rev*. (1984) p. 717 at p. 734.

[15] On the problems of underproduction and underutilization of information, see G. Hertig, R. Kraakman, and E. Rock, 'Issuers and Investor Protection', in Kraakman, et al., op. cit. n. 2, p. 193 at pp. 204-207.

[16] On the public good nature of information, see A. Ogus, *Regulation – Legal Forms and Economic Theory* (Oxford, Clarendon Press 1994) pp. 33-35; J.P. Trachtman, 'The Applicability of Law and Economics to Law and Development: The Case of Financial Law', in J.J. Norton and M.T. Andenas, eds., *Emerging Financial Markets and the Role International Financial Organizations* (London/The Hague, Kluwer Law International 1996) p. 54.

[17] A.C. Page and R.B. Ferguson, *Investor Protection* (London, Weidenfeld and Nicholson 1992) pp. 36 et seq.

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"a desirable cost reduction strategy through which society, in effect, subsidizes search costs to secure both a greater quantity of information and a better testing of its accuracy."[18] Absent mandatory disclosure, investors would also have greater private incentives to invest in the pursuit of information that gives rise to trading gains. As Coffee observes, "collectivization through mandatory disclosure minimizes the social waste that would otherwise result from misallocation of economic resources to this pursuit."[19] In addition, agency problems like opportunistic management behavior to the detriment of corporate creditors could give managers a private incentive to manipulate the disclosure of information, either by concealing bad news or exaggerating good news.[20]

Information markets are also subject to signaling problems that can make it impossible to distinguish high-quality credible information from low-quality information. These difficulties can arguably lead to a "lemons" type failure. Furthermore, even if each issuer had an incentive to provide just the right quantity and quality of information to the market, they could do so using a wide variety of different formats and reporting conventions. These variations could impose significant information-processing costs on investors seeking to compare and contrast voluntary reports. Mandatory disclosure conventions economize on these costs.[21]

Recent advances in behavioral economics provide yet another rationale for mandatory disclosure regimes. Executives and promoters are arguably subject to perceptual biases which can cause them to be honestly more optimistic than the proverbial "prudent merchant" acting under similar circumstances. A mandatory disclosure regime which requires that bad news be revealed along with an insider's honestly held optimistic assessment can arguably help correct for a range of cognitive biases and at the same time promote more accurate pricing in the markets.[22]

Alternatively, it has been argued that, left to their own devices, companies and their management will ultimately produce sufficient information for the market to provide optimum levels of protection and information for investors, because investors will discount the value of securities in respect of which less information is disclosed, as those securities represent a riskier investment when compared to

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18 Coffee, loc. cit. n. 14, at p. 722.

19 Ibid.

20 P.G. Mahoney, 'Mandatory Disclosure as a Solution to Agency Problems', 62 *U. of Chi. L. Rev*. (1995) p. 1047.

21 M. Kahan and M. Klausner, 'Standardization and Innovation in Corporate Contracting (or "The Economics of Boilerplate")', 83 *Va. L. Rev.* (1997) p. 713.

22 D. Langevoort, 'The Epistemology of Corporate-Securities Lawyering: Beliefs, Biases and Organizational Behavior', 63 *Brook. L. Rev*. (1997) p. 629.

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securities in respect of which more information is disclosed.[23] Where information would not be produced other than via a mandatory disclosure system, the benefits of the information in question are outweighed by the costs of production. As companies compete for creditors' funds, they are, one might argue, already given adequate incentives to produce information to the extent and quality required by the market. Proponents of this line of reasoning can rely on empirical research comparing the disclosure produced by US companies before and after the introduction of the mandatory federal disclosure regime in 1933 and 1934. This research found that companies typically voluntarily produced financial statements (albeit in accordance with a listing obligation) which contained, for the most part, a large proportion of the information which would be required subsequently under the mandatory federal regime.[24] In the US context, this argument has two far-reaching implications. First, voluntary disclosure is preferable over mandatory disclosure. Second, securities regulation is not a proper subject for federal jurisdiction. Hence, it should be returned to the individual state legislatures where it was before the federalization of securities legislation,[25] bringing disclosure regulation back to the realm of competition ("competitive federalism"[26]), thereby ensuring that information is disclosed in such quantity and quality as the market requires. From the perspective of pragmatism, however, it seems that public control over companies and their disclosure policies ensures that disclosure is made available in a standardized manner which facilitates investors in making comparisons. Indeed, the importance of standardization is highlighted in the reforms which have been proposed to the European Union's current disclosure regime.

3. Reality: Current State of Creditor-Protective Mandatory Disclosure

3.1 Harmonized EU Member State law

Today, by virtue of EU company law regulations, all EU jurisdictions share an identical minimum standard level of disclosure.[27] According to the First Company

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[23] Cf., H.S. Scott, 'Internationalization of Primary Public Securities Markets', 63 *Law and Contemporary Problems* (2000) p. 71 at p. 75 et seq., who challenges the discounting theory.

[24] F.H. Easterbrook and D.R. Fischel, 'Mandatory Disclosure and the Protection of Investors', 70 *Va. L. Rev*. (1984) p. 669; R. Romano, 'Empowering Investors: A Market Approach to Securities Regulation', 107 *Yale L.J*. (1998) p. 2359 at p. 2373 et seq.

[25] See the thorough analysis in R. Romano, *The Advantage of Competitive Federalism for Securities Regulation* (Washington, AEI Press 2002).

[26] Romano, op. cit. n. 25, at pp. 112-146.

[27] V. Edwards, *EU Company Law* (Oxford, Oxford University Press 1999) p. 19 et seq.

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Law Directive of 1968, companies have to disclose a number of documents and particulars, e.g., the instrument of constitution; the appointment, termination of office and particulars of the representatives and the directors of the company; and on an annual basis the amount of capital subscribed as well as the balance sheet and the profit and loss account.[28] The First Directive itself justifies this minimum standard with the following reasoning. The coordination of national provisions concerning disclosure is of special importance, particularly for the purpose of protecting the interests of creditors. Moreover, the basic documents of the company should be disclosed in order that creditors may be able to ascertain their contents and other information concerning the company. The duty to disclose the annual accounts is then defined more precisely in Fourth Company Law Directive of 1978, stipulating that the annual accounts shall give a true and fair view of the company's assets, liabilities, financial position, and profit or loss.[29] Finally, the Fourth Directive requires companies to submit professional audits.

However, in practice the seemingly high standard of the disclosure obligation for all companies under EU law is toned down in part for three reasons. First, European jurisdictions freely use their power to simplify accounting requirements for medium[30] and small-sized[31] companies. Second, they do not provide for satisfactory enforcement of public disclosure requirements, particularly in the case of closely held companies, which still flout EU mandatory disclosure to a remarkable extent.[32] Third, and most importantly, several jurisdictions reject EU accounting methodology and stick with traditional accounting principles. This is the case under domestic German accounting law, which still disregards the information-oriented "true and fair view" accounting standard just mentioned in favor of a more conservative so-called "precaution" approach that purports to be more protective of creditor interests by signaling that a company's assets and revenue can safely cover its liabilities or, if they might not, by ensuring that creditors know this and can file for corrective action.[33]

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[28] Art. 2(1)(a)-(f) of First Council Directive 68/151/EEC of 9 March 1968 on co-ordination 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, with a view to making such safeguards equivalent throughout the Community, *OJ* 1968 L 65/8-12.

[29] Art. 2(3) of Fourth Council Directive 78/660/EEC of 25 July 1978 based on Art. 54(3)(g) of the Treaty on the annual accounts of certain types of companies, *OJ* 1978 L 222/11-31.

[30] Art. 47(2) of Fourth Council Directive 78/660/EEC.

[31] Art. 11 Fourth Council Directive 78/660/EEC.

[32] M. Habersack, *Europäisches Gesellschaftsrecht*, 2nd edn. (Munich, Beck 2003) p. 44.

[33] The 'true and fair view' approach is not considered an overriding principle of accounting but is limited to the notes to the annual accounts. This is known in German accounting as the 'uncoupling' approach (*Abkopplungsthese*), see R.W. Walz, 'Der Einfluß von Globalisierung

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This apparent reluctance to implement disclosure is pretty much in line with a certain continental paternalism regarding disclosure as a regulatory tool.[34] Such paternalism may in part be due to an overly emphasized investor protection policy. The position is expressed quite well by a comment on the High Level Report by the Group of German Experts on Company Law: "One has to insist that disclosure requirements can replace substantive regulation only in rare instances. Unfortunately, the High Level Group fails to recognize that the main function of disclosure requirements is limited to reinforce and to supply substantive rules. It is only in the area of corporate governance and only with respect to issues of minor importance that substantive regulation is dispensable. The High Level Group is wrong in believing that disclosure requirements would be generally apt to prevent misgovernance and in particular the exploitation of minority shareholders and creditors."[35] Another critical assessment can be found in a recently published study on alternative systems for capital protection, sponsored by the Dutch Government: "The publication of financial information offers only limited protection to creditors. … Creditor protection via a duty to publish is therefore not sufficient."[36] Correspondingly, politicians as well as many academics in Germany, like in other continental jurisdictions, adhere strongly to shareholder and creditor protection through merit regulation mostly of the "legal capital preservation" type,[37] and it is only a minority of commentators that have begun to question the virtues of that traditional concept in light of modern disclosure-based regimes abroad.[38]

3.2 **United Kingdom**

Opposed to what could be fairly described as the continental mainstream is the situation under UK law. Since the early 1990s, there has been a broad consensus

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und Europäisierung auf die Auslegung des geltenden Bilanzrechts (Einzelabschluß)', *Zeitschrift für betriebswirtschaftliche Forschung*, Sonderheft 40 (1998).

[34] K.J. Hopt, 'Disclosure Rules as a Primary Tool for Fostering Party Autonomy', in S. Grundmann, W. Kerner, and S. Weatherhill, eds., *Party Autonomy and the Role of Information in the Internal Market* (Berlin/New York, De Gruyter 2001) p. 246 at p. 249; cf. more generally as to contract law A.T. Kronman, 'Paternalism and the Law of Contracts', 92 *Yale L.J.* (1983) p. 763.

[35] See 'Zur Entwicklung des Europäischen Gesellschaftsrechts: Stellungnahme der Arbeitsgruppe Europäisches Gesellschaftsrecht (Group of German Experts on Corporate Law) zum Report of the High Level Group of Company Law Experts on a modern Regulatory Framework for Company Law in Europe', 24 *Zeitschrift für Wirtschaftsrecht* (2003) p. 863.

[36] H.E. Boschma, M.L. Lennarts, and J.N. Schutte-Veenstra, *Alternative Systems for Capital Protection* (Groningen, Institute for Company Law 2005) s. 4.2.2.

[37] For a critical analysis, see P.O. Mülbert and M. Birke, 'Legal Capital – Is There a Case against the European Capital Rules', 3 *EBOR* (2002) p. 695.

[38] For an early challenge to the traditional legal capital concept, see F. Kübler, *Aktie, Unternehmensfinanzierung und Kapitalmarkt* (Cologne, 1989).

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that the matters covered in the various corporate governance codes which have been issued should not be legally enforceable or governed by merit-type regulation. Instead the codes have been linked to disclosure on a "comply or explain" basis in the rules of the UK Listing Authority. Breach of these rules can theoretically lead to public or private censure and in extreme cases to fines for the company or individual directors, although no cases have been reported in which any of these sanctions have been applied in relation to the corporate governance regime. Disclosure via "comply or explain" has been accepted as the most effective means of achieving the greatest possible level of compliance with the corporate governance regime in the United Kingdom.[39]

3.3 Corporate governance codes

In the meantime, in many EU Member States compliance with corporate governance codes became voluntary, with disclosure recommended. The different methods of disclosure adopted by the Member States do not necessarily mean that the various codes lack force and effect. Reputational and market forces, combined with increased disclosure, may result in significant pressure for compliance depending on a number of factors, including status of the entity responsible for issuing the code and the amount of information about compliance which is available to the market.[40]

3.4 ECJ case law

At the same time, the European Court of Justice has become a most powerful proponent of creditor protection through disclosure obligations. Moreover, the Court has expressed strong reservations about the concept of creditor protection through statutory regulation of capital maintenance. In *Inspire Art*,[41] the Court favored the idea of creditor protection via capital market disclosure and information, as opposed to the company law concept of statutory regulation of capital maintenance. The Court did not spend any time examining whether or not statutory minimum capital requirements provide a suitable mechanism for protecting creditors. Instead, the Court established that the company's potential creditors were adequately protected by the mere knowledge that the establishment of limited liability companies from different jurisdictions is regulated by different legal provisions, as far as minimum capital requirements and the liability of

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[39] Law Society of England and Wales, *Memorandum* (2001) p. 8.

[40] See European Commission, *Comparative Study of Corporate Governance Codes Relevant to the European Union and its Member States* (January 2002).

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

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company directors are concerned. At the same time, the Court clarified that attempts by the Member States to circumvent the incorporation principle or to introduce provisions relating to capital which discriminate against the establishment of foreign companies would be held incompatible with the principle of freedom of establishment.

In its earlier *Centros* decision,[42] the Court put a strong emphasis on mandatory disclosure as a less restrictive but suitable equivalent to a substantive minimum capital requirement. The possibilities for the company creditors and contracting parties to distinguish by way of disclosed information between a foreign branch and a domestic company, as well as supportive Community law measures (annual accounts and disclosure requirements), provide most effective protection.

According to *Überseering*,[43] the protection of domestic creditors could only under very specific circumstances and conditions justify an impairment of the freedom of establishment by substantive regulation. Obviously, the Court again favors creditor protection through disclosure over merit regulation, which is less capable of infringing upon the freedom of establishment.

In contrast to EC law, US corporate law sharply distinguishes between close and public corporations. With respect to close corporations, the law of the States only requires them to *keep* financial accounts. There is no duty to *publicly disclose* those accounts. This leaves creditors of close corporations rather unprotected by statutory law. With respect to public corporations, some protection is given to creditors through extensive financial disclosure requirements under securities regulations which originally and in the first place were designed for the protection of actual and potential shareholders, with the publication of the annual accounts lying at the center. In addition, US accounting law, like the law of the United Kingdom, seeks to protect creditors by requiring public corporations to present a true and fair view of their current financial position. In the United States, most of the information needed by creditors to evaluate the solvency of their client corporations is provided for on a private or contractual basis. Closely held US corporations have to submit detailed financial information to credit rating agencies in order to get access to financing in the ordinary course of business. Credit insurers and credit rating agencies have the power to obtain in many circumstances voluntary information on corporate accounts. Furthermore, there are additional sources they can rely upon to build up files on corporations. These include the press, privately compiled director's databases, trade references, and the payment history of corporations.[44]

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

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

[44] B.R. Cheffins, *Company Law, Theory, Structure and Operation* (Oxford, Clarendon Press 1997) p. 518 et seq.

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4. LIMITATIONS TO CREDITOR-PROTECTIVE MANDATORY DISCLOSURE

4.1 Creditors

4.1.1 *Heterogeneous group*

In considering key limitations to the concept of creditor-protective mandatory disclosure, let us begin with corporate creditors. They form a pretty heterogeneous group, with banks and large institutional investors at the upper end, medium- and small-sized commercial creditors mostly in supply industries in the middle range, and the proverbial small tradesman rendering services to the corporation at the low end. Some of these creditors are very sophisticated, others are not. Most of them extend credit to several or even many corporate debtors, thereby diversifying their risk.

4.1.2 *Hybrid creditors*

Let us consider large, professional, and sophisticated creditors first. In many cases, these creditors are simultaneously shareholders of the debtor corporation, with considerable shareholdings that grant access to all internal information of the corporation. For this group of insider-creditors (or hybrid creditors), mandatory disclosure is of marginal relevance at best. It provides a first-hand or supplemental informational basis of limited value and size, while more substantial and important information is provided for by internal (and confidential) information exchange.

On the other hand, if debt is traded by securitization on large and liquid debt capital markets, the situation of creditors (mainly investment funds) is comparable to securities investors. Here, the need for extensive disclosure of debtor-related information is identical to disclosure under securities regulation.

4.1.3 *Large creditors*

What has been said about hybrid creditors is likewise true for those creditors that grant credit only on the basis of financial covenants, like public bonds, bank loans, and private placements. As we see in the US and UK credit industry (and to a growing extent in continental practice as well), creditors can find out much of what they want to know without the assistance of legislation. A party that is contemplating lending money or extending credit in most instances has the option of declining to proceed unless those running the corporation agree to provide information concerning its current financial status and submit designated material facts at relevant intervals. Those that are seeking to borrow money or obtain credit will then comply or have to look elsewhere. Creditor pressure can similarly

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provide a company with the incentive to arrange for an audit or similar external review.

In practice, US professional creditors do their best to install relevant safeguards into credit arrangements, typically in the form of financial covenants.[45] In these agreements, which typically are built into the loan contract, companies promise to restrict their dividend payments, maintain a certain minimum capital, and maintain a healthy relationship between proprietary and borrowed capital. This method of regulation is rounded off and effectuated by the fact that company adopts information and accountancy obligations, including, in particular, the delivery of so-called "soft" company data.[46] A comparison of these individual contracts with German capital maintenance law reveals that the two are remarkably similar.[47] Quite pointedly, it looks as though the German statutory law regarding capital maintenance is being replicated contractually.[48] On the same note, it cannot be denied that this contractual protection is less reliable.[49] Creditors must individually and contractually safeguard themselves, which leads to an increase in transaction costs. However, since financial covenants are available for many different industries as model contracts, the increase in transaction costs and the lack of reliability is limited.[50]

4.1.4 *Small creditors*

This brings us to small contractual creditors. It is obvious that the viability of the rescission of financial covenants depends on the bargaining power of the creditor in question. Small creditors, who lack sufficient bargaining power to negotiate a financial covenant in the first place, or who do not wish to negotiate a covenant because of the time, cost, and expertise required, are indirectly protected through a kind of reflex, which originates in the covenants already negotiated by the larger

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[45] S.A. Ross, R.W. Westerfield, and J.F. Jaffe, *Corporate Finance*, 7th edn. (Boston, McGraw-Hill 2005) p. 425; B. Manning and J.J. Hanks, *Legal Capital*, 3rd edn. (Westbury, N.Y., The Foundation Press 1990) pp. 105-113; Mülbert and Birke, loc. cit. n. 37, at p. 723 et seq.

[46] For a brief discussion of soft information, see Hertig, Kraakman, and Rock, loc. cit. n. 15, at p. 199 et seq.

[47] C. Leuz, 'The Role of Accrual Accounting in Restricting Dividends to Shareholders', 7 *European Accounting Review* (1998) p. 580; R. Leftwich, 'Accounting information in private markets: evidence from private lending agreements', 58 *Accounting Review* (1983) p. 23.

[48] W. Schön, 'Gesellschafter-, Gläubiger- und Anlegerschutz im Europäischen Bilanzrecht', 29 *Zeitschrift für Unternehmens- und Gesellschaftsrecht* (2000) p. 706 at p. 727.

[49] For an overview of UK law, see A. Keay, 'Director's Duties to Creditors: Contractarian Concerns Relating to Efficiency and Over-Protection of Creditors', 66 *Modern L. Rev*. (2003) p. 665.

[50] H. Merkt, 'Der Kapitalschutz in Europa – ein rocher de bronze?', 33 *Zeitschrift für Unternehmens- und Gesellschaftsrecht* (2004) p. 305 at pp. 317-319.

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creditors. Those large creditors exercise the function of a factual trustee for all small creditors. Borrowers, on the other hand, generally have longstanding relationships with one or several banks, giving the latter privileged access to firm-specific information. Hence, major banks can be expected to often have much better solvency information than other creditors.[51]

Admittedly, such protection offered to smaller creditors is not comprehensive, for they are neither able to influence the alteration nor the abolition of the contract to which they are not a party in a formal sense. Moreover, if larger creditors are able to obtain satisfactory repayment before insolvency occurs, then smaller creditors will be completely unprotected. As for the companies which are subject to the covenants, they often find themselves subject to contradictory or cumulative obligations which can restrict their trading capacity to an unreasonable extent.

Seen from the continent, however, caution is urged with regard to financial covenants, as the influence exerted by creditors can reach such an extent that, as under French or Italian law, the outside creditors could become liable under the law of bankruptcy, as a result of poor company management being attributable to the outside creditor, or, as under German law, the prohibition on the repayment of loans under the law of equity could be activated. Nonetheless, it is interesting to observe the growing significance of this individual contractual creditor protection on the continent. In particular, large banks which have advocated the statutory capital maintenance rules for decades increasingly desire to safeguard their creditors' businesses as a result of falling interest rates on loans and improved return on equity.[52]

4.1.5 *Involuntary creditors*

Let us finally consider involuntary creditors, e.g., tort victims of dangerous corporate activity. Involuntary creditors are by definition not among the addressees of disclosure. However, even involuntary creditors might benefit from disclosure since disclosure operates to the advantage of all corporate creditors, whether voluntary or not. In the case of involuntary creditors, disclosure is effective in its so-called "controlling" or "enforcement" function.[53] For example, a

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[51] G. Hertig, *Using Basel II to Facilitate Access to Finance: The Disclosure of Internal Credit Ratings*, ECGI-Law Working Paper No. 31/2005 (March 2005) p. 9, available at: <http://ssrn.com>, advancing however this rationale in favor of mandatory disclosure of internal bank rating.

[52] K.J. Hopt, 'Gesellschaftsrecht im Wandel', in H. Hirte, K. Frey, and R. Wank, eds., *Festschrift für Herbert Wiedemann zum 70. Geburtstag* (Munich, Beck 2002) p. 1013 at p. 1019.

[53] Kraakman, loc. cit. n. 13, at p. 97.

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legal requirement that the corporation has to remain solvent or may not become insolvent would be meaningless without disclosure of the annual accounts. Similarly, a limitation as to dividend payments in order to protect corporate liquidity requires extensive public disclosure to alert creditors or minority shareholders about possible violations of that limitation. However, as in the case of small contractual creditors, large creditors that negotiate for financial covenants act in their capacity as trustees for all small creditors, both voluntary and involuntary. If they insist on a conservative valuation of a company's assets, all other creditors benefit automatically. If they bargain for certain dividend payment restrictions, those restrictions are enforced to the benefit of all creditors.

4.1.6 *Preventive vs. corrective protection*

Compare this type of creditor protection to the standard creditor protection of the type still prevalent on the continent. In case of default, a senior secured creditor may have a simple interest in getting possession of collateral no matter what happens to the firm.[54] Negotiating for a pledge asset, e.g., a mortgage, a security interest, or a lien, amounts to "cherry picking" to the detriment of smaller creditors and, in most cases, accelerates insolvency instead of preventing it, because it limits the company's financial flexibility.

In sum, given the growing extent to which creditors individually contract for protection through financial covenants and the like, the market failure rationale (underproduction of information) as a justification for creditor-protective mandatory disclosure is gradually losing its persuasive power.

4.2 **Debtor companies**

4.2.1 *Trading activity vs. market participation*

In order to determine which companies are obliged to comply with mandatory disclosure, the High Level Report suggests dividing corporations into three basic types: listed companies, open companies (whose internal structure allows listing) and closed companies (whose shares are not freely transferable). According to the High Level Report, "there may be good reasons why the regulatory approach in company law for these three types of companies should be different. For listed companies, a certain level of uniform, compulsory, substantive rules may be required to sufficiently protect both shareholders (investors) and creditors. On the

[54] See R. La Porta, F. Lopez-de-Silanes, A. Shleifer, and R.W. Vishny, 'Law and Finance', 106 *Journal of Political Economy* (1998) p. 1113 at p. 1144.

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other hand, disclosure requirements and market forces may provide powerful alternative disciplinary instruments."[55]

This appears to be a somewhat formalistic and inflexible concept of threefold disclosure for listed, open, and closed companies. First, this approach conceals rather than clarifies the true justification for disclosure. If disclosure is a suitable regulatory tool to protect creditors, then capital market trading activity is the wrong trigger for disclosure duties. Disclosure is the natural correlative not only of stock exchange or securities market trading but also, in a more general fashion, of market participation in its widest sense, be it in share capital markets, mercantile markets, markets for services, or debt capital markets. Disclosure, therefore, is determined by the market impact of the individual company.[56] This, however, calls for a much more flexible determination of both the scope and the content of disclosure. Correspondingly, creditor protection is not a one-size-fits-all function but needs to be differentiated according to the various market segments for different categories of goods traded. In that regard, it is not convincing to limit mandatory disclosure in general to limited companies, like most EU jurisdictions do, but to fine-tune the extent of disclosure within the group of limited companies according to varying criteria like size or public trading activity. If size does matter, it matters likewise in unincorporated or partnership-type firms.[57]

4.2.2 *Limited quality of small company disclosure*

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 information submitted suffers from important limitations. At any time, the use of accounts to forecast insolvency is difficult, since a company's prospects and future plans have a much more significant bearing on its creditworthiness than does past financial performance.[58] 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 not enough staff to implement a system of controls. 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.[59]

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[55] High Level Report, op. cit. n. 6, at p. 35.

[56] For a comprehensive analysis of this concept, see Merkt, op. cit. n. 10.

[57] Kraakman, loc. cit. n. 13, at p. 101.

[58] C. Campbell and B. Underdown, *Corporate Insolvency in Practice: An Analytical Approach* (London, Chapman 1991) p. 3 et seq.

[59] J. Dunn, *Auditing: Theory and Practice* (New York, Prentice Hall 1991) p. 99.

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5. CHALLENGES TO CREDITOR-PROTECTIVE MANDATORY DISCLOSURE

5.1 **Materiality of information**

5.1.1 *Need for "soft" information*

According to corporate finance theory, information commonly used to assess creditworthiness includes the following: financial statements presenting the current position of the client, credit reports on customer's payment history with other firms, bank information on creditworthiness, and the customer's payment history with the firm.[60] Once such information has been gathered, the potential creditor has to decide whether to grant the credit. This decision is commonly based on the following three considerations: (1) the customer's willingness to meet credit obligations; (2) the customer's ability to meet credit obligations out of operating cash flows; and (3) the customer's financial reserves.[61] However, under current statutory law, no single item on this list is provided for by mandatory disclosure regulation, neither in the United States or the United Kingdom, nor on the continent (with the exception of those US and UK financial statements and financial reserves that follow the true and fair view).

5.1.2 *Creditors vs. equity investors*

Moreover, it becomes obvious that information relevant for creditors is different from information relevant for share capital investors. To restate the self-evident comparison: the typical share capital investor is looking for return *on* investment whereas the average creditor is looking for return *of* investment. Equity investors need fine-tuned information on the current value of their investment in order to decide on a daily basis whether to keep the investment or to reinvest. "Value" in that context has many individual aspects, e.g., dividend expectation, stock price, voting right exercise, additional features like preemptive right, and the like. The average creditor, however, in principle needs information only as to whether the corporation is going to be sufficiently solvent to repay credit and interest as they fall due; hence, the only concern is solvency. Furthermore, information on solvency is needed only at the time the credit is granted (initial screening),

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[60] Many organizations sell information on the credit strength of business firms. The best known and largest firm of this type is Dun & Bradstreet, which provides subscribers with a credit reference book and credit reports on individual firms. The reference book has credit ratings on many thousands of businesses.

[61] See, e.g., Ross, Westerfield, and Jaffe, op. cit. n. 45, at p. 788 et seq., mentioning two further considerations, namely a pledge asset in the case of default and general economic conditions.

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because once the credit is granted the ultimate risk lies with the creditor. Later on, the creditor needs to learn only about those circumstances that might bring the debtor in the vicinity of insolvency, since that might trigger certain creditor reaction (continuous screening). Initial and continuous screening for creditor purposes (expected solvency) is less fine-tuned than screening for equity investors purposes (expected profitability). Obviously, average creditors need less information on a less frequent basis than average equity investors. This does not mean that creditors and equity investors need completely different sets of information. The opposite is true. The amount of mandatory disclosure to protect creditors is dependent on the amount of disclosure for investor protection: the higher the standard of investor disclosure, the less comprehensive creditor disclosure is needed. Furthermore, most small creditors do not want to spend money on collecting and analyzing information pertaining to their debtor's financial position, in view of the fact that these creditors spread risk by means of a diversified engagement and by calculating losses into their prices.

5.1.3 *Solvency test*

In order to provide creditors with the required forward-looking "soft" information, some jurisdictions use a solvency test.[62] While Australia and New Zealand apply a liquidity test, Delaware and the Revised Model Business Corporation Act (RMBCA) apply a balance sheet test (net asset test) or a combination of both.[63] One option to improve creditor protection through mandatory disclosure could be to require the regular publication of such a test. These tests and their effectiveness with regard to protecting creditors will not be discussed here, since they form the subject of other papers.

5.1.4 *Disclosure of internal ratings under Basel II?*

A different and yet innovative way of improving the quality of mandatory disclosure has been advanced by Gerard Hertig. In a recently published paper, he argues that the Basel II accord provides an opportunity to efficiently externalize

[62] Solvency-test-type reform is proposed by J. Rickford, ed., 'Reforming Capital – Report of the Interdisciplinary Group on Capital Maintenance', 15 *EBLR* (2004) p. 919.

[63] Under 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 coming period (e.g., twelve months) as a result of its ordinary business operations. In a *balance sheet test* (or net assets test), the criterion is whether after making a distribution the assets of the company are at least equal to its debts and provisions. Only the surplus may be distributed, see Boschma, Lennarts, and Schutte-Veenstra, op. cit. n. 36, at s. 4.2.2.

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internal rating information across jurisdictions.[64] He suggests requiring the disclosure of the internal ratings of those banks that adopt the Internal Rating of Banks Approach (IRB) under the Basel II accord for calculating capital requirements. Disclosure would occur in average form through multiple third parties, whereas borrowers would be allowed to opt out to prevent outsiders from having access to their internal ratings. This framework, he argues, would minimize the disadvantages of disclosure while preserving its advantages.

This is not the place for comprehensive discussion of mandatory internal ranking disclosure. However, five brief points might be raised. First, with internal ratings publicly disclosed, the risk of banks being held liable for their ratings is likely to jump up remarkably. This, in turn, will most likely influence rating and credit cost. Second, in most credit agreements, so-called "trigger clauses" provide for a premature termination right of the loan in case of downgrading by rating agencies.[65] If internal bank ratings are publicly disclosed, this triggering effect might activate a chain reaction with fatal consequences for debtor companies. Third, internal rating procedures and rating methods are currently regarded as business secrets of the rating banks.[66] Mandatory disclosure therefore might come close to a form of expropriation. In that context, an opt-out right in favor of banks that do not want their ratings being disclosed would not be of much help as long as opting-out is limited to hardship cases.[67] Fourth, it is debatable whether the sophisticated and demanding standards of risk analysis under IRB represent the proper standard for average creditors. Consider that IRB standards are designed to protect high-profile creditors against the risk of accumulated default, whereas average non-bank creditors do not incur comparable default risks. Even if many creditors would individually prefer a less rigorous standard, it is hard to believe that those creditors would ignore the results of a disclosed internal rating under IRB, given the very good standing of such IRB ratings in the credit community. Hence, disclosure of IBR ratings might have a "slipping" effect which in the end is detrimental to the credit market. Fifth and finally, to a certain extent the idea of requiring disclosure of internal ratings militates against what we have seen in the context of financial covenants. If information regarding solvency of single creditors is produced sufficiently on a contractual level, the case for market failure and for regulatory intervention in the form of mandatory rating disclosure is weak. And it is difficult to see why all market participants should be provided with the results of internal ratings by way of disclosure despite the fact that only a

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64 Hertig, op. cit. n. 51.

65 See M. Habersack, 'Rechtsfragen des Emittenten-Ratings', 169 *Zeitschrift für das gesamte Handels- und Wirtschaftsrecht* (2005) p. 185 at p. 188.

66 See C. Kersting, 'Discussion Report', 169 *Zeitschrift für das gesamte Handels- und Wirtschaftsrecht* (2005) p. 242 at p. 245.

67 See Hertig, op. cit. n. 51, at p. 16.

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limited number of commercial and small creditors is in need of enhanced information.

5.2 Standardization

5.2.1 *Standardization as cost reducing feature*

It is obvious that disclosure calls for standardization, i.e., the use of an identical format for disclosure in order to facilitate comparison of the data disclosed. Such standardization of balance sheets, income statements, and interim reporting might contribute to reducing the costs incurred by interested addressees in processing disclosed information. Standardization also presents another characteristic. Because investors are interested in comparing information gathered from various companies, it could be advisable under certain circumstances to disclose a negative piece of information that would not reach the threshold of materiality if the company were evaluated in isolation.

However, the quest for standardization finds itself to a certain degree in conflict with the call for flexible disclosure regulation that takes into account the particular needs of smaller businesses not capable of steadily publishing large amounts of information. Therefore, standardization should be limited to companies within a certain class of size.

5.2.2 *Proper regulatory level*

Closely linked to the quest for standardization is the debate over the proper regulatory level for mandatory disclosure. In the United States, economists and legal scholars have long struggled with this issue. Advocates of decentralized disclosure regulation argue that only regulatory competition might produce the regime most suitable for market participants.[68]

Apparently, the High Level Report challenges this view by advocating centralized disclosure rules at EU level in order to achieve harmonization of disclosure requirements within the Union. This conclusion can be drawn implicitly from the Report's proposition that the European Union should consider whether disclosure requirements are better suited to achieve the desired effects than substantive rules.[69] In endorsing this concept, the Commission's Action Plan[70] states: "In view

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[68] See Romano, loc. cit. n. 24.
[69] High Level Report, op. cit. n. 6, at p. 34.
[70] See Communication from the Commission to the Council and the European Parliament 'Modernising Company Law and Enhancing Corporate Governance in the European Union – A Plan to Move Forward', COM (2003) 284 final (hereinafter cited as 'Action Plan').

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of the growing integration of European capital markets, a common approach should be adopted at EU level with respect to a few essential rules [which include mandatory disclosure] and adequate coordination of corporate governance codes should be ensured."[71] At the same time, the Action Plan leaves no doubt that "a self-regulatory market approach, based exclusively on non-binding recommendations, is clearly not always sufficient to guarantee the adoption of sound corporate governance practices."[72]

There are basically three points that need to be addressed briefly in this context. First and foremost, in light of the overriding principle of subsidiarity within the European Union, the introduction of a "common approach" to mandatory disclosure at EU level requires a sound and convincing justification. Such a justification might be derived from the simple fact that the need to comply with different disclosure requirements imposed by Member States can serve as a substantial obstacle to the credit industry. As a consequence, additional costs of gathering investor information produced under differing standards (with varying language, content, etc.) can deter the investment of funds.[73] Moreover, exposure to varying and rigorous sanctions and liability regimes can also impair the credit-raising process. Although the former have been addressed by the EU regime, the latter remain subject to Member State regulation. Today, regulators are increasingly willing to cooperate to foster the convergence of disclosure standards. The foundations for the US-Canada multi-jurisdictional disclosure system were laid in 1991. In 1998, IOSCO adopted international disclosure standards to be applied to cross-border offerings and initial listings by foreign issuers which were designed to serve as the basis for a disclosure document passport regime which would allow issuers to rely on a document prepared in accordance with the standards for multi-jurisdictional offerings and listings.[74]

In the context of supranational standardization, accounting methodology is a key element. Despite the fact that many jurisdictions have moved toward the Anglo-Saxon "fair presentation" concept, important differences remain. Accounting methodology in continental Europe still is significantly less demanding than in the United Kingdom and the United States. The effectiveness of recent reforms, such as those requiring EU firms listed on regulated markets to apply International Financial Reporting Standards beginning in 2005, remains to be seen. Today, most companies on the continent are by law permitted to submit less

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71 Action Plan, loc. cit. n. 70, at s. 3.1.

72 Ibid.

73 This point was acknowledged by the SEC in the context of the disclosure requirements applicable to foreign issuers in 1999, see SEC Release No. 33-7637 (1999).

74 IOSCO, *International Disclosure Standards for Cross-Border Offerings and Initial Listings by Foreign Issuers* (Madrid, IOSCO 1998).

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transparent accounting reports than UK and US companies, which are remarkably different from those across the Atlantic.[75]

Second, assuming that disclosure regulation interferes less with private rights than merit regulation does, a regulatory concept that combines disclosure requirements on the central level with merit regulation at Member State level appears to be preferable.

Third, mere disclosure regulation can be transferred easily from one national law to another and therefore is more in line with the concept of legal harmonization than substantive merit regulation.[76] In this context, it has recently been argued that EU directives are not the appropriate legal instruments for implementing disclosure regulation. The process from proposal (by the European Commission) to adoption to implementation, the argument goes, is too slow and reform is even slower. As in the case of merger regulation, regulations are preferable over directives.[77] The validity of this reasoning depends on the character of European disclosure regime envisaged. Certainly, a comprehensive and detailed regime of disclosure duties at European level requires direct rulemaking without burdensome and time-consuming implementation procedures. However, a basic framework leaving sufficient room for individual and competitive membership implementation, as favored by both the High Level Report and the Action Plan, is better served by the use of directives. Hence, the choice between directives and regulations is a choice between different basic regulatory concepts and requires careful analysis.

5.3 Comprehensibility

5.3.1 *What standard to chose?*

It is self-evident that disclosed information needs to be comprehensible for addressees. However, the question at what audience disclosure should be aimed is a classical yet fundamental question, even though the issue of understandability is addressed neither in the High Level Report nor in the Commission's Action Plan. In theory, three answers are possible: at the unsophisticated, at the financial expert, or at the hypothetical "reasonable" investor of average sophistication. Throughout its history, the SEC has struggled with this question. It may well be unanswerable. A balance must be struck which reflects, to the greatest extent possible, the needs of all who have a stake in the debt finance markets. The US regime's preoccupation at

[75] See La Porta, et al., loc. cit. n. 54, at p. 1144.

[76] See S. Grundmann, *Europäisches Gesellschaftsrecht* (Heidelberg, Müller 2004) p. 40 et seq.

[77] M. Becht, 'European Disclosure for the New Millennium', in K.J. Hopt and E. Wymeersch, eds., *Capital Markets and Company Law* (Oxford, Oxford University Press 2003) p. 87 at p. 89.

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certain stages with making detailed disclosure fully comprehensible to a model retail investor, even though in practice such investors did not understand or even read the disclosed information, has been subjected to harsh criticism.[78]

5.3.2 *Financially literate investors*

However, the concept of disclosure for reasonably sophisticated investors becomes increasingly questionable. Despite the fact that continental Europe's financial markets traditionally are more intermediary-oriented, equity holdings and investment behavior in continental Europe are gradually shifting toward the more market-oriented patterns found in the United Kingdom and United States.[79] Most creditors lend money or extend credit to several or even many corporate debtors, thereby diversifying their risk. A diversified creditor, however, can no longer collect and evaluate all investment-relevant information on each company in his portfolio. He turns to support from various sources like rating agencies, banks, press, and intermediaries such as investment companies and pension funds. These sources process solvency-relevant information regarding the portfolio companies and, on the basis of their findings, make recommendations to, or even investment decisions for, the investor. This system certainly does not make it unnecessary to disclose material information to investors. Rather, the addressee of the disclosed information has changed from the creditor himself to the intermediary. Hence, disclosure need no longer be primarily tailored to the knowledge of the unsophisticated or average investor. Therefore, under the EC Listing and Reporting Directive, an annual financial statement, for instance, is meaningful to a "financially literate" investor.[80]

5.4 **Timeliness**

5.4.1 *Time is of the essence*

Timeliness is a pretty important feature of efficient disclosure. Channels for the dissemination of the information disclosed are as important as the information

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[78] H. Kripke, 'The Myth of the Informed Layman', 28 *Bus. Law.* (1973) p. 631.

[79] See Hertig, op. cit. n. 51, at p. 5.

[80] See Art. 21(1) of Council Directive 2001/34/EC of 28 May 2001 on the admission of securities to official stock exchange listing and on information to be published on those securities. Some years ago, the German High Court (*Bundesgerichtshof*) held the "average investor" the relevant addressee, refusing to attribute to such average investor the ability to understand financial statements, *Wertpapiermitteilungen* (1992) p. 901 at p. 904. The decision has been subject to fierce criticism, e.g., W. Groß, *Kapitalmarktrecht*, 2nd edn. (Munich, Beck 2002) §§ 45, 46 Exchange Act No. 25; E. Schwark, *Börsengesetz*, 2nd edn. (Munich, Beck 1994) §§ 45, 46 No. 13; H. Fleischer, *Gutachten zum 64. Deutschen Juristentag* (Munich, Beck 2002) F 21.

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itself. While disclosure of information is often provided for by legislation, filing and access to information can be cumbersome and costly. Within the European Union, most countries still prescribe filing with company registers and subsequent paper filing in selected local financial newspapers that are rather expensive and not necessarily circulated throughout the Union. Moreover, many Member States have a great number of local registers, as in the case of Germany, where approximately 720 local registers are simultaneously engaged in the administration of company filings.[81] In addition, documents are usually filed in a local language that investors at large or regulators do not readily understand. Another serious flaw of current disclosure results from the fact that annual reports are already outdated on the day they are published. In addition, the ultimate date currently permitted for publication of the annual accounts in most Member States is much too late, e.g., twelve months after the end of the fiscal year under the German statutory provision[82] and thirteen months under Dutch law.[83] The Dutch "Final Report on Alternative Systems for Capital Protection" of August 2005 has therefore recommended to cut down this period to six months.[84]

5.4.2 *The need for electronic filing*

These and various other obstacles to timely disclosure have led to the proposition that the company's website may be a better place for the publication of information,[85] a suggestion that has been supported by both the High Level Group[86] and the Action Plan.[87] In the meantime, the European Union has adopted two directives – on disclosure requirements[88] and transparency[89] – in order to modernize corporate disclosure and to harmonize electronic publishing via the internet.

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[81] For a comprehensive analysis of the current German system, see U. Noack, *Infobasen für Unternehmensdaten* (Cologne, Bundesanzeiger Verlag 2003) and Noack., *Unternehmenspublizität* (Cologne, Bundesanzeiger Verlag 2002).

[82] See § 325(1) German Commercial Code.

[83] Boschma, Lennarts, and Schutte-Veenstra, op. cit. n. 36, at s. 4.2.2.

[84] Ibid.

[85] E.g., Becht, loc. cit. n. 77, at p. 89.

[86] Consultative Document of the High Level Group, Question 6(a).

[87] Action Plan, loc. cit. n. 70, at s. 3.1.2.

[88] 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.

[89] 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.

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6. Enforcement of Disclosure Duties

6.1 Various enforcement options

Efficient creditor protection through mandatory disclosure finally depends on effective enforcement mechanisms. Enforcement of disclosure obligations is not easy, since it requires insider knowledge that usually is hard to get. Apart from extra-judicial mechanisms like reputation and warranties, relying on market intermediaries, or trusting accounting firms, the law basically offers three different ways to cope with the problem of enforcement of disclosure duties. First, it can impose liability on the debtor corporation itself for misreporting. Second, it can impose personal liability or other civil or criminal sanctions on those individuals responsible for misrepresentations. Third, it can entrust institutions with enforcement functions, like audit committees, rating agencies, intermediaries, or administrative bodies.

6.2 Liability for misreporting

Imposing liability on the debtor company itself might turn out to be counterproductive. Because misreporting would usually entitle a large number of creditors to damages, liability would impair the company's solvency and thus would indirectly harm creditors. However, imposing liability directly on those mangers or on those individuals that are responsible for misreporting is for practical reasons not as effective as one would expect. First, major misrepresentations usually occur when the company is on the verge of failure, a final period in which managers tend to make risky or even erratic and desperate attempts in order to save the company and themselves. It is a matter of experience that, under those extraordinary circumstances, managers do not tend to be overly impressed by legal rules designed to deter. Moreover, managers usually lack the personal assets to cover the damages they cause. Given the money at stake, they may not be deterred by other civil sanctions like disqualification from office. Finally, criminal sanctions impose a heavy burden of proof and in addition threaten to over-deter disclosure by risk-averse managers.

6.3 Enforcement institutions

Against this background, entrusting particular institutions, like audit committees, rating agencies, intermediaries, or administrative bodies, with enforcement functions appears to be an interesting alternative. A good example of that kind of enforcement strategy is the Sarbanes-Oxley Act of 2002, which was the principal legal answer to the preceding corporate governance scandals. The measures chosen in order to improve enforcement of disclosure duties range from requiring

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CEOs and CFOs to certify financial statements and internal controls of their firms to new rules to ensure the independence and competence of audit committees, the independence of accounting firms, and the responsible advice of outside counsel. Any evaluation of these measures turns on the balance of costs and benefits. However, even three years after the adoption of Sarbanes-Oxley, a final assessment seems to be difficult.

Meanwhile, Germany has chosen a different approach by setting up a quasi-governmental institution for the audit of annual reports.[90] The so-called Auditing Agency for Financial Reporting, established under the Balance Sheet Control Act of 2004, examines whether a company's most recently approved annual accounts comply with statutory requirements. The Agency conducts an audit in one of three cases: (1) if there is reason to believe that accounting standards were violated; (2) upon request by the Federal Financial Supervisory Authority; or (3) without immediate cause (spot check).[91] It is important to note that no company is under a duty to cooperate with the Agency. However, if the company refuses to cooperate with the Agency, the latter will report it to the Federal Supervisory Authority.[92] This new and unique proceeding has still to prove its effectiveness. In addition, there are still several important legal and practical questions that have to be answered: What is the legal nature of the proceeding? What remedies are available to the company? What is the standard of review for the audit? Is it preferable to cooperate or to refuse cooperation?

However, the most fundamental questions relates to the rationale behind the administrative agency concept. Should the government interfere with the business of auditing at all? Should it take away the risk of assessing the quality of accounting and rubber-stamp annual accounts, a risk that is typically and in conformity with market mechanisms borne by market participants? This brings us back to the beginning. In the early years of US securities regulation, many states did apply merit regulation to securities offerings. Under the merit standard, the pertinent state securities administration could prevent an offering from going forward because it was not "fair, just, and equitable." Under merit regulation, therefore, adequate disclosure was not the decisive criterion. It was the substantive fairness of the offering that had to be scrutinized above all, with fatal consequences: of about 1,500 applications for admission of offerings just about 100 were admitted. The securities market was on the verge of complete collapse.[93] This example

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[90] See 69 *Federal Law Gazette I* (2004) p. 3408 et seq.; H.F. Gelhausen and H. Hönsch, 'Das Neue Enforcement – Verfahren für Jahres- und Konzernabschlüsse', 50 *Die Aktiengesellschaft* (2005) p. 511 et seq.

[91] § 342b(2) German Commercial Code.

[92] § 342b(6) German Commercial Code.

[93] M.I. Steinberg, *Understanding Securities Law*, 2nd edn. (New York, Matthew Bender 1996) p. 90.

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dramatically demonstrates that any legislator should be extremely careful with administrative merit regulation.

7. Conclusion

All in all, the case for creditor protection through mandatory disclosure is far from being unambiguous. While according to economic and legal theory mandatory disclosure is an important instrument to improve market efficiency and prevent market failure, practical experience indicates clear limitations of the concept and numerous challenges to its effectiveness. First, large professional creditors negotiating for financial covenants and thus ensuring the solvency of the company act as factual trustees of small creditors, thereby limiting the need for additional disclosure. Second, the disclosure of small firms in particular suffers from important limitations regarding solvency expectations and reliability. Third, the current mandatory disclosure regime does not sufficiently provide for soft information on the expected solvency of the company. Finally, reform with respect to comprehensibility, timeliness, and enforcement of disclosure appears to be necessary in order to protect creditors of corporations more effectively.

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