THE TREATMENT OF NON-MONETARY CONTRIBUTIONS, FEBRUARY 1992

A Problem for Investors in Bulgaria

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THE TREATMENT OF NON-MONETARY CONTRIBUTIONS

A Problem for Investors in Bulgaria

- The recent passage by the National Assembly of the Law on Economic Activity of Foreign Persons and on Protection of Foreign Investments represents a major step forward in the nation's efforts to build the legal structures for foreign investment in post-Communist Bulgaria. Many of the perceived shortcomings in the prior Law on Foreign Investment were removed, making Bulgaria more attractive to Western investors.

One area of significant improvement in -the new Law is the deletion of the requirement of a US ,000 cash investment in a commercial firm. Under Article 3, paragraphs (1) and (2) of the Law, foreign investors are permitted to engage in economic activity on the same basis as Bulgarian citizens, with a few limited exceptions. This provision clarifies the right of foreign investors to invest by contributing non-monetary assets to Bulgarian firms. Contributions of this type are permitted under the Law on Commerce for Bulgarian citizens, and this right is now extended to foreigners.

The new Law, however, does not address the more general restrictions on non-monetary contributions contained in the Law on Commerce passed in May of 1991. Yet these limitations may significantly

reduce the amount of non-monetary foreign investment which will be made in Bulgaria. Restrictions of this type also substantially impede domestic investment of non-monetary assets in new firms.

This outcome is particularly unfortunate because these impediments need not exist. With a clear understanding of the issues and the methods used elsewhere to deal with those issues, Bulgaria can devise other mechanisms to fairly regulate these investments. Towards that goal, it is helpful to understand the nature of the problem.

THE PROBLEM

Non-monetary contributions under the Bulgarian Law on Commerce are highly regulated. The cash value of any non-monetary contribution to a firm must be stated in the Articles of the firm. [Article 72, paragraph (1)] When the firm is registered, the court must appoint three experts to value to the contribution. [Article 72, paragraph (2)] If the value assigned by the experts to the non-monetary contribution is less than stated in the Articles, the latter must be adjusted to reduce the contributor' s share to the lower value. While the investor may withdraw his contribution if he disagrees with the valuation, the net effect of this procedure is to make private investment decisions subject to significant regulation by public authorities.

Moreover, this valuation requirement applies to all forms of business organizations permitted by the Law on Commerce. Under that Law, five forms of organization are recognized: general partnership, limited partnership, limited liability company, joint stock company, and public limited company. Regardless of the form of organization, non-monetary contributions must be valued using the above procedure.

The impact of this requirement on investors is threefold. First, the freedom of the market is removed. Businesspersons cannot negotiate with other investors to set the value of a particular asset. Instead the State, in the persons of three court-appointed experts, will impose a value on the parties. Many investors will be discouraged by the thought of spending time and money to structure a new organization, only to have their plans overturned by three State-appointed experts.

Second, the delays and costs inherent in such a system will impede business. The registration system is cumbersome and slow. Experience to date with the system suggests that it is often unworkable. Large amounts of time are required for judges to find and appoint experts, wait for their report, review it, and either approve or reject the registration. Experts on some subjects are difficult to find or refuse to serve. If different types of assets are contributed to the same firm, multiple three-expert panels must be appointed to value the various kinds of assets for a single firm. Modem business does not accept delay, because market opportunities move too quickly. And, since the fees of the experts must be paid by the registrant, the costs of registration are increased.

Lastly, the uncertainty caused by the system dissuades businesspersons from even attempting such investments. Businesspersons dislike uncertainty. Under the procedure created by the Law on Commerce, no investor can know in advance what value will be placed on a non-monetary contribution. One of the fallacies often accepted by governments is that there is a scientifically ascertainable value for an item of non-monetary property. In reality, the value of such property arises only from a person's ability to utilize it to make money. No expert, particularly one with little or no experience in such matters, can scientifically determine the value of many types of property, especially forms of

intellectual property such as patents, technical knowledge, or copyrights. Investors know this, and will avoid legal systems which leave their fate in the uncertain hands of unknown and undertrained experts.

WHY IS THIS IMPORTANT?

New investments are the life blood of any economy. Non-monetary contributions are an integral part of the investment made in many new businesses. Domestic and foreign investors often have assets of a non-monetary nature which they are willing to invest in a new business.

The impediments to non-monetary investment raised by the Law on Commerce cause particular problems in the area of foreign investment. The loss of control, delay, cost and uncertainty of the existing system dissuades foreign firms or businesspersons from making such investments in Bulgaria.

The loss of such foreign investment may have substantial impacts on the nation. An often-stated goal of Bulgaria's long term economic strategy is to become the "Switzerland of the Balkans." By utilizing the nation's highly educated population and geographic position, the nation hopes to become a center of technology for the region.

Private Western companies have knowledge and technology to contribute to this effort. Frequently they are willing to contribute this intellectual property to an overseas joint venture, so long as the process is reasonable and their property is protected. This type of non-monetary investment would help Bulgarian companies become competitive, and move the nation towards its technological goals. For these reasons, the removal of unnecessary impediments to such investment should be a priority.

Because the present Law on Commerce contains impediments to non-monetary contributions which are neither legally or economically necessary, consideration should be given to amending that law. In this way, Bulgaria can increase its ability to attract foreign investors and move forward with the modernization of its economy.

POTENTIAL SOLUTIONS

The treatment of non-monetary contributions to business firms is not a new issue. Legal systems around the world have faced the issue and dealt with it in different ways. The solutions developed by other countries offer alternatives for Bulgaria to consider in reviewing its present system. Among the solutions utilized in the West are the following:

1. ***Do not require any expert valuation, but impose liability on the contributor if the value of the non-monetary contribution is improperly overstated.***

- In several European commercial codes, there is no requirement that the value of a non-monetary contribution be established by an independent appraiser. Instead, these laws allow the members of a firm to negotiate and set the value they place on the contribution. At the time of registration, the court does not question this value. The reasonableness of the valuation only arises if there is a problem, i.e. if the firm liquidates and cannot pay its creditors. Under such circumstances, the court can determine if the value was improperly overstated and, if it was, impose personal liability on those making the valuation.

For example, under the Polish Commercial Code, founders of a limited liability company need only state in the Deed of Association the name of the shareholder making a non-monetary contribution, the

subject of the contribution, and the number and amount of the shares given in exchange. [Article 163, paragraph (1)] Upon registration, the Company is simply required to note that some shareholders made non-monetary contributions. [Article 166] The valuation issue does not arise unless the company becomes insolvent within three years after the date of registration. If that occurs, and it is determined that the non-monetary contributions were accepted at an amount "far in excess of their real value" at the time the Deed was made, the shareholder who made the contribution and the members of the Management Board who accepted it with the knowledge of this state of affairs are jointly and severally liable to make good the loss to the company. [Article 176, paragraph (1)]

The systems of other countries use similar mechanisms. Under the Hungarian Company Act, members of firms who make non-monetary contributions are liable for five years from the date of contribution for losses suffered if the value of the contribution at the time of transfer was not equal to the value indicated in the Deed. [Article 22, paragraph (3)] French laws governing a *societes a responsabilite limitee* (SARL) or limited liability company contain analogous provisions.

These provisions maintain the European philosophy of conserving capital to pay firm debts, while at the same time freeing investors from the delay, cost, uncertainty and loss of control which arise from the procedures in the the Bulgarian Law on Commerce. The authors of these laws recognized that valuation is only important upon insolvency. Rather than impede all firms by creating a cumbersome registration process, these laws focus only on those few firms who overstate their capital and quickly go insolvent. These laws also rely upon the threat of personal liability to persuade investors to place a reasonable value on non-monetary contributions when forming a firm. While not eliminating impediments, such an approach dramatically improves the mechanisms for registering both foreign and domestic investments.

2) Require valuation by an expert chosen by the parties, and impose liability if the value of the non-monetary contribution is overstated.

Another approach utilized in Europe is to require that non-monetary contributions to firms be valued by an expert, but to allow the parties to retain the expert. This value is stated at the time of registration, but the court will simply accept the value if other conditions are met. Impartiality could be enforced by imposing liability in the event of insolvency, if it is determined that the expert has overstated the value of the contribution.

The best example of this approach is in the Czechoslovak Joint Stock Companies Act. Under this Act, the founders must create an establishment plan for a joint stock company. One requirement for such a plan is that it state the nature and value of the non-monetary contribution, the identity of the contributor, and the name of the expert who made a preliminary valuation of the contribution. [Article 17, paragraph (3) (e)j The value assigned to the contribution by the plan cannot exceed this preliminary valuation. [Article 181 After the stock is fully subscribed, the company's general meeting determines the value of the non-monetary contribution [Article 23] which can be no higher than the amount stated in the plan or in the report of the expert. [Article 24, paragraph (2)]

Though this approach is more cumbersome for an investor than the first alternative, it at least reduces the delay and uncertainty surrounding the investment. By having the appraisal done prior to formation of the company, the investor would know the anticipated value in advance. This value could be changed by the general meeting but, assuming he had some voice in the decision, the investor could feel

reasonably confident that the valuation would be accepted. At least he would not face the delay and uncertainty of a three expert panel similar to that described in the Bulgarian Law on Commerce.

Protection of creditors comes from two sources. First, the expert's independent appraisal will be at least some indication of value. Second, contributors and experts could be personally liable if the value was improperly overstated. The net result is still an impediment to investment, but less bothersome than the existing Bulgarian Law on Commerce.

3) Ignore the value of capital when registering firms.

- A third, more radical approach is to abandon the European concept of government involvement to verify and conserve firm capital. Instead, Bulgaria could adopt the approach taken in the United States, based on the idea that those who deal with the company must take responsibility to protect themselves.

To understand this approach, one must recognize the difference between the approaches to company regulation on the two sides of the Atlantic. Under the typical European system, the State assumes the role of guardian of company creditors by seeking to insure that adequate capital exists for the repayment of debts. Minimum capitalization requirements, valuation of non-monetary contributions, corporate registration and other similar mechanisms are used in furtherance of this goal.

In the United States, a far different approach prevails. This scheme recognizes that capital is marginally relevant, since it is the net equity of the company which protects creditors. A company may have massive capital, but if it accumulates even more massive debt, the creditors are harmed.

Moreover, in the United States, the burden is on the creditor or investor to protect his own interest. The system assumes that a potential creditor will

a. make inquiry into the financial status of the company before extending credit, and

b. obtain adequate security to protect himself if there is concern. Investors will likewise make their own determination whether non-monetary contributions of co-investors are fairly valued.

- Finally, the system in the United States enforces these goals with laws structured to protect a creditor who works within the system. The accuracy of financial information is assured by a well-defined system of accounting procedures, coupled with the threat of personal liability for those who provide inaccurate information. The adequacy of security is assured by a comprehensive set of laws which provide a creditor with safe methods of securing a debt.

The net result is that under the U.S system, stated capital has little relevance to the protection of creditors. Potential creditors examine the finances of a firm by looking at its books and audited financial statements. These items are not required by the commercial law; they are required by the market since firms which cannot provide such information are often unable to do business. Creditors then obtain from the firm the security which they deem necessary to protect their interests. If problems arise, these creditors are protected by the laws which reward the diligent.

Because this approach is taken, corporate registration in the United States is a formality. No court or government official investigates the company other than to insure the proper forms are signed and filed. With rare exceptions, no minimum capitalization is required. The system simply relies upon those involved to protect themselves; government involvement is minimal.

The treatment of non-monetary contributions is consistent with this philosophy. For example, the Model Business Corporation Act which is intended to cover joint stock companies provides that the Board of Directors of a company may issue shares for "any tangible or intangible property or benefit to the corporation, including cash, promissory notes, services performed, contracts for services to be performed, or other securities of the corporation." Before issuing the shares, the Board must determine that the contribution is adequate. Once this contribution is found to be adequate, the decision of the Board in conclusive. [Section 6.21] No court or government official reviews this information, since it need not even be disclosed upon registration. A similar philosophy is followed in laws dealing with other forms of organization such as general partnerships, limited partnerships and limited liability companies.

From a theoretical standpoint, this approach has significant general appeal. In the foreign investment context, the strengths are even more obvious. A foreign investor has little incentive to overstate the value of a non-monetary contribution because, if the firm goes insolvent, he will lose his investment (e.g. patents, licenses, copyrights) in the insolvency. There is little chance that he could abscond with money from the company prior to insolvency due to the restrictions on repatriation of funds contained in the foreign investment laws. More than even a domestic investor, he has every incentive to make the business prosper.

But reality intrudes upon theory. The reality is that Bulgaria must operate in a European environment which places emphasis on the identification and preservation of stated capital. Moreover, the entire structure of the existing Law on Commerce presupposes that the European approach to capital conservation will be followed. The type of fundamental change needed to fully implement a United States' style system is simply not practical, though the concepts upon which they are based may influence changes in the present Bulgarian system.

4) Adopt different approaches for different types of firms.

Few European commercial laws adopt the Bulgarian approach of identical treatment for non-monetary contributions to all types of firms. Most European laws instead have different rules for different forms of business organizations. For example, the rules for partnerships may be quite different from the rules for joint stock companies. This approach recognizes that the policy issues vary from organizational form to organizational form. While this approach may lack theoretical purity, it is a pragmatic response to the various policy concerns which face authors of commercial laws. If properly drafted, laws of this type offer an investor choices concerning the form of organization which best fits his situation. In short, this approach represents an improved solution to a multi-faceted problem.

A PROPOSAL

As previously discussed, the Bulgarian Law on Commerce recognizes five forms of business organizations. Each form has distinct strengths and weaknesses. Yet the Law on Commerce treats capital contributions to all five forms in precisely the same manner. Since this treatment is extremely conservative, the result is to significantly discourage non-capital contributions to all forms of organizations.

But when the five forms are individually examined, it becomes apparent that identical treatment, especially such a conservative treatment, makes little theoretical or practical sense. The solution for

Bulgaria is to adopt the fourth alternative discussed above: different rules for non-monetary contributions to different forms of organizations. In this way, many of the policy concerns expressed in the present law can be preserved, while those forms of organization where the concerns have little validity can be freed from unnecessary regulation. Equally important, the Bulgarian system can become consistent with the modem European laws on these issues.

Looking at the five forms of organization in the Law on Commerce, the following changes could be made without seriously disrupting the present law:

1. ***General Partnerships***

- For general partnerships, the United States' approach of not requiring any valuation of capital could be adopted. The principal rationale for requiring valuation of capital is to protect the capital for creditors of a limited liability firm in the event of insolvency. But this rationale has no application to general partnerships for two reasons.

First, there is no limited liability given to members of general partnerships. On the contrary, the Law on Commerce states that all partners have unlimited joint and several liability. [Article] Second, general partnerships are not "capital companies" under the European system. Thus, there are no minimum capitalization requirements for general partnerships. For this form of organization, creditors should be looking to the partners, not capital, for protection in the event of insolvency. Under such circumstances, the pre-formation valuation of non-monetary contributions is essentially meaningless.

If the Law on Commerce was amended in this way, at least one avenue of investment would open for investors where valuation problems could be avoided. In exchange for assuming personal liability, they could form a partnership without going through the process of valuing their non-monetary contributions. Creditors would have the same protections as when they contract directly with the investor: his personal liability on the debt. As a result, investment could be made more attractive with no reduction in the protections offered creditors.

2) Limited partnerships

Limited partnerships pose a slightly different problem. General partners in limited partnerships have unlimited personal liability, but the limited partners are liable only for the amount of their agreed contributions. One approach would be to treat limited partnerships like general partnerships, and have no valuation requirement for non-monetary contributions. Since there is no minimum capitalization for limited partnerships, and since general partners remain personally liable, creditors should not be relying on capitalization to pay debts. The elimination of valuation requirements for non-monetary contributions should accordingly cause little harm, while non-monetary investments would be encouraged.

On the other hand, some form of valuation of non-cash contributions must take place for the internal organization of the limited partnership. The share of each limited partner must have some valuation, since this value is the limit of a partner's liability. For this reason it may be preferable to treat non-monetary contributions to a limited partnership like contributions to a limited liability company, discussed below.

A third option would be to prescribe different treatments for general and limited partners. No valuation would be required for non-monetary contributions by general partners, since they remain subject to unlimited personal liability. Non-monetary contributions by limited partners could be subject to separate valuation requirements of the type discussed below.

Regardless which option is chosen, there are no strong policy reasons for maintaining the present system contained in the Law on Commerce. The options described above provide sufficient protection for creditors, without unnecessarily impeding non-monetary investments in Bulgarian limited partnerships.

3) Limited Liability Companies

Because all members of limited liability companies have limited liability, creditors of such companies do not have the option open to creditors of partnerships, i.e. to collect partnership debts from the general partners. To protect creditors, many European countries have special rules for non-monetary contributions to such companies. But those special rules do not create a cumbersome system of regulation. Instead, the modern European laws attempt to restore to creditors the rights they otherwise would have had, in situations where the non-monetary contribution was used to deprive the creditors of access to monetary capital to pay debts.

The mechanism frequently adopted in Europe in such situations is the first alternative discussed above: to dispense with any expert valuation, but impose liability for improper over-statement of the value of a non-monetary contribution. By this approach, company members would lose the protection of limited liability if they improperly acted. Creditors in such situations would be returned to the position and the rights they had prior to the formation of the company, i.e. the right to impose personal liability on the investor. Yet the sort of cumbersome administrative mechanism now contained in the Law on Commerce could be avoided.

The laws on this subject in the various European countries are similar, but each contains slightly different provisions. If such a law is to be adopted in Bulgaria, it should contain the following components:

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  - a) The members of the company should be required to state a value for non-monetary contributions at the time of registration. This value need not be supported in any fashion other than the signature of the members on the registration documents.

b) Liability would arise if the company becomes insolvent within a certain number of years after the registration of the value. The length of time in existing laws varies from country to country. In Hungary and France the period is five years, while in Poland the period is three years.

c) Liability should be imposed only if it can be shown that the value of the non-monetary contribution was improperly overstated. As discussed above, non-monetary assets often are extremely difficult to value. Investors should not be liable when good faith, reasonable valuations turn out to be in error. For

this reason, liability should be based on fault, such as negligence, gross negligence or intentional wrong doing.

d) The law should specify who may be liable. Some European laws impose personal liability only on the person making the contribution. On the other hand, the Polish Commercial Code imposes liability on other members of the Management Board who approved the valuation with knowledge that it was excessive.

e) Liability should be co-extensive with loss. That is, if the non-monetary contribution was overvalued by 10,000 leva, the liability of responsible persons should be limited to that amount.

While these details must be discussed, the primary concern should be to adopt some system of this type in Bulgaria. The treatment of limited liability companies under the present Law on Commerce is a deterrent to domestic and foreign investment. By adopting a position consistent with general European law, Bulgaria will remove this impediment without unnecessarily sacrificing the protections for creditors.

4) Joint Stock Companies

The strongest arguments for the valuation of non-monetary contributions can be made in situations where joint stock companies are formed by public subscription. In partnerships and limited liability companies, there is little need to protect other investors from overvalued non-monetary contributions, since these investors are few in number and presumably have adequate information to protect their own interests. But where a joint stock company is formed by public subscription, there may be many small investors with little access to information concerning such matters.

For this reason, several European company laws do require outside valuation of non-monetary contributions to joint stock companies. But these countries do not generally require evaluation by a panel of three court-appointed experts. The delay and expense of this type of system is too great in a modern economy.

Instead, valuation of non-monetary assets is performed by a single expert. In some countries the expert is court-appointed, while in others he is retained by the contributor as in the second alternative discussed above. The report of the expert sets the maximum value for the asset, though the members of the company are free to set a lower value.

For Bulgaria, a change to a system of this type would be appropriate. A viable approach would be to change the existing Law on Commerce to the following system:

a) Prior to formation of a joint stock company, a founder must obtain a sworn valuation of a proposed non-monetary contribution from a qualified appraiser.

b) When the proposal for opening subscription is made, it must contain:

i. The valuation report of the expert,

ii. A statement concerning the expert's qualifications; and

iii. A sworn declaration by the expert that he has no relationship with the contributor, and that he will receive no compensation for his valuation report other than his customary fee.

- c) The proposal for subscription may value the non-monetary contribution no higher than stated in the expert's report.

d) If the subscription is completed, the Constituent Assembly of the company must set the final value for the non-monetary contribution. This value may be no higher than the amount set forth in the proposal for subscription. If the Constituent Assembly lowers the valuation, the contributor is free to withdraw his non-monetary contribution.

e) If the joint stock company becomes insolvent within a certain number of years, personal liability could be imposed. The criteria for liability would be similar to those discussed above in connection with limited liability companies, with three exceptions:

i) In addition to imposing liability on the contributor and other founders of the company, the law would make the expert potentially liable.

- ii) The expert's liability could arise not only from overvaluation, but also from false statements concerning his compensation, relationship with the contributor, or qualifications.

iii) Subscribing investors as well as creditors would be able to recover damages from persons liable.

By utilizing this system, Bulgaria could simplify the use of non-monetary investments while maintaining protections for creditors and investors. The use of private experts would free the courts from the task of appointing three experts for every company seeking to register and free the investor from the delay and expense of this process. It would also permit an investor to know the likely valuation of his non-monetary contribution in advance, reducing the uncertainty which otherwise might dissuade foreign investors in particular from further investment.

***5)*Public limited companies**

Since this form has features of both limited partnerships and joint stock companies, the regulatory scheme applicable to either could be utilized. It may be more appropriate to follow the scheme selected for joint stock companies, because the Law on Commerce generally prescribes the same rules for both types of firms. Regardless, the present system should be revised for this type of firm to permit investors to move forward without unneeded obstacles.

CONCLUSION

Economic progress in the modem world depends on new investment, particularly in technology, ideas, and know-how. These types of intellectual property frequently are the principal assets of modem enterprises. Often, this property has great value, but that value is hard to quantify.

The goal of any legal system should be to facilitate, not impede, economic progress. Bulgaria is in need of an infusion of innovative technology from the West, ideas which firms in Europe and North America are willing to provide. The present Law on Commerce unnecessarily slows the transfer of non-monetary property, especially intellectual property. With proper amendments consistent with approaches taken

in the West, Bulgaria can protect its citizens from exploitation while opening the door much wider for needed foreign and domestic investment.