From Azerbaijan to Europe and the USA: Examining Efficacy of Legal Capital Requirements in Protecting Creditors

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Abstract

The Legal Capital is able to serve as a guarantee for creditors while protecting companies from the risk of potential bankruptcy when it meets certain standards. However, whether to or not to apply these standards is a matter of debate. This issue in question forms different approaches in many jurisdictions from Europe to America. Meanwhile in national legislation the requirements that the legal capital must pay are measured by the "interest of creditors". Since this statement is rather vague, the Azerbaijan legislation requires more thorough regulation of the rules of legal capital for effective protection of creditors ' interests. Thus, the article examines different jurisdictions and the function of approved capital requirements in ensuring the financial stability of businesses and safeguarding the interests of creditors in order to close this gap. At last, taking into account the issues caused by the absence of precise minimum ammount of legal capital in Civil Code of AR, it proposes specific recommendations.

Annotasiya

Nizamnamə kapitalı müəyyən standartlara cavab verdikdə şirkətləri potensial müflis olma riskindən qoruyaraq kreditorlar üçün zəmanət rolu oynaya bilir. Bununla belə, bu standartların gözlənilib-gözlənilməməsi müzakirə mövzusudur. Sözügedən məsələ Avropadan Amerikaya bir çox yurisdiksiyalarda müxtəlif yanaşmalar meydana gətirir. Yerli qanunvericilikdə isə nizamnamə kapitalının ödəməli olduğu tələblər "kreditorların marağı" etalonu ilə ölçülür. Bu ifadə olduqca qeyri-müəyyən olduğundan Azərbaycan qanunvericiliyində kreditorların maraqlarının effektiv müdafiəsi üçün nizamnamə kapitalı qaydalarının daha dəqiq tənzimlənməsinə ehtiyac duyulur. Odur ki, bu boşluğu aradan qaldırmaq məqsədilə məqalədə müxtəlif yurisdiksiyalar təhlil edilərək nizamnamə kapitalı qaydalarının şirkətlərin maliyyə sabitliyi və kreditorların maraqlarının müdafiəsindəki rolu təhlil edilmişdir. Daha sonra Azərbaycan Respublikasının Mülki Məcəlləsində Məhdud Məsuliyyətli Cəmiyyətlər üçün konkret minimum nizamnamə kapitalı tələbinin olmamasından irəli gələn məsələlərə diqqət yetirilərək konkret təkliflər irəli sürülmüşdür.

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Introduction

What is the necessity of the concept of "legal capital" in Limited Liability Companies (hereinafter – LLC) if there is no measurable indicator of minimum amount of legal capital on the Civil Code of Azerbaijan (hereinafter – CC)? Imagine the below-mentioned hypothetical cases.

1. As of right now, Company X is a tiny firm that has just been founded. Its legal capital is 1000 AZN in cash. This sum was contributed by Company X's founders before commencing the business, and as it expands, they intend to progressively increase their financial capital. Company X is hopeful about its future and intends to grow its activities in the upcoming years, despite its limited financial capital.

2. On the other hand, Company Y is a recently created business that possesses significant financial resources. Its legal capital is 10,000 AZN in cash which shows their strong financial power. Company Y has been in business since Company X started its business activity. As they have great financial capital, they are using it to invest in new projects, expand their product line, and explore new markets. Moreover, Company Y's legal capital capacity has permitted it to endure financial crises.

From the first sight, it seems that there is no problem occurs in both cases, because of not having specific amount for the minimum limit of legal capital requirement in the legislation.[1] According to Article 90.1 of Civil Code "the amount of legal capital of a company may not be less than the amount that secures the interests of its creditors". However, the main question "what is the interest of creditors?" arises as the phrase "the interest of its creditors" is vague, broad, and even controversial. In the context of Article 90.1, following issues come into existence: In the first scenario, the Company X has a little amount of legal capital that can put itself in very risky situations such as not having enough capital to pay the creditors of the company in case of default or corporate insolvency.[2]

On the other side, the Company Y will most probably achieve their mission as they intended. This means that the probability of Company Y's bankruptcy is less than the probability of Company X's bankruptcy, as Company Y puts favorable amount in the legal capital. However, we cannot see the same

[1] According to Law of the Republic of Azerbaijan No. 936 dated July 6, 2023 on amending the Civil Code of the Republic of Azerbaijan, there is an exception for regulated entities (such as banks, investment companies and etc.) and the procedure for their formation. They are determined in accordance with the requirements of sector-specific legislation.

[2] Kong Shan Ho, *Revisiting the Legal Capital Regime in Modern Company Law*, 12 The Journal of Comparative Law 1, 1 (2015).

situation in the first scenario. In the first scenario, Company X benefits from the ambiguity of the article 90.1 of CC which can be regarded as a “shield” of the companies that allows them to get into the business environment without strong financial power.

The paper would delve extensively into the main role of legal capital in safeguarding the interests of creditors within corporate governance frameworks. It would analyze how legal capital operates as a pre-emptive measure, effectively serving as a financial safety net ingrained within the corporate asset ”pool”. The article would also underscore the crucial function of minimum capital rules, positing them as a prerequisite for obtaining the privilege of limited liability. Through these lenses, in the first chapter of the article, the paper would articulate how minimum capital rules not only impose an ”entry fee” for limited liability but also ensure that companies possess adequate resources to meet their financial obligations. Moreover, it would indicate how these regulations signify a seriousness threshold for businesses, deterring the formation of entities with meager net assets that could swiftly succumb to insolvency.

In the second part, a comprehensive comparative analysis would examine the complex legal environments and how different jurisdictions impact corporate governance dynamics. Further paper would include an assessment of the legal capital directives established in the European Union with a focus on the Second Directive and its implications for corporate governance rules and creditor protection systems. With underlying principles, the paper would delineate how European legal capital systems prefer to protect creditors’ interests, while American frameworks prioritize flexibility for shareholders. The study aims to enhance our understanding of the diverse approaches adopted and the complex stipulations regarding a company’s legal capital. It will illustrate the transformation of these principles within the overall framework of corporate law. In this context, the paper would unravel the multifaceted interplay between legal frameworks, economic imperatives, and society’s expectations, enriching the discourse on legal capital’s role in shaping corporate governance paradigms.

Moving forward, this paper carefully presents a number of criticisms of statutory minimum legal capital requirements expressed by scholars. It would begin with a thorough examination of the fundamental challenges associated with reconciling fixed minimum capital requirements with the diversity of businesses and the economic activities they govern. This paper addresses the complexity of this debate through a concise analysis and considers arguments that question the relevance and effectiveness of introducing uniform minimum legal capital standards. Additionally, it examines the complexities of adapting minimum capital requirements to the specific financial needs and risk profiles of different companies, thereby highlighting the potential disconnect between regulatory requirements and commercial reality. This

nuanced examination would contribute to a deeper understanding of the nuanced trade-offs inherent in minimum legal capital rules, shedding light on their intricate interplay with economic imperatives and regulatory objectives.

In the next heading, an analysis will focus on the ambiguous term "the interest of creditors" as enshrined within the CC of Azerbaijan. This paper takes a nuanced look at the interpretive challenges posed by this vague and broad legal standard, and questions its practical implications in the context of corporate governance and creditor protection. By clarifying the complexities of this normative framework, this document resolves ambiguities in its interpretation and its enforceability and effectiveness in the absence of specific minimum capital requirements for LLCs in Azerbaijan. Through incisive critique, the paper would underscore the imperative for clarity and precision in legal standards governing creditor protection, highlighting the inherent risks posed by an ambiguous legal framework. Moreover, it would scrutinize the potential ramifications of this vagueness on investor confidence and corporate accountability, thereby enriching the discourse on legal capital regulations within the Azerbaijani legal landscape. This analysis would serve as a catalyst for broader discussions surrounding regulatory reforms aimed at strengthening creditor protection mechanisms and enhancing the stability of the business environment in Azerbaijan.

I. An Entry Price for LLC

The minimum capital rules require those incorporating a business at least to have the minimum amount in order to ensure the stability of the business.[3] These regulations aim to settle any disagreements that may arise over the distribution of corporate assets between creditors and shareholders. This becomes especially crucial when a company faces insolvency and doesn't possess adequate funds to fulfill its financial commitments. These regulations effectively prioritize the interests of creditors in resolving such conflicts.[4]

Additional arguments supporting the legal capital regime propose that it establishes a cost for accessing limited liability.[5] As limited liability favors shareholders but puts creditors at a disadvantage, the legal capital requirement which limits capital distributions and sets a minimum capital threshold, provides a form of assurance for creditors in cases of default or bankruptcy.[6] Thus, since shareholders could restrict their liability to their invested capital even in smaller enterprises, regulations mandating minimum

[3] John Armour, *Legal Capital: An Outdated Concept?*, 7 European Business Organization Law Review 5, 9 (2006).
[4] Jennifer Payne, Legal Capital in the UK Following the Companies Act 2006, Oxford Legal Studies Research Paper No. 13, 2 (2008).
[5] Armour, *supra* note 3, 17.
[6] Shan Ho, *supra* note 2, 6.

capital levels began to be seen as a means of safeguarding creditors.[7] Generally, a portion of business risks are transferred to creditors, as shareholders may enjoy significant benefits from dividend payouts and increases in share value if the business performs well.[8] However, if the company faces insolvency, creditors may only have access to the company's limited or non-existent assets.[9] Therefore, adhering to a set of regulations, including minimum capital requirements, is necessary to realize these benefits.

As previously mentioned, the primary objective of legal capital is to establish a minimum level of financial stability for businesses, thereby mitigating the risk of companies being established with insignificant net assets.[10] This, in turn, reduces the likelihood of newly formed companies facing insolvency due to a lack of substantial groundwork. In a situation of insolvency, creditors may need special protection since their main interest of recovering their credits is at stake. By definition, in a situation of insolvency a company cannot repay in an ordinary way its outstanding liabilities. That's why ensuring minimum legal capital through contributions from shareholders is equivalent to acquiring entry to the benefits of limited liability—a prerequisite for operating within this privileged framework, as well as protecting the interests of creditors.

However, there are some disputes related to the application of these rules. Thus, critics among various scholars have raised concerns regarding the rigidity of minimum legal capital regulations. They find it challenging to reconcile the function of minimum legal capital requirements with their uniform fixed amount, applicable to all companies of a particular type. These academics argue that the concept of legal capital fails to consider the diverse economic activities[11] or levels of debt that different corporations may undertake.[12] To illustrate, they assert that a heavily leveraged corporation involved in transporting radioactive waste should not be subjected to the same minimum capital requirements as a software design company with lower leverage.[13] Consequently, it becomes difficult to align the intended purpose of minimum capital requirements with their standardized quantity, which does not reflect the actual financial needs of individual firms. At this

[7] Francisco Soares Machado, Effective Creditor Protection in Private Companies: Mandatory Minimum Capital Rules or Ex Post Mechanisms?, 5 (2009). Available at: https://ssrn.com/abstract=1568731 (last visited May 9, 2024).
[8] *Ibid*.
[9] *Ibid*.
[10] An "insignificant net asset" typically refers to an asset with a very low or negligible worth in relation to other assets or in the context of a certain financial situation.
[11] Robert Charles Clark, Corporate Law, 77-78 (1986).
[12] Eilís Ferran, Company Law and Corporate Finance, 312 (1999).
[13] Luca Enriques & Jonathan Macey, *Creditors Versus Capital Formation: The Case against the European Legal Capital Rules*, 86 Cornell Law Review 1165, 1186 (2001).

point, it becomes crucial to analyze minimum legal capital requirements in other jurisdictions in order to know how different legal systems regulate legal capital concept.

II. The Comparative Analysis of Legal Capital Concept

As the world shifted towards new geopolitical and economic paradigms, the focus of economic debate shifted dramatically. The dissolution of the Soviet Union and the downfall of communism essentially put an end to the discussion regarding the advantages of market-driven economies versus centrally planned ones in allocating capital within an economy.[14] However, although the debate over capitalism versus communism has largely subsided, the disagreement has shifted towards defining the appropriate roles of fixed claimants (creditors) and equity claimants (shareholders) within a market-based system.[15] That's why there are different approaches related to their roles in different legislations.

Europe and the United States have staked their economic well-being on the effectiveness of their legal capital regulations.[16] However, there is a significant divergence between European and American perspectives regarding the treatment of fixed claimants and equity claimants.[17] In Europe, fixed claimants are central to corporate governance, and legal capital regulations are designed to safeguard them against opportunistic actions by residual claimants.[18] The primary objective of corporate law in Europe is to ensure the protection of creditors with legal provisions rather than contracts.[19] However, the situation in the United States is different. Fixed claimants engage in corporate governance with considerable risk, and legal capital regulations are crafted to offer shareholders the utmost flexibility.[20] The primary objective of corporate law in the United States is to facilitate extensive freedom for private arrangements within a framework aimed at maximizing shareholder value.[21] In this context, creditors seeking protection from potentially opportunistic behavior by shareholders must rely on contractual agreements.[22]

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[14] Peter Koslowski, The Social Market Economy: Theory and Ethics of the Economic Order, 140 (1998).
[15] Enriques & Macey, *supra* note 13, 1173.
[16] *Ibid*.
[17] *Ibid*.
[18] Jonathan Macey & Geoffrey Miller, *Corporate Governance and Commercial Banking: A Comparative Examination of Germany, Japan, and the United States*, 48 Stanford Law Review 73 (1995-1996).
[19] *Supra* note 13, 1173.
[20] *Ibid*.
[21] *Ibid*.
[22] Frank Easterbrook & Daniel Fischel, The Economic Structure of Corporate Law, 12 (1991). Available at: https://chicagounbound.uchicago.edu/books/223 (last visited Apr. 25 2024).

Creditors in the United States have limited protection under the legal capital framework, as discussed above. The justification of such regulations is not widely agreed upon by legislators.[23] In general, there is hardly anything in corporate law that is intended to safeguard creditors' interests. Instead, in order to safeguard themselves from going too far in favor of shareholders, creditors must primarily depend on contractual safeguards that have been established, fraudulent transfer legislation, and bankruptcy courts.[24] As a result, not many academics in the US are satisfied with the par value system. The majority of individuals would concur that the system was merely a trap for the naive and produced unnecessary legal work.

To summarize, creditors and stockholders no longer see the legal capital regime in the United States to be significant. In addition to the statutory and common law safeguards already mentioned, creditors are principally dependent on the agreed contractual provisions. LLCs, which are completely free from the legal capital regime, have multiplied in recent years and don't seem to be unfavorable in the credit markets, suggesting that this system has functioned rather effectively. The legal capital regime is approached differently in other financial markets across the world. Specifically, that system has been practically locked into place by the European Union's codification through the Second Company Law Directive.

The fundamental rationale behind European-style legal capital regulations, aimed at safeguarding creditors, is that adherence to such regulations represents the cost firms must bear to enjoy the advantages of limited liability.[25] According to the Europe approach limited liability has advantages for shareholders but disadvantages for creditors.[26] In a typical European legal capital framework, shareholders are required to contribute a minimum amount (capital) to the company, and these contributions cannot be refunded to shareholders during the company's existence.[27] This traditional viewpoint remains widely endorsed by the majority of European legal scholars. However, in recent years, European legal scholars who closely monitor developments in American law have started to question the validity of this traditional perspective.[28]

All European Union Member States adhere to the legal capital doctrine, partly due to the imposition of this doctrine by the European Union through the adoption of the Second Directive.[29] This directive imposes regulations concerning minimum capital, contributions, shareholder distributions, and

[23] *Supra* note 2, 12.
[24] *Ibid*.
[25] *Supra* note 13, 1173.
[26] *Ibid*.
[27] Sabine Dana-Démaret, Le Capital social, 253 (1989).
[28] *Supra* note 13, 1174.
[29] Directive (EU) 2017/1132 of the European Parliament and of the Council, art. 1 (2017).

changes in capital.[30] One aspect of the European Union's legal capital regulations focuses on minimum capital requirements. These provisions mandate that Member States enact laws requiring companies to have a minimum capital of at least €25,000 before commencing business.[31]

Furthermore, this capital must consist solely of assets that can be economically assessed,[32] with specific exclusions outlined in Article 46 of the Second Directive, such as undertakings to perform work or supply services.[33] The Second Directive applies exclusively to publicly traded companies—those limited liability companies that issue shares and other securities to the public under the laws of the Member States in which they operate.[34] This focus on public companies is justified by their suitability for large enterprises dealing with significant financial amounts, which means public companies are regarded as vital contributors to a state's economy, often receiving more attention and prestige compared to private companies. Thus, according to the Second Directive, fulfilling mandatory minimum legal capital requirements of publicly traded companies is considered the most crucial part of starting the business.

On the other hand, private companies also hold substantial significance within a country's economy, despite sometimes receiving less attention. That's why certain European countries, notably the UK and Ireland, opposed extending legal capital rules to private companies as investors in these companies benefit from the flexible legal framework they operate within.[35] Although jurisdictions such as England and Ireland have never viewed minimum capital rules as an efficient creditor protection mechanism and hence have never deployed it in the context of private companies, legal capital rules play an important role in the UK. That's why it is an example of a jurisdiction where, although capital rules play a role in the context of public companies, still a minimum capital requirement is generally taken as superfluous.[36] For instance, out of over 2,000,000 registered companies, only 11,500 are public in UK.[37]

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[30] *Supra* note 13, 1174.

[31] *Supra* note 29, art. 45 (1). Article 45 (2) provides:
"Every five years the Council, acting on a proposal from the Commission, shall examine and, if need be, revise the amounts (of €25,000) in the light of economic and monetary trends in the Community and of the tendency towards allowing only large and medium-sized undertakings to opt for the public limited-liability company".

[32] *Id*., art. 46.

[33] *Ibid.*

[34] *Id*., art. 1.

[35] *Supra* note 2, 15. The United Kingdom Companies Act 2006 has exempted private limited companies from the legal capital rules.

[36] Machado, *supra* note 7, 30.

[37] *Id*., 3.

Similarly, in Germany, approximately 98.8% of companies are GmbHs (limited liability company).[38] Moreover, a study conducted by the European Commission highlighted that over 99% of all enterprises in the European Union are small and medium-sized enterprises providing approximately 70% of private employment.[39] As it seems from statistics, in these countries private companies are many times more than public ones, but they are not subject to the minimum legal capital requirements. There are also other jurisdictions that show the diminishing effect of legal capital regulations.

For example, Japan allows a minimum of 1 yen to establish both a limited liability company (Godo-Kaisha), modeled after the US limited liability corporation, and a joint-stock company (Kabuki-Kaisha).[40] Theoretically, a business can be formed with just one yen in equity capital, even if company formation requires approval.[41]

In the Netherlands, a group of law experts prepared a report emphasizing the necessity of abolishing minimum capital rules.[42]

"Since 2007, a bill (short title, Wet vereenvoudiging en flexibilisering bv-recht) proposing the abolishment of minimum capital for the BV (Dutch private company equivalent) has been drafted and it will be discussed in the Dutch Parliament by September. Among other amendments, the proposal also recommends the deployment of both a balance-sheet and a solvency test, so that creditors may be protected".

Before 2003, LLCs (Societé à Responsabilité Limitée,[43] hereinafter "SARL") had to have a minimum legal capital of €7,500 according to French legislation.[44] On the other hand, a significant legislative change happened that year. In order to facilitate business formation through various measures aimed at administrative simplification, such as the possibility of registering a company online and, inter alia, conferring greater facility for domiciling companies whose shareholders are individuals, the Dutreil statute,[45] was passed. After this, the elimination of the minimum capital requirements for SARLs was the most significant achievement.[46] Due to the elimination of minimum capital rules, in France, 2003, an increase of 8.7 percent was

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[38] Holger Altmeppen & Günter H. Roth, Gesetz betreffend die Gesellschaften mit beschränkter Haftung (GmbHG), § 6-12 (4th ed. 2003).
[39] *Supra* note 7, 3.
[40] *Id*., 30.
[41] *Ibid*.
[42] *Ibid*.
[43] Limited Liability Company.
[44] *Supra* note 7, 31.
[45] *See more:* The loi du 1er août 2003 pour l'initiative économique.
[46] Joëlle Simon, *A Comparative Approach to Capital Maintenance: France*, 15 European Business Law Review 1037, 1037 (2004).

observed in business creation.[47] That is the reason law has been said to be "an evolution, rather than a revolution".[48]

A significant overhaul of the GmbH[49] was approved by the German Parliament on June 28, 2008. November 2008 saw the implementation of the MoMiG (Law for the Modernization of the GmbH and to Stop its Misuse).[50] The introduction of a sub-type of GmbH that may be founded with a €1 legal capital is one of the bill's significant changes, notwithstanding the advocacy by some for a lowering of the minimum capital to €10,000.[51] Therefore, these regulations necessitate the development of alternative mechanisms to safeguard creditors, beyond Germany's minimum capital requirement.[52]

As it seems from examples, the European Union has also began to adapt the United States's approach by abolishing or appointing very little amount of minimum legal capital. Meanwhile, in Azerbaijan, the minimum legal capital requirement is regulated by legislation,[53] however its effectiveness is questionable.

III. "Interest of Creditors" as a Vague Phrase in Civil Code of Azerbaijan

The purpose of minimum legal capital requirements has not always been to directly safeguard creditors.[54] Actually it is accepted approach that one of the main functions of minimum capital is to ensure the stability of activity of businesses.[55] Until the 19th century, the creation of businesses was extremely depend on the state's permission. The States would only allow the entities which considered to have enough resources for being successful.[56] By doing this, state wants to protect its interest on highly valued companies. Also, even if not set at a high value, minimum legal capital would accrue to an indication of seriousness by entrepreneurs, so that no companies are formed carelessly. Nowadays, those who are in favor of minimum capital usually either contend that a seriousness test is the only function of minimum capital or go further and submit it protects creditors. Azerbaijan is also in favor of regulation of minimum legal capital rules by state. However, lack of clear rules for the legal

[47] *Supra* note 7, 33.
[48] Simon, *supra* note 46, 1043.
[49] GmbH (Gesellschaft mit beschränkter Haftung) – Limited Liability Company in Germany
[50] *Supra* note 7, 33.
[51] Drafted in 2004, the Mindestkapitalgesetz – Gesetz zur Bekämpfung von Missbräuchen, zur Neuregelung der Kapitalaubringung und zur Förderung der Transparenz im GmbH-Recht (Law to stop abuses, restructure the raising of capital and strengthen transparency in the law of private companies) proposed such reduction but it was never passed.
[52] *Supra* note 7, 33.
[53] Article 90 of CC for limited liability companies, article 103 for joint stock companies.
[54] *Supra* note 7, 4.
[55] *Ibid*.
[56] *Ibid*.

capital of limited liability companies in the CC leads to various abuses by entrepreneurs.

According to №224 decision of Cabinet of Minister, there is minimum capital requirement for the open and close joint-stock companies.[57] However, in CC of Azerbaijan there is no minimum capital requirement for the LLC.[58] For that reason, it becomes necessary to protect creditors in case of insolvency/bankruptcy when there is no minimum legal capital requirement for the LLC.

According to Article 90.1 of CC "the amount of legal capital of a company may not be less than the amount that secures the interests of its creditors". Instead of exact amount of minimum legal capital requirement, there is such kind of norm. However, the main question "what is the interest of creditors" arises as the phrase "the interest of its creditors" is vague and broad a. It needs an explanation because it can be regarded as any amount. In terms of banks, the minimum legal capital requirements are more precise and clearer. For instance, in the US there are mandatory legal capital requirements applied to banks in order to reduce the risks connected with banking operations.[59] By imposing capital requirements on banks, authorities may guarantee the safe and sound operation of financial institutions. The reason behind it is because banks are the biggest players in the financial markets and have a huge impact on the country's economy. These minimum legal capital requirements are based on risk-weighted assets (RWA), which determines the needed amount of capital based on the riskiness of the bank's assets. As it seems from this context the concrete ammount of minimum capital plays a crucial role. That's why it is important to change the minimum legal capital requirement for limited liability companies in national legislation.[60] In this context, before imposing minimum legal capital rules, the following questions about overall level of capital requirements should be taken into account. According to Andrew P. Scott, in order to define the precise limit of minimum legal capital, the following questions should be answered: *Are they too high, too low, or completely, right? What is the most efficient limitation to reduce levels if they are too*

[57] "Azərbaycan Respublikası Mülki Məcəlləsinin qəbul edilməsindən irəli gələn bəzi məsələlərin həll edilməsi haqqında" Azərbaycan Respubikası Nazirlər Kabinetinin Qərarı (2000); "The minimum legal capital of a joint-stock company should be determined in the amount of 10 million manats for a closed joint-stock company, and 20 million manats for an open joint-stock company".

[58] As discussed above, in EU and USA the limited liability companies can publicly sell their shares. Public and private limited companies pay dividend to their creditors. However, in Azerbaijan we do not have such kind of division. In LLC of Azerbaijan, it can pay interest from its net profit to the creditors of the company.

[59] Andrew P. Scott, Bank Capital Requirements: A Primer and Policy Issues, 2 (2023).

[60] *Ibid*.

high? Should different capital requirements be recalculated to better match the objectives of public policy with incentives?[61]

The interpretation and application of the notion of "interest of creditors" as a guiding principle in legal capital regulations for LLC present challenges, particularly in the CC of Azerbaijan, where minimum capital requirements are not explicitly defined. This ambiguity highlights the need for more precise rules and structures to ensure effective creditor protection. To address these issues, legislative changes should be considered. Specifically, the concept of "interest of creditors" should either be removed as it proves impracticality or supplemented with clear regulations setting exact minimum capital requirements for LLCs. Establishing a precise legal capital threshold would provide clarity and enhance the protection of creditors by ensuring that companies have a defined financial baseline to support their obligations.

Otherwise, the existence of such a norm in the legislation will create conditions for the increase of abuses against the creditors. Presently, the term "interest of creditors" does not have any efficiency in terms of legal capital rules.

IV. Alternatives for Creditors

"*The first thing that ought to be taken into consideration when the legislature wants to intervene is whether creditors are able to shield themselves from losses or whether it is instead necessary for mandatory rules to be deployed*".[62]

The central question is rather: Can creditors use private-ordering methods to protect their interests? In contrast to European jurisdictions, the majority of US jurisdictions opt to construct company law without a legal capital base because they believe that private ordering instruments provide sufficient protection to creditors. The majority of creditors are able to safeguard themselves and are not in need of the legal system's favor. In other words, "borrowing is a repeat game".

While having a viable business model and skilled managers is crucial, most companies also need capital to operate effectively. Capital typically comes in two forms: equity and debt, each with distinct characteristics.[63] However, for small private companies, this distinction can be less clear. Often, when these companies are first established, their founders might take out personal loans to meet the initial capital requirements, providing personal guarantees and then investing that borrowed money as equity into the business. Beyond this initial funding, companies frequently engage with lenders for various reasons, such as recovering from financial difficulties or pursuing new

[61] *Ibid*.
[62] *Supra* note 7, 13.
[63] How Do Cost of Debt Capital and Cost of Equity Differ? (2021), https://www.investopedia.com/ask/answers/032515/what-difference-between-cost-debt-capital-and-cost-equity.asp (last visited May 9, 2024).

investments. To sustain and grow, companies often turn to lenders multiple times throughout their existence.[64] Thus, lenders could use different strategies to prevent borrowers from abusing them. Primarily, they can modify agreements based on what they assume is advantageous for them. The relationship between the contractual mechanism and the legal capital is such that creditors can safeguard their interests by entering into specific agreements to recover their funds in the event of a default risk. Due to abuses of statutory requirements (such as companies being registered with minimal legal capital), creditors can negotiate terms in the debt contract or enter into separate agreements to ensure their ability to recover their investments in the event of a company's default. This means that the right to reclaim funds can be established even when a risk arises. Without such measures, recovering funds from a company that has already defaulted can become an exceedingly protracted process. On the other hand, creditors can simply reject to grant financing, if they feel that the project has little chance of success.[65] They may also impose higher interest rates to make up for the increased risks they are taking on if they determine that there is a higher chance of default.[66] Basically, the ration behind it is, when investing in riskier projects, investors face greater uncertainty about future returns. To compensate for this higher risk, investors demand higher potential returns. Higher interest rates on investments in riskier projects serve as a risk premium,[67] compensating investors for the increased likelihood of adverse outcome.

Consequently, the contract is a very strong tool that creditors may use.[68] They can impose loan covenants in addition to charging reasonable interest rates. In exchange for a lower interest rate, the borrower has to agree to some limitations to manage the company; these limitations are frequently included in loan agreements or bond indentures.[69] For example, these agreements could usually limit the borrowers' ability to transfer assets to shareholders or forbid distributions made when debt is being issued to finance a transaction.

They could also demand adherence to a certain cash flow development or debt-to-equity ratio.[70] In order to prevent the risk of default from becoming opportunistically higher than it was at the time of contracting, loan covenants are intended to grant certain control powers to creditors. If a firm is

[64] *Supra* note 7, 13.
[65] *Ibid*.
[66] *Ibid*.
[67] A risk premium is the additional return an investor demands or expects for taking on the additional risk associated with an investment compared to a risk-free asset. It represents compensation for the uncertainty and potential volatility of returns relative to a lower-risk investment.
[68] Payne, *supra* note 4, 4.
[69] *Supra* note 2, 5.
[70] *Supra* note 7, 14.

established without any assets, creditors can still request a floating charge,[71] which will come into effect the conditions outlined in the agreement. The system in the United States seems to have worked reasonably well: Such a system would be preferable for companies and creditors and would introduce more flexibility and efficiency to the system without diminishing creditor protection. In Azerbaijan legislation, there can be also such system in which creditors and shareholders make an agreement according to their own purpose and as result more desirable protection can be reached throughout the contract. Incorporating a similar framework into Azerbaijani legislation could potentially offer significant benefits. By adopting a system where creditors and shareholders have the flexibility to reach agreements tailored to their specific needs and objectives, Azerbaijan could enhance the overall effectiveness of its financial and corporate governance structures. This approach would empower parties involved to negotiate terms that reflect their unique circumstances, promoting more customized and practical resolutions. Such a system could lead to improved protection for all stakeholders involved. Through detailed contracts and negotiated settlements, creditors could achieve a higher level of assurance regarding the recovery of their investments, while companies could gain the flexibility to implement restructuring plans that are better aligned with their operational realities and strategic goals.

Conclusion

In summary, there is a wide range of viewpoints and legal jurisdictions in the discussion of minimum legal capital requirements and their effects on creditor protection, corporate governance, and economic stability.

Minimum legal capital requirements are justified by the requirement to protect companies' budgets, especially where limited liability is involved. These laws seek to reduce the danger of insolvency and protect the interests of creditors by requiring owners to provide a minimum amount of capital contribution. Critics counter that these criteria are not flexible enough to take into consideration the different financial demands and risk profiles of different organizations, which calls into doubt their effectiveness.

This article has compared and contrasted the different approaches adopted by the United States, European Union and other jurisdictions in regulating the legal capital regime. Although scholars who are against the legal capital rules claim that legal capital regime lost its significance for creditors and shareholders, the regime continues to place high priority in protecting the creditors interests.

In places like Azerbaijan, the vague "interest of creditors" rule in legal capital laws highlights the need for clearer guidelines. While Europe uses

[71] A floating charge is a type of security interest used in finance and law that allows a lender or creditor to secure a loan or debt against the assets of a borrower.

strict minimum capital requirements to protect creditors, the U.S. relies on flexible contracts to handle these risks. As financial systems change, combining these approaches could also provide a balanced solution. By allowing flexible financial arrangements but also setting clear capital rules, countries like Azerbaijan can improve both their economic stability and legal frameworks. This could mean updating regulations or setting specific capital thresholds to create a more secure and adaptable business environment.