



UvA-DARE (Digital Academic Repository)

Insider guarantees in corporate finance

An economic analysis of Dutch, US and German law

Jonkers, A.L.

[Link to publication](#)

Creative Commons License (see <https://creativecommons.org/use-remix/cc-licenses/>):

Other

Citation for published version (APA):

Jonkers, A. L. (2020). *Insider guarantees in corporate finance: An economic analysis of Dutch, US and German law*.

General rights

It is not permitted to download or to forward/distribute the text or part of it without the consent of the author(s) and/or copyright holder(s), other than for strictly personal, individual use, unless the work is under an open content license (like Creative Commons).

Disclaimer/Complaints regulations

If you believe that digital publication of certain material infringes any of your rights or (privacy) interests, please let the Library know, stating your reasons. In case of a legitimate complaint, the Library will make the material inaccessible and/or remove it from the website. Please Ask the Library: <https://uba.uva.nl/en/contact>, or a letter to: Library of the University of Amsterdam, Secretariat, Singel 425, 1012 WP Amsterdam, The Netherlands. You will be contacted as soon as possible.

CHAPTER 3

Opportunistic use of the guarantee relationship in corporate finance

1 Introduction

The analysis in chapter 2 has shown that use of the guarantee relationship in corporate finance could, under certain circumstances, lead to beneficial results. However, as has also received some attention in the literature, the guarantee relationship could be used opportunistically towards insiders in the guarantee relationship, most notably towards the guarantor. This chapter will map and discuss the social costs that can be associated to such opportunistic use towards insiders in paragraph 2, but will not stop there. Most notably, the function of the guarantee relationship in corporate finance is to align incentives between creditor, guarantor and debtor. This function, that can indeed create beneficial effects for the parties involved, is however by nature also problematic. The function is in its core to change the incentives of guarantor and debtor, more specifically to align those incentives with those of the guaranteed creditor. This is not a neutral way to save some transaction costs by for example allowing specialization in certain tasks such as monitoring and risk-bearing, but an elaborate governance device that changes the behavior of the guarantor and debtor. These changes in behavior will have consequences for outsiders to the guarantee relationship.

Understanding the guarantee in corporate finance as a governance device raises the question: what are the consequences for outsiders to the relationship? Can the relationship be used opportunistically to the detriment of outsiders? Chapter 2 only focused on the effects on the parties involved in the guarantee relationship, not on the externalities towards outsiders. Using mainstream economic analysis, this chapter also aims to expose and explain such externalities to outsiders in paragraph 3 below. This chapter partly breaks new ground, as an extensive and comprehensive analysis of the externalities of guarantees in the context of corporate finance does not exist yet.

The central question to be answered in this chapter is:

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

2 Opportunism towards parties inside the guarantee relationship

Although the guarantee relationship could, under certain circumstances, have positive economic functions, the guarantee could also be used to act opportunistically towards weaker parties *within* the relationship. Especially the guarantor often suffers from such opportunism. This problem, especially regarding weak guarantors, is widely recognized and often regulated to a certain extent. In the context of corporate finance, the question however often remains to which extent shareholders or directors that guarantee business debt also enjoy specific protection as arguably weak parties. The discussion of opportunism within the guarantee relationship will specifically focus on private persons who are shareholders or directors of the debtor.

2.1 Opportunism towards a weak guarantor

Private persons often guarantee debts of family members,²⁹⁰ of small privately owned businesses, or of their employer.²⁹¹ Many may not properly oversee what they are signing.²⁹² Non-sophisticated parties that act as a guarantor, such as natural persons guaranteeing the debts of their own business, are known to be overoptimistic and overconfident in assessing the risk involved in their business.²⁹³ The guarantor may also be induced to sign the guarantee because of his personal relationship with the debtor, for example as a good friend, as a mother or father, or as a husband or wife. In the context of the last, some speak of ‘sexually transmitted debt’.²⁹⁴ Where such emotional reasons lead to the guarantor assuming an obligation, the guarantor may not be able to weigh or even know the advantages and disadvantages of the guarantee construction. Of course, the same can occur with a person taking out a direct loan, but then this person at least enjoys the loan. The case of blindly signing a guarantee contract is often much more devastating, as the guarantor may not, possibly not even indirectly, receive anything in return and becomes highly dependent on the debtor. The guarantee obligation sometimes even outreaches the personal wealth of the person signing the guarantee, meaning guaranteed bankruptcy in case the guarantee is called upon by the creditor. Particularly bleak are cases in which the guarantor is an employee who signs the guarantee contract under pressure from his employer, threatening to fire the employee,²⁹⁵ or in which a small business owner signs a

²⁹⁰ A famous example is that of Garfield Barwick, arguably Australia’s most successful barrister of the last century and the longest serving Chief of Justice of Australia, who had to file for bankruptcy because of his liability as a guarantor for some of his brother’s business debts – see also Bridge, 1997.

²⁹¹ See also: Ciacchi, 2007, p. 15.

²⁹² See for example *Sky News*, 2015.

²⁹³ See on overoptimism Williams, 2014, pp. 336–343; see also Greenfield, 2014, p. 525; Ang, 1992, p. 191; in essence, the same problem can occur in any contractual relation in which one party is in a substantially weaker position than the other party. The guarantee however poses special problems in the sense that it only involves a contingent liability. The guarantor may be overconfident in assuming the circumstances upon which the guarantee is contingent won’t occur. When a weak party contracts for a non-contingent liability, the downsides are often more concrete at the moment of signing the contract.

²⁹⁴ See for example Scheelings, 2004; Cherednychenko, 2007.

²⁹⁵ Ciacchi, 2007, p. 16.

guarantee contract under pressure from a lender when the business is already in financial distress. Relationships and lives can be ruined this way, resulting in vast social costs.

An abundant literature exists on opportunism towards, and thus the warranted protection of, weak guarantors in Europe.²⁹⁶ Many legal systems protect the guarantor to some extent.²⁹⁷ Often, fairness-based notions are invoked to oppose the redistributive effect that a guarantee can have on the relationship between the guarantor and the lender. The guarantee often entails a wealth transfer from the weak guarantor to a strong lender, while the guarantor may not have properly understood this, or may have been moved primarily by emotional motives, which has led to unequal bargaining.²⁹⁸ This thesis is not primarily concerned with notions of fairness. It suffices to notice that the guarantee relationship can be distributionally suspect,²⁹⁹ and that there is a large body of literature addressing this distributional problem.³⁰⁰

A strong focus on the fairness of legal rules is a good thing, but also risks a blind spot to other problems. That is particularly the case in the context of corporate finance (and particularly small-business finance) on which this book focusses. Business owners and directors are, when focusing on notions of fairness, often assumed not to be weak parties, for example because they have an indirect economic interest in the guarantee or because they are considered to have some knowledge of business transactions. Moreover, one may think that the small business owner could also have conducted the business in his own name instead of incorporating and guaranteeing towards the creditor, in which case he would also have been personally liable for business debt. Thus, possibly somewhat counterintuitively, focusing on notions of fairness often seems to justify allowing shareholders and directors to freely assume guarantee liabilities and to uphold these, often combined with the assumption that this would be most efficient.

The possibility discussed above of a private person conducting business in his own name (or through a legal entity that does not enjoy limited liability), thus assuming full liability for all business debts, exists, but the comparably (possibly) grave consequences to the guarantor of a combination of incorporation and a guarantee to the main financier are too often overlooked. When combining incorporation with a guarantee to a large creditor, an ideal situation is created for the creditor. On the one hand, business assets are shielded from claims of private creditors of the guarantor,³⁰¹ whilst on the other hand the guaranteed creditor is not shielded from claiming on the guarantor (see extensively paragraph 3.1 below). Moreover, the guarantor will have all the incentives to influence the company in preferring the guaranteed creditor above other business creditors (see extensively paragraph 3.2 below). It is this setup, probably combined with real security rights on business assets, that may persuade the creditor to provide the loan, where he might not have done so if the guarantor would not have conducted business through a legal entity but instead in his own name. As such, the guarantor becomes liable for large risks, which he might not have been able to take in his own name.

²⁹⁶ See for example Parry, 2005; Ciacchi, 2007; Cherednychenko, 2007; Kull, 2007; Drobniig and Clive, 2007; Ciacchi and Weatherill, 2010; Heine and Janal, 2010; Kenny and Devenney, 2011; Mackaay and Parent, 2013; Schwartz, 2017.

²⁹⁷ See for a large comparative study in Europe: Ciacchi and Weatherill, 2010; see also Schwartz, 2017.

²⁹⁸ Compare Gordon and Landry, 2015, p. 69.

²⁹⁹ Not only towards the weak guarantor, but also to creditors of the guarantor and debtor, this will be developed further in paragraph 3 below.

³⁰⁰ See for an overview Ciacchi and Weatherill, 2010.

³⁰¹ This is known as 'entity shielding', see for example Hansmann, Kraakman and Squire, 2005.

These dynamics and potentially enormous risks are typically also hard to oversee for the guarantor,³⁰² who is likely to be heavily influenced in his risk-assessment by his or her own involvement in the business (see also chapter 2 paragraph 2). See on this point for example De Meza and Southey (as already cited above):

*"[...] borrowers actually have biased expectations. Our general perspective is that it is the unrealistically optimistic who, through self-selection, will dominate the entrepreneurial class (...)"*³⁰³

From an efficiency viewpoint, with a focus on opportunism, the issue of weak guarantors is thus also very problematic, especially in the context of small-business finance. Protecting a business owner that guarantees business debts certainly doesn't defy economic logic.

Specialization in risk bearing has been mentioned in chapter 2 paragraph 5 as a possible efficient effect of the guarantee relationship. However, as also discussed there, a guarantee often has the opposite effect. A guarantee may transfer risk to a party that is less efficient in risk-bearing, for example because of a lower degree of diversification or liquidity, than the creditor is. When credit extended by professional lenders is guaranteed by a small business owner or a group company, it is very likely that risk is indeed transferred to a less efficient risk bearer.³⁰⁴ Professional lenders are by nature efficient risk bearers, whereas humans or group companies are typically not, though exceptions exist. They are much less likely to bear the risk cheaply if it manifests, often because their wealth is locked up in assets that would have to be sold first, and because they often don't have a diversified investment portfolio. Especially if the guarantee liability pushes the guarantor into bankruptcy, the costs of risk-bearing can be very high (and these are not just borne by the guarantor, but also by others involved), which makes the guarantor a very inefficient risk-bearer. Thus, a guarantee that pushes the guarantor into bankruptcy is unlikely to have produced overall efficient results. From an efficiency viewpoint, the law should deter the use of such guarantees.

Guarantees can also create serious bankruptcy costs in another context.³⁰⁵ Large corporate groups often exist of a complicated web of subsidiaries with cross-ties (guarantees).³⁰⁶ One of the most difficult problems a bankruptcy court can be faced with is unraveling the group structure.³⁰⁷ It is often difficult to establish which assets belong to which group member, which can lead to costly litigation.³⁰⁸ The fact that it is often difficult to establish which subsidiary owns what can have many causes. An important cause is often the vertical integration of the group. Many groups are run as one business but are subdivided for technical reasons (doing business in different jurisdictions, tax reasons, et cetera). As Hansmann & Squire argue, the fact

³⁰² See extensively on the point that small business owners as guarantors often don't understand the dynamics involved in the guarantee relationship, which dynamics can create vast risks: Gordon and Landry, 2015.

³⁰³ De Meza and Southey, 1996.

³⁰⁴ See chapter 2 paragraph 5 above. See also Freedman, 2000, p. 340; Compare also Mann, 1999, p. 2260; Gordon and Landry, 2015, p. 69.

³⁰⁵ See on the bankruptcy costs created by strong creditor rights also Buckley, 1992, pp. 252–256.

³⁰⁶ Squire, 2011.

³⁰⁷ An instructive example is the Nortel case, discussed in footnote 118, in which the bankruptcy costs totalled € 2 billion dollars, and the greatest challenge involved assessing which assets belonged to which subsidiary (which could not be established in the end). Moreover, a dispute over the effect of guarantees given to some bondholders complicated matters further.

³⁰⁸ Widen 2007, p.261 at fn 79.; Squire 2011, pp.614–617; Ayotte & Hansmann 2013, pp.720–721; see also paragraph 3.1.2 below.

that a group uses intra-group guarantees fosters the problem of sloppy accounting: the guarantees probably mean that the group will not bother to make specified subsidiary level reports, because the ultimate shareholders and main creditors only care about the value of the group as a whole because of the guarantees.³⁰⁹ The guarantees, by creating a complicated structure and by fostering sloppy accounting, can thus lead to serious transaction costs, which will weigh on the parties.

The danger is furthermore that the creditor has used his often extensive control over the guarantor to make the debtor make payments to the creditor, possibly exposing the guarantor to extensive preference risks that the guarantor may not have foreseen.³¹⁰ Although the creditor, as a repeat player, will have a good picture of these complex dynamics that get even more complex near and in bankruptcy of the debtor, the guarantor is unlikely to have any overview of this when signing the guarantee.

The often-heard notion that the question of protection of weak guarantors mainly involves balancing economic considerations with social considerations³¹¹ is therefore dismissed.³¹² That is not to say there are no social considerations involved. The guarantee relationship often involves strong social consequences, unduly over-indebting guarantors and thus ruining relationships and lives along the way, which deserve close scrutiny from a social perspective. The analysis here has shown that guarantees by weak parties are not only suspect from such a social perspective, but also from an economic perspective by creating inefficiencies such as transferring too much risk to inefficient risk-bearers and subsidizing value-destroying overinvestment, especially in the context of small-business finance.

Moreover, it should not be forgotten that guaranteed lending is considerably more complex than straightforward lending. Because the guarantee relationship involves relations between three parties that are, to complicate matters further, interdependent, transaction costs are likely to be higher than in a simple loan. These additional costs will weigh on the parties and are, in an unbalanced relationship, likely to especially weigh on a weak guarantor. Although the analysis in chapter 2 has shown that some costs that are high in unguaranteed lending can be reduced through guaranteed lending, it should thus not be neglected that the guarantee relationship in any case always also entails additional cost factors, such as more drafting of contracts, more monitoring and more litigation. If costs are saved through the guarantee relationship, they need to at least offset the costs that a more complicated transaction involves in order to lead to an efficient outcome to the parties.³¹³

2.2 Opportunism towards the debtor

While, in the context of corporate finance, an insider guarantee may cure the problem of overinvestment associated with limited liability rules (see chapter 2 paragraph 3), the lender

³⁰⁹ Hansmann and Squire, 2016, para. 3.

³¹⁰ Gordon and Landry, 2015, p. 80.

³¹¹ See for example Van Gerven, 2007; Schmid, 2007.

³¹² See extensively Kaplow and Shavell, 2006.

³¹³ See also Katz, 1999, p. 113; Mann, 1999, p. 2239.

may also not have optimal incentives.³¹⁴ Take for example a firm that is slightly insolvent, or almost insolvent. Investments with a net present value with a substantial amount of risk involved would often be opposed by lenders because they bear the downside risk, while shareholders enjoy (most of) the upside potential of the investment.³¹⁵ While a large amount of literature has focused on the problem of overinvestment by debtors, it should not be forgotten that creditors also not necessarily have optimal incentives. Neither of the parties has optimal incentives.³¹⁶ As Mann argues (in relation to real security rights):

“The lender's disproportionately large share of the downside risk and disproportionately small share of the upside potential give it preferences that are as unduly conservative as the borrower's preferences are unduly risky. A lender that pursues these preferences does more than deter value-decreasing risky transactions; it also deters value-increasing risky transactions.”³¹⁷

Mann has conducted interviews with lenders and borrowers and concludes, in relation to collateral given by the debtor, that the control a lender obtains not only leads to important efficiency gains, but necessarily also to costs associated with the lender's risk averse preferences.³¹⁸ He also shows that borrowers are well aware of this problem, and therefore appreciate unsecured loans more than secured loans and are consequently willing to pay more for unsecured loans.³¹⁹ Even though sophisticated borrowers may be able to understand this mechanism, assessing the future costs of this will often be impossible, as it will be unknown which investment opportunities the future will bring. This uncertainty may lead them to irrationally use collateral now in order to get an interest rate discount, without worrying enough about the future. This applies all the more so to non-sophisticated borrowers, which we are likely to find especially in the context of small-business finance.

This is not to state that secured loans *always* lead to underinvestment. Collateral may also have the opposite effect, overinvestment. A secured creditor with comfortable security right does not necessarily care enough about overinvestment because the security rights protect the secured creditor from the negative consequences of overinvestment. The point made here, and by Mann as cited above, is however that this may change under circumstances. Collateral does not only protect the creditor in case the project fails, but also to an important extent hands control over to the creditor, as described by Mann. Security rights don't always offer full protection and enforcing security rights can be time consuming and costly. Therefore, after having provided credit which may subsidize overinvestment, the creditor may under certain conditions have a preference for certain types of investments or projects that are less likely to jeopardize the secured position of the creditor. For example, the creditor may prefer investment in real estate to investment in research and development. Creditor control through collateral may thus

³¹⁴ see generally Tung, 2009; Tracht, 2000, p. 510.

³¹⁵ Triantis, 1993, pp. 911–912; see also Berkovitch and Kim, 1989.

³¹⁶ Lin, 1993; Gilson and Vetsuypens, 1994; Hu and Westbrook, 2007; R. J. Mann, 1997, p. 664; Scott, 1986, p. 929; Tracht, 2000, p. 508; Buckley, 1992, pp. 252–256; Triantis, 1993, pp. 911–912; Gilson and Vetsuypens, 1994, pp. 1010–1011; Lin, 1993.

³¹⁷ R. J. Mann, 1997, p. 664, with reference to Hansmann and Kraakman, 1992, pp. 628, 649; Macey and Miller, 1995, pp. 73, 77–81; Shupack, 1995, pp. 787–814; Scott, 1986, p. 929; compare also Mann, 1999, p. 2235, explaining that posting a bond (such as a guarantee) in general can deter a subsequent efficient breach.

³¹⁸ R. J. Mann, 1997, p. 665; see also extensively Buckley, 1992, pp. 252–256.

³¹⁹ R. J. Mann, 1997, p. 665.

prevent value-increasing risky projects, such as innovative research and development, whilst at the same time stimulating overinvestment in for example real estate.

This analysis also applies in the case of an insider guarantee. The guarantor assumes risk, and the debtor is likely to internalize this risk through his relationship with the guarantor.³²⁰ The debtor is thus forced to internalize some of the unduly conservative preferences of the lender, possibly leading to sub-optimal investment decisions from the perspective of the debtor. In other words, transferring control to one creditor through a guarantee relationship can, apart from being detrimental to other creditors,³²¹ cause the firm to make inefficient decisions. The problem of inefficient shareholder control is not solved by the guarantee relationship, but converted into problems associated with creditor control.³²² The solution would therefore be to design rules that address both problems, as Lin explains:

“Although actions that maximize the value of a financially troubled corporation benefit both shareholders and creditors and minimize overall loss, the self-interested behavior of these constituencies deviates from this socially desirable goal. Efficiency-minded lawmakers should re-enforce directors' duty to maximize the firm's value, even if pursuit of this business strategy diverges from what shareholders or creditors (and even managers themselves) would have chosen.”³²³

But the problem for the debtor reaches further. The creditor may use the guarantee opportunistically, calling in the guarantee ('seizing the hostage') at a moment not contemplated ex ante by the debtor and guarantor. That danger especially exists when the guarantor's obligation under the guarantee presents the creditor with a substantial source of recourse.³²⁴ That danger can be somewhat restricted by the terms of the guarantee. Opportunistic use is obviously less likely when the guarantee is subsidiary and dependent, as the guarantor has defenses flowing from the dependent and subsidiary nature in such a case. But even if the guarantee is subsidiary and dependent, the creditor could opportunistically exploit small defects, or fake defects, in the debtor-creditor relationship to call upon the guarantor. Again, as also discussed in chapter 2 paragraphs 2 and 3, this danger of reverse-opportunism shows the importance of asymmetrical valuation.³²⁵ As Scott notes:

“Ideally, therefore, the hostage [here: the guarantor, AJ] should constrain the debtor, but not tempt the creditor”³²⁶

As the amount that the creditor can recover through the guarantee increases, the temptation to opportunistically call upon the guarantee becomes harder to withstand. The creditor may be somewhat restricted in acting opportunistically when his reputation is at stake,³²⁷ but this will not always deter all opportunism, especially not when it is hard to prove or detect, or when the stakes are high enough.

³²⁰ Of course, the insider element of the guarantee is essential here. If guarantor and debtor are unrelated, and the guarantee thus does not give the creditor any control over the debtor, the analysis does not apply; compare Mann, 1999, p. 2259; see extensively paragraph 3.2 below.

³²¹ See further paragraph 3.2 below.

³²² Compare Ayotte and Morrison, 2009.

³²³ Lin, 1993.

³²⁴ Scott, 1986, p. 930.

³²⁵ See also Garvey, 1994; Mann, 1999, p. 2232 ff; Scott, 1986, p. 930.

³²⁶ Scott, 1986, p. 930.

³²⁷ Scott, 1986, p. 929; Mann, 1999; compare also Bertrams, 2017; Weert, 2017.

Of course, opportunistic use of the guarantee towards the guarantor does not directly hurt the debtor, but concerns the guarantor. We should however not forget that, in the context of especially SME finance, debtor and guarantor are often closely connected. If the guarantor is shareholder or director of the company, recourse of the creditor on the guarantor can paralyze the debtor, which is likely to be partly run and financed by that same guarantor.

Also apart from opportunistic use of guarantees, the debtor can be seriously harmed by the existence of guarantees, or even the practice of lenders to require guarantees. Institutional lenders routinely require small-business owners to issue personal guarantees.³²⁸ Depending on the amount that small-business owners are required to guarantee,³²⁹ this practice can make limited liability virtually unavailable to the business owner, especially in a market dominated by large institutional lenders.³³⁰ Of course, the guarantee only cancels limited liability to one lender, but if the guaranteed amount is large, the small-business owner assumes a large part of the downside risk of the business and does thus not really profit from limited liability when all goes wrong. In fact, in such a set-up, it is the guaranteed lender that profits most from limited liability (and entity shielding), having a claim on two distinct asset pools instead of one. In such a setup, the entrepreneur is not really encouraged in taking risks,³³¹ which limits the appetite of the debtor to seize business opportunities.

In short, the problem that the guarantee creates is that it may, under circumstances, influence the debtor to be too cautious, in circumstances where he shouldn't be.³³² Business ventures may not be undertaken and innovative ideas may not be pursued because of the guarantee relationship, which is thus costly to the debtor.³³³ The point is not that this is always the case. As discussed in chapter 2, the guarantee may actually round the sharp edges of limited liability by deterring excessive risk taking. The point is however that creditor control through guarantees can, under circumstances, in turn also lead to inefficiencies by deterring welfare enhancing projects that are not in the interest of the secured creditor. Next to possibly leading to underinvestment, the debtor may suffer from opportunistic behavior of the creditor, which becomes more likely as the amount that the creditor can recover through the guarantee increases and as the defenses of the guarantor are weakened.

Furthermore, a consumer debtor will often not be able to oversee that a guarantee of a relative for his or her debt will de facto limit future options of making a debt-free fresh start by applying for bankruptcy and completing the procedure. Most legal systems offer such a procedure for natural persons, making sure such persons get a 'second chance' with a clean slate subject to certain conditions. The fact that a debtor can foresee a future with a clean slate may theoretically lead him to overinvest, or to shift assets to family members just before applying for bankruptcy. A lender could protect himself against such behavior by requiring a guarantee by one or more relatives. Such a guarantee can, apart from possibly changing the debtor's behavior towards the lender, have a side effect that seriously endangers the debtor's fresh start. If the debtor does go bankrupt and, assuming the guaranteed creditor is not paid in full, calls on the guarantor, that

³²⁸ See the introduction to this thesis; see also Mann, 1998; Hahn, 2006.

³²⁹ For example, in the Netherlands, small business owners typically only guarantee a part of the loan, see also Haentjens, 2010.

³³⁰ Hahn, 2006.

³³¹ Compare Acharya, Amihud and Litov, 2011, testing and proving the notion that strong creditor rights can lead to sub-optimal investment strategies; See also Tung, 2009, p. 174.

³³² Compare Hu and Westbrook, 2007.

³³³ And costly to society at large, a point to be developed further below.

guarantor will get a recourse claim on the debtor. Such a recourse claim will probably not be enforceable after the debtor is granted a fresh start under the applicable bankruptcy laws. However, if the guarantor is a close relative, which will often be the case in the consumer context, the fact that the claim is not enforceable by law may not change much. The debtor may still feel obliged to pay back the guarantor that has bled for him or her in one way or another.³³⁴ Or worse, if the guarantor is the spouse of the debtor, the family remains indebted until both have gone through bankruptcy with a fresh start. In essence, by using the moral bond between guarantor and debtor, the parties have to a large extent circumvented the fresh start rules that bankruptcy provides, and undercut the policy considerations underlying such fresh start rules.³³⁵

2.3 Summary

Chapter 2 showed the efficient functions of the insider guarantee relationship, which can mainly be ascribed to aligning the interests of guarantor and indirectly the debtor to those of the creditor. This section discussed that the guarantee relationship can also be used to act opportunistically towards parties in the guarantee relationship, most notably the guarantor. While there has been a strong focus in the recent literature on the protection of weak sureties such as family members of the debtor, the cost of opportunistic use of guarantees towards weak parties *in the context of corporate finance* has mostly been overlooked. This chapter explained the costs of such opportunistic use, calling for regulation of the problems identified.

The guarantee relationship is not only dangerous for the weak guarantor, but can also lead to sub-optimal investment incentives for the debtor, who next to that also runs the risk of reverse-opportunism. In such a set-up it is the guaranteed lender that profits most from limited liability (and entity shielding), having a claim on two distinct asset pools instead of one. The entrepreneur is not really encouraged in taking risks, which limits the appetite of the debtor to seize business opportunities.

Both opportunism towards a weak guarantor and towards a weak debtor are not only distributionally suspect, but also create inefficiencies that should be addressed. The idea that guarantees in corporate finance generally promote efficiency is thus thoroughly challenged.

³³⁴ Instructive is the following quote of James Benamor, CEO of 'Amigo Loans', an outlet that offers guarantor loans to consumers: *"When it's a social relationship people are much less likely to walk away from a debt than if it was to a bank"*.

³³⁵ See for such policy considerations inter alia the proposal of the European Commission for a Directive 'on preventive restructuring frameworks, second chance and measures to increase the efficiency of restructuring, insolvency and discharge procedures and amending Directive 2012/30/EU' (COM (2016) 723 final, 22 November 2016): *"Inefficient second chance frameworks result in entrepreneurs being locked into debt-traps or driven to the black economy"*.

3 Opportunism towards outsiders to the guarantee relationship

This thesis aims to fundamentally change the debate on guarantees by questioning the economic function of the guarantee relationship in corporate finance. By casting a wide net, it becomes clear that guarantees are often used opportunistically towards outsiders. In this setting, the guarantor may actually be the stronger party, imposing costs on outsiders. While one of the most important functions of the guarantee can be to reduce opportunistic behavior of debtor and guarantor, the guarantee relationship can just as well be used to opportunistically extract rents from outsiders that did not agree to the guarantee relationship and may not even know of it. In this paragraph, the ability of the guarantee relationship to create such externalities will be discussed, with a focus on the context of corporate finance. Creating such externalities is problematic and can be inefficient.³³⁶ The idea that guarantees in corporate finance generally promote efficiency is thus challenged.

Two clearly distinguishable categories of externalities of the guarantee relationship are opaque priority structures and covert insider dealing. In the first case, a guarantee relationship is used to set up a structure in which, often in a complex and covert way, the creditor or the guarantor is, or both are, from the outset ('ex ante') put in a priority position vis-a-vis the other creditors of the debtor, to the detriment of those other creditors and other stakeholders. The opportunistic behavior in this category is the creation of that opaque priority structure. In the second case, a guarantee by an insider (such as a shareholder or director) gives the insider incentive to influence the debtor to make preferential distributions to the guaranteed creditor. This incentive often becomes especially strong in financial distress of the debtor, (long) after concluding the guarantee ('ex post'). Such insider dealing by the guarantor may remain covert exactly because of the guarantee relationship.

3.1 Ex ante opportunism: Opaque priority structures

In the context of corporate finance, guarantees often serve as a device to create a structure in which one creditor or guarantor has structural priority over other creditors. This is not directly apparent, because it seems that the guaranteed creditor has recourse to an alternative source of payment with the guarantee and thus is not prioritized above other creditors of the debtor. But when one zooms out from the entity level, the priority granted by guarantees, and the externalities that come with it, become apparent. The priority that a guarantee can grant a creditor or a guarantor works much like the priority that real security rights can offer, but important differences also exist. Most importantly, the priority granted through complex guarantee structures is often much more covert and, because of that, often much more problematic.

Simply put, parties can create an opaque priority structure by combining limited liability incorporation with a guarantee by the shareholder to certain creditors. Thus, a selectively pierced limited liability shield is created. This situation is very common in practice. Such a

³³⁶ Bebchuk and Fried, 1996; 1997; see also Baird, 1994a, p. 2265.

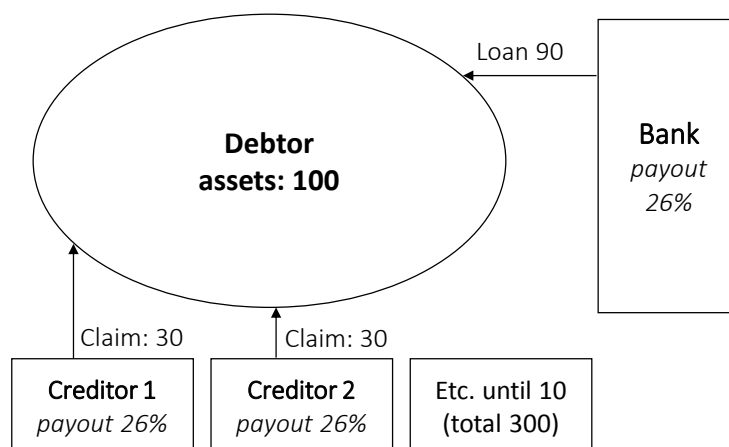
structure is often used in small-business finance, in which the business owner often guarantees certain business debts towards a major creditor such as a bank. It can also often be found in the financing of corporate groups, in which group companies guarantee each other's debts (or even all the group debts) towards a bank. This paragraph will discuss the opaque priority structures that a guarantee relationship can create in the context of corporate finance and will discuss to which extent and under which circumstances such priority is justified from an economic perspective.

First, the way in which guarantees effectively grant seniority status is explained and dissected (paragraph 3.1.1). After that, the justification for a selectively pierced limited liability shield is discussed by using both the literature on the justification for limited liability (par. 3.1.2) and on the justification for real security rights (par. 3.1.3). This discussion concludes that using guarantees to create a selective limited liability structure is highly problematic from an economic perspective.

3.1.1 Opaque seniority through guarantees³³⁷

Guarantees can be used to create an opaque priority structure, which enables creditor and guarantor to create benefits, to the disadvantage of other creditors of the debtor. The structural seniority that the guaranteed creditor receives by a combination of incorporation and a piercing guarantee, can be dissected in various elements. The first element comprises the fact that the guaranteed creditor has a choice of whom to claim from, whereas other creditors do not. The second element is that the guaranteed creditor can also choose not to choose, but to first claim the full amount from one (co-)debtor or guarantor and consequently claim a possible deficiency from another. The third element is that the creditor, depending on the rules applicable, may even submit full claims to both guarantor and debtor. To understand these elements, an example will be used.

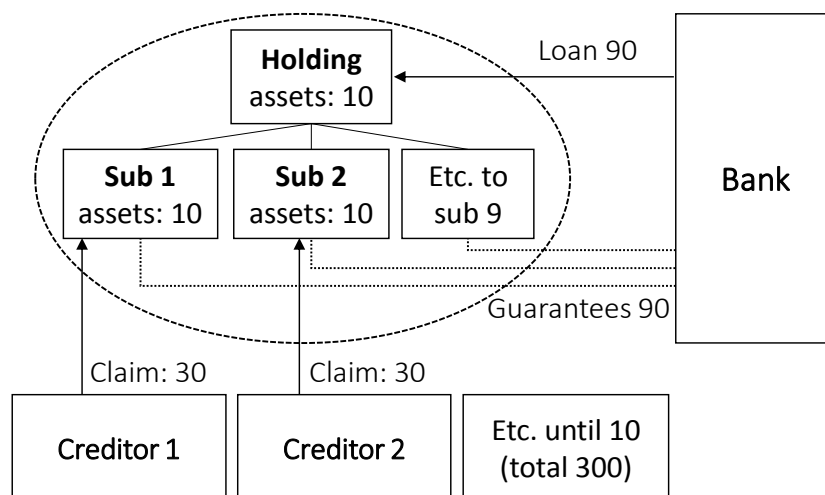
Consider for example a bank that has an unsecured claim of 90. There are 10 other unsecured creditors, each with a claim of 30. The debtor has assets worth 100. In case of distribution in insolvency, each would receive (rounded) 26% (see figure 1).



³³⁷ Part of the analysis in this paragraph is based on my article in the *Maandblad voor Vermogensrecht*: Jonkers, 2018.

Figure 1: Simple case without guarantees

As a variation, consider the debtor is not one single entity, but is subdivided into a Holding company and 9 subsidiary entities, each with limited liability. Everything else stays the same, though the bank has provided the loan to the Holding company with guarantees of all subsidiaries for the full sum, as is common in group finance. All other creditors only have a claim in relation to one single debtor and each on a different subsidiary (figure 2).³³⁸

Figure 2: Case with incorporation and piercing guarantees to bank³³⁹

The first element of structural seniority for the bank, compared to the simpler case in which there was only one entity and no guarantees, is that the bank is protected against bankruptcy of for example subsidiary 1 in a situation in which the rest of the group survives. If that subsidiary is declared bankrupt, the position of the bank is not necessarily weakened if the other debtors are still solvent. The bank keeps a claim of 90 on all the other debtors and, if they are solvent, they should in principle be able to pay the bank eventually. In the example, creditor 1 is however not protected. This creditor has a claim of 30 on a bankrupt entity with assets worth 10 and can thus at most, assuming the bank does not take part in the insolvency proceedings, look forward to 33% pay-out, foregoing costs. However, the bank could also assert a claim of 90. If allowed, the pay-out percentage drops to 8,3% (10 assets divided by 120 liabilities). The creditor gets 8,3% and has no other source of recourse, whereas the bank also gets 8,3% whilst keeping recourse against the 9 solvent entities.

The structural seniority that the bank gets through a combination of incorporation and piercing guarantees does not stop there. If the whole group is declared bankrupt, the bank does, under most legal systems, not have to choose whom to claim on. The bank just submits its full claim in each insolvency proceeding, recycling the same claim again and again, even though the amount

³³⁸ This example takes a corporate group with quite a few (10) entities, as the effect is very strong in this context. The analysis however also holds and the effects are substantial in the simpler case a single person incorporates one entity and guarantees the debts of the entity.

³³⁹ In this example, one of the ten creditors without guarantees has a claim on the holding, which is for reasons of simplicity not clearly depicted here

of 90 has only been provided once. This effect, which has been termed ‘squeezing down’ ordinary creditors by Widen, is for an important part related to a mechanism that we can call ‘double proof’ or ‘double dipping’.³⁴⁰ Double proof occurs when a creditor is able to make more than one claim in relation to a single debt. This mechanism can, dependent on the legal rules, occur in two different degrees of strength. The strong version is when the bank is indeed allowed to submit the full claim ten times, without regard to pay-out in either of the bankruptcy cases. The weaker form is when the bank can only recycle the deficiency claim in each proceeding. Recycling just the deficiency claim will be developed further below with an example.

If, in a bankruptcy of all the group entities, the bank would be allowed to submit its claim of 90 in each bankruptcy proceeding in full without regard to pay-out in the proceedings of the other bankruptcy cases, the strong form of double (or actually 10-fold) proof occurs. The bank is able to make ten claims of 90, thus total 900, whilst it has only made a loan of 90. The pay-out of the bank rises from 26% in figure 1 to 83% in figure 3. Allowing the bank to every time assert a claim of 90, the pay-out in each entity is (10 assets divided by 120 liabilities, times 100) 8,3%. That means a pay-out of 7,5 for the bank in each separate case, totalling 75 pay-out in the ten cases together. In total, the bank thus gets a pay-out of 75 on a claim of 90, which is 83%, equalling (logically) 10 times the pay-out percentage in each individual case. The other creditors are left with 8,3% each (see figure 3).³⁴¹

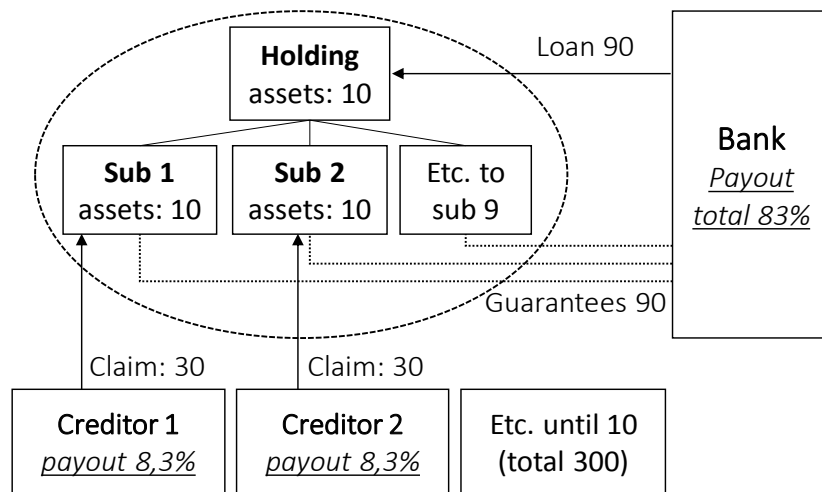


Figure 3: Strong-form double proof

From the perspective of the bankruptcy proceeding of an individual group entity of a bankrupt group, double proof can also lead to odd results. Assume an individual group company that is relatively small, for example with a balance sheet total of 300.000 whereas the group has a balance sheet total of 50 million. The group as a whole may have used a credit line of 20 million, guaranteed by all individual group companies. The total of creditors (other than the bank) of the

³⁴⁰ Widen 2007, p.301 ff.; Kronfeld, 2012.

³⁴¹ See further, also for other numerical examples, Widen 2007, p.307 ff; see also, with a slightly different approach, Squire 2011. This example is not used to suggest that this would be the main reason for banks and companies to structure the company and the loan in this way. There are many reasons why subdividing into subsidiaries may be functional, see for an overview Rock 2013, p.1968.

individual group company could be 400.000, whereas there could, after liquidation, only be 200.000 in assets to distribute, amounting to a pay-out of 50%. However, the bank also submits its claim of 20 million, even though this individual group company obviously did not use the full credit facility of 20 million. Admission of this claim would reduce the pay-out to creditors to roughly (200.000 divided by 20.4 million =) 1%. The 200.000 thus almost entirely goes to the guaranteed bank; the other creditors are left with barely nothing, whilst they (probably) actually extended credit to this entity, whereas the bank merely extended credit to the group as a whole.

Two variations to strong-form double proof can be conceptualized. In the first, the bank would only be allowed to submit its deficiency claim in each insolvency, which would mean 90 in the first and, if the pay-out in the first is 8,3% (= 7,5) (as in the example above), 90 minus 7,5 = 82,5 in the second, etcetera (see figure 4). Most legal systems have this rule for real security rights granted by the debtor. The creditor would then only get a percentage of the proceeds of the unencumbered assets based on the *unsecured* part of his claim. Squire calls this ‘single proof’ as opposed to double proof. According to Squire, the difference between single proof and double proof is often actually not that dramatic.³⁴² The larger value transfer from unsecured creditors to the bank lies in the fact that the bank can issue a claim against ten asset pools, even though he only extended credit once, possibly combined with *correlation seeking*.³⁴³ Whether each claim is allowed to be the full claim, or only a deficiency claim, is in many cases indeed a detail, but can also make a substantial difference in some cases.³⁴⁴

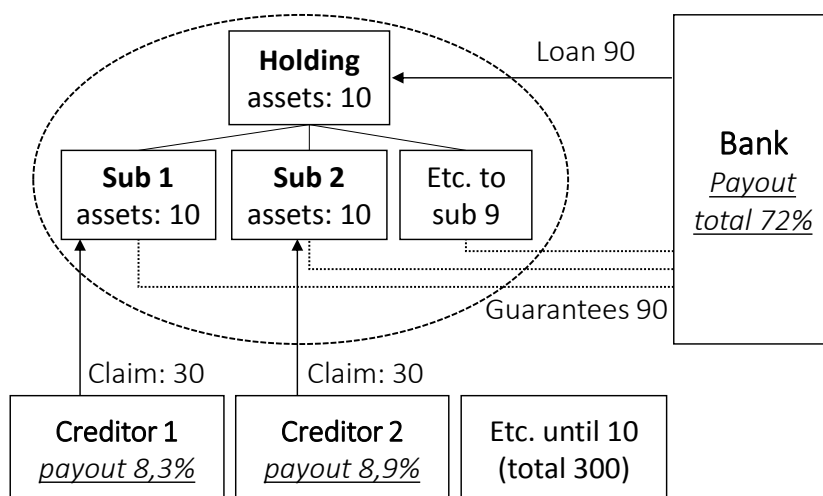


Figure 4: Example with deficiency double proof

Referring to this as ‘single proofing’ (as Squire does) is somewhat confusing. A better term, which I use here, is *deficiency double proof*. Deficiency double proof essentially still allows for double proofing, but just for smaller amounts. If the guaranteed creditor can share pro rata in the distribution in the first bankruptcy based on a claim of 90, and after receiving 7,5 can share pro rata in the second bankruptcy based on a claim of 82,5, double proofing still occurs but just

³⁴² See for a simple model Squire, 2011, pp. 634–635.

³⁴³ See on correlation seeking Squire, 2010; 2011; see extensively also paragraph 3.1.4 on correlation seeking.

³⁴⁴ See for example the Nortel cases, with billions of US Dollars in claims, in which the difference between single proofing and double proofing makes a substantial difference. See Westbrook, 2015.

for smaller amounts. The guaranteed creditor now gets a combined return of roughly 72%³⁴⁵, compared to (on average) 12%³⁴⁶ for the other creditors. Although he only extended 90 of credit, he is able to, in the ten bankruptcy cases combined, assert a total claim of 593³⁴⁷ (down from 900 in the case of strong-form double proof), squeezing down ordinary creditors that are only able to assert the amount of their claim once and in one bankruptcy proceeding. In short, if the guaranteed creditor is only allowed to assert deficiency claims against each co-debtor, double proof still occurs, but just in a weaker form.

When allowing strong form double proof with guarantees, cases become extreme when real security rights are taken into the equation. What if the claim of the guaranteed creditor is for 90% secured by real security rights? Assume for simplicity that the assets on which the security rights rest are primarily held by one subsidiary. Would the creditor really be allowed to submit the full claim against the other subsidiaries, whilst 90% payment is already secured because of the security rights? Particularly interesting here is the fact that, as already mentioned above, most legal systems do not allow such strong form double proof with real security rights at the entity level. If a creditor has security rights given by a certain entity, he can only share pro rata with other creditors in the insolvency of that entity based on the unsecured part of the claim, not on the basis of the full claim. It seems that this rule can easily be circumvented by placing the assets in various subsidiaries and having them guarantee the full debt towards the creditor. Why would such circumvention be allowed? There seems to be little justification for this.

Double proof becomes especially problematic in relation to credit bids. The term credit bidding is used to describe a practice in which a creditor with security rights over certain property bids on the property in an execution sale. Such a bid is done in paper money, as the receiving party is the creditor himself, at least in as far as the creditor has an outstanding claim. The creditor can thus make a bid up to the amount of his outstanding claim, without having to provide actual money. Above, it was discussed that creditors, in the context of group finance, can have artificially high claims on all group entities because of guarantees. Without any considerable brakes on either double proof or credit bids, the creditor could use these artificially high amounts to make artificially high credit bids on all the property over which he also holds real security rights, thus keeping strong control over the debtor's property, possibly even without such credit bids affecting his claims over other group companies (although one could argue that the creditor can, in all the bankruptcy proceedings together, only credit bid up to a total of the outstanding claim, because he would otherwise on paper receive more than 100% of his claim).

The example above (figure 3) may need some explanation on the nature and appearance of double proof. If the bank in the example above extended a total of 90 credit to 10 group companies, and thus has a claim of 90 on each, the strongest version of double proofing would mean that, in case of a group insolvency, the bank can claim 90 in each insolvency, disregarding any payments the bank receives on the debt after the date of bankruptcy filing. I call this *strong-form double proof*.

³⁴⁵ $((10/120) \times 90 = 7,5) + ((10/112,50) \times 82,5 = 7,3) + ((10/105,2) \times 75,2 = 7,15) + ((10/98,05) \times 68,05 = 6,94) + ((10/91,11) \times 61,11 = 6,71) + ((10/84,4) \times 54,4 = 6,45) + ((10/77,95) \times 47,95 = 6,15) + ((10/71,8) \times 41,8 = 5,82) + ((10/68,98) \times 38,98 = 5,65) + ((10/63,33) \times 33,33 = 5,26) = \text{total } 64,93 \text{ payment on a claim of } 90, \text{ which amounts to } 72\% \text{ pay-out.}$

³⁴⁶ The total of assets in all bankruptcies combined was 100. 100 minus 64,93 (see footnote above) = 35,7, which is the total distribution to the other creditors, who together have a total claim of 300. $35,7/300 \times 100\% = 12\%$.

³⁴⁷ See also calculation above, $90 + 82,5 + 75,2 + 68,05 + 61,11 + 54,4 + 47,95 + 41,8 + 38,98 + 33,33 = 593,33$.

In short, the structural seniority that the guaranteed creditor receives by a combination of incorporation and a piercing guarantee, can be dissected in various elements. The first element comprises the fact that the guaranteed creditor has a choice of whom to claim from, whereas other creditors do not. The second element is that the guaranteed creditor can also choose not to choose, but to first claim the full amount from one (co-)debtor or guarantor and consequently claim a possible deficiency from another (deficiency double proof). The third element is that the creditor, depending on the rules applicable, may even be allowed to submit full claims to both guarantor and debtor in bankruptcy ('strong form double proof').

3.1.2 Justification for selective perforation of limited liability?³⁴⁸

As discussed at various points above, insider guarantees are often used in combination with incorporation, often to neutralize, as far as the guaranteed creditor is concerned, the agency problems that incorporation creates. This creates a somewhat paradoxical combination of incorporation and a partial cancellation of the effects of incorporation. Incorporation partitions a pool of assets by way of both entity shielding and limited liability; the guarantee, in turn, selectively perforates that partition for the benefit of one or more creditors.³⁴⁹ Paragraph 2 above already discussed that, because of the guarantee, especially the guaranteed creditor profits from the principle of limited liability (and entity shielding), rather than the entrepreneur. This situation of two asset pools (with perforations) can create externalities for the creditors that can only reach one asset pool, at least if compared to a situation in which all assets remain in one pool (see extensively paragraph 3.1.1 above).³⁵⁰

The fact that incorporation combined with a perforating guarantee can be used to move value away from unsecured, and especially from non-adjusting,³⁵¹ creditors is not particularly

³⁴⁸ Part of this paragraph is based on my earlier Dutch article on the McGregor bankruptcy: Jonkers, 2017.

³⁴⁹ Squire also speaks of perforation in this context, see Squire, 2011; the word 'partition' itself relates to separation of an asset pool by way of entity shielding and owner shielding. Entity shielding means the shareholder's creditors cannot claim on the business directly, owner shielding (limited liability) means the shareholder is protected from claims of creditors of his corporation. (Hansmann & Kraakman 2000; Hansmann et al. 2006) A guarantee could either pierce the entity shield, or the owner shield, or both (a mutual guarantee).

³⁵⁰ Consider a person, X, with some personal wealth, who wants to engage in some business activity. Y is willing to provide X a loan. X's business plan looks solid, but because of working with dangerous chemicals, there is small risk of making tort creditors. If this risk indeed materialises, the possible liability of X is likely to outreach his assets by large numbers. For both Y and X, it may therefore be sensible to incorporate X. In other words: X becomes the sole shareholder of a new company: C. C takes the loan from Y, X in turns guarantees the loan in order to prevent X from acting opportunistically, and to secure Y's payback in case the risk of above indeed materializes. If the risk does not materialize, this option may prove slightly more expensive than a direct loan to X without incorporating because of higher transaction costs, but in case the risk does materialize both X and Y have made a good choice. Y will, unlike the tort creditors, have recourse to X under the guarantee, after sharing with the tort creditors in C's bankruptcy. X in turn will not be confronted with the tort creditors (absent options for corporate veil-piercing), he just loses his equity stake in C and will have to refund Y in as far as Y does not receive sufficient pay-out in insolvency proceedings of C. What happens here is that Y and X externalize costs with a combination of incorporating and guaranteeing on tort creditors that are not able to adjust, as they are involuntary creditors (See further Lopucki 1996, pp.19–23, see also Hansmann & Kraakman 1991, compare Millon 2007; Muscat 1996; Landers 1975).

³⁵¹ See on non-adjusting creditors Bebchuk and Fried, 1996; Warren and Westbrook, 2005; See also Barneveld, 2014, pp. 56–61.

surprising. The rule of limited liability can obviously be used to create such externalities.³⁵² A rich literature exists on the justification for and downsides of incorporation³⁵³ and limited liability in general, often in the context of the most far reaching remedy against limited liability: veil-piercing.³⁵⁴ This paragraph considers those arguments for and against limited liability,³⁵⁵ but in the particular context of limited liability perforated by guarantees. The question is, simply put, whether possible arguments for and against limited liability (still) apply when the limited liability shield is voluntarily perforated by guarantees. Is limited liability, and the externalities it creates, (still) justified if voluntarily perforated in relation to strong, financial creditors?

The effect of limited liability in the corporate context is that shareholders of a corporation are not liable for the debts of the corporation. In case of failure, they do not lose more than their equity investment. In that sense, they are *limitedly* liable, with their initial investment as a maximum loss. Limited liability is often viewed as the greatest advantage of the corporation.³⁵⁶ In this context, reference is often made to a quote by the then president of Columbia University:

“[T]he limited liability corporation is the greatest single discovery of modern times, even steam and electricity are far less important than the limited liability corporation, and they would be reduced to comparative impotence without it It substitutes co-operation on a large scale for individual, cut-throat, parochial competition. It makes possible huge economy in production and in trading ... it means the only possible engine for carrying on international trade on a scale commensurate with modern needs and opportunities.”³⁵⁷

Limited liability limits the exposure of shareholders to risk, but does not make the risk decrease or disappear. The limited liability rule encompasses a transfer of risk from shareholders to

³⁵² See generally for example Bainbridge, 2005, p. 95; Lopucki, 1996; Millon 2007, p.1342; Barneveld, 2014, pp. 65–67.

³⁵³ The questions why and when incorporation could be efficient are possibly the most discussed questions in law and economics since its emergence. This debate is generally referred to as the ‘Theory of the Firm’, and arguably started with Coase’s 1937 article ‘The Nature of the Firm’ (Coase 1937). The question Coase addresses is why people organize behavior in firms instead of using the price mechanism the markets offer. He takes the position that “(...) *the operation of the market costs something and by forming an organization and allowing some authority (an “entrepreneur”) to direct the resources, certain market costs are saved*”. It is impossible to discuss the full debate on the Theory of the Firm, but generally these theories do not have much to say on why incorporation would be necessary to organize behavior in a firm and more specifically on why the concept of limited liability would have to be applied (Ayotte & Hansmann 2013, p.719). Indeed, limited liability is, against popular belief, not a necessary feature of the business corporation (Hansmann et al. 2006; Hansmann and Squire, 2016).

³⁵⁴ See on justifications for limited liability in the corporation generally: Bainbridge and Henderson, 2016; Easterbrook and Fischel, 1985; Hansmann, Kraakman and Squire, 2006; Hansmann and Squire, 2016; Blumberg, 1986; Freedman, 2000, p. 347; Ribstein, 1992, p. 428; see on limited liability and (justifications for) veil-piercing: Presser, 2016, chap. 1; Macey and Mitts, 2014; Thompson, 2004; Thompson, 1991; Oh, 2010; Bainbridge, 2005; Rapp, 2006; see on justification for limited liability in the context of tort claims specifically: Hansmann and Kraakman, 1991; Leebron, 1991.

³⁵⁵ And its less well known counterpart: entity shielding, see further below and see Hansmann, Kraakman and Squire, 2006. When discussing the upside and downside of limited liability, it is important to distinguish roughly between two alternative rules, that each have their own up- and downsides: pro rata liability of shareholders (which can be specified in different ways); and joint and several liability of shareholders. See also Blumberg, 1986, pp. 611–612.

³⁵⁶ Presser, 2016, para. 1:1; Bainbridge and Henderson, 2016, chap. 2.

³⁵⁷ See Presser, 2016, para. 1:1, the quote is by President Butler of Columbia University; see for a comparable statement The Economist redaction, 2016; Barber, 1981, pp. 371–372; see however Hansmann and Kraakman, 2000; Hansmann, Kraakman and Squire, 2006, asserting entity shielding is a more important feature of the corporation.

corporate creditors.³⁵⁸ If the corporation fails and, upon failure, does not have enough assets to satisfy claims of creditors, the creditors are left emptyhanded. As has been discussed in chapter 2, paragraph 5, such a shift of risk may lead to efficient outcomes, for example if the creditor is a cheaper risk bearer, or a better monitor of the debtor. This is what economic arguments supporting or attacking the default rule of limited liability for corporations focus on: when does the shift of risk to creditors as a default rule make economic sense?³⁵⁹

In discussing arguments for and against limited liability, it is helpful to make a broad distinction between three types of cases with differing underlying policy considerations: (a) limited liability of the dispersed shareholders of a large public company; (b) limited liability of a parent corporation for corporate subsidiaries within a corporate group; (c) limited liability of the shareholders of small, closely held corporations. Guarantees by shareholders are plentiful in situation (b) and (c), but almost never found in situation (a). The discussion below of the arguments supporting limited liability in each situation will help understand why – and will show why the arguments supporting limited liability are much weaker in case of perforating guarantees.

a) Limited liability in the public corporation

In the case of dispersed shareholders of a large public company, limited liability is relatively uncontroversial.³⁶⁰ It is easy to see why limited liability and the shift of risk this encompasses from shareholders to creditors make economic sense. The shareholders could be thousands of different persons or entities, possibly from different countries and with differing wealth and abilities. The shareholders are probably not the best monitors of firm performance. Shifting risk and thus monitoring activity to the possibly less dispersed group of creditors may be rational.³⁶¹

Moreover, if shareholders would be jointly and severally liable for the corporation's debts, they would also have to monitor the wealth of the other shareholders.³⁶² If they would instead be pro rata liable, the shareholders would not have to monitor each other, but the *creditors* of the company would still have to monitor the company and the shareholder's wealth.³⁶³ Allowing for limited liability simplifies the arrangement considerably for all actors involved by reducing the number of factors to take into account when assessing the value of their claim.

Moreover, in large public companies, small shareholders often have little influence on (daily) decisions of the company. Ownership and control are thus to a large degree separated, at least as

³⁵⁸ See also Vanderkerckhove, 2007, p. 8.

³⁵⁹ See for example Bainbridge and Henderson, 2016, p. 9 ff.

³⁶⁰ Klein and Jr., 2007, p. 147; Bainbridge and Henderson, 2016, p. 10. Somewhat controversial, also in this situation, is limited liability in relation to tort creditors because they are involuntary creditors, see Hansmann and Kraakman, 1991, and in relation to voluntary creditors that do not have the means or sophistication to bargain, see Freedman, 2000, p. 330.

³⁶¹ The weakness of the argument is that this is not always the case, and does not apply to all creditors equally. That a financing bank is a better monitor than a natural person that holds a few shares in a large company is obvious, but small trade creditors and involuntary creditors pose more difficult questions. Freedman, 2000, p. 330; see on tort creditors extensively: Hansmann and Kraakman, 1991, arguing that limited liability should not be upheld against this category of creditors. One could also argue that the argument that shareholders are dispersed and thus not the best monitors does not substantiate the rule of limited liability as such, because the group of shareholders is often dispersed especially because limited liability is available. If it would not be, the shareholders would not be dispersed whereas the creditors would probably.

³⁶² Easterbrook and Fischel, 1985, pp. 94–95; Hansmann and Squire, 2016, para. 2.1; Freedman, 2000, p. 328.

³⁶³ Compare Hansmann and Squire, 2016, para. 2.1.

a practical matter. Both from a moral, and from an economic perspective, it may thus make sense not to hold shareholders liable for the company's debts.³⁶⁴ The economic argument would be that shareholders would otherwise be deterred from investing in the company (though one could argue they would simply invest as creditors if limited liability were not available). The risk that they become liable for a large sum while not even having had much influence on the decision-making is likely to put them off becoming a shareholder.³⁶⁵

Another often mentioned argument, which has a close connection to the former two arguments, is that limited liability of shareholders makes diversification a more rational strategy.³⁶⁶ The reduced need to monitor the firm because of limited liability, and the reduced need to monitor other shareholders, makes it more rational to hold many small shareholdings, instead of one non-diversified large share. This means that less wealthy people or institutions can also enjoy the benefits of diversification more easily.³⁶⁷

Unlimited shareholder liability, whether pro rata or joint and several, can also hamper transferability of shares.³⁶⁸ Not only would future shareholders have to assess the risk of future liability extensively (this is the less interesting point, because limited liability in turn means creditors will have to monitor the risk of future liability more extensively), but a transfer of a share from a not very wealthy shareholder to a wealthy shareholder would also become less likely, because this would mean a (potential) benefit to the corporation's creditors, at the expense of the wealthier shareholder.³⁶⁹ This would generally mean that sales of shares would be more rational from richer to poorer shareholders, thus seriously undermining the liquidity of shares.

Easy transferability of shares and a high degree of liquidity could in turn also help to keep management sharp. Shareholders, especially small shareholders, may not have enough incentive to monitor management, but if the firm is poorly managed, other investors may buy blocks of shares at a discount and (influence to) replace management (shareholder activism). The mere possibility that shares are bought by such activist investors, may keep management alert and committed.³⁷⁰

Limited liability of course also has its downsides,³⁷¹ most notably inviting opportunism by the debtor as extensively discussed in chapter 2 paragraph 3.³⁷² Another downside is the fact that risk is shifted not only to sophisticated creditors, but also to involuntary and unsophisticated voluntary creditors.³⁷³ These creditors are often not able to bear the risk better than the shareholders, of course dependent on the specific situation.³⁷⁴

³⁶⁴ Blumberg, 1986, p. 612.

³⁶⁵ Blumberg, 1986, p. 612.

³⁶⁶ Easterbrook and Fischel, 1985, pp. 94–95; Manne, 1967; Hansmann and Squire, 2016, para. 2.4; Freedman, 2000, p. 328.

³⁶⁷ As Blumberg notes, the argument is less applicable to very wealthy investors, because they were probably already able to diversify because of a large asset portfolio, see Blumberg, 1986, p. 613.

³⁶⁸ Rapp, 2006, p. 1093; Freedman, 2000, p. 328.

³⁶⁹ Hansmann and Squire, 2016, para. 2.2.

³⁷⁰ Easterbrook and Fischel, 1985, p. 95.

³⁷¹ See for example Blumberg, 1986, p. 616 ff; Hansmann and Squire, 2016, paras 2.9–2.10.

³⁷² Hansmann and Squire, 2016, para. 2.9; Easterbrook and Fischel, 1985, pp. 103–104.

³⁷³ Freedman, 2000, p. 330; Blumberg, 1986, pp. 616–617.

³⁷⁴ It has in that context been argued that limited liability should be abolished towards tort claimants, see Leebron, 1991; Hansmann and Kraakman, 1991.

These downsides are not very relevant in the situation of dispersed shareholders of a large corporation. The separation of ownership and control (managers are in charge, not shareholders directly) puts a brake on shareholder misconduct.³⁷⁵ And because shareholders are so dispersed, the chance that they would be better at bearing risk than managers is small. The upsides of limited liability probably often outweigh the downsides here, although there are some controversial issues (think again of involuntary creditors).³⁷⁶ It should come as no surprise that courts almost never pierce the veil in the case of large public corporations.³⁷⁷ Moreover, guarantees by shareholders for debts of such companies are hardly conceivable and also almost never found in practice. That should also not be a surprise, as limited shareholder liability is probably the more efficient rule, and because shareholder guarantees would be highly impractical to bargain for because of the large number and diverse group of shareholders.³⁷⁸

(b) Limited liability within a corporate group

In the second situation, that of limited liability of a parent corporation for corporate subsidiaries within a corporate group, the arguments supporting limited liability are much less strong than in the situation of limited liability of dispersed shareholders.³⁷⁹ Some benefits can obviously not be provided by limited liability for a parent corporation: there is only one shareholder, so shareholders don't have to monitor each other and liquidity of shares is already provided by limited liability of the shareholders of the parent corporation.³⁸⁰ The other benefits can theoretically be applicable, but usually are not.³⁸¹ Diversification by the parent is for example unlikely.³⁸² The creditors as a group may be better risk-bearers and monitors, but in a group of companies, the parent is more likely to be a better risk bearer and monitor.³⁸³ This however depends on the circumstances. In any case, if a sophisticated creditor successfully bargains for a guarantee from the parent, this could be a signal that the creditor is not a better risk bearer.³⁸⁴

One last possible benefit of limited liability within the corporate group however may need some more explanation. The most influential theory over the last few decades on why firms would subdivide and more specifically why limited liability makes sense within a corporate group, is probably Richard Posner's reply to Landers on this point. In 1975, Landers criticized the reliance of corporate subsidiaries on limited liability, which would allow groups to constantly move assets around within the corporate group to move value away from creditors.³⁸⁵ Posner famously replied that subdividing groups does make economic sense, particularly to creditors.³⁸⁶ His theory has become known as the Creditor-Monitoring theory and is to date the most influential theory on the subject. Simply put, Posner argues monitoring a large firm is expensive for creditors because there is a large amount of assets and liabilities they have to monitor.

³⁷⁵ Bainbridge, 2001, p. 501.

³⁷⁶ Klein and Jr., 2007, p. 147.

³⁷⁷ Easterbrook and Fischel, 1985, p. 109; some even say that this never happens, see for example Klein and Jr., 2007, p. 149, asserting that "*no case has ever held individual shareholders of a public, as opposed to a closely held, corporation to be personally liable.*"

³⁷⁸ See for this second point also Cheng, 2014, pp. 155–156.

³⁷⁹ Adolf A. Berle, 1947; Easterbrook and Fischel, 1985, pp. 110–111; Hansmann and Squire, 2016, para. 3; Blumberg, 1986, pp. 623–626; Cheng, 2014; Rapp, 2006, p. 1094; Vanderkerckhove, 2007, p. 9.

³⁸⁰ Klein and Jr., 2007, p. 147; Hansmann and Squire, 2016, para. 3; Blumberg, 1986, pp. 623–626; Rapp, 2006, p. 1095.

³⁸¹ Hansmann and Squire, 2016, para. 3; Blumberg, 1986, pp. 623–626.

³⁸² Hansmann and Squire, 2016, para. 3; Blumberg, 1986, pp. 623–626.

³⁸³ Cheng, 2014, p. 160.

³⁸⁴ Hansmann and Squire, 2016, para. 3.

³⁸⁵ Landers, 1975.

³⁸⁶ Posner, 1976.

Subdividing would reduce the amount of information that a creditor has to gather, both ex ante and ex post becoming a creditor. Moreover, subdividing would promote specialization among creditors by allowing creditors to lend only to those divisions that they understand and can thus easily monitor.³⁸⁷ In other words, limited liability counterintuitively suits the needs of creditors.

This theory is however very controversial. It becomes especially hard to maintain in the case guarantees are used.³⁸⁸ Various authors argue that the theory is too elegant to be real and is contradicted by the facts. Large corporate groups do not consist of tidy organized subsidiaries that each own a clearly demarcated asset pool. Instead, group structures are in reality rather messy.³⁸⁹ Corporate groups routinely perforate their internal structure by granting institutional lenders (usually banks or bank syndicates) guarantees on loans to group companies. Commentators report this practice as being '[used] almost invariably'³⁹⁰, 'very common'³⁹¹, 'a common element of many financial transactions'³⁹², 'typical',³⁹³ 'often [present]'³⁹⁴, 'commonly encountered'.³⁹⁵

Both Squire and Widen argue furthermore that groups are in reality also notoriously bad at keeping track of which assets and liabilities belong to which subsidiaries.³⁹⁶ As Hansmann & Squire argue, the fact that a group uses intra-group guarantees fosters the problem of sloppy accounting: the guarantees probably mean that the group will not bother to make specified subsidiary level reports, because the ultimate shareholders and main creditors only care about the value of the group as a whole because of the guarantees.³⁹⁷ Widen's report gives a good illustration of how messy structures often are:

*"In practice, I have been involved in numerous transactions in which (1) the parent could not provide a list of all its subsidiaries without extensive due diligence, (2) the parent could not provide an accurate list of the officers and directors of its subsidiaries, (3) when a list of officers and directors of subsidiaries was provided, many of the named individuals had retired or died, (4) no share certificates existed bearing the current names of the subsidiaries (often because the subsidiaries were acquired in a merger), (5) when minute books could be found, the most recent entries were many years old, and (6) other similar lapses were present. These issues all came up in the context of preparing opinions for transactions with third parties or preparing due diligence rooms for acquisitions. Many of these transactions involved large, well-known, investment-grade companies that otherwise appeared to be well run."*³⁹⁸

³⁸⁷ Posner, 1976; see also Squire, 2011, pp.612–614; Ayotte & Hansmann, 2013, pp.720–721.

³⁸⁸ Hansmann and Squire, 2016.

³⁸⁹ Ayotte & Hansmann, 2013, pp.720–721; Squire, 2011, pp.614–617; Rock, 2013, p.1967 ff.

³⁹⁰ Klein and Jr., 2007, p. 147.

³⁹¹ Rock 2013, p.1970.

³⁹² Williams 1994, p.1404.

³⁹³ Squire 2011, p.605.

³⁹⁴ Rosenberg, 2013.

³⁹⁵ Dunne et al. 2012, p.4.

³⁹⁶ Squire 2011, p.616; Widen 2007, p.261.

³⁹⁷ Hansmann and Squire, 2016, para. 3.

³⁹⁸ Widen 2007, p.261 at fn 79.

This reality of messy corporate group structures is hard to reconcile with Posner's theory.³⁹⁹ Posner's theory of why limited liability would make sense for corporate subsidiaries does not hold in a world of messy group structures and intra-group guarantees.⁴⁰⁰ Instead, subdivision and the mess created by it, opens up room for asset shifting within the group, thus acting opportunistically towards non-guaranteed creditors.⁴⁰¹

In short, both the, already generally weak, arguments that may support applying limited liability in the parent-subsidiary context, are much weaker when the parent has guaranteed certain debts of the subsidiary.⁴⁰² Such a guarantee can be an indication that the shareholders are superior risk-bearers, and that creditor-monitoring benefits are probably not relevant.⁴⁰³ See also Leebron:

³⁹⁹ Squire 2011, pp.614–617; Ayotte & Hansmann, 2013, pp.720–721; One interesting reason for subdividing and guaranteeing has been developed by Casey (Casey, 2014). He argues that the question of why subdividing may be efficient has until now been treated as a binary question, with the options of either subdividing or not subdividing. He however proposes that 'tailored partitioning' can reduce the cost of credit. By tailored partitioning, he refers to the situation that a company does subdivide by incorporating a subsidiary, but undoes this partly by contractual constructions such as guarantees. (He also mentions other possible contractual provisions that can achieve such tailoring: cross defaults and cross accelerations. See Casey, 2014.) The way in which this can lower the cost of credit is slightly complicated to understand. He assumes the corporate group is dealing with one primary lender for the whole corporate group that specializes in monitoring the performance of the group. According to Casey, the tailored partitioning of the group creates a selective enforcement mechanism that gives the lender the choice what to do in case one of the group companies defaults. This works as follows. A default of one group company gives a signal to the lender that something is wrong. If we assume that the fortunes of the group of companies are partly correlated, this may tell the lender something about the quality of the loan to the group as a whole, thus on the expected return of the loan as a whole. Depending on what kind of information this default gives the lender, the lender can, if guarantees or guarantee-like devices are in place, either decide to enforce against the defaulting entity or enforce against the whole group (or part of the whole group). If other parts of the group are likely to continue to be financially sound, the lender will leave them alone and continue to receive interest payments. The lender can thus effectively choose ex post whether he treats the groups as one, or treats the group as consisting of separate entities. The lender could not have made the same informed decision ex ante making the loan, because the signal of default was not yet known then. In short, the tailored partitioning provides a selective enforcement tool to the lender. (Casey, 2014) Hansmann and Squire however argue that this theory rests on factual assumptions that are implausible, namely that subsidiaries are truly distinct subsidiaries that keep distinct assets and accounts, and that directors would let one subsidiary default whilst the others are still solvent, instead of propping it up with funds from other subsidiaries. (Hansmann and Squire, 2016, para. 3).

⁴⁰⁰ Squire 2011, pp.614–617.

⁴⁰¹ The famous Nortel case can serve as an instructive example here. Nortel formed a group, with the parent in Canada, and subsidiaries in (inter alia) the US and the UK. In fact, the group was however highly integrated, acting as one entity. The main asset of Nortel at the time of bankruptcy was its bundle of IP rights, which were sold by the bankruptcy administrators for around 7 billion USD. It could however not be established which group company owned the IP rights. Therefore, the courts in Canada and the US decided to distribute the value of the IP rights over all the group companies. Parties however differed on the point of the method for distribution, which, after a lot of litigation on who owned the IP rights, led to much more litigation, the costs of which were, in summer 2016, thought to add up to around 2 billion USD, with litigation still going on (Westbrook, 2015; Brickley, 2016). Salient detail is that guarantees given by the US subsidiary to bondholders of the Canadian parent complicated matters further. (Westbrook, 2015) This is an example of the fact that guarantees by business owners are likely to undo many of the benefits of asset partitioning (see also Hansmann and Squire, 2016). This is not entirely surprising, as the guarantee is a contractual perforation of the asset partition. In the example of Nortel, the guarantees increased bankruptcy costs dramatically.

⁴⁰² See also Hansmann and Squire, 2016, para. 3; Leebron, 1991, p. 1631.

⁴⁰³ Hansmann and Squire, 2016, para. 3; Cheng, 2014, p. 119: *"The prevalence of limited liability, however, is more plausibly explained as a reflection of the relative bargaining powers of contractual parties than as an expression of the parties' desired outcome. Trade creditors and employees accept limited liability, not because it is what they prefer, but because it is too costly to negotiate to alter it. The fact that financial creditors, which generally wield the most bargaining power among the various*

“[by issuing a guarantee to a creditor] the shareholders in effect promise to contribute enough additional capital to the corporate enterprise to make sure its debts are paid, or at least the debts that are so guaranteed. If contractual creditors believe such a promise is necessary, it reflects an arm's length determination that the capital and expected earnings of the enterprise may be insufficient to meet the corporation's obligations. In effect, such creditors insist that assets of the shareholders conditionally become corporate assets. For these reasons, the obligation also ought to run in favor of non-contractual creditors. These creditors have no opportunity to bargain; it is a reasonable presumption that if they could, they too would insist on the guarantee”⁴⁰⁴

Especially in the group context, next to limited liability, another aspect of incorporation should also be discussed in the context of guarantees. Incorporation does not only partition assets by shielding the shareholder from claims by the corporation's creditors, but also protects the corporation from claims of personal creditors of the shareholder. Those creditors can generally not directly have recourse to the corporation's assets, they can only have recourse to the (value of the) shares. Only when they can somehow become shareholders through recourse could they theoretically reach the corporation's assets by liquidating the company (which probably requires a majority vote). But the creditors of the company will probably have to be paid first in case of such a liquidation, before the shareholders can receive a distribution. In that sense, incorporation locks assets into the company, thus protecting the going concern value of the company.⁴⁰⁵ This way of protecting the incorporated entity's assets against personal creditors of the shareholder(s) has been called 'affirmative asset partitioning' (to distinguish from the defensive asset partitioning that the limited liability rules provide),⁴⁰⁶ but is now more generally known as 'entity shielding'.⁴⁰⁷

Hansmann & Kraakman famously argued that entity shielding is actually the more important function that organizational law (which includes corporate law) provides, whereas limited liability (owner shielding) can more easily be succeeded through contracting.⁴⁰⁸ The most notable benefit of such partitioning is that it protects the going concern value of the entity, which cannot directly be contaminated by financial problems of the parent.⁴⁰⁹ A guarantee can however pierce the entity shield.⁴¹⁰ If the entity issues an upstream guarantee, the benefit of providing asset lock in and thus protecting the going concern value of the entity is lost if the guarantee is for a substantial debt. Even a guarantee to one of many creditors puts the entity at

types of creditors, are the only ones that consistently succeed in obtaining personal guarantees from shareholders substantiates this interpretation.”; Of course, as has become apparent from the discussion of the function of the guarantee in chapter 2, the guarantee could also just be employed to get control over the debtor, which means the existence of the guarantee does not necessarily signal that debtor is undercapitalized. A discussion of the externalities of that control function follows in paragraph 3.2.

⁴⁰⁴ Leebron 1991, p.1631.

⁴⁰⁵ Hansmann and Kraakman, 2000.

⁴⁰⁶ Hansmann and Kraakman, 2000.

⁴⁰⁷ See for example Hansmann and Squire, 2016.

⁴⁰⁸ Hansmann and Kraakman, 2000; they explain that entity shielding could also be provided by contracting, but would be complicated and costly, whereas limited liability is relatively easy to contract for (but of course only as far as contractual creditors are concerned).

⁴⁰⁹ Hansmann and Squire, 2016, para. 2.7; Hansmann and Kraakman, 2000.

⁴¹⁰ A guarantee can either selectively pierce limited liability (owner shielding), or it can selectively pierce entity shielding. A downstream guarantee (guarantee by the parent for a subsidiary's debt) pierces limited liability, whereas an upstream guarantee (guarantee by subsidiary for parent's debt) pierces entity shielding. In the group context, both are common (often, a combination of downstream, upstream and cross-stream guarantees is used). With an upstream guarantee, the entity issuing the guarantee at least partly loses the benefits that entity shielding potentially produces.

risk of contamination. Thus, such an upstream guarantee seriously calls into question the justification for upholding this separateness.⁴¹¹

(c) Limited liability in the closely held corporation

The last situation to discuss is that of a small, closely held corporation. It is generally acknowledged that the micro-economic case for limited liability is much less strong in a closely held corporation than in a publicly held corporation.⁴¹² The problem in large corporations is that it is relatively expensive for shareholders to monitor the company. This is usually not the case in small businesses. Moreover, monitoring the other shareholders is usually not necessary because the shareholders are often involved in the daily business and, if there is more than one shareholder, often know each other well. There is often no or very little separation of ownership and control. Shareholders are thus able to monitor each other and the company without incurring additional costs.⁴¹³ Moreover, the benefits that limited liability provides in terms of possibilities for diversification are much less important in most closely held corporations.⁴¹⁴

The most serious downside of limited liability, increasing the agency cost of debt (in other words: inviting debtor opportunism), is, however, likely to be more serious in the closely held corporation.⁴¹⁵ Shareholders are often in direct control of the corporation. Little stands in their way to act opportunistically. The microeconomic case for limited liability in closely held corporations really is very thin.⁴¹⁶

However, one macro-economic argument stands out in the closely held corporation: limited liability encourages risk-taking by small-entrepreneurs, and thus fosters an innovative business climate.⁴¹⁷ This argument is hard to assess and test empirically, one could for example argue it only encourages excessive risk taking towards non-adjusting creditors, but it certainly has appeal.⁴¹⁸ It can also be turned into an argument based on equality and democracy, which according to some reflects the actual historical development of limited liability: making limited liability available to even the smallest businesses can be seen as democratic, allowing everyone to reap the benefits.⁴¹⁹ Otherwise, limited liability would be reserved for the larger corporations.

⁴¹¹ Other benefits discussed by Hansmann & Squire include correcting debt overhang and simplifying bankruptcy. Hansmann and Squire, 2016, paras 2.6-2.8. Again, a guarantee for major debts makes the entity liable for the shareholders' debts towards certain creditors and thus doesn't correct debt overhang, and bankruptcy proceedings are often complicated further by a guarantee, as the Nortel case explained in footnote 118 illustrates.

⁴¹² Easterbrook and Fischel, 1985, pp. 109–110; Halpern, Trebilcock and Turnbull, 1980; Bainbridge and Henderson, 2016, p. 10; Freedman, 2000, pp. 331–332; Cheng, 2014; Rapp, 2006, pp. 1093–1095; Barneveld, 2014, p. 47; compare also Vanderkerckhove, 2007, p. 535.

⁴¹³ Easterbrook and Fischel, 1985, p. 110; Freedman, 2000, pp. 331–332; Cheng, 2014, p. 139 ff; Mitchell, 1989, pp. 1175–1176; Bainbridge, 2001, pp. 501; 503.

⁴¹⁴ Easterbrook and Fischel, 1985, p. 110; Freedman, 2000, pp. 331–332.

⁴¹⁵ Bainbridge, 2001, p. 501; Freedman, 2000, pp. 331–332; Easterbrook and Fischel, 1985, pp. 109–110; Mitchell, 1989, pp. 1180–1181; Ziegel, 1990, pp. 1081–1082; Barneveld, 2014, pp. 47–48.

⁴¹⁶ See also Halpern, Trebilcock and Turnbull, 1980; Even Bainbridge and Henderson, generally strong proponents of the limited liability principle, struggle to find justification for limited liability for closely held corporations and come up with a merely practical defense: “*The best argument in favor of limited liability is that it would be difficult to draw a sensible line between firms that should be subject to unlimited liability and those that should have limited liability.*”, Bainbridge and Henderson, 2016, p. 12.

⁴¹⁷ See for example Presser: “*That traditional justification always has been that limited liability reduces the potential costs of purchasing shares, and thus encourages investment.*” Presser, 2016, para. 1:7.

⁴¹⁸ Though it has also often been argued that limited liability makes little difference in the decision of business persons to incorporate, see for example Mitchell, 1989, pp. 1172; 1179.

⁴¹⁹ See Presser, 2016, p. 17.

If we want to give small entrepreneurs equal treatment, limited liability should arguably also be available to small businesses, even if it cannot be justified from an economic perspective.

Of course, the risk does not just disappear. The risk is transferred to creditors of the corporation, who are thus discouraged to engage in business. Hence the point that, from a microeconomic perspective, this transfer is not interesting, unless the creditors are somehow better able to bear the risk, or better able to monitor, or suffer less from coordination problems, all of which are unlikely in closely held corporations.⁴²⁰

Even if limited liability indeed encourages risk taking, a guarantee by the shareholder would probably largely undo this incentive. Consider a closely held corporation in which the shareholder/manager has guaranteed a large business debt. Let's take a typical example of a small limited liability company ('Company') with a single shareholder and director ('Shareholder'). Assume that the company is, next to a small equity investment by the shareholder, highly dependent on bank financing.⁴²¹ The shareholder has guaranteed the loan of the bank to the company, and the guarantee is partly secured by a mortgage on the personal home of the shareholder. Does the fact that the shareholder is not liable towards contractual trade creditors and potential tort creditors of the company mean he is actually encouraged in pursuing his business venture and taking risks? That is hardly conceivable, unless the bank is already fully secured by security rights provided by the company, which is unlikely in practice. In case the bank is not fully secured by security rights provided by the company and the company's business fails, the shareholder will be exposed towards the bank under the guarantee. It is unlikely that the shareholder's decisions on taking business risks will be very different if he were also exposed to other creditors. As noted before (chapter 2, paragraphs 2 and 3), Mann argued people are likely to put an extremely high value on their personal assets.⁴²² The risk of losing a substantial amount of assets will probably deter the shareholder in taking risk already.

Because of the omnipresence of guarantees, especially in small-business lending, limited liability may in practice do little to encourage risk-taking for those small entrepreneurs that most need it. This brings us again back to the statement in paragraph 2 of this chapter that especially the guaranteed creditor thus, because of the guarantee, profits from the principle of limited liability (and entity shielding), rather than the entrepreneur. Only large entities profit by shifting risk to small creditors, who are often those small entrepreneurs. In that sense, limited liability works counterproductively and the democracy argument described above (making limited liability available to everyone, not just large corporates) does not apply. A much more effective way of promoting risk taking would therefore be to remove the often-perceived stigma on personal insolvency, and to provide a swift process for personal insolvency.⁴²³ Most legal systems need a lot of improvement on this point (see chapters 4, 5 and 6). Hahn calls this 'velvet bankruptcy'.⁴²⁴ In short, a guarantee for a major debt undercuts the potentially strongest argument in favor of

⁴²⁰ Easterbrook and Fischel, 1985, pp. 109–110.

⁴²¹ The example is at least typical in European countries such as The Netherlands and Germany; US companies are generally much less reliant on bank lending.

⁴²² Mann 1998, pp.19, 23.

⁴²³ Compare also the reasoning of the European Commission in the proposal for a Directive 'on preventive restructuring frameworks, second chance and measures to increase the efficiency of restructuring, insolvency and discharge procedures and amending Directive 2012/30/EU' (COM (2016) 723 final, 22 November 2016).

⁴²⁴ See extensively Hahn 2006.

limited liability in a closely held corporation. Guarantees may even make limited liability work counterproductively, reducing the risk-appetite of especially small entrepreneurs.

It should be noted that the other arguments for limited liability are also undercut by an insider guarantee for a major debt. It was already discussed above that these arguments do not carry much weight in the closely held corporation. But even if they generally carry some weight, a guarantee makes that position much harder to maintain. A guarantee by a shareholder for example makes transferability of shares even harder, because either the lender will have to agree that the new shareholder assumes the guarantee, or the old shareholder remains liable under the guarantee. It is also unlikely that a closely held corporation is used to diversify risk if insiders guaranteed substantial debts of the corporation.⁴²⁵ Absent a guarantee, the argument could be that shareholders can avoid investing all their wealth in the business because they profit from limited liability. They could, next to their business, for example hold some shares in other businesses, or invest in real estate. If they however guarantee substantial business debt, these other investments are also affected by the performance of the company.⁴²⁶ In short, the case for limited liability is less strong in closely held corporations,⁴²⁷ and much less so in case a substantial part of the debts is guaranteed by the shareholders of small, closely held businesses.⁴²⁸

Some, however, have argued that the possibility to contract around limited liability with guarantees, actually justifies limited liability as a good default rule, also for small corporations.⁴²⁹ The idea is that the guarantee controls the main problem that limited liability creates: moral hazard by giving an incentive towards 'debtor misconduct', for example taking excessive risks.⁴³⁰ The guarantee can indeed be used to control debtor opportunism, as has been extensively discussed (see chapter 2 paragraph 3), but this doesn't as such substantiate the argument that this justifies limited liability as a default rule for small, closely held corporation. Firstly, as discussed in chapter 2 paragraph 3, the guarantee does not always solve moral hazard problems, and as discussed in paragraph 2 above and 3.2 below, the guarantee is able to create many new moral hazard problems. The statement that the problems created by limited liability can be solved with a contract is therefore far too simplistic. Secondly, limited liability shifts risk from shareholders to all creditors. Often, only the most sophisticated creditors are able to shift part of or all of their risk back by requiring a guarantee.⁴³¹ That leaves involuntary and unsophisticated voluntary creditors with the rest of the risk of default of the debtor, next to the fact that they are vulnerable to moral hazard problems *created* by the guarantee (see in particular paragraph 3.2 below). Those are the creditors that are probably not the best monitors and not the best risk-bearers.⁴³² And because the interests of different creditors can widely differ, especially in distress, the involuntary and unsophisticated creditors do often not benefit from the control exercised by one creditor through the guarantee.⁴³³ In short, far from repairing

⁴²⁵ Easterbrook and Fischel, 1985, p. 109 ff; see otherwise Leebron, 1991.

⁴²⁶ Freedman, 2000, pp. 331–332.

⁴²⁷ See also Easterbrook and Fischel, 1985, p. 110.

⁴²⁸ See also extensively Freedman, 2000; compare Widen 2007.

⁴²⁹ Ribstein, 1992, p. 428.

⁴³⁰ See extensively chapter 2 paragraph 3 (on overinvestment, underinvestment, inadequate effort supply, and asset shifting); see also Hansmann and Squire, 2016, para. 2.9.

⁴³¹ Freedman, 2000, pp. 339–340; Keay, 2003, p. 689; see also Barneveld, 2014, pp. 56–58.

⁴³² See also Freedman, 2000, p. 347; compare also Mitchell, 1989, pp. 1776–1777.

⁴³³ See paragraph 3.2; see also Barneveld, 2014, pp. 62–63.

inefficient aspects of limited liability in small firms, the guarantee may be able to exacerbate certain inefficient aspects, shifting even more risk to those least able to bear it.⁴³⁴

To summarize, incorporation combined with a guarantee that pierces the limited liability shield (or entity shield) that incorporation creates is hard to justify theoretically from the policy arguments that support limited liability. In essence, such a combination of incorporation and a piercing guarantee allows the guaranteed creditor and guarantor together to use limited liability of the debtor as a shield against non-guaranteed creditors. Such a shield cannot be justified from the arguments generally supporting limited liability. In fact, the existence of the guarantee seriously weakens those arguments in as far as they do apply to closely held corporations.

3.1.3 Justification for priority analogous to real security rights?

Paragraph 3.1.2 above discussed how the general justification for limited liability becomes very weak in case of perforating guarantees. The somewhat paradoxical combination of incorporation and a guarantee by insiders for certain debts can also be approached from another angle, using a different strand of literature. A guarantee combined with incorporation has strong functional parallels with a real security right. The guarantee relationship is not often perceived as giving a creditor priority over the debtor's other creditors. One may be inclined to think that the other creditors should be happy with the guarantee relationship: at least the guaranteed creditor has a separate asset pool (the guarantor) to go after, which may make him less aggressive in the struggle for the debtor's assets (although the guarantor may be able to submit a recourse or subrogation claim under certain circumstances). However, if we take a step back, we can see that the guarantee often actually gives priority to the guaranteed creditor, especially in the corporate context.⁴³⁵

The guarantee is often closely linked to incorporation and its consequence: asset partitioning.⁴³⁶ By incorporating, part of the shareholder's personal asset are partitioned off and shielded in two ways: his personal creditors cannot directly claim those assets (entity shielding) and the corporation's creditors cannot claim on his personal assets (owner shielding).⁴³⁷ A guarantee contractually pierces one or both of these shields: a guarantee by the business to a personal creditor of the shareholder pierces entity shielding, a personal guarantee by the shareholder to a business creditor pierces owner shielding, but both only towards the guaranteed creditor. By (sub-)incorporating and guaranteeing, a debtor can thus create a situation in which the guaranteed creditor can reach two (or more) asset pools, whereas his personal and the corporation's creditors respectively can only reach one asset pool.⁴³⁸ This gives the guaranteed creditor priority compared to the situation absent incorporation and guaranteeing.⁴³⁹

⁴³⁴ Freedman, 2000, para. 333.

⁴³⁵ See also Leebron: "Where the parent corporation guarantees a loan to a subsidiary, the function is identical to the provision of security for the loan; but this method creates greater flexibility than the property-bound secured transactions concepts would otherwise allow." Leebron, 1991, p. 1614.

⁴³⁶ See on asset partitioning generally Hansmann and Kraakman, 2000; Kraakman *et al.*, 2009; Hansmann and Squire, 2016.

⁴³⁷ Hansmann, Kraakman and Squire, 2006.

⁴³⁸ Of course, incorporating and guaranteeing does more than creating a situation in which one creditor can reach two asset pools. Incorporation also involves 'affirmative asset partitioning' (see Hansmann and Kraakman, 2000), also known as 'entity shielding' (see for example Hansmann and Squire, 2016), which ensures that the personal creditors of the shareholder(s) cannot (directly) claim on the entity's

Whether granting a creditor priority over other creditors is efficient to society at large is probably the most discussed question in economic analysis of secured transaction law. The point has been highly debated for over three decades, with inconclusive results.⁴⁴⁰ One of the arguments put forward to support the notion that secured debt can be efficient is that the secured creditor may value priority higher than the guarantor's other creditors do. Why the creditor values such priority higher than other creditors can have to do with an advantage in monitoring the specific asset on which he obtains a security right, an inferior position in monitoring the guarantor's other assets, or a lower risk-preference.⁴⁴¹ A second explanation, already touched upon before, is that secured credit may mitigate adverse selection problems.⁴⁴²

Another explanation for the efficiency of real security rights or guarantees is that it provides a solution to a coordination problem between creditors. At the time the creditor extends credit, he can inform himself of the current situation of his debtor, but does not know what the debtor will do in the future. Will he pursue risky projects? Will he take out more loans from other creditors, which would dilute the claim of the first creditor? Because of this uncertainty, the expenses made by the creditor in informing himself are likely to be high. Security rights can be seen as a place-fixing mechanism, fixing the rank that a creditor will have in the event of default, to enable creditors to adjust to each other cheaply, thus solving the coordination problem.⁴⁴³

These explanations of priority have never gone far. They were often challenged soon after they were put forward,⁴⁴⁴ and a persuasive response to the criticism on priority was never produced.⁴⁴⁵ In Westbrook's words:

"Its [secured credit, A] proponents in that debate have gotten no farther than the Scottish verdict, "not proven."⁴⁴⁶

assets, which in turn protects the going concern value of the entity. These attributes of affirmative asset partitioning are not realized by giving a creditor real security rights instead of incorporating and guaranteeing (see extensively Hansmann and Kraakman, 2000, p. 417 ff). As Hansmann & Kraakman explain, this difference between real security rights and incorporation is illustrated by the practice of securitization, in which a debtor uses a special purpose vehicle (a trust or incorporated entity) to which assets are transferred and which in turn issues bonds. Thus, a type of affirmative asset partitioning with protection of the assets against claims by the debtor's personal creditors is created that cannot be created with security rights alone.

⁴³⁹ This priority position can also be perceived from a slightly different angle with a simple example. Suppose corporation X holds all the shares in corporation Y. Y needs 100 cash to pursue an investment opportunity, and X is willing to provide Y with 100 extra in equity to do so. If the opportunity fails and this pushes Y into insolvency, all Y's creditors enjoy a share in the 100 (or what is left of it), but Y of course doesn't share because he is last in line as a shareholder. Instead, X could also invite Z to make a loan to Y, guaranteed by X (Steijvers, Voordeckers and Vanhoof, 2010, p. 246, who also liken the guarantee by a shareholder to an equity investment; see also Leebron, 1991, p. 1631 at fn 98: *"In effect, the shareholder guarantee is a form of equity contribution to the corporation"*). In case of bankruptcy of Y, Z now shares pro rata with Y's other creditors, diminishing their return, but also enjoys the priority of a claim on Y. The guarantee relationship, combined with asset partitioning, can thus create tailored priority schemes, functionally comparable to giving a creditor real security rights (Compare Katz, 1999, p. 81).

⁴⁴⁰ See particularly: Schwartz, 1984; Schwartz, 1981; see for an overview of the early debate Warren, 1997, n. 5; see also Hudson, 1995, Westbrook, 2004, p. 838 ff.

⁴⁴¹ See for example Jackson and Kronman, 1979; White 1984, p.491 ff; see for criticism of the risk-preference argument Schwartz, 1981.

⁴⁴² See chapter 2 paragraph 2; see also Mann, 1999, also for the limits of security rights in signaling to mitigate adverse selection; see for criticism on the argument also Schwartz, 1981.

⁴⁴³ Bowers 2000, p.105; Kanda and Levmore, 1994a.

⁴⁴⁴ See for example early on in the debate Schwartz, 1981; 1984; Hudson, 1995.

⁴⁴⁵ Westbrook, 2004, p. 840; LoPucki, 1994: *"It will be difficult to prove security efficient because, in all probability, it is not."*

That leaves the case for security problematic at best.⁴⁴⁷ Any gains the parties may realize with the priority that security grants, are probably offset by losses of unsecured creditors,⁴⁴⁸ and are returned to the debtor through higher interest rates for unsecured credit in as far as unsecured creditors are adjusting creditors.

More generally, Squire has argued secured credit, including guaranteed credit, creates asymmetries between creditors that do not incentivize creditors to monitor efficiently if compared to a symmetrical relationship between creditors.⁴⁴⁹ The first problem that creates possible inefficiencies, is that the creditors have to pay for monitoring themselves, but, in this asymmetrical arrangement, do not get the full benefit of monitoring (or the cost of not monitoring), as they share this with the other creditors. This separation of monitoring and benefit of monitoring can create inefficient incentives for monitoring.⁴⁵⁰ In short, the guarantee relationship creates an asymmetrical relationship from an otherwise symmetrical relationship, which creates inefficiencies.

Secured credit is, however, often used in practice. The fact that the efficiency of priority cannot or at least has not been proven, leaves open the question why it is often used.⁴⁵¹ Some have therefore provided explanations for using secured credit that show a certain benefit to the parties involved, but that are distributionally suspect and probably inefficient for society as a whole. By using secured credit, lender and borrower are able to impose externalities on non-adjusting creditors of the borrower, and thus stimulate value-destroying overinvestment.⁴⁵² Bebchuck and Fried, providing a detailed analysis of the costs of full priority, argued that

⁴⁴⁶ Westbrook, 2004, p. 837.

⁴⁴⁷ Westbrook, 2004, p. 840; see also Bowers, 2000.

⁴⁴⁸ See for example: Scott, 1986, p. 902; Hudson, 1995.

⁴⁴⁹ Squire 2009; to understand the difference by symmetry and asymmetry, and to understand how widely applicable this is to different types of guarantees, I adapted Squire's example of symmetry and asymmetry slightly. Consider a simple example of two at first separate debtor-creditor relationships: Creditor 1 has a claim of 100 on Debtor 1, and Creditor 2 has a claim of 100 on Debtor 2. Assume, to keep things simple, that there are no other creditors. Both debtors have assets of 100. Creditor 1 now monitors (the assets of) Debtor 1, and Creditor 2 those of Debtor 2. If either asset pool devaluates, the creditor will fully bear the burden, so he will have the right incentives to monitor his debtor (of course, the debtor usually also has incentive to maximize the value of his assets, but this may change in difficult times. See extensively chapter 2, paragraph 3 above. He may, in difficult times, engage in overinvestment, or may give away or hide assets. For those reasons, the creditor may want to monitor). We could call this arrangement symmetrical (Squire has a slightly different notion of symmetrical, with only one debtor that partitions his assets, which makes sense as he mainly discusses the asymmetry that secured credit creates. See Squire, 2009. The example with two creditors is however more instructive in the context of a guarantee). The rights that Creditor 1 has towards Debtor 1, mirror those Creditor 2 has towards Debtor 2. In a way, a somewhat similar symmetrical situation is created when a debtor incorporates and in which one creditor has a claim on the asset pool in the corporation, and the other on the debtor himself (given entity shielding and limited liability) – (see on entity shielding and owner shielding: Hansmann and Kraakman, 2000, in which they call entity shielding 'affirmative partitioning' and owner shielding 'defensive partitioning'). See also Hansmann and Squire, 2016. A guarantee by Debtor 1 for the benefit of Creditor 2 would make the situation asymmetrical. Creditor 1 would only have a claim on Debtor 1, but Creditor 2 has a claim on both Debtor 1 and Debtor 2. Creditor 1, which only has a claim on Debtor 1, would now also have to monitor Debtor 2, because he may have to share with Creditor 2 in case Debtor 2 does not have sufficient assets. Moreover, Creditor 2, with a claim on both asset pools, does not directly feel the full pain if Debtor 2's asset pool depletes, because he can also claim on the other asset pool, which may make him indifferent to monitoring, depending on the cost of monitoring and the benefit.

⁴⁵⁰ Squire, 2009.

⁴⁵¹ Westbrook, 2004, p. 840.

⁴⁵² LoPucki 1994; Bebchuk & Fried 1997; Squire 2009; Bebchuk & Fried 1996.

secured credit could lead to inefficient contracting between creditors and debtor. They propose three rules of partial priority to repair these inefficiencies.⁴⁵³

Others have brought forward explanations of the efficiency of secured credit that do not focus on the priority that security gives to the lender, but on other aspects, most notably moral hazard and control.⁴⁵⁴ Security rights may limit future borrowing by the debtor, thus possible overinvestment because the collateral cannot be used to secure new loans, and the creditor more generally gets control over the way in which the collateral is used.⁴⁵⁵ This argument relates to the place-fixing argument described above, but takes a slightly different angle in the sense that the place fixing argument focuses on the transaction costs of monitoring, whereas this argument focuses on the change in behavior of the debtor because of security rights, shielding the creditor from debtor misconduct. A related mechanism is that security gives the creditor control over the debtor through the threat of foreclosure, because foreclosing can be very costly to the debtor.⁴⁵⁶ In that sense, it may work like a hostage device.

The efficiency of priority is probably one of the most discussed topics of secured transactions law and is unlikely to be resolved. In discussing the guarantee relationship, insights can be taken from the resemblance of the guarantee with secured credit. 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."*⁴⁵⁷

This may be even more applicable to guarantees than to secured credit. Secured credit can often at least be justified by the fact that it is somewhat public.⁴⁵⁸ Guarantees are probably not much less commonly found in practice than real security rights, but are much less apparent, often operate in the background, are almost never registered in public registers and are relatively underexposed in legal literature,⁴⁵⁹ while their economic impact on the interest rate of a loan may be even higher than that of real security rights.⁴⁶⁰ This makes their use more likely than real security rights to contain aspects that are deceptive, misleading and involuntary. As Widen puts it (specifically in relation to guaranteed lending by bank syndicates to corporate groups):

"If secured lending presents fairness problems, the unsecured syndicated guarantee may be the 800-pound gorilla in the corner that goes unnoticed"

⁴⁵³ Bebchuk & Fried 1996; compare also Manove et al. 2001.

⁴⁵⁴ See for an overview Westbrook, 2004.

⁴⁵⁵ Carlson, 1994, p. 2213; R. J. . Mann, 1997; Mann, 1999.

⁴⁵⁶ Scott, 1986, p. 929; Westbrook, 2004; Mann, 1999 agrees this can be a function of secured credit, but is somewhat sceptical of how relevant this is in practice; see also R. J. . Mann, 1997, p. 222, explaining that foreclosure is often not a viable option for the creditor because the results are often disastrous in terms of the high costs and limited yield to the creditor; such control can be efficient, but can obviously also be problematic, as discussed in paragraph 3.2 below. See also Westbrook, 2004, p. 844.

⁴⁵⁷ LoPucki 1994, p.1947.

⁴⁵⁸ Compare Brinkmann, 2008, pp. 256–261

⁴⁵⁹ Widen, 2007, p. 309; Katz 1999, pp.47, 52ff; Avery et al. 1998; Mata Muñoz 2010, p.1; Mackaay & Parent 2013.

⁴⁶⁰ Brick & Palia 2007, pp.472–473.

Moreover, one of the important defenses of secured credit has always been that security at least is quick and cheap in the sense that (in many legal systems) it gives the creditor the ability to foreclose on collateral without having to obtain judgment first, thus saving on litigation costs.⁴⁶¹ A guarantee does not carry that advantage in itself, as it only grants a claim on a (legal) person and no procedural rights on specific assets. In fact, a guarantee is likely to increase litigation costs and complicate matters further because of the complicated three party relationship it brings to life. Lastly, as explained in paragraph 3.2.4 below, whereas real security rights may serve a benign control function, the control that a lender obtains through an insider guarantee is substantially different, and much more problematic.

As discussed in paragraph 3.1.2, the case for upholding asset partitions in bankruptcy is less strong when guarantees that selectively pierce those partitions are used.⁴⁶² Also the angle that incorporating and guaranteeing can, from a priority viewpoint, be functionally equivalent to giving a real security right to a creditor, can lead to that conclusion. In bankruptcy, some systems, such as the US system, automatically temporarily limit the exercise of rights by secured lenders, in order to keep the bankrupt estate together. This is in the US referred to as the automatic stay. Structuring security differently, as a sub-incorporation that holds the collateral and gives a guarantee (possibly secured) to the lender, circumvents the automatic stay, or at least the automatic application of the stay, and thus the policy considerations behind that stay, with all the costs associated to that circumvention as a result.

In short, the guarantee relationship, when combined with incorporation, creates externalities by giving the guaranteed creditor priority over non-guaranteed creditors that can only reach one asset pool. This priority position can, as has been extensively discussed, not be justified with reference to arguments brought forward in the debate on the justification of real security rights. Not only has the priority that real security rights grant never been convincingly justified in the literature, the priority a guarantee grants is also often more covert and thereby more misleading and deceptive, making the case for the priority that a guarantee grants even weaker than the case for the priority of real security rights (see further also paragraph 3.2.4.).

3.1.4 Justification for strong-form double proof and deficiency double proof?

Paragraph 3.1.1. on the seniority structure created by incorporation combined with guarantees, discussed that the seniority created by guarantees can be dissected in essentially three elements. The first element consists of the fact that the guaranteed creditor has a choice of whom to claim from, whereas other creditors do not. The second element is that the guaranteed creditor can also choose not to choose, but to first claim the full amount from one co-debtor or guarantor and consequently claim a possible deficiency from another. The third element is that the creditor, depending on the rules applicable, may even be allowed to submit full claims against both guarantor and debtor. The discussion above on the justification for pierced limited liability structures and the justification of security rights asked the question whether such a priority structure with guarantees could generally be justified. This paragraph specifically focusses on the justification for double proof. Why does the guarantee offer the creditor more than just the

⁴⁶¹ See for example Kripke, 1985; however, the point that secured credit is 'cheap' is heavily contested, see particularly R. J. Mann, 1997; Mann, 1998.

⁴⁶² Hansmann and Squire, 2016; see also Leebron, 1991, pp. 1631–1632.

first element of security as identified, the choice to choose whom to claim on? Is there any justification for double proofing of claims?

Often, the guarantor does not receive a direct premium for issuing the guarantee. Not paying the guarantor a premium is standard practice for guarantees issued between group companies, for guarantees issued by shareholders or directors and for guarantees issued in the family context. In such a case, there may not be a clear upside of the guarantee from the perspective of the guarantor's other creditors because the guarantor does not obviously benefit from the guarantee, but is contingently liable under the guarantee. If the guarantor pays a possibly large sum and recourse to the principal debtor proves impossible, the guarantee may even be the source of financial trouble, with severe consequences for the other creditors. When the guarantor is not compensated for issuing the guarantee, the question may therefore come up whether the guarantee in fact amounts to a wealth transfer that defrauds creditors.

Of course, the benefit to the guarantor will often be indirect. A parent company that guarantees the debt of a subsidiary to a lender is often indirectly compensated through a reduction in the subsidiary's cost of credit. When, however, a subsidiary guarantees the debt of a parent company, the existence of an upside to the subsidiary is less obvious. In such cases, the guarantee may be a wealth transfer from guarantor to the beneficiary (the guaranteed creditor), which transfer deserves scrutiny when made in financially troubled times.

This is often where the analysis of wealth transfers made by guarantees stops.⁴⁶³ There is however much more at play. Guarantees are contingent liabilities. If the debtor does not pay, the guarantor becomes liable. The analysis above on the sufficient premium to the guarantor only focused on the benefit to the corporation as such. Which stakeholder of the corporation profits from this benefit depends highly on the circumstances under which the contingent liability is likely to be triggered. Squire asks the question: what if the guarantee is probably only triggered when the guarantor is insolvent?⁴⁶⁴ In that case, even if (from the perspective of the corporation) a sufficient premium was paid, the other creditors of the guarantor would be prejudiced by this. The shareholders of the guarantor, by contrast, stand nothing to lose from the guarantee, as it will only be triggered when they are 'out of the money'. They do, however, enjoy the premium paid by the creditor for the guarantee. In short, as Squire shows, even when a premium was paid, the issuing of the guarantee entails a wealth transfer away from non-guaranteed creditors towards the shareholders (possibly shared with the creditor, dependent on how they divide the benefit among themselves) when the correlation is high.

The law should therefore be concerned with the correlation between the fate of the guarantor and the fate of the debtor.⁴⁶⁵ The higher this correlation, the more likely that the issuing of the guarantee transfers wealth from the corporation's unsecured creditors to the corporation's shareholders.⁴⁶⁶ If such a correlation exists, the guarantee can be compared to selling part of the insolvent estate of each of the co-debtors to one creditor. Whereas a simple contract for the ex ante sale of part of one's own insolvent estate would be unenforceable or voidable in many legal systems, correlation seeking probably escapes these rules.⁴⁶⁷

⁴⁶³ See extensively Squire, 2011, on who's work the analysis below is to a large extent based.

⁴⁶⁴ Squire, 2011; Squire, 2017.

⁴⁶⁵ Squire, 2011, p. 649 ff.

⁴⁶⁶ Compare Freedman, 2000, p. 347.

⁴⁶⁷ Squire, 2010, pp. 1157–1158.

Let's look in more detail at the mechanism of the correlation. Absent a positive correlation between the guarantor's and the debtor's fate, the premium paid for the contingent debt that the guarantee relationship creates for the guarantor, should protect the creditors of the guarantor. Of course, this premium that the guaranteed lender would normally pay for the guarantee relationship is much smaller than the face value of the contingent debt, for example 2% of the face value. In case the guarantor is declared bankrupt, two options are possible: the guarantee is not triggered, and the premium of 2% is available for the other creditors, or the guarantee is triggered, and the creditors are faced with a large, formerly contingent, claim of the guarantor for 100% of the face value.⁴⁶⁸ Normally, the premium combined with the risk that the guarantee is triggered, should make the other creditors (assuming risk-neutrality) indifferent to the contingent claim. However, if there is a strong correlation between the fate of the guarantor and that of the debtor, the guarantee obligation will almost always be triggered when the guarantor is insolvent, which means the creditors will almost never be in the situation that they enjoy the small premium without also the large guarantee obligation of the debtor. In other words, they share little in the upside (the premium) and bear a lot of the downside. The shareholders of the guarantor, on the other hand, always enjoy the premium, but almost never bear the downside, because in case of the downside scenario occurring, the guarantor is insolvent anyway and they would already be out of the money.⁴⁶⁹ Moreover, because the shareholders don't share in the downside, it becomes likely that they settle for an insufficient premium in the first place.

Is it likely that a strong correlation between the fate of the guarantor and that of the debtor exists? As Squire argues, especially in the context of intragroup guarantees, the correlation is often strong.⁴⁷⁰ Groups of companies may consist of many subsidiaries that together run one business activity. They are thus highly intertwined in the sense that they all depend on the success of that business activity. Consider, for example, a group that sells pocket calculators and that consists of a holding company, a finance subsidiary, a communication subsidiary, a sales subsidiary, a design subsidiary, and a manufacturing subsidiary. All of these subsidiaries essentially depend on the market for pocket calculators. If people suddenly stop buying pocket calculators because of the rise of smartphones, the whole group goes down together. In that sense, their fate is highly correlated. The correlation can also emerge in another way. When the group structure is messy, with many financial cross-ties within the group and an unclear structure, the fate of the individual group companies is inherently correlated, even when the individual companies may be involved in different lines of business. Such messy group structures are not uncommon. In short, in the context of corporate groups, the correlation is often high.

The corporate group context is not unique in showing high correlations between the fates of individual entities. Also in the simple example of a small business with a single shareholder, a high correlation can often be found. As extensively discussed, guarantees by shareholders are omnipresent in the context of small-business finance.⁴⁷¹ It is, also absent the guarantee, probably not likely that the shareholder survives when the company is declared bankrupt. Small business owners' assets are often badly diversified. Much of their wealth is invested in the company, and they may even have large loans outstanding towards the corporation. Not only their wealth will often be contained in the corporation, but they also depend on the corporation for their monthly

⁴⁶⁸ Or a bit less than face value if a rule of single proof rather than double proof is applied, see above.

⁴⁶⁹ Squire, 2010, p. 1159.

⁴⁷⁰ Squire, 2011, p. 622.

⁴⁷¹ See the introduction to this thesis.

income. When the company fails, the business owner will under such circumstances be likely to struggle to survive. In other words, the fate of the small business owner is often highly correlated with that of the company.

According to Squire, complex corporate group structures may actually exist because groups artificially create the structure to be able to engage in correlation seeking.⁴⁷² Although this could indeed be the case, there are also limitations to correlation seeking. Perfect correlations often don't exist, and when correlations are high, it is logically less likely that the guarantor has substantial debt outstanding. When the correlation is high, it means the company that guaranteed the debt (let's say a parent company) will be rendered insolvent upon insolvency of its subsidiary. That means the parent has not much to go on without the subsidiary, meaning probably not many assets (apart from the equity stake in the subsidiary). Thus, there won't be many creditors of the parent that can be disadvantaged by correlation seeking.⁴⁷³ The flip side is that, if there are many assets and liabilities, the correlation will be likely to be somewhat lower. In other words, the group cannot endlessly complicate its corporate structure in order to engage in correlation seeking. Still, the mechanism Squire describes can be (and often is) used to move value away from unsecured creditors and can thus give inefficient incentives towards providing too many guarantees. Group companies can of course each own many assets and liabilities but still be highly intertwined.

This is not just a redistribution problem, but also an efficiency problem.⁴⁷⁴ The fact that the guarantor and guaranteed lender take the whole upside, but can externalize at least part of the downside (or even the full downside in case of a perfect correlation), means that it is rational for the guarantor and lender to agree on a guarantee even if they would not have done this if they would have to internalize the full downside. Therefore, the guarantee relationship can lead to overinvestment.⁴⁷⁵ Because credit extended by the guaranteed lender is artificially subsidized by the externalities imposed on unsecured creditors, credit that should not be extended can now be extended, and projects that should not be undertaken can now be undertaken.⁴⁷⁶ It should also be remembered that the guarantee itself is not cost-neutral. The guarantee can involve serious transaction costs because of the complicated three-party relationship it creates, with many openings for litigation. See for example the Nortel bankruptcy case, in which the complex group structure with guarantees led to more than 2 billion USD in litigation costs.⁴⁷⁷

No economic (or other) justification exists for strong-form double proof, other than the rather weak defence that it may seem simpler to apply.⁴⁷⁸ The question remains whether *deficiency double proof* can be defended. As the discussion on correlation seeking shows, both strong-form and deficiency double proof cannot be defended when the correlation between the fate of the debtor and the guarantor is high. This will usually apply to group companies guaranteeing each other's debts. In those cases, double proof should be ruled out altogether as it leads to inefficient

⁴⁷² Squire 2011. See also paragraph 3.1.1 above.

⁴⁷³ An important exception are groups that consist of many entities that each own assets and have liabilities, but which are all essentially part of the same, inseparable business project. Any problems with the project will affect the whole group. See for a good example, again, the Nortel case (see footnote 118), probably the most expensive bankruptcy case to date.

⁴⁷⁴ Squire, 2011, pp. 643–644; Squire, 2017, para. III A.

⁴⁷⁵ See extensively Squire, 2011; Squire, 2010.

⁴⁷⁶ Compare also LoPucki, 1994.

⁴⁷⁷ Brickley, 2016.

⁴⁷⁸ See for this argument for example Bergervoet, 2014.

results. An alternative could be to subordinate the claim on the guarantee to the claims of the guarantor's other creditors.

3.1.5 The shareholder guarantee as an indirect shareholder loan

Another functional, economic perspective on a guarantee in corporate finance, more specifically a guarantee by a shareholder, is to view the guarantee as a way of financing the company by the shareholder. If a shareholder guarantees corporate debts towards a certain lender in a situation where the shareholder provides adequate recourse when the liability is triggered, the construction can functionally be seen as an indirect shareholder loan. The shareholder ultimately bears the risk of non-payment by the company towards the creditor, the creditor only runs the risk that both shareholder and corporation can't or won't pay. The shareholder is thus functionally investing in the company, with the external creditor as an intermediary.

There is an extensive debate on the question how shareholder loans should be characterised: as normal loans that can rank *pari-passu* with other loans, or as a particular type of loan that deserves subordination to other loans. The latter view is often substantiated by the possibility that shareholders may otherwise be able to use their insider status to get unfair advantages over non-insider creditors.⁴⁷⁹ They may for example use such loans, possibly even secured by security rights, to gamble for resurrection of the company in a situation in which no outside lender would provide such loans.⁴⁸⁰ The danger is that the reason why the shareholder would provide the loan is not the expected return on the loan itself, but rather to gamble on a (small) chance that the equity stake in the company can be rescued. Even if such gambling is inefficient, it can make sense from the position of the shareholder because of his equity stake. Some are however also cautious about subordinating shareholder loans in general, because such a rule may in their vision also deter efficient rescue attempts by shareholders.⁴⁸¹

Whereas legal systems such as in France, the UK and the Netherlands do not have special rules on the treatment of shareholder loans in insolvency, in some legal systems, such as in Germany, Italy, Hungary, Austria, Sweden, Spain, Slovenia, Poland, Portugal, Romania and the US, loans of shareholders to a company may under circumstances be treated differently than a loan of an outsider, resulting in a lower-ranking claim of the shareholder.⁴⁸² As a result, both the shareholder's equity and his loan will usually be wiped out in case of insolvency of the company in which the shares are held.

The debate on the efficiency of shareholder loans is not fully reproduced here, but the point to make in relation to guarantees in corporate finance is that, as pointed out above, such guarantees often functionally amount to shareholder loans. Such guarantees thus deserve the same scrutiny and, depending on the circumstances, the same treatment. This is an important point, as shareholder guarantees to external lenders are probably even more common in practice than direct shareholder loans.

⁴⁷⁹ See for example Cahn, 2006, p. 298.

⁴⁸⁰ Cahn, 2006, pp. 298–299.

⁴⁸¹ See for example Gelter, 2006; see further on the debate on shareholder loans: Verse 2008; Gelter 2006; Cahn 2006; Gelter & Roth 2007; Weijs 2008; De Weijs, Abendroth and Fransis, 2013.

⁴⁸² See extensively Keay, Brown and Dahlgreen, 2016, p. 130 ff.

Although guarantees in corporate finance are often functionally equivalent to a shareholder loan, the construction may also escape subordination mechanisms, even when these are in place. This could be due to factual circumstances, for example because the bankruptcy administrator has no knowledge of the guarantee construction. The guarantee may not need to be recorded in the books of the debtor. It could also be due to legal circumstances in case the legal system, even if the guarantee construction is known to the administrator, does not qualify this construction as equivalent to a shareholder loan. That is somewhat understandable, given the fact that qualifying the indirect construction through a guarantee by a shareholder as an indirect shareholder loan can lead to complications. Although the construction is economically equivalent to a shareholder loan, the direct counterparty of the debtor is not a shareholder, but an external party. Treating the loan of this external party as a shareholder loan and thus subordinating the loan (in systems where subordination applies) may seem harsh towards the external party. On the other hand, the external party still has recourse to the guarantor in as far as his claim remains unpaid by the debtor. A solution that circumvents this problem could be to require the creditor to try and get satisfaction from the guarantor first, before claiming on the debtor and subordinating the recourse claim of the guarantor (see chapter 6, paragraph 4.1.2 for the German law solution along these lines).

3.1.6 Summary

Insider guarantees, combined with incorporation, can create an opaque priority structure for the benefit of the guarantor and creditor (and possibly debtor) and to the detriment of outsiders. Is such a structure justifiable? The analysis has shown that the insider guarantee, when combined with incorporation of the debtor, is clearly at odds with justifications underpinning limited liability. Therefore, the externalities that limited liability obviously creates are hard to justify when a guarantee is used by insiders to pierce the liability shield selectively. Such a situation does give the guaranteed creditor priority in relation to non-guaranteed creditors, but such priority is in itself hard to justify, as a review of the extensive debate on priority in relation to real security rights has shown. The mechanism of double proof of claims through guarantees enhances the priority of the guaranteed creditor even further and without any serious justification, to the (further) detriment of other creditors of the guarantor, debtor, or both. Another important point that was made above is that shareholder guarantees to external creditors are often economically equivalent to direct shareholder loans. In so far as shareholder loans should be treated with suspicion, this should under circumstances also apply to such indirect shareholder loans.

3.2 Ex post opportunism: covert insider dealing

Paragraph 3.1 above discussed that the guarantee can be used to set up an opaque priority structure that creates externalities for outsiders ('ex ante opportunism'). Not unrelated, but clearly distinguishable from such opportunistic behavior is the opportunistic behavior that the guarantee incentivizes *after* ('ex post') concluding the guarantee.

The guarantee relationship can give the guaranteed lender substantial control over the debtor through the guarantor, which is often the point of using the guarantee construction.⁴⁸³ Such control can be problematic.⁴⁸⁴ In chapter 2 paragraph 3, I discussed that the guarantee acts as a bonding mechanism between both the guarantor and the debtor with the creditor. In doing so, this type of *lender governance*⁴⁸⁵ economizes on transaction costs by limiting the incentives for opportunistic behavior of the guarantor and the debtor towards that single creditor. Just like resolving the shareholder-management agency problem intensifies the shareholder-creditor agency problem, resolving the latter versus one creditor is likely to intensify both the shareholder-creditor agency problem with other creditors, and the coordination problem between creditors.⁴⁸⁶ Creditor control over the debtor, with the help of insider guarantees, can thus lead to inefficient and value destroying behavior of the debtor.⁴⁸⁷ The fact that the guarantor thinks like one creditor, will give incentive to influence the debtor to generally favor this particular lender above other counterparties.

The most blatant form of creditor opportunism through guarantees is the situation in which the creditor uses his control over the guarantor to make the guarantor influence the debtor in making value-destroying preferential payments when the debtor is in distress. The creditor may not even have to actively apply pressure to induce the debtor to make such payments, because the guarantor will have internalized the interests of the creditor through liability under the guarantee towards that particular creditor. Next to such preferential payments, more subtle forms of opportunistic behavior that are often even harder to detect and control can present themselves. Think for example of late or early bankruptcy filing in order to prefer the creditor, or behavior known as “feeding the lien” in which the debtor behaves in a way that “feeds” the secured position of the guaranteed creditor, whilst this is value-destroying from the perspective of the overall estate. Paragraph 3.2.1 first discusses preferential payments, after which more subtle forms are discussed in paragraph 3.2.2 After that, the inefficiency of creditor control in general is discussed in some more detail in paragraph 3.2.3, followed by a comparison to creditor control through real security rights (paragraph 3.2.4) and a discussion of the specific dynamics in attempted reorganization (paragraph 3.2.5).

⁴⁸³ See chapter 2 paragraph 3, see also Baird, 1994a, p. 2262 ff; Baird, 1994b, p. 925; Nussbaum, 1990, p. 614.

⁴⁸⁴ R. J. . Mann, 1997, p. 235; Baird, 1994a, p. 2262 ff; Nussbaum, 1990, pp. 614–615; compare (in relation to collateral given by the debtor) R. J. Mann, 1997, p. 664, with reference to Hansmann and Kraakman, 1992, pp. 628, 649; Macey and Miller, 1995, pp. 73, 77–81; Shupack, 1995, pp. 787–814; Scott, 1986, p. 929; The notion that strong creditor rights can lead to sub-optimal investment strategies has been tested and confirmed in empirical research, see Acharya, Amihud and Litov, 2011; See also Tung, 2009, p. 174; Jackson and Scott, 1989, p. 173.

⁴⁸⁵ See on lender governance generally Tung 2009; compare Ayotte and Morrison, 2009.

⁴⁸⁶ Compare Ayotte and Morrison, 2009; Westbrook, 2004, p. 837; Baird, 1994a, p. 2262 ff.

⁴⁸⁷ Important to note is that the interests of creditors are not always aligned. In fact, the interests of creditors are often very diverse, especially when their debtor is in financial distress, Hu and Westbrook, 2007, pp. 1353–1354; Barneveld, 2014, pp. 62–63. As Hu and Westbrook argue, secured creditors often want to liquidate, take their money, and forget about the investment, whereas unsecured creditors may prefer reorganization with a fruitful future relationship in mind. Hu and Westbrook, 2007, pp. 1353–1354. In other words, the secured lender is likely to behave in a self-interested manner, if necessary at the expense of the total value of the bankrupt estate.

3.2.1 Preferences in the twilight zone

The insider guarantor is likely to influence the borrower to favor the guaranteed lender above others by making payments or in another way transferring value to the guaranteed lender before insolvency. In other words, the guarantee creates incentives to act opportunistically in favor of the guaranteed lender to the detriment of other creditors. The reason why is simple. The incentives of the guarantor are clearly influenced by the guarantee relationship: the guarantor will have a high preference for preventing default of the debtor in relation to the guaranteed creditor and will care less about default of the debtor towards other creditors. There will, in other words, be an incentive for selective payment of the guaranteed creditor. Illustrative is the explanation of a bank manager interviewed by Mann on the question why he requests guarantees from managers/shareholders of borrowers:

"When we get into trouble, where the company runs into difficulty, we find that the borrower's owners are much more willing to help us when they're personally liable."⁴⁸⁸

Simply put, the guarantee relationship by an insider leads to preferential treatment of the guaranteed creditor, from which the non-insider creditor also profits. Consider the following simple example. A lender has extended secured credit of 100 to a closely held corporation, for which the shareholder and manager has given a guarantee with a maximum of 20. A few months before insolvency the lender calculates that he will probably only get 60 for his secured claim in insolvency because the value of the asset that serves as security is only 60 and little pay-out is to be expected on unsecured claims. The shareholder and manager now clearly has incentive to make sure the creditor is paid off (or given security for) at least 40 before the debtor files for bankruptcy. He will thus try to influence the debtor to make a payment of 40 to the creditor, to the creditor's and guarantor's benefit and to the detriment of other (unsecured or partly unsecured) creditors.⁴⁸⁹

The quote and example show that guarantees give incentive for preferential treatment of the guaranteed creditor. One could even critically refer to the guarantee contract as a promise of preferential treatment of the guaranteed creditor. The guarantee however does more in this context. Not only the incentive for preferential treatment of the guaranteed creditor is created by the guarantee but at the same time the guarantee covers up the indirect benefit of the guarantor when such preferential treatment occurs. Many legal systems have detailed rules that should guard against preferential treatment, especially preferential treatment of insiders. The benefit of an insider by limiting the exposure under a guarantee is however indirect and more complex.⁴⁹⁰ The debtor makes a payment to a non-insider creditor, from which the insider-guarantor indirectly profits. Although the insider guarantor does not receive any direct payment, his exposure under the guarantee is diminished by the payment from debtor to guaranteed creditor.

⁴⁸⁸ Mann, 1998, p. 24, quoting from an interview with Carmen Mastroianni, Senior Vice-President, Chase Manhattan Corp.

⁴⁸⁹ Of course, transaction avoidance or preference laws may deal with such behavior, but whether it does is the subject of later chapters, and will always depend on the legal system and the circumstances, such as the time of the transfer, the question whether the payment was in the normal course of business, or whether there was a pre-existing legal duty to make the transfer. The point to be made here is that the incentive exists to prefer the guaranteed lender.

⁴⁹⁰ See also Gordon and Landry, 2015, p. 75.

Even if the legal system is wary of indirect insider dealing, the example above presents complications. The exposure of the guarantor in that example is only 20, and the debtor pays the creditor 40 of a 100 debt. This payment thus does not directly reduce the exposure of the guarantor. However, taking into account that the creditor is secured for 60 the de facto exposure of the guarantor is limited by the payment. Another example is the case in which an insider guarantor with an exposure of 30 under a guarantee would induce the debtor to pay the whole debt of 100 to the guaranteed creditor. The payment reduces the exposure of the insider-guarantor with 30. One could say that the guarantor engaged in self-dealing with a benefit of 30. However, the creditor, who is not an insider himself directly, benefitted 100 from such insider dealing. The creditor and guarantor can both benefit from covert insider dealing, possibly for different amounts.

In chapter 2 paragraph 3 it was explained that the guarantee can be understood as an important device to curb debtor misbehavior and that one of such forms of misbehavior is asset shifting, which especially looms in corporate groups. Professor Landers argued that corporate groups can opportunistically move value around within the group to move it away from creditors.⁴⁹¹ A guarantee cures this problem as far as the guaranteed lender is concerned. That lender doesn't care whether assets are moved around within the group and doesn't care about sloppy accounting on the subsidiary level, as guarantees by the parent or even by all of the group entities will allow that lender recourse against the group assets, wherever they are in the group.

The guarantee however only makes things worse for the other lenders. Above, some examples have been given on the preferential treatment the debtor may give the guaranteed lender. In a corporate group, the debtor and guaranteed lender now together profit from moving value around. Absent a guarantee, the main creditors would probably have incentive to monitor the debtor in order to prevent this and would monitor proper accounting within the group in order to make sure it is clear which entity owns what. Guarantees are often granted to larger or the largest lenders.⁴⁹² Because of the guarantee, the guaranteed creditor has no incentive to monitor, at least not for moving value within the group (he may of course still want to monitor the group more generally). That means that this burden to monitor for moving value within the group falls completely on the other creditors, who are thus worse off because of the guarantee. These creditors are typically less efficient monitors than the large, sophisticated creditors. Moreover, the guaranteed creditor is often a repeat player that knows the tricks of the trade. Whereas moving value within a group by a debtor could probably be detected with close monitoring by a sophisticated creditor, the sophistication of the guaranteed creditor may actually help the borrower disguise such opportunistic behavior.

3.2.2 Subtler forms of opportunism: feeding the lien, Inefficient investment attitudes, inefficient bankruptcy filing

The effect of a guarantee to create incentive for preferential payments to the guaranteed creditor was discussed above. Preferential treatment can also be much subtler than payment.

⁴⁹¹ See extensively paragraph 3.1.2.

⁴⁹² Smaller creditors typically don't get guarantees, one reason why could be that the transaction costs involved in the guarantee relationship are more likely to be prohibitively high when the amount of credit outstanding is smaller, and because smaller creditors often don't have the market power or sophistication to demand guarantees.

Think for example of the problem known as feeding the lien.⁴⁹³ Scott & Jackson explain this problem as a self-interested secured creditor exercising control over the debtor in distress in order to make the debtor make business decisions that are value destroying for the overall estate, but positive from the perspective of the security position of the secured creditor. If the secured creditor for example does not have a security right, whilst the secured creditor can exercise security over accounts receivable, the creditor could use his control to make the debtor sell goods at a discount.⁴⁹⁴

Another example of such lien feeding, which is a form of covert opportunistic behavior of a guarantor towards non-guaranteed lenders of the borrower, could be the following. Suppose the debtor runs a shoe factory. Various parties extended (trade) credit. The main bank has a large claim, partly (but not fully) secured by real security rights. One of the real security rights is a right of pledge on the (future) stock of the shoe factory. One of the trade creditors is the supplier of leather, who has a large claim, partly secured by a retention of title. Only the bank claim is secured by a guarantee given by the owner/director of the company. Suppose the owner/director is considering filing for bankruptcy. Because of the guarantee relationship, he will have incentive to quickly make shoes out of all the stock leather. That will probably, but of course dependent on the applicable law, make the shoes fall under the bank's pledge, while the supplier of leather loses his security. Of course, there may be ex post legal mechanisms to sanction such opportunistic behavior by the owner, but as long as he maintains he thought he could still sell the shoes it may, depending on the legal system, be hard to control such behavior.

Another, even simpler and probably more common, example of lien feeding is the example of simply letting payments by third parties for goods or services flow to the guaranteed creditor. In this example, the creditor is often a bank at which the debtor has an account. The guarantor could make sure already late payments are quickly made before bankruptcy, on the bank account on which the lender has a security right. Or the guarantor could influence the debtor to sell goods, if needed at a discount, to third parties, making sure they pay on the specified bank account. This is a form of de facto and often inefficient (early) liquidation of the company, induced by the guarantor acting in his own interests. The bank receiving the payments for the debtor will then claim set-off, or may have a right of pledge on the account, thus using the incoming payments as collateral for the outstanding debts (if allowed by the rules applicable). As a result, the exposure of the guarantor under the guarantee reduces.

Next to lien feeding, guarantees can also lead to underinvestment. To understand why is not difficult. A secured lender may have to take some, or even quite substantial, loss in a liquidation of his debtor, but there is also a clear upside of direct liquidation in the sense that he gets the value of the collateral. A reorganization may give a chance of receiving some more on the unsecured part of his claim, but it may also jeopardize his secured position, for example because of further depreciation of the value of the collateral. Especially when the collateral consists of things such as stock-in-trade, outstanding claims, cars and intellectual property rights, such depreciation is not unlikely and can happen quickly. An unsecured creditor, on the other hand, may prefer reorganization, as he will receive nothing or almost nothing in liquidation, but has a chance of receiving something in reorganization. What we see here is that both creditor and debtor/guarantor probably don't have optimal incentives towards projects with a positive net present value, as secured creditors bear a substantial part of the downside of reorganization and

⁴⁹³ See for example Jackson and Scott, 1989, p. 173.

only a small part of the upside, whereas unsecured creditors bear little of the downside but do share in the upside. Reversely, whereas unsecured creditors bear the downside of liquidation and hardly any of the upside, secured creditors have a good stake in the upside and only partly bear the downside.⁴⁹⁵ The guarantee can lead to the guarantor and in turn the debtor acting in the interest of the guaranteed creditor, thus having the same incentives towards underinvestment as the guaranteed creditor. In short, a new problem of underinvestment is created by the guarantee.⁴⁹⁶

The guarantee may also lead to overinvestment and delay a bankruptcy filing in a situation where it would be efficient to file. The underinvestment problem discussed above arises when the insider guarantor has to internalize the risk of (further) asset depreciation and the guarantor therefore influences the debtor to act too carefully from the perspective of the debtor. However, guarantees are often granted by insiders for a small part of a loan. A creditor that extends credit of 100, may for example obtain a guarantee of 20 from an insider, next to collateral given by the debtor. A situation that often occurs in the vicinity of bankruptcy is that it is clear to the parties that if bankruptcy is filed, the guarantee relationship will be triggered for the full amount, for example because the collateral given by the debtor is only worth 60 and no distribution is to be expected on unsecured claims. In chapter 2 paragraph 3 the point was made that this may induce the debtor to inefficiently gamble for resurrection, maybe even more so than without a guarantee. In other words, the incentive for overinvestment only becomes stronger.⁴⁹⁷

Next to that problem, this situation could also give the lender control over the decision of the debtor to file for bankruptcy. Such a filing will trigger the guarantee liability, which the debtor

⁴⁹⁵ Compare the example given by Hu & Westbrook: Hu and Westbrook, 2007, pp. 1367–1368; A known counterargument against the problem of underinvestment is that the debtor could incorporate a subsidiary and pursue the investment with a positive net present value in that subsidiary, thus shielding his creditors from the downside risk through asset partitioning, using the limited liability of the subsidiary. In reality, this is however often implausible, especially in relation to a strong creditor that has a substantial amount of equity. The business opportunity, even if separately incorporated, will probably have to make use of the assets of the debtor, and thus puts the value of those assets at risk. Subdividing won't shield the secured creditor from all the risk. Moreover, there is often a large difference between the going concern value of assets, and the value of the same assets in a fire sale. Pursuing a new investment opportunity, which could just mean continuing the company for hope of a turnaround, can put that going concern value at risk, whereas not pursuing the opportunity and stopping may mean selling the assets now for their going concern value, as long as that is still possible. Usually, this is the decision the management is faced with when considering to file now or continue the business. Simply subdividing does not offer a solution in such a case. That would only offer a solution if the investment opportunity is completely separate or separable from the rest of the business.

⁴⁹⁶ The notion that strong creditor rights can lead to sub-optimal investment strategies has been tested and confirmed in empirical research, see Acharya, Amihud and Litov, 2011; see also Tung, 2009, p. 174. A guarantee by a corporate insider can certainly be perceived as giving the creditor a strong position. Compare also Westbrook, 2004, Buckley, 1992, pp. 252–256; however, as noted before in chapter 2 paragraph 3, there are many other factors that influence the guarantor and debtor in their behavior. There is some recent research in behavioral economics that relates this to overoptimism. Managers often underestimate the possibility of bankruptcy and overestimate their ability to avoid it (Dickerson, 2003). Overoptimism is believed to be of especially strong influence on decision making by managers (Greenfield, 2014, p. 524). In that context, some incentive towards underinvestment may not always be that harmful.

⁴⁹⁷ This can also be the case with full guarantees in as far as the guaranteed amount outweighs the guarantor's assets, and the guarantor is at a given point thus virtually already bankrupt if the guarantee would be called upon. Under such circumstances, the guarantor may influence the debtor to overinvest, in order to gamble for resurrection, or at least delay liability under the guarantee for as long as possible. Guarantees are often granted for amounts that outweigh the guarantor's assets, see for example Mann, 1998, pp. 22–25.

may want to avoid because of close ties with the guarantor. Whereas the threat of filing for bankruptcy normally gives the debtor some control and thus rebalances the relationship with an often powerful lender, the guarantee relationship can undo this. The 'carrot' that bankruptcy law offers the debtor and its management, by giving some breathing room by (at least temporarily) shielding the debtor from debt collection by creditors, can thus be neutralized by a guarantee relationship. In other words, it gives the creditor control over the decision to initiate a bankruptcy procedure. This will influence the debtor to initiate bankruptcy at a time when it suits the lender, which is not necessarily the time that would be most efficient to all involved.

3.2.3 The inefficiency of creditor control through guarantees

Is creditor control through guarantees problematic from an efficiency perspective? It could of course be argued that it is generally known that lenders ask guarantees, that guarantees create externalities and that most business creditors adjust to this. However, a large portion of the creditors is often non-adjusting.⁴⁹⁸ Some are non-adjusting by definition because they are involuntary creditors such as tort creditors, or, in some sense, tax authorities, others are non-adjusting because they lack the sophistication to adjust.⁴⁹⁹ The preference problem that the guarantee relationship creates leads to a redistribution of wealth, away from these non-adjusting creditors, which are often weak parties, to guaranteed creditors such as banks. No justification exists for this redistribution. Moreover, the redistribution subsidizes the guarantee, which means that parties may have incentive to enter into a guarantee relationship even when this is inefficient taking account of the externalities.⁵⁰⁰

If creditors were adjusting (which they are often not), the redistribution problem may be undone. However, from the viewpoint of efficiency (more specifically opportunism and the related transaction costs) this doesn't defeat the preference problem.⁵⁰¹ The problem is firstly that other lenders do not know whether a guarantee relationship between the debtor and a lender is in place, which creates an information asymmetry that can lead to friction. The mere existence of the possibility to guarantee claims of some creditors thus means the cost of credit towards other creditors is generally higher, even if none of the debt has been guaranteed. Sophisticated creditors have to price in the very likely possibility that the debtor will use guarantees and that these guarantees will lead him to prefer the guaranteed creditors, thus diminishing the chance of any return for the non-guaranteed creditor in case of distress. The cost of credit for the debtor will thus be raised generally (if creditors are indeed sophisticated), which increase will not only have to reflect the anticipated wealth transfer to the guaranteed creditor, but also the increased transaction costs of additional monitoring and additional security rights or credit insurance. Additional monitoring is now rational because early intervention will mean that there may still be recourse, whereas late intervention may mean the debtor has already used his assets to prefer the guaranteed lender.

⁴⁹⁸ See for empirical evidence Warren and Westbrook, 2005; the term 'non-adjusting creditors' was coined by Bebchuk & Fried, 1996.

⁴⁹⁹ Compare Cheng, 2014, pp. 129–132, explaining why even voluntary creditors are unlikely to adjust; see also Ziegel, 1990, pp. 1083–1084; see also Barneveld, 2014, pp. 56–58.

⁵⁰⁰ Bebchuk and Fried, 1996; 1997.

⁵⁰¹ See also Baird, 1994a, p. 2262 ff; Compare Squire, 2017, para. III A.

In that sense, the guarantee recreates exactly the problem that bankruptcy law generally,⁵⁰² and specifically preference law, is meant to prevent: early dismemberment of the company.⁵⁰³ Westbrook therefore has called the purpose of guarantees of giving control to certain lenders '*illegitimate*'.⁵⁰⁴ According to Westbrook, the value of pure-control guarantees '*lies almost completely in the sort of pressure the anti-dismemberment policy is designed to prevent*'. The economic literature confirms that powerful lenders have incentive to constrain or cut credit, possibly even liquidating the firm as the least risky way to recover a loan. This increases the financial distress costs suffered by the firm.⁵⁰⁵

Moreover, the guarantee puts the burden of monitoring the debtor's conduct on the non-guaranteed creditors. Practice shows that it is however the strong, guaranteed creditor that is often the superior monitor, whereas other creditors such as trade creditors or involuntary tort creditors are much less sophisticated in monitoring, which means the cost of monitoring generally becomes much higher, which costs will be reflected in the cost of credit for the debtor.⁵⁰⁶ The foregoing shows that the preference problem is not just a problem of redistribution, but also a serious efficiency problem, undermining the core efficient function of bankruptcy law, which may raise the overall cost of credit for the debtor, even if the cost of credit in relation to the guaranteed lender is lowered by the guarantee.⁵⁰⁷

In as far as indirect preferences through guarantees are indeed able to avoid scrutiny in a situation in which direct payments would be scrutinized, this is undesirable from an economic perspective. In the creditors' bargain theory, the most influential theory of insolvency law of the last few decades, preference law is explained as "*essentially a transitional rule designed to prevent individual creditors from opting out of collective proceeding once that event becomes likely. It is part of the attempt to ameliorate the effects of a common pool problem that justifies a collective proceeding in the first place.*"⁵⁰⁸ In other words, preference laws make sure the function of bankruptcy (as explained by the creditors' bargain theory) is not undone by actions occurring just before bankruptcy. It is thus undesirable that preference law rules could be bypassed by guarantees.

⁵⁰² Thomas H. Jackson famously explained the underpinning of bankruptcy as preventing common pool problems, (Jackson, 1982) which account, often referred to as the creditors' bargain theory, is still the most influential explanation of the bankruptcy process; Bowers, 2000; see for recent work that heavily relies on the creditors' bargain theory for example Hummelen, 2015 – but this really just is an example. Almost every major theoretical work in English on bankruptcy gives Jackson's theory an important place.

⁵⁰³ Westbrook, 1991, pp. 80–81.

⁵⁰⁴ Westbrook 1993, pp.1393–1396.

⁵⁰⁵ Keasey, Pindado and Rodrigues, 2015.

⁵⁰⁶ It should also be remembered that the guarantee often transfers risk from a superior risk-bearer, such as a bank, to an inefficient risk-bearer with a low degree of diversification, such as a business owner, which also increases the overall transaction costs the guarantee raises. See also Mann, 1999, p. 2260; Pozzolo, 2004 and chapter 2 paragraph 5.

⁵⁰⁷ In other words, the fact that other creditors 'price in' the fact that their return in bankruptcy is likely to be lower, is from an efficiency viewpoint not a satisfactory answer.

⁵⁰⁸ Jackson, 2001, p. 125.

3.2.4 Control through guarantees is more problematic than through real security rights

The control a lender obtains through an insider guarantee is substantially different and much more problematic than the control that a lender may obtain through other frequently used devices such as secured credit (secured by collateral of the debtor).⁵⁰⁹ The literature on secured credit has identified the control the security gives to the lender as an important feature of such security and an important reason parties use secured credit in practice.⁵¹⁰ The control of the lender originates in the fact that a forced fire sale of the collateral will result in a low price for the collateral, which means substantial damage to the debtor. Therefore, the debtor has an incentive to give in to pressure of the secured lender and pay that lender first. Such control does not exist under all circumstances and is especially less strong when a fire sale is clearly also not in the interest of the creditor, because the threat of foreclosure is not credible in such a case.⁵¹¹ In the small-business context the control of the lender will often be rather limited because the value of the collateral tends to be low in small businesses. The lender probably relies strongly on the cash flow of the debtor for repayment, and seizing the collateral will, in the small-business context, almost invariably destroy the cash flow.⁵¹² Moreover, if paying the lender first also comes at a cost from a business perspective, which will often be the case, the debtor will have to factor in these costs in deciding whether to give in to the lender. In other words, the debtor may concede under pressure from the lender, but only when this is in the best interest of the business of the debtor, and only when the threat is credible.

The insider guarantee creates a different dynamic: the insider will want to influence the debtor in taking decisions that are not in the best interest of the debtor, but that are in the best interest of the insider. Especially in severe distress, when the debtor is beyond rescue, the temptation to put the interests of the insider at the forefront will be strong because the debtor may already be a lost case. This temptation is especially powerful when the guarantor is a private person that places a high value on his personal assets.⁵¹³ Even a guarantee for a small amount could do the trick, exactly because the guarantor may wish to protect personal assets at any cost. The control that credit secured by collateral consisting of the debtor's assets creates, shows the reverse picture: when the debtor is beyond rescue, the collateral will no longer provide serious control. The control that credit secured by the debtor's collateral gives, is thus much less problematic from a preference and self-dealing perspective.

Moreover, from a different perspective, collateral given by the debtor can also *prevent* preferential treatment of creditors, because property law probably makes it harder to use the assets that are used as collateral to make preferential transfers to related parties.⁵¹⁴ Insider guarantees do not have that positive effect.

⁵⁰⁹ See also Baird, 1994a, p. 2266.

⁵¹⁰ See for example R. J. Mann, 1997, p. 645 ff.

⁵¹¹ R. J. Mann, 1997, p. 646 at fn 76.

⁵¹² Mann 1998, p.17 ff.

⁵¹³ Mann 1998, pp.19, 23; Westbrook 1993, p.1402.

⁵¹⁴ Tracht, 2000, p. 510; Bebchuk and Fried, 1997, p. 1330.

3.2.5 Specific dynamics in a reorganization procedure

A guarantee by an insider may change the dynamics of an attempted reorganization, be it in the family context, the small business context or within large corporate groups. For example, the right of recourse or subrogation of the guarantor vis-à-vis the debtor may jeopardize the restructuring process if that claim cannot also be included in the restructuring.⁵¹⁵ If such a recourse or subrogation claim indeed obstructs the restructuring process, all the other parties involved suffer externalities from the guarantee relationship. Contracting around the bankruptcy rules on cram-down with a guarantee relationship should therefore be obstructed. This could be done by reducing the recourse or subrogation claim with the same haircut, or by not allowing a subrogation claim at all after a restructuring.

Not only the subrogation claim of the guarantor can provide difficulties in a reorganization. Also the claim of the creditor on the guarantor can obstruct efficient reorganization in various ways. If the guarantor is an insider in the business to be restructured, he may only want to support the restructuring if his personal liability under the guarantee relationship is stayed or even cancelled during the restructuring.⁵¹⁶ Especially if the guarantor himself is essential to the restructuring process, for example because of his unique knowledge of the business, which will often be the case in the small-business context, allowing the guarantor to stay or cancel his liability under the guarantee may aid a successful reorganization. This could be done by restricting the creditor's right to invoke a guarantee, or it could be done by giving the guarantor easy access to bankruptcy himself, possibly even jointly with the debtor.⁵¹⁷

There is however another side to this. Guarantees should not too easily be excused or restructured when the debtor is insolvent whilst the guarantor is not. The guarantee can be used as an insurance against default of the debtor,⁵¹⁸ which would mean that excusing or restructuring the guarantee would probably be directly contrary to the parties' intentions. Not honoring the intention of the parties can and is often warranted in bankruptcy law, especially when externalities are at play, even though the guarantor is not bankrupt. The danger is however that the guarantor exploits such an opportunity to cancel a guarantee opportunistically, by making a promise (recourse under the guarantee) that he knows he doesn't have to uphold. Or even worse, the guarantor could induce the debtor to request bankruptcy, just so the guarantor escapes liability.⁵¹⁹ Moreover, control of a lender over the guarantor can also be a good thing in the restructuring. As discussed in chapter 2 paragraph 3, the hostage-function of a guarantee can be especially important to a creditor in small closely held corporations where the shareholder(s) is/are also the main 'asset' in terms of human capital of the company. If a company is highly dependent on the specific skills of the shareholders, the creditor may want to make sure these shareholders stay committed. In absence of a guarantee relationship, the shareholder or manager could threaten the creditor that to divert their human capital to another firm if the creditor does not want to renegotiate. This danger is especially real in a restructuring, though it may often be questionable how credible such a threat is, given the few alternatives the

⁵¹⁵ Keay, Brown and Dahlgreen, 2016, p. 351; Giancristofano, 2016.

⁵¹⁶ Compare Zaretsky, 1988.

⁵¹⁷ Keay, Brown and Dahlgreen, 2016, pp. 351; 354.

⁵¹⁸ However, as discussed extensively in chapter 2 paragraph 5, insider guarantees are generally not very efficient devices in performing insurance-like functions, because the guarantor is often not the most efficient risk-bearer.

⁵¹⁹ Gamble, 2011, p. 844; Starr, 1993.

shareholder or manager often has. Upholding the shareholder guarantee would mitigate such incentive for opportunistic behavior.

The role of guarantees in a restructuring of course highly depends on the specifics of a restructuring procedure, most notably on who takes important decisions in such a restructuring. If the debtor himself remains largely in charge and keeps the initiative, the guarantee given by management or shareholders of the debtor will have a much stronger influence and thus deserves much closer scrutiny than in a restructuring in which the shots are called by an independent person such as a court-appointed bankruptcy administrator.

Releasing the guarantor from liability will often go too far and give all kinds of inefficient incentives to the guarantor, such as making the debtor file for bankruptcy just to get a third-party release, and issuing guarantees that the guarantor knows he won't perform.⁵²⁰ Temporarily staying guarantee liability during a reorganization process does not carry these inefficiencies, but may still aid the reorganization process. In that sense, a full release is often not necessary to aid reorganization.⁵²¹ A temporary stay gives the insider guarantor breathing room, and may thus also offer a 'carrot' to timely request bankruptcy. Moreover, this enables the insider guarantor to fully focus on the reorganization, temporarily released from pressure on him personally through the guarantee, and invest all his energy and efforts in reorganization of the debtor.⁵²² If a reorganization plan succeeds and allows for substantial payment of the guaranteed creditor, this will benefit the guarantor as well.

In short, the guarantee relationship may influence reorganization dynamics in an adverse way that creates externalities, but often just as well creates a fruitful dynamic. Therefore, some kind of open-ended norm that allows the courts to include the guarantee in circumstances under which upholding the guarantee would be clearly burdensome could be a good thing. However, it is often impossible for a court to establish whether release is indeed necessary to the reorganization.⁵²³ Less evasive measures are therefore better placed.⁵²⁴ For example, a temporary stay of guarantor liability could aid a reorganization process, without doing much harm. If the debtor remains largely in control of the restructuring process, guarantees given by insiders generally deserve much closer scrutiny because of the increased danger of insider dealing.

3.2.6 Summary

In short, insider guarantees are likely to create externalities for other creditors by giving an incentive for insider dealing whilst at the same time covering up such insider dealing. First and foremost, control of one lender is likely to lead to preferential treatment of that lender, which leads to redistributions, often from weaker to stronger parties, and to serious efficiency costs that raise the overall cost of credit for debtors. This type of creditor control is much more problematic than the control that a secured creditor can have through real security rights.

⁵²⁰ Compare Boyle, 1992, p. 422.

⁵²¹ Brubaker, 1997, p. 1021.

⁵²² Gamble, 2011, pp. 856–857.

⁵²³ Brubaker, 1997, p. 1027.

⁵²⁴ Gamble, 2011; compare also Silverstein, 2006, p. 138, who concludes that third-party release is a drastic measure, the availability of which should be resolved by Congress, after diligent consideration of countervailing values.

Preferential treatment induced by insider guarantees should be deterred by legal rules. The difficulty of regulating such behavior is that the behavior is often covert and indirect and can be subtle, such as lien feeding, delayed bankruptcy filing or underinvestment.⁵²⁵ In the specific setting of a reorganization procedure, insider guarantees could also jeopardize the reorganization. Some stay of recourse against insider guarantees could therefore be implemented, though caution should be taken in affecting creditors' rights against third parties such as guarantors.

4 Conclusion

This chapter has sought to answer the 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?

Whereas the social costs of secured debt have been analyzed to a great extent by both lawyers and economists, the social costs of the guarantee relationship in the context of corporate finance are until now underexposed. This chapter both provided an overview of the fragmented existing literature on the topic and builds on this literature, as well as on literature on devices with a resemblance to or connection with the guarantee relationship, to provide a comprehensive analysis of the social costs of the guarantee relationship in the context of corporate finance.

Firstly, the problem of opportunistic use of guarantees towards insiders has been discussed. Both debtor and guarantor risk being the victim of opportunistic use of the guarantee relationship, which can, apart from being problematic from a moral perspective, lead to inefficient results. This calls for solid protection of weak guarantors and debtors against opportunistic use.

Secondly, opportunistic use towards outsiders has been discussed. On this point, the analysis has partly broken new ground, as a comprehensive account of opportunistic use of the guarantee relationship in the context of corporate finance did not yet exist. The effects of guarantees on outsiders can be substantial. A guarantee by a shareholder for the debt of a limited liability company creates an opaque priority structure, which is hard to justify. Such a structure is at odds with theoretical justifications underpinning limited liability and at odds with the theoretical justification underpinning priority in general.

The guarantee relationship often also gives the guaranteed creditor direct or indirect control over the debtor, leading to possible underinvestment, overinvestment and most notably preferential treatment to the guaranteed creditor. These effects are often harmful to outsiders and at odds with theoretical underpinnings of bankruptcy law in general and preference law in particular.

⁵²⁵ As Westbrook & Hu put it: “*We want managers to take risks, even perhaps to embark on “bet the company” projects when it makes sense to do so. We should reduce the opportunities for managers to engage in self-serving cowardice.*” (Hu and Westbrook, 2007, p. 1380; See also Finch, 2005, p. 735; Compare also Hahn, 2006; Acharya, Amihud and Litov, 2011; although, given the fact that management is often overoptimistic, the effect of the incentive the guarantee may give for underinvestment may not always be that harmful, depending on the circumstances.)

The often-used justification for not extensively regulating guarantees because they are generally efficient through lowering the cost of credit in corporate lending should thus be revised. Insider guarantees could, as shown in chapter 2, possibly be efficient when compared to straightforward lending, but such efficiency gains may be undone when the externalities discussed in this chapter go unchecked. Rules on the guarantee relationship, whether in contract law, insolvency law or corporate law, should be designed to minimize the negative effects of the guarantee relationship while ideally still allowing parties to use the relationship to perform arguably efficient functions, most notably curbing moral hazard and possibly signaling credit quality.

It should be reiterated that, as already discussed in chapter 1, this should not be read as a call for more focus on efficiency goals in designing laws. The focus of law should not only or primarily be on efficiency but also on other values. In fact, this chapter has shown that some, though not all, efficiency claims for insider guarantees are often doubtful, thus paving the way for regulation of the guarantee relationship that would previously too easily be viewed as inefficient.