Insider guarantees in corporate finance

An economic analysis of Dutch, US and German law

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Introduction

This thesis is focused on the research question:

> *How should opportunistic use of the guarantee relationship in the context of corporate finance be regulated?*

The guarantee relationship and the relevance of the guarantee relationship to corporate finance are introduced below. After that, the agenda of this thesis is revealed, followed by a quick overview of the structure of this thesis.

1 The guarantee relationship

The guarantee[1] relationship in its most basic form can be described as follows. The relationship involves three parties: a creditor, a principal debtor and a guarantor. The principal debtor has an obligation towards the creditor. The guarantor is obliged to render a performance to the creditor, usually payment of money, for the purpose of security of the obligation of the debtor to the creditor.[2] The purpose of security is essential to the understanding of the guarantee relationship. The creditor is ultimately only entitled to one payment.

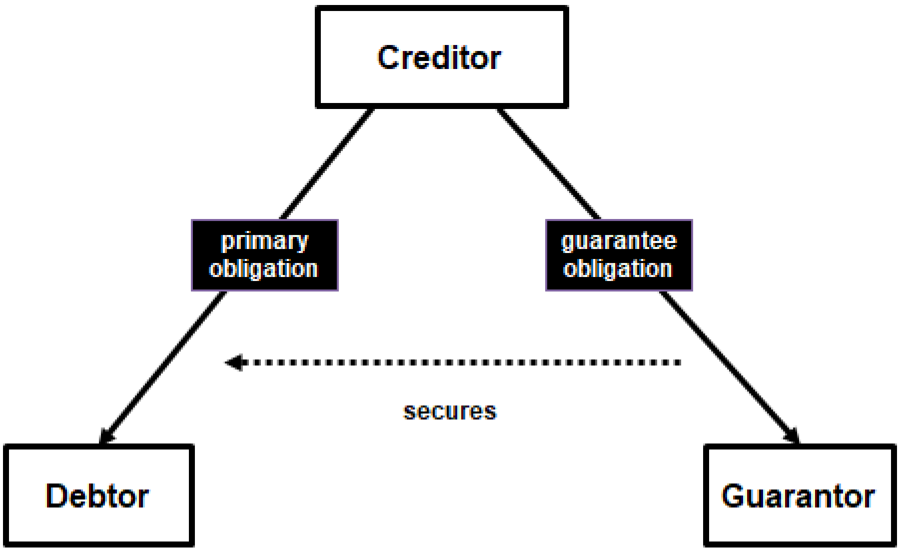

Figure 1: simple guarantee relationship

[1] The alternative spelling guaranty is also often found, although rarely outside of legal jargon. Guarantee can both be a noun and a verb, whereas guaranty is currently only used as a noun. I will use the, at least in ordinary language, more common spelling guarantee, both for the verb and the noun. See on guarantee and guaranty further Garner, 2013.

[2] Compare Drobnig and Clive, 2007, p. 79.

The concept of a personal guarantee securing a credit contract can be dated back thousands of years, as Hewitson puts it (using the term 'suretyship', which for now can be equated with 'guarantee'):

> *"(...) the need which suretyship was conceived to meet is common to humanity, and as old as humanity.".*[3]

The oldest surviving written contract of guarantee is probably from the ancient Middle East in cuneiform writing, 670 B.C.:

> *"Minuhdi-ana-ili shall pay the silver to Siinm-A'ur if Pudu-Piati does not pay it. (…) [I] think we may say that Minuhdi-ana-ili becomes surety for Pudu-Piati".*[4]

There are indications of guarantee relationships in the Ancient Middle East even long before that, for example in the code of Hamurabi (2285-2242 B.C.).[5] The Bible also provides evidence of the use of the guarantee relationship thousands of years ago.[6] The book of Proverbs for example makes mention of suretyship and shows awareness of the dangers involved in such a contract:

> *"[h]e that is surety for a stranger shall smart for it, and he that hateth suretyship is sure"*[7]

> *"[a] man void of understanding shaketh hands in pledge, and becometh surety in the presence of his friend"*[8]

> *"[b]e not thou one of them that strike hands or of them that are sureties for debts;".*[9]

This early recognition of the dangers involved in the guarantee would soon be reflected in early Roman law, making the guarantor the 'favorite of the law'.[10] Many rules, some unknown in modern times, protected the guarantor.[11] One of the main features was the subsidiary and accessory nature of the guarantee. The guarantor could invoke most defenses and exceptions that the debtor would be able to invoke towards the creditor.[12] In modern times, the concept of an accessory and subsidiary obligation is still seen as the standard form of a guarantee in many legal systems.

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[3] Hewitson, 1927, p. 1.
[4] Johns, 1898, p. 165; see also Morgan, 1926, p. 156.
[5] Hewitson, 1927, pp. 11–12.
[6] Hewitson, 1927, pp. 13–14.
[7] Prindle, 1994, bk. Proverbs 11:15; In the NABS translation: "[h]e who is guarantor for a stranger will surely suffer for it, but he who hates being a guarantor is secure." PublicationsFoundation, 1997, bk. Proverbs 11:15.
[8] Prindle, 1994, bk. Proverbs 17:18; In the NABS translation: "[a] man lacking in sense pledges, and becomes guarantor in the presence of his neighbor." PublicationsFoundation, 1997, bk. Proverbs 17:18.
[9] Prindle, 1994; In the NABS translation: "[d]o not be among those who give pledges, among those who become guarantors for debts." PublicationsFoundation, 1997, bk. 22:26; See further Morgan, 1926, p. 157.
[10] Morgan, 1926, p. 159.
[11] Jones Jr., 1977; Morgan, 1926, p. 159.
[12] Jones Jr., 1977; Morgan, 1926; Hewitson, 1927, p. 28.

2 The insider guarantee in corporate finance

This thesis focusses on insider guarantees in the context of corporate finance. Our modern economy relies heavily on credit,[13] which has become almost unthinkable without security rights. Guarantees are, next to proprietary security rights, omnipresent in corporate finance. Insider guarantees play a crucial role in both the structuring of lending transactions of small and medium enterprises (SMEs) and large corporate group structures, but the dynamics involved are underexposed in legal literature.

The term 'insider guarantee' is used to refer to a guarantee given by some person or entity that has a close connection to the debtor. The term 'insider' is understood in a broad sense, encompassing friends, family members, and insiders to a corporation (employees, shareholders, managers, group companies etcetera). In corporate finance, particularly shareholders (or group companies) of the debtor often guarantee debts of the debtor. This is the situation this thesis primarily focusses on. Closely related situations, such as directors of a limited liability company that guarantee debts of the company, spouses of a shareholder that guarantee debts of a company and subsidiaries that guarantee debts of a parent are also discussed.

The discussion of guarantees in this thesis mostly excludes those guarantees given by guarantors that are in the business of extending such guarantees on a daily basis, such as the bank guarantees often used in international trade. Such guarantees have more resemblance with insurance and involve distinct dynamics. Of course, some of the analysis may very well apply or be informative to the dynamics involved in such guarantees as well, and reference will often also be made to such guarantees where relevant, but the primary focus is on the insider guarantee in corporate finance.[14]

In the practice of corporate finance two groups of insider guarantees can roughly be distinguished: the guarantee by a private person who is shareholder or director of a small or medium enterprise towards a professional creditor (usually a bank) on the one hand and guarantees by group companies for group debts towards a professional creditor (usually a bank) on the other hand. Both situations are very common in practice and are relatively underexposed in legal literature. Both these situations will be discussed briefly below, starting with shareholder/directors that guarantee debts of their company.

Shareholders and directors[15] often personally guarantee the debts of their limited liability company, usually on the request of a professional creditor, often a bank. As far as shareholders are concerned, the limited liability shield of the company is thus pierced to the benefit of that single creditor. Through this arrangement the creditor can hold the shareholder or director accountable when the company does not perform on a loan. Such shareholder guarantees are very common in practice. The guarantee has been called 'ever present but seldom noticed',[16] 'of overwhelming importance in small-business finance',[17] 'common practice for SMEs',[18] present 'in

[13] See for example Featherby, 2012.
[14] Also the situation in which the guarantor is not an insider, but the creditor is an insider of the debtor will be considered.
[15] In the smallest businesses, the shareholder and director are often the same person. They could also be different people, in which case a guarantee by a director for corporate debts is somewhat less common, but can also occur.
[16] Tracht 2000, p.497.
[17] Tracht 2000, p.497.

many instances',[19] a 'major force (...) [that] plays a crucial role',[20] 'a routine feature of banking practice, (…) [although] far less ubiquitous (and less attractive for creditors) in England and Wales than, for example, in Germany'.[21] In interviews conducted by Mann with small-business lenders in the US, lenders uniformly reported policies asking personal guarantees from shareholders in all but very unusual circumstances.[22] Blazy & Weill report that 46,5% of loans in their dataset of loans to French distressed SMEs was secured by a guarantee of an individual, 13,7% by a guarantee of a company, and 56,6% by other types of collateral.[23] Steijvers et al report, based on a dataset of loans to US SMEs in 1998, that 13,5% of loans was unsecured, 30,3% by just business collateral and 56,2% of loans was secured by 'personal commitments' (in which they include all guarantees and collateral provided by a natural or legal person other than the borrower), of which 60% was also (partly) secured with business collateral. Also Ang et al, using data on loans to US SMEs, find that personal guarantees are very frequent in small-business lending, with roughly between 50 and 75 percent of loans (depending on company type) secured by personal guarantees.[24]

The second situation in which guarantees are a very common phenomenon is the situation of financing a corporate group. Corporate groups often perforate their internal structure by granting institutional lenders (usually banks) guarantees on loans to group companies. Such guarantees are a partial lifting of the principle of limited liability, towards one or more specific creditors. Commentators report this practice as being 'very common'[25], 'a common element of many financial transactions'[26], 'typical',[27] 'often [present]'[28], 'commonly encountered'[29], 'ubiquitous'[30], 'pervasive'[31]. Squire shows that in 2010 the 100 US companies with the largest revenue reported an average of 245 major subsidiaries, with only five reporting fewer than five subsidiaries; 63 percent of these 100 companies reported use of intragroup guarantees. Such disclosure is however not necessary in case of reporting on a consolidated basis. The percentage of groups that use intra-group guaranties is therefore likely to be significantly higher.[32]

[18] SME: Small and Medium Enterprise. SMEs are of major importance to the European economy. Around 99.8% of businesses in Europe are SMEs (SMEs are Small and Medium Enterprises employing less than 250 people and with a turnover of less than €5 million or a balance sheet total of less than €43 million, see EU recommendation 2003/361). The 20 million European SMEs account for around two-thirds of all jobs and 57.8% of the gross value added, generated by the private, non-financial economy in Europe. Of these SME's, micro enterprises employing less than 10 employees and with a turnover or balance sheet total of less than €2 million form an important part, accounting for roughly a third of all jobs in Europe and 20% of the gross value added. See also Gagliardi et al. 2013.
[19] Baird 1994, p.2263.
[20] Mann 1998, p.10.
[21] Kenny et al. 2010, p.142.
[22] Mann 1998, p.23.
[23] Blazy & Weill 2013, p.1114.
[24] Ang et al. 1995, p.204.
[25] Rock 2013, p.1970.
[26] Williams 1994, p.1404.
[27] Squire 2011, p.605.
[28] Rosenberg 2013.
[29] Dunne et al. 2012, p.4.
[30] Katz 1999, p.47.
[31] Luciano and Nicodano, 2014, p. 2736; see also Merton and Bodie, 1992, p. 87.
[32] Squire 2011, p.606; it is also likely to be higher because some commentators report that especially smaller groups use intra-corporate guarantees, Blumberg 1987, pp.686–687.

3 The agenda of this thesis

The debate on personal security rights in Europe in the last decades has had a rather narrow scope. On the one side distributional concerns on the effects of guarantees on weak guarantors have extensively been brought forward in the literature and have (rightly so) in many legal systems been addressed by at least some legislation or case law protecting the (weak) guarantor.[33] On the other side the importance of the economic function of the guarantee relationship in the lending industry and thus the assumed efficiency of the relationship has often been stressed. This has led to a classic efficiency versus distribution debate.[34]

This thesis aims to fundamentally change that debate. Firstly, the debate should not exclusively focus on weak party protection. The guarantor certainly deserves protection under certain circumstances, but is not always a weaker party. Secondly, efficiency of the guarantee relationship in corporate finance should not too easily be assumed. By casting a wider net and thoroughly reviewing the guarantee relationship from the perspective of opportunism, it becomes clear that insider guarantees are often used by creditor, debtor and guarantor together to externalize costs towards outsiders, leading to various inefficiencies and distributional questions.

The insider guarantee is, in the context of corporate finance, often understood as reducing the cost of credit by reducing opportunistic behavior of the guarantor and the debtor. There is some evidence that the guarantee can indeed reduce the cost of credit compared to the cost of credit simple debtor-creditor relationship.[35] However, the complex guarantee relationship in turn *creates* openings and incentives for opportunistic behavior, not only of the creditor towards the guarantor, but also of all the parties in the guarantee relationship towards outsiders, which means that outsiders can suffer from externalities of the guarantee relationship. These externalities are often, but not always, related to incorporation. Incorporation creates asset partitions in the sense that the shareholders are presumed not to be liable for the corporation's debts (limited liability) and the creditor of the shareholder can in turn not directly seize assets of the corporation (entity shielding).[36] A guarantee by the corporation or by an insider selectively pierces the partition. Thus, insiders can create 'tailored partitions',[37] to suit the needs of themselves and certain creditors, which can come to the detriment of other stakeholders. The guarantee by an insider effectively gives a creditor substantial leverage over corporate decision making, which can be good for that creditor, but creates the danger of creditor misbehavior towards other stakeholders. This not only raises distributional concerns, but may also lead to inefficiencies. Both these distributional concerns and inefficiencies are too often neglected in policy debates on both the guarantee relationship and on the corporation.

[33] See for example Krzemiński and Pepłowska-Dąbrowska, 2014, p. 178; Ciacchi, 2007; Ciacchi and Weatherill, 2010; Cherednychenko, 2007, chap. 6; Kull, 2007; Kenny, 2007; Devenney, Fox and Kenny, 2008; Drobnig, 2003.
[34] See for example the UK House of Lords in Barclays Bank v. O'Brien ([1993] UKHL 6 (21 October 1993), see on this decision also Cherednychenko, 2014, p. 681.
[35] See for example Pozzolo, 2004; Haas and Millone, 2016; however see Blazy and Weill, 2013, reaching a contrary conclusion.
[36] See extensively on asset partitioning Hansmann and Kraakman, 2000, distinguishing between 'defensive asset partitioning' (better known as limited liability, or owner shielding), and 'affirmative asset partitioning', now better known as entity shielding.
[37] See for this term Casey, 2014.

This thesis therefor also examines the case for efficiency of the guarantee relationship. This case is often presented in much too simple fashion. A guarantee may very well reduce the cost of credit as compared to a simple debtor-creditor relationship, but firstly does not necessarily do so because of a danger of reverse-opportunism and secondly the guarantee may increase the cost of credit with the same amount (or more) towards non-guaranteed lenders. There is a large body of literature on the inefficiencies created by real security rights. The debate on the inefficiencies created by personal security rights, which inefficiencies sometimes run parallel to those created by real security rights, but often also differ, is however underdeveloped. This thesis will map those inefficiencies. This analysis, as has been undertaken for real security rights, shows that the case for the efficient functions can, under certain circumstances, cautiously be made when only taking the parties directly involved into account, but often becomes hard to maintain when externalities are taken into account.

The aim of this thesis is not to show that the guarantee relationship is bad or inefficient. The aim is however to show that the dominant narrative that defends the guarantee relationship in the context of corporate finance as an in principle efficient device is flawed. It should not be forgotten that the relationship often works in the interest of stronger market parties, most notably professional lenders, large corporate groups and shareholders, and to the detriment of the weaker parties participating in the market economy, most notably weak guarantors, small entrepreneurs, trade creditors and non-voluntary creditors. As professor (now Senator) Warren puts it in in relation to real security rights:

> *"Their [prof. Bebchukck, prof Fried and prof LoPucki's] scholarship sets the stage for a heretical question: If the secured credit system might be both inefficient and distributionally suspect, perhaps the time has come to revisit its premier place in the commercial world."*[38]

Abolishing a relationship that is deeply ingrained in popular and legal culture and that dates back much further than Roman times would probably be practically impossible in the short term. Instead, the most problematic aspects should be singled out and discussed, to quote Lopucki:

> *"[S]ecurity (…) has [never] been justified and probably never can be. That does not mean that we should rush to abolish it, however. Security is so ingrained in the legal and popular culture that it may not be worth uprooting. Parties are free to contract out of most aspects of security. Only the aspects of security that are deceptive, misleading, or involuntary are harmful. It is to those aspects that the movement for reform should be directed."*[39]

This quote of Prof. LoPucki was probably mainly aimed at real security rights. The quote is however even more applicable to guarantees. Insider guarantees can perform functions very similar to real security rights (see extensively chapters 2 and 3). Guarantees are omnipresent in corporate finance, but are much less apparent, often operate in the background, are almost never registered in public registers and are relatively underexposed in legal literature.[40] As the analysis will show, guarantees often have a disguising effect, either because the guarantee relationship itself remains hidden or because the wealth transfer for which the guarantee serves as a vehicle is indirect and thus relatively hidden because of the guarantee relationship. This

[38] Warren, 1997, p. 1379.
[39] LoPucki 1994, p.1947.
[40] Katz 1999, pp.47, 52ff; Avery et al. 1998; Mata Muñoz 2010, p.1; Mackaay & Parent 2013.

makes guarantees much more likely than real security rights to contain aspects that are deceptive, misleading and involuntary. It is time to change that. Proper understanding of the efficiencies and inefficiencies of the guarantee relationship can lead to better rules, which in turn can lead to an overall reduction in the cost of credit and a more stimulating environment for entrepreneurship.

As the analysis in chapter 2 will show, guarantees can certainly perform efficient functions. Regulation of the externalities that guarantees can create should ideally not prejudice these efficient functions. In order to design the right regulations, a proper understanding of the core economic function in the context of corporate finance is necessary. Only after this core economic function is exposed and the externalities are mapped, regulation that supports the core function while addressing externalities can be designed. The analysis will also show that measures regulating the inefficient functions can indeed largely leave the efficient functions intact.

4 Structure of this thesis

This thesis is focused on the research question:

> *How should opportunistic use of the guarantee relationship in the context of corporate finance be regulated?*

Chapter 1 will introduce and elaborate the method of research used to answer this question: comparative law and economics. Chapter 1 will also explain and defend the choice for using micro-economics, more specifically transaction cost economics with a focus on opportunism.

Chapter 2 discusses the economic function of the guarantee relationship, by answering the sub-question:

> *What is the beneficial economic function of the guarantee relationship in corporate finance?*

In answering this question, chapter 2 focusses on the positive function to the parties involved, without taking externalities into account. Those externalities are in turn discussed in chapter 3, by answering the sub-question:

> *Which social costs can be associated to opportunistic use of the guarantee relationship in corporate finance, towards both insiders and outsiders of the relationship?*

After both the efficient functions and the externalities have been mapped, this thesis answers the question whether and how Dutch (chapter 4), US (chapter 5) and German (chapter 6) law deal with opportunistic use of the guarantee relationship. For each of these legal systems, the following sub-question is answered:

> *How does the legal system deal with opportunism with the guarantee relationship in the context of corporate finance?*

The discussion of the legal systems is followed by a comparison of the regulatory responses in each legal system and, using the economic analysis of chapters 2 and 3, a discussion which responses are optimal. The question answered in that chapter (chapter 7) is the main question:

> *How should opportunistic use of the guarantee relationship in the context of corporate finance be regulated?*