Insider guarantees in corporate finance

An economic analysis of Dutch, US and German law

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CHAPTER 7
Comparison & synthesis

1 Introduction

The debate on personal security rights in especially Europe in the last decades has had a rather narrow focus. On the one side distributional concerns on the effects of guarantees on weak guarantors have been brought forward in the literature and have in many legal systems been addressed by legislation or case law protecting the weak guarantor.[1368] On the other side the importance of the economic function of the guarantee relationship in the lending industry and thus the assumed efficiency of the relationship has often been stressed. This thesis aims to fundamentally change the debate. By casting a wider net and having thoroughly reviewed both the efficient[1369] and the opportunistic[1370] uses of the guarantee relationship in the context of corporate finance, a much more refined picture of the dynamics involved in and created by the guarantee relationship is painted. To do this, an economic approach is used, as explained and defended in chapter 1.

As the analysis in chapter 2 has shown, guarantees can, in the context of corporate finance, certainly perform efficient functions, but only under certain circumstances. The analysis in chapter 3 has shown that guarantees can be used by creditor, debtor and guarantor together to externalize costs towards outsiders. The externalities discussed in chapter 3 should be regulated, ideally without prejudice to the efficient functions as identified in chapter 2.

The economic analysis was followed by an analysis of Dutch, US and German law on the economic issues identified. The approach taken in this comparison was explained and defended in chapter 1 and can be labeled comparative law and economics. Simply put, economics have been used to identify a set of problems after which the approaches to these problems under Dutch, US and German law have been described. This chapter follows on by comparing those approaches in light of the economic analysis. The analysis of Dutch (chapter 4), US (chapter 5) and German (chapter 6) law has shown various regulatory responses. This chapter compares those regulatory responses and, using the economic analysis of chapters 2 and 3, discusses which responses are optimal. The question answered in this chapter is the main question of this thesis:

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

The analysis of the responses is not necessarily limited to responses currently in place in one of the legal systems discussed. In designing the optimal technique the analysis often goes further than the approaches in place in either of the systems discussed, with the ideal in mind that externalities should be regulated, in as far as possible without prejudice to the efficient functions. As no comprehensive analysis of both the problems identified in chapter 3 and the

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[1368] See extensively chapter 3, paragraph 2.
[1369] See chapter 2
[1370] See chapter 3

optimal techniques to address those problems exists yet, this analysis breaks new ground at various points.

The chapter starts, in paragraph 2 below, by summarizing the beneficial economic function of guarantees as discussed in chapter 2, which function should be guarded. After that the focus will shift to possible opportunistic use of guarantees and the regulation of such opportunism. Opportunism towards insiders of the guarantee relationship is shortly analyzed and the regulatory approaches to such opportunism are discussed, compared and evaluated in paragraph 3. This will be followed by a discussion, comparison and evaluation of regulatory approaches to opportunism towards outsiders of the guarantee relationship. This discussion starts with opportunistically setting up an opaque priority structure using guarantees (paragraph 4). Opportunistic behavior that is, in turn, incentivized by guarantees that are already in place and the regulation of such opportunism are discussed in paragraph 5.

As the analysis will show, all three legal systems (Dutch, German and US law) could, though on different points and to a different extent, do with substantial amendments in order to curb opportunistic use of guarantees. Often, such amendments can be made whilst preserving the core efficient functions of the guarantee relationship in corporate finance.

2 The beneficial function of guarantees in corporate finance

As discussed in the introduction to this chapter, the debate on personal security rights has had a narrow focus on, on the one side, distributional concerns towards weak guarantors, whilst, on the other side, the importance of the economic function of the guarantee relationship has often been stressed. What is the economic function of the guarantee relationship in corporate finance? Chapter 2 answered this question. One may easily assume the function is to grant the guaranteed creditor more security, but that in itself does not explain why parties would use the guarantee relationship. The risk of the guaranteed creditor does not disappear but is (partly) shifted to the guarantor. If the guarantor would somehow be a more efficient risk-bearer or more efficient monitor, the relationship could make sense from an efficiency perspective. The analysis in chapter 2 has however shown that guarantees in corporate finance typically do not perform these functions well. Risk is often shifted to inferior risk-bearers and inferior monitors, whereas the guaranteed creditors are often expert risk-bearers and expert monitors.[1371] From this perspective, such guarantees are often inefficient, which inefficiencies are possibly offset by other efficient functions.

As an alternative explanation it has been brought forward that guarantees may be used to signal credit quality towards the guarantor. The evidence on this function is however not clear. If it can perform this function, the guarantor would preferably have to be a sophisticated, unrelated party, which is often not the case in the context of corporate finance.[1372]

[1371] See on risk-bearing chapter 2 paragraph 5 and on monitoring chapter 2 paragraph 4
[1372] See extensively on signaling chapter 2 paragraph 2

The most convincing economic function of the insider guarantee is to reduce moral hazard in relation to the lender.[1373] Although the relevance of the classic problems of overinvestment and underinvestment is somewhat questionable, the danger exists that the debtor will misbehave in times of distress by shifting assets away to related parties. Such behavior can shortly be described as asset shifting or asset stripping. The insider guarantee relationship can fix this problem as far as the guaranteed lender is concerned, by infusing the insiders with the interests of the guaranteed lender. In other words, the guarantee will make sure or will at least increase the likelihood that the guarantor (and often indirectly also the closely related debtor) will act in the interest of the guaranteed creditor.[1374]

The analysis in chapter 2 of the economic function of the guarantee relationship in corporate finance has in short shown that the guarantee relationship can indeed often lead to efficiency gains. However, those gains can usually not be ascribed to the relatively uncontroversial functions of specialization in risk bearing, specialization in monitoring or signaling credit quality. Instead, the guarantee relationship in corporate finance often leads to efficiency gains by influencing the behavior of guarantor and debtor, more specifically reducing moral hazard created by limited liability towards the lender. This function deserves close scrutiny, as changing the behavior of debtor and guarantor is likely to have effect on outsiders to the guarantee relationship.

3 Opportunism towards parties inside the guarantee relationship

Whereas chapter 2 discussed the possibly beneficial functions of the guarantee relationship, chapter 3 shifted the focus to possible opportunistic use of guarantees, first by discussing opportunistic use towards insiders to the guarantee relationship.[1375] This paragraph will start by shortly summarizing the problems with such opportunistic towards insiders. After that, a comparison of the regulatory approaches to such opportunistic use will be made (paragraph 3.2 below) and an advice on the preferred approach will be given (paragraph 3.3 below). As the analysis will show, none of the systems discussed offers appropriate protection to guarantors in the field of corporate finance. Such protection does (to different extents) exist for guarantees in a family- or consumer context, but is mostly lacking in the context of corporate finance, in which context business owners often guarantee business debts. The analysis will show that protection of the guarantor is also warranted in that field in order to ensure a healthy business climate and that such protection can be effected without much prejudice to the core efficient functions of the guarantee relationship. In that sense, the analysis here brings new insights to the debate and offers substantial and extensive proposals for change in (at least) all three legal systems discussed.

[1373] See chapter 2, paragraph 3 for an explanation of moral hazard
[1374] See extensively chapter 2 paragraph 3
[1375] See chapter 3, paragraph 2

3.1 The problems with opportunism towards parties inside the guarantee relationship

Chapter 3, paragraph 2, discussed that the guarantee relationship can be used to act opportunistically towards parties within the guarantee relationship, most notably the guarantor. Opportunism towards the debtor can also occur, but generally seems less of a problem.[1376] While there has been a focus in the literature on the protection of weak sureties such as family members of the debtor, the cost of opportunistic use of guarantees towards weak guarantors in the context of corporate finance (often shareholders or directors) has mostly been overlooked. Opportunism towards a weak guarantor is distributionally suspect, also in the context of corporate finance. Through guarantees, business owners and directors can become liable for large debts that they may not have been able to take in their own name and the risks of which they may not have been able to oversee, for example because of over-optimism. Business owners may often also have little other choice than to guarantee loans to their company if they want to be eligible for financing.

Opportunism towards a weak guarantor is not only distributionally suspect, but also creates inefficiencies that should be addressed, the most important of which are overoptimism of guarantors closely involved in the business for which they guarantee debts at the moment of signing the guarantee and under circumstances overly cautious behavior of guarantor and debtor because the guarantor risks losing personal assets. Moreover, if a guarantee pushes a guarantor into bankruptcy, society at large incurs serious costs, which should be avoided if possible.

3.2 The approaches of US, German and Dutch law to opportunism inside the guarantee relationship

US law hardly protects weak sureties specifically. General US contract law and the Statute of Fraud give some, but very limited protection to weak sureties.[1377] The protection of (subcategories of) consumer sureties is however rather extensive in both German and Dutch law, though the approaches vary. The famous German case law on immorality of suretyship offers extensive protection to certain consumer sureties. The protection is both procedural and substantive, though the substantive protection offered by German law is mostly restricted to cases in which there is a close relationship, more specifically an emotional relationship or economic dependence between debtor and guarantor.[1378] Dutch law takes a broader but more formal approach, stipulating inter alia information duties and other formal requirements for consumer suretyship, whilst hardly policing the content of the suretyship.[1379]

German, Dutch and US law offer very limited protection to sureties in the context of corporate finance. US law needs little discussion on this point, as it hardly protects weak sureties in the first place. Both in German and Dutch law some rules on consumer suretyship can in principle

[1376] See chapter 3, paragraph 2
[1377] See extensively chapter 5, paragraph 3
[1378] See extensively chapter 6, paragraph 3
[1379] See extensively chapter 4, paragraph 3

extend to shareholders or directors that stand surety for corporate debts, but do so only in a very limited number of cases. Under Dutch law a surety falls outside the realm of consumer protection if he or she is both director and (alone or together with the other directors) holds the majority of shares of the debtor, and the suretyship is on behalf of the normal operation of the business. This excludes many suretyships by shareholders and directors in corporate finance from consumer protection.[1380] The German case law on immorality of suretyship does generally not apply to suretyship in the context of corporate finance.[1381] Some other consumer protection mechanisms can in principle extend to suretyship in the corporate finance context, for example unfair terms control, doorstep sales law and the written form requirement, though there are exceptions. In short, the protection against opportunistic use of guarantees in relation to a weak guarantor in the context of corporate finance is very limited in all three systems.

3.3 Conclusions on the optimal approach to opportunism inside the guarantee relationship

It would be advisable for all systems to offer substantive protection, policing guarantees by natural persons in which there is a gross disproportionality between the financial means of the guarantor and the obligation incurred. Substantive protection would mean that the guarantor is not just protected with formal requirements such as information duties, but is granted an avoidance or nullification action if the guarantee is substantively unfair because of gross disproportionality between the means of the guarantor and the obligation incurred. A cue could be taken from German law in this context, at least in as far as the test itself is concerned.[1382] However, unlike under German law, a gross disproportionality test should particularly also apply in the context of corporate finance, in which manager-shareholders often overoptimistically guarantee corporate debts of their company. This test should only apply to guarantors that are natural persons. The efficient function of guarantees as reducing opportunistic behaviour of the guarantor towards the creditor should not be undermined. Guarantees do not need to outweigh the financial means of a guarantor in order to align the incentives of guarantor and creditor, which is the main economic function of such guarantees. It is therefore unlikely that the cost of credit will be driven up or the supply of credit reduced by policing such guarantees on the substance. As natural persons often place a high value on their own assets (the endowment effect), the risk of losing some will usually already suffice to align incentives. A rule limiting the use of disproportionate guarantees should therefore include the power of a court to substantially reduce the amount of the guarantee, without fully annulling it. The interests of the creditor would hardly be prejudiced. This also economizes on the serious costs of personal insolvency proceedings of the overindebted guarantor involved. Insolvency of a corporate debtor should wipe out the equity stake, not the equity holder itself.

A concern could be that applying a test as described above leads to an increased cost of credit and less available credit. Even if this would indeed be the case, this would particularly apply to family sureties and much less so to guarantees in the context of corporate finance, as the main aim and function of the latter is to reduce moral hazard (particularly asset stripping) and to a

[1380] See extensively chapter 4, paragraph 3.5
[1381] See extensively chapter 6, paragraph 3.1.6
[1382] See chapter 6 paragraph 3.1

much lesser extent actual recourse if the debtor does fail (and to the extent this would be the function, this is generally an inefficient by-product[1383]). In the case of family sureties, the chance that these are extended to provide actual recourse is much more likely. In that sense, there is (possibly counterintuitively) a much stronger economic case for policing sureties for business debts than for policing family sureties.

In addition to such substantive protection that protects guarantors against overburdening guarantees, formal techniques of protection should be implemented to make sure guarantors and their spouses are properly informed when deciding to issue a guarantee. Making sure the guarantor and his or her spouse have a proper understanding of the risks involved in guaranteeing business debts can somewhat address the inefficiencies related to overoptimism and is also likely to prevent at least some excessive guarantees, without generally prejudicing the efficient function of guarantees as preventing asset shifting.

Dutch law features a duty of the creditor to inform the guarantor of the risks involved and features the requirement that the spouse has to sign the guarantee for the guarantee to be valid, but this information duty does not apply to most guarantees that are given for corporate debts of a business in which the guarantor is strongly involved. The same applies to requirement of a signature by the spouse.[1384] That is unfortunate, as especially these guarantees are often for very large sums and especially regarding these guarantees the guarantor is likely to be overoptimistic about the business he or she is involved in. Such an information duty should thus particularly apply to all guarantees issued by natural persons.

Moreover, other than under Dutch law,[1385] the duty to inform should extend to the spouse of the guarantor as well, as the spouse also runs serious risks and the spouse may also be able to provide a more detached perspective and thus a possible balance to overoptimism. The information duty can only have the desired effect if the consumer is able to use the information rationally. In the context of business finance, the person directly involved in the business is likely to be less able to assess such information in a rational and detached manner, whereas his or her spouse will likely have more distance and thus a better starting point for reliably processing information on the risks and acting upon it. One may assume spouses to talk to each other and inform each other before making important decisions such as guaranteeing large business debts, but it should be kept in mind that the spouse involved in the business will not pass on the information as such, but his or her own (often overoptimistic) interpretation of the information. A direct information duty towards the spouse would therefore promote efficient decision-making.

[1383] See extensively chapter 2
[1384] See chapter 4, paragraph 3.4
[1385] See chapter 4, paragraph 3.7

4 Opportunism towards parties outside the guarantee relationship: (1) opaque priority structures

Two categories of opportunistic use of guarantees towards outsiders have been identified in chapter 3, paragraph 3: opaque priority structures[1386] and covert insider dealing[1387].[1388] These two categories of opportunistic use can be distinguished as follows. When guarantees are used in setting up an opaque priority structure, the opportunistic behavior essentially occurs on the moment that the guarantee is issued. With a combination of incorporating and piercing the shield that incorporation creates with a guarantee, the guaranteed creditor can opportunistically profit from this often opaque structure in relation to other creditors of the debtor and guarantor. This category of opportunistic behavior will be discussed in this paragraph. Paragraph 5 below in turn deals with the category of covert insider dealing through guarantees, which comprises opportunistic behavior that occurs after the guarantee is concluded, but which is incentivized by the guarantee.

After shortly reiterating the problems with opaque priority structures (paragraph 4.1 below), the regulatory approaches to opaque priority structures under Dutch, German and US law will be compared (paragraph 4.2 below) and the optimal approach will be identified (paragraph 4.3 below). As the analysis will show, all three systems could do with amendments in order to curb opportunistic opaque priority structures. This can be effected without prejudice to the core economic functions of the guarantee relationship in corporate finance.

4.1 The problems with opaque priority strucutres

Chapter 3, paragraph 3 identified the ways in which guarantees can be used opportunistically towards parties outside the guarantee relationship. One category of such opportunistic use is the creation of opaque priority structures.[1389] Parties can create an opaque priority structure by combining incorporation with a guarantee by the shareholder(s) to certain creditors. Thus, a selectively pierced limited liability shield is created. This situation is very common in practice. Such a structure is often used in small-business finance, in which the business owner often guarantees certain corporate debts towards a major creditor such as a bank. A selectively pierced limited liability shield can also often be found within corporate groups, in which group companies guarantee each other's debts (or even all the group debts) towards a major lender, often a bank.

The structural seniority that the guaranteed creditor receives through a combination of incorporation and a piercing guarantee can be dissected in various elements.[1390] The first element comprises the fact that the guaranteed creditor has a choice 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

[1386] Chapter 3, paragraph 3.1

[1387] Chapter 3, paragraph 3.2

[1388] A third category, concerning the issues with guarantees in reorganization, has also shortly been discussed in chapters 3-6, but is left out of the discussion in this chapter because the issue is outside the main aim and focus of this thesis.

[1389] See extensively chapter 3, paragraph 3.1.

[1390] See extensively chapter 3, paragraph 3.1.1.

element is that the creditor, depending on the rules applicable, may even submit full claims to both guarantor and debtor (strong form double proof), possibly leading to an enormous increase in pay out.[1391]

In chapter 3, paragraph 3.1.2 the justification for a selectively pierced limited liability shield was discussed by using the literature on the justification for limited liability. The discussion concluded that using guarantees to create a selective limited liability structure is highly problematic from an economic perspective. 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 fact a piercing guarantee makes the justification of upholding the principle of limited liability much harder to maintain in such a case.

The guarantee relationship can also be approached from the viewpoint of the literature on the efficiency of security rights, as the guarantee gives the guaranteed creditor priority over non-guaranteed creditors that can only reach one asset pool.[1392] 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 much weaker than the case for the priority of real security rights.

Moreover, chapter 3, paragraph 3.1.4 discussed the specific inefficient effects of double proof. Double proof occurs when a creditor is able to make more than one claim in relation to a single debt. If a bank for example extends a total of 90 credit to 10 group companies, which all guarantee the full amount, the bank 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. A weaker version can also be conceptualized, referred to here as 'deficiency double proof', in which the bank is only allowed to submit its deficiency claim in each insolvency. Double proof would then still occur, as the bank would in total submit an amount in all insolvencies together of far more than 90, though the bank only extended 90 credit. No economic (or other) justification exists for strong-form double proof, other than the rather weak defence that it may seem simpler to apply. Whether deficiency double proof should be allowed depends on the correlation of the fate of the guarantor and the debtor. When this correlation is high, which for example is often the case within corporate groups, allowing deficiency double proof leads to inefficient behaviour.

From yet another perspective, guarantees in corporate finance can be deemed inefficient in as far as shareholder loans are inefficient. Chapter 3, paragraph 3.1.5 explained that guarantees by shareholders for corporate debts are often functionally equivalent to direct shareholder loans. Although the debate on the efficiency of shareholder loans has not been reproduced in chapter 3 to its full extent, it can at a minimum be stated that such loans (or: equal ranking of such loans) are suspicious from an efficiency perspective and thus deserve close scrutiny. As chapter 3

[1391] See extensively chapter 3, paragraph 3.1.4.
[1392] See extensively chapter 3, paragraph 3.1.3.

explained, shareholder guarantees, which are omnipresent in corporate finance, deserve the same close scrutiny as functionally equivalent shareholder loans.

These inefficient effects of guarantees should be addressed, whilst as much as possible guarding the efficient function of the guarantee, which can in this context be summarized as protection against asset stripping.

4.2 The approaches of US, German and Dutch law to opaque priority strucutres

Chapters 4 (Dutch law), 5 (German law) and 6 (US law) have shown that there are roughly four regulatory approaches by which a legal system could address the inefficiencies created by pierced limited liability structures as such: (1) not upholding limited liability ('tearing down the walls'), (2) avoiding the piercing guarantees ('reinstating the walls'), (3) subordinating loans guaranteed by shareholders (somewhat reinforcing the walls, though only to protect the patrimony of the debtor) and (4) disallowing double proof (again, somewhat reinforcing the walls). These approaches are discussed and evaluated one by one, after which an overall conclusion on the most desirable approach will be given.

4.2.1 Annulling limited liability ('tearing down the walls')

Paragraph 4.1 above summarized the problems with opaque priority structures using guarantees. Within a corporate group or corporation-shareholder relationship, the effects of such a structure can be undone by annulling the limited liability walls between guarantor and debtor. This does not address the guarantee relationship directly, but annuls the partition that the guarantee relationship pierces. Annulling limited liability between guarantor and shareholder combines the patrimonies of guarantor and debtor, thus making the guarantee obsolete. The creditor is, after limited liability is annulled, left with one claim on one patrimony. This has much further reaching effects than just protecting creditors of the guarantor and debtor against adverse effects of the guarantee. On the upside the creditors of guarantor and debtor are also protected against adverse effects of the asset partitioning that limited liability has created. On the downside however this is likely to also have negative effects on at least some of the individual creditors, even though the creditors as a group benefit because the adverse effects of the guarantee are undone. To which extent do Dutch, German and US law take this approach of annulling limited liability in case piercing guarantees are in place?

Dutch law does not clearly consider the guarantee by a shareholder a relevant factor in shareholder liability cases.[1393] In that sense, Dutch law has little attention to the opaque priority structure that the guarantee and incorporation together can create.

German law is famous for its highly regulated and extensively codified approach of corporate groups in the *Konzernrecht*.[1394] The rules of the *Konzernrecht* essentially mean the corporate veil is pierced extensively, which, if the rules are applicable, effectively neutralizes the opaque

[1393] See on Dutch law on this point extensively chapter 4, paragraph 4.1.1.
[1394] See on German law on this point extensively chapter 6, paragraph 4.1.1.

priority structure that a guarantee to a single creditor can create. The German statutory *Konzernrecht* can, again if applicable, thus be effective in addressing the problems identified with opaque priority structures with guarantees. However, the *Konzernrecht* only applies to cases in which an *Aktiengesellschaft* (AG, the German type of a publicly owned corporation) is the controlled company. The rules do not apply to the far more common private company (GmbH). In the case of GmbHs, the rules on direct veil-piercing *(Durchgriffshaftung)* or on shareholder tort liability for undercapitalization could be relied on, but such cases are very rare and German (case) law and commentaries on German law do not clearly mention the use of guarantees as a directly relevant factor that has substantial weight in this context.

US law deals more effectively with opaque priority structures with guarantees.[1395] US law on veil-piercing is fact-oriented and hard to capture in generalizations, but it can comfortably be stated that guarantees by shareholders have often been treated as a relevant factor in veil-piercing cases. The existence of such guarantees is by itself certainly not enough to support a case, but the recognition as a relevant factor is well-established.

In short, only US law seems to treat guarantees by shareholders as a relevant factor in shareholder liability cases, and thus has some attention to the opaque priority structures that guarantees can help create. Other systems should follow this approach, ideally approaching guarantees by shareholders with even more suspicion than US law does, by anchoring the presence of shareholder guarantees to certain creditors as a relevant circumstance in shareholder liability cases.

4.2.2 Avoiding the piercing guarantees ('enforcing the walls')

Instead of tearing down the limited liability walls, the walls can also be enforced by allowing avoidance actions against guarantees that pierce the walls, thus also addressing the problems associated to opaque priority structures with guarantees somewhat. The setting would be that the bankruptcy administrator of a guarantor tries to avoid the guarantee in order to escape liability under the guarantee which would in turn reduce the amount of debts in the bankrupt estate of the guarantor. Although this addresses, like tearing down the limited liability walls, the problems to opaque priority structures, it does so from a different perspective and with different effects. If we look at the corporate group context, avoiding a guarantee would leave the partitions within the group intact, but undoes the benefit the guarantee gives the guaranteed creditor by annulling the guarantee liability, leaving the creditor with a claim on the principal debtor (and possibly other guarantors). This thus protects the creditors of the guarantor from the adverse effects of the guarantee, but not from the adverse effects of partitioning in the first place. It also does not protect the creditors of the principal debtor. To the opposite, the pressure on the patrimony of the principal debtor is arguably increased (though not formally) because the creditor does no longer have the patrimony of the guarantor as an alternative source of collection. To which extent do Dutch, German and US law take this approach?

US law offers comparatively extensive possibilities to annul the guarantee itself by invoking fraudulent transfer law.[1396] The look-back period of federal fraudulent transfer law is two years

[1395] See on US law on this point extensively chapter 5, paragraph 4.1.1.
[1396] See on US law on this point extensively chapter 5, paragraph 4.1.2.

and up to four years under the law of some states. Two important requirements for invoking fraudulent transfer law are whether the debtor was insolvent at the time the transfer was made (here the moment the guarantee was issued) and whether the transfer was against reasonably equivalent value.

A first complexity that courts struggle with is how to count the guarantee in the context of the insolvency test: does the guarantee count for the full liability on the balance sheet, or are the possible recourse or subrogation claims or the probability that the guarantee is invoked discounted? The last approach seems to be the most used and is also the most appropriate, as recourse and subrogation claims on related parties (group companies or a shareholder) often prove to be illusory. However, the insolvency test does not seem suitable for issuing guarantees in the first place, as a guarantee is only a contingent liability. The test should rather be whether insolvency at the moment the guarantee would be triggered was foreseeable.

The complexity with the reasonably equivalent value test is that guarantees are often granted without direct consideration. In the corporate context courts often make a distinction between downstream guarantees (parent guarantees debts of subsidiary) on the one side and upstream (subsidiary guarantees debts of parent) and cross-stream (subsidiary guarantees debts of another subsidiary of parent) guarantees on the other side. Downstream guarantees are often regarded as for reasonably equivalent value, because the parent is assumed to profit from the guarantee through share-ownership. With upstream and cross-stream guarantees such an assumption is generally not made and courts are likely to investigate to which extent the guarantee has given the guarantor indirect benefits, which benefits have to be somewhat tangible to qualify as such.

Under Dutch law it is much harder to avoid the guarantee itself.[1397] The guarantee can be avoided by the bankruptcy administrator[1398] by invoking transaction avoidance law (*pauliana*), but the administrator would (amongst other requirements) have to show that both the guarantor and the creditor receiving the guarantee should have reasonably foreseen bankruptcy and a shortage in bankruptcy at the moment the guarantee was issued. This largely subjective test with a burden of proof on the bankruptcy administrator is hard to pass. In the year before bankruptcy a rebuttable evidentiary presumption may apply, but due to technical difficulties as discussed in chapter 4, it is unclear to which extent this applies to common types of guarantees. One of the grounds on which this evidentiary presumption could apply, is if the value of the promised performance on the side of the debtor substantially exceeds that on the side of the creditor, which tests presents the same difficulties as discussed above under the discussion of US law on the somewhat comparable 'reasonably equivalent value'-test (though Dutch law is less developed on this point).

Under German law, guarantees themselves cannot easily be avoided or declared void, but both the rules on capital requirements and the rules on director liability do limit the use of guarantees within corporate groups. The law is somewhat unsettled on these issues, but in practice directors are certainly concerned about director liability in this context, which incentivizes directors to not conclude too extensive guarantees in name of the GmbH. Thus, the problem of opaque priority structures is somewhat addressed.

[1397] See on Dutch law on this point extensively chapter 4, paragraph 4.1.2.
[1398] And outside bankruptcy also by a creditor, but this is rare and the conditions are slightly different.

4.2.3 Limiting double proof

Yet another technique to somewhat address the problems associated with opaque priority structures with guarantees is to limit the double proofing of claims through guarantees. 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 creditor is allowed to submit the full claim time and time again against bankrupt co-debtors, without regard to pay-out in either of the bankruptcy cases. The weaker form is when the creditor can only recycle the deficiency claim in each proceeding. By limiting double proof, the benefit that the guaranteed creditor receives from the guarantee can be limited, thus addressing the problems associated to opaque priority structures with guarantee, which can be done without prejudice to the core efficient function of the guarantee relationship in corporate finance (reducing moral hazard) by leaving the security function of the guarantee in place.

In both German and Dutch law the statutory law clearly allows strong form double proof.[1399] German law however disallows, to some extent, double proof in one important other category: shareholder guarantees. A creditor with shareholder guarantees should first pursue the shareholder according to the rule laid down in § 44a InsO. Unclear is thus far however whether a creditor that receives partial satisfaction from the shareholder can still share in the insolvency proceedings of the principal debtor on the basis of its full claim, or only on the basis of his deficiency claim. Most commentaries seem to assert that the creditor can share in the proceedings on the basis of his full claim, because the goal of § 44a InsO would, in that view, not entail weakening the position of the third-party creditor, but the law is still somewhat unclear.[1400] Even if the creditor can only share on the basis of a deficiency claim, double proof is not ruled out completely. In case of various bankrupt co-guarantors, the creditor would still be allowed to double proof the deficiency claim.

US case law seems to allow strong form double proof as a matter of bankruptcy law, but the (state) law applicable to the claim itself could restrict the strong-form version of double proof. In that case, deficiency double proof would still be allowed.

4.2.4 Indirectly and partially Subordinating shareholder-guaranteed claims

As discussed in chapter 3, paragraph 3.1.5 a guarantee by a shareholder for corporate debts can often functionally be equated with a direct shareholder loan. As also discussed in chapter 3, shareholder loans (or: equal ranking of shareholder loans) are suspect from an efficiency perspective. This paragraph discusses to which extent Dutch, German and US law scrutinize shareholder loans under the veil of shareholder guarantees.

Also from a more general perspective on the guarantee relationship combined with incorporation as an opaque priority structure, legal treatment of shareholder loans is relevant. As discussed in chapter 3, paragraph 3.1 and reiterated above, a limited liability shield selectively pierced by shareholder guarantees is highly problematic from the perspective of the

[1399] See on Dutch law chapter 4, paragraph 4.1.4; on German law chapter 6, paragraph 4.1.4.
[1400] See extensively chapter 6, paragraph 4.1.4.

economic justification for both limited liability and real security rights. The priority that such a structure grants is even stronger when the legal system applicable allows pari-passu ranking of the claim of the guaranteed creditor in the bankruptcy proceedings of the debtor. Or in other words, subordinating shareholder guaranteed claims can be seen as a regulatory technique that somewhat curbs the priority that a guarantee combined with incorporation can create.

No general rule of subordination of direct shareholder loans exists under Dutch law and the literature and case law are inconclusive, both on the specific circumstances under which subordination of direct shareholder loans may be warranted and on the legal basis on which such subordination can be grounded, if at all. It should, from this perspective, not surprise that Dutch law is underdeveloped on the issue of possible subordination of covert shareholder loans, such as the often-occurring case of loans by third parties guaranteed by shareholders.[1401]

German law automatically subordinates most shareholder loans. German law also generally treats indirect shareholder loans as partially and indirectly subordinated (by requiring the guaranteed creditor to first try to take recourse to the shareholder-guarantor and subordinating a recourse claim of the shareholder-guarantor on the corporation), thus weakening, though not fully, the opaque priority structure that can be created using a combination of incorporation and a guarantee. Notable is that the rules on subordination of indirect shareholder loans are set up in such a way that the priority position of the creditor through the guarantee structure is minimally affected, whereas the position of the shareholder is strongly affected.[1402]

Under US law, shareholder loans are not automatically subordinated. The doctrine of equitable subordination can however be used to target specific shareholder loans. For a bankruptcy court to equitably subordinate a claim of a creditor, the creditor must have behaved inequitably, which must have injured the other creditors or given the lender an unfair advantage and subordination of the claim must not be inconsistent with the Bankruptcy Code. An important factor in establishing inequitable conduct is undercapitalization. Non-insider lenders are however unlikely to be confronted by subordination because of undercapitalization because non-insider lenders are generally not required to keep their debtor sufficiently capitalized. Insider lenders such as directors or shareholders are often confronted with equitable subordination because of undercapitalization. Guaranteed debts present a special case because of their hybrid character. Equitable subordination of the claim of the guaranteed creditor is more difficult to achieve than subordination of a direct shareholder loan. Although the US thus has some sensitivity in uncovering covert shareholder loans, the rules on equitable subordination of shareholder loans probably do not have much effect in deterring the opaque priority structure of a limited liability shield perforated by guarantees.[1403]

German law addresses the problems associated with indirect shareholder loans most accurately. The German approach at the same time leaves the most important function of the guarantee in the context of corporate finance as identified in chapter 2 (reducing opportunism by the guarantor) mostly intact by mainly affecting the position of the shareholder and not the position of the creditor with the rules on subordination. From that perspective the German approach also has very little downsides. It should however be noted that the German approach, and also the US approach, have further reaching effects than just subordinating shareholder guaranteed claims. The direct aim of these rules is of course to address problems associated to shareholder loans in general, which problems have not been extensively discussed in this book.[1404]

[1401] See extensively chapter 4, paragraph 4.1.3.
[1402] See extensively chapter 6, paragraph 4.1.3.
[1403] See extensively chapter 5, paragraph 4.1.3.
[1404] See chapter 3 paragraph 3.1.5 for a concise discussion.

4.3 Conclusions on the optimal regulatory approach to opaque priority structures

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 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 submit full claims to both guarantor and debtor (strong form double proof).[1405]

Although indirectly subordinating shareholder-guaranteed claims may be warranted in its own right from the perspective of the dynamics involved in shareholder loans,[1406] it is not an ideal technique to address inefficient effects associated with opaque priority structures created by a combination of incorporation and piercing guarantees. The reason for this is that it has a limited effect on such priority structures. At the level of the debtor such a rule would mean that strong form double proof is not allowed, but only deficiency double proof is allowed. This protects the patrimony of the debtor somewhat from the adverse effects of guarantees, but does not protect the patrimony of the guarantor from the adverse effects. As discussed below, strong form double proof should in any case not be the rule, and even deficiency double proof should be ruled out. Therefore, the regulatory technique of subordinating shareholder-guaranteed claims does too little.

The first step in the regulatory approach should be to rule out strong form double proof altogether and limit deficiency double proof to cases in which there is no correlation between the fate of guarantor and debtor.[1407] As clearly follows from the economic analysis, strong form double proof should not be allowed, especially not in cases in which the co-debtors are strongly intertwined, which is for example usually the case with guarantees in group finance. All systems should at least restrict double proof in that context and apply a rule of single proof, with an option to choose who to claim from and for which amount. For unrelated co-debtors or unrelated debtors and guarantors, strong-form double proof is less harmful but still unnecessary. Deficiency double proof could be applied in that context.

A rule that would really limit the guaranteed creditor to single proof, would limit the total amount that the creditor asserts against all co-debtors together. That limit would be the total amount of the debt. If the creditor has a claim of 90 on one company which is fully guaranteed by ten group companies and the group is declared bankrupt, the creditor could for example be limited to asserting a claim of 9 in each bankruptcy proceeding, only sharing pro rata based on that amount. But the claim of 90 could also be distributed over the other creditors in a different fashion. If the creditor himself is allowed to choose, the security and opportunism-reducing function of the guarantee remain essentially intact, but without the adverse effect of double proof to other creditors of the bankrupt debtors.

Important to note is that such a rule of single proof does not jeopardize the core economic function (protection against asset shifting and asset stripping) of the guarantee given by a party

1405 See chapter 3 paragraph 3.1.
1406 Which dynamics have only been discussed concisely in this book, see chapter 3, paragraph 3.1.5.
1407 See on this correlation extensively chapter 3, paragraph 3.1.4, with reference to Squire.

related to the debtor, it just to a large extent (but not fully) eliminates the unnecessary side-effect of moving value away from other creditors.

The inefficiencies of correlation seeking that Squire describes in the context of group guarantees, show why both strong-form double proof and deficiency double proof are inefficient when the correlation Squire refers to is high.[1408] Squire suggests that fraudulent transfer law should be used to attack guarantees in which the correlation was high. If guarantees are attacked as fraudulent transfers, the focus should indeed principally be on the aforementioned correlation.

However, fraudulent transfer law is not the ideal remedy for various reasons. Firstly it may do too much by annulling the full guarantee and not just addressing the identified problems of double proof and deficiency double proof. For that reason courts are also likely to (and should) only allow avoidance sparingly. Furthermore, the remedy often can only be applied to transfers in a certain period before bankruptcy. A simpler and less far-reaching solution that both overcomes the technical difficulties of applying fraudulent transfer law to a guarantee issued long before bankruptcy and overcomes the problem that fraudulent transfer law does too much, could be to keep the guarantee in place but disallow both strong form and deficiency double proof in bankruptcy, in any case when the correlation is high.

Of course, substantive consolidation in bankruptcy (one of the ways of annulling limited liability, discussed above in paragraph 4.2.1) of the co-debtors would also do away with the problem of double proof, because this merges the bankrupt estates of the co-debtors into one asset pool.[1409] Veil-piercing would also have this effect but to a lesser extent. Both veil-piercing and substantive consolidation however have much further-reaching effects than just preventing double proof and may thus not always be warranted, especially not outside the context of closely-knit corporate groups. A rule of single proof in the context of group finance has, in contrast, very few side-effects, especially when combined with a choice of the creditor how to allocate the total claim over the debtors. The security function is left intact, the creditor can still base his risk-assessment on the creditworthiness of the group as a whole and does not have to monitor for asset shifting within group boundaries. Just the ability to squeeze down ordinary creditors by asserting an artificially high claim is prevented.

If a rule of single proof with a choice for the creditor how to allocate the burden over the co-debtors would be used, the creditor would still receive structural seniority, though to a lesser extent. Chapter 3 paragraph 3.1.3 on the justification of security rights discussed that such priority can be problematic from an economic perspective, even though security rights are strongly ingrained in our legal culture. Therefore the advisable approach is to in principle allow such structural seniority (as long as the problems of deficiency double proof and strong form double proof are addressed) and only treat such priority with suspicion under aggravating circumstances, such as bad record-keeping or other deceptive or misleading behavior. In such cases, an open norm could be applied that allows courts to take either of the following remedies. A first possibility would be to still allow the guaranteed creditor's claim, whilst basing the division of the burden over the debtors not on the choice of the creditor but on the extent to which each co-debtor actually used the line of credit or benefitted from it. Other possibilities include annulling the guarantee or annulling limited liability, but these have much wider-ranging effects that are not always warranted. In determining whether veil-piercing or annulling

[1408] See chapter 3, paragraph 3.1.4, with reference to Squire.
[1409] See chapter 3, paragraph 3.1.1, with reference to Widen.

the guarantee is warranted, the existence of the guarantee could and should however play an important role.

5 Opportunism towards parties outside the guarantee relationship: (2) covert insider dealing

Two categories of opportunistic use of guarantees towards outsiders have been identified in chapter 3 paragraph 3: opaque priority structures and covert insider dealing.[1410] Paragraph 4 above has summarized and compared the findings on the category of opaque priority structures in which guarantees play an essential role. In that category of opportunistic behavior, it is the creation of the structure itself, including the issuing of the guarantee, that can under circumstances be regarded as opportunistic. When guarantees are used in setting up an opaque priority structure, the opportunistic behavior essentially occurs on the moment that the guarantee is issued. With a combination of incorporating and piercing the shield that incorporation creates with a guarantee, the guaranteed creditor can opportunistically profit from this often opaque structure in relation to other creditors of the debtor and guarantor. The paragraph below will in turn discuss the category of covert insider dealing. In this category of opportunistic behavior the issuing of the guarantee itself is not necessarily opportunistic, but the behavior incentivized by the guarantee that is already in place is, under circumstances, opportunistic.

After shortly reiterating the problems with covert insider dealing (paragraph 5.1 below), the regulatory approaches to covert insider dealing will be compared (paragraph 5.2 below) and the optimal approach will be identified (paragraph 5.3 below). As the analysis will show, all three systems could do with amendment in order to curb value-destroying covert insider dealing. Such amendments can be effected without substantially prejudicing the core economic functions of guarantees in corporate finance. These findings are not entirely new to all systems discussed: both German and US law recognize the problem of insider dealing incentivized by guarantees to a substantial extent, whereas Dutch law hardly does. However, both German and US law are far from perfect on these points and would need further amendment in order to more effectively curb opportunistic covert insider dealing with guarantees.

5.1 The problems with covert insider dealing

The most blatant form of creditor opportunism through guarantees is the situation in which the guaranteed 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.[1411] The creditor may not even have to actively apply pressure to induce the debtor to make such

[1410] A third category, concerning the issues with guarantees in reorganization, has also shortly been discussed in chapters 3-6, but is left out of the discussion in this chapter because the issue is outside the main aim and focus of this thesis.
[1411] See extensively chapter 3, paragraph 3.2.

payments, because the guarantor will have internalized the interests of the creditor through liability under the guarantee towards that particular creditor. There will, in other words, be an incentive for selective payment of the guaranteed creditor.

Not only the incentive for preferential treatment of the guaranteed creditor is created by the guarantee, at the same time the guarantee covers up the indirect benefit of the guarantor when such preferential treatment occurs.[1412] 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. 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.

Such indirect payments to insiders, which insiders often have an information advantage compared to other creditors, do not only lead to redistribution of wealth towards stronger creditors but are often also value-destroying. The guarantee leads exactly to the sort of behavior that bankruptcy law in general, and specifically preference law, is meant to prevent: early and value-destroying dismemberment of the company.[1413] The control that a lender obtains over the debtor through an insider guarantee is also much more problematic than the control that collateral granted by the debtor itself creates, because the control increases especially in the problematic period before bankruptcy.[1414] Payments on insider-guaranteed loans in the twilight zone should thus be policed strictly.

Preferential treatment can also be much subtler than payment. Chapter 3, paragraph 3.2.2 identified insider guarantees as creating or exacerbating the problems of feeding the lien, inefficient (early or late) bankruptcy filing and underinvestment. Even if preference law rules are in principle sensitive to indirect transfers through guarantees, such behavior is often hard to police with preference law rules because there is often not one clearly identifiable transfer of property that can be attacked with preference law rules (though dependent on the legal system applicable). This analysis calls for flexible preference law rules and well-developed fallback systems that disincentivize such behavior.

5.2 Approaches of US, German and Dutch law to covert insider dealing through guarantees

Chapters 4 (Dutch law), 5 (German law) and 6 (US law) have shown that there are roughly four regulatory approaches by which a legal system could address the inefficiencies created by covert insider dealing through guarantees: (1) allowing easier avoidance of preferential payments from which an insider as guarantor profited, by allowing recourse to either the insider guarantor, the creditor or both; (2) allowing easier shareholder liability claims for damage caused by preferential behavior of the debtor when such behavior has profited the shareholder by limiting his exposure under a guarantee; (3) allowing easier director liability claims for damage caused by preferential behavior of the debtor and (4) allowing easier recourse to the guaranteed lender when the lender has profited from preferential payments that have been incentivized by insider guarantees. These approaches are discussed and evaluated one by one, after which an overall conclusion on the most desirable approach will be given.

[1412] See extensively chapter 3, paragraph 3.2.1.
[1413] See extensively chapter 3, paragraph 3.2.3.
[1414] See extensively chapter 3, paragraph 3.2.4.

5.2.1 Transaction avoidance

Dutch transaction avoidance law deals poorly with indirect preferences. It distinguishes between avoidance of obligatory and voluntary acts. This distinction is flawed in the sense that it allows creditors to contract around it by ex ante making sure, using contractual provisions, that preferences given on the eve of bankruptcy will be qualified as obligatory payments. Avoidance of obligatory payments is generally very difficult under Dutch law. The circumstance that an insider such as a manager or shareholder has guaranteed the debt that was paid may arguably make avoidance of the payment easier, but very unclear is whether this is indeed the case and if it is, how much easier it makes avoidance of the payment. Most striking is the lack of attention to this problem in both practice and the literature, especially if compared to Germany, the US and also the UK. Furthermore, both in case of obligatory and voluntary payments, Dutch law strongly relies on subjective factors that are often hard to prove. Relevant objective factors such as the fact that an insider has indirectly profited from a certain transaction hardly play an articulated role, neither in statutory law nor in case law. Lastly, Dutch transaction avoidance law is very narrowly focused on 'legal acts', which does not encompass all transfers of value and can only be invoked against the direct counterparty of the legal act, not against a guarantor that indirectly profits.[1415]

Both German and US law pay much more attention than Dutch law to the indirect preference problem. German and US law however each take a fundamentally different approach. German law approaches the problem entirely and exclusively from the perspective of indirect shareholder loans, whereas the approach of US law in principle has a much wider scope, though it allows for many exceptions.[1416]

German law makes a clear distinction between normal loans and shareholder loans (§ 39(1) nr 5 InsO) and in this context also has attention for and special rules on indirect shareholder loans, such as loans granted by third parties but guaranteed by shareholders (§ 44a InsO). Payments in the year before insolvency on such guaranteed loans can much more easily be avoided by the insolvency administrator in relation to the guarantor (§ 135(2) and § 143(3) InsO) than payments on normal loans. Security rights granted by the principal debtor to the guaranteed creditor cannot easily be avoided, but the bankruptcy administrator can have recourse to the surety (up to the amount of the guarantee) when the creditor enforces his security rights against the principal debtor.[1417] German law thus protects the creditor, but not the guarantor.

In case of avoidance of payments on guaranteed debts German law also protects the creditor from the effects of such avoidance. German law stipulates that the insolvency administrator should turn to the shareholder-guarantor for repayment, which duty to repay is limited to the amount of the guarantee (§ 143(3) InsO).[1418] The downside of this approach is that the shareholder-guarantor is often not likely to be able to perform his duty to repay, firstly because he might also be in financial trouble when the principal debtor fails, secondly because the guarantor has not received the payment. Moreover, the benefit that the shareholder-guarantor has had in terms of limiting his exposure under a guarantee could be (much) lower than the actual payment made, because guarantees by shareholders are often given for a limited amount.

[1415] See extensively chapter 4, paragraph 4.2.1.
[1416] See extensively on German law chapter 6, paragraph 4.2.1 and on US law chapter 5, paragraph 4.2.1.
[1417] See chapter 6, paragraph 4.2.1.
[1418] See further chapter 6, paragraph 4.2.1.

In such cases, the specific law on indirect preferences through shareholder guarantees only allows to claw back that limited benefit that the shareholder had, not the whole payment to the creditor, even though that whole payment was probably incentivized by the guarantee.[1419] The strict German law rules on indirect insider preferences furthermore only apply to (most) shareholder guarantees and not to other insider guarantees, such as guarantees by directors or guarantees by close relations such as family members of shareholders or directors.[1420]

US law allows the bankruptcy administrator to directly attack the indirect benefit that a guarantor receives when a transfer is made from principal to creditor as a preference, because § 547(b) allows that transfers 'for the benefit of' a creditor are addressed and § 101(5) and (10) Bankruptcy Code include in the definition of 'creditor' someone that has a contingent claim on the debtor. By default the guarantor has a contingent claim on the principal for reimbursement. US law thus sees the indirect benefit that a guarantor receives when the guaranteed debt is paid, as a transfer for the benefit of a creditor.

The standard look-back period for preferences is 90 days, but in the case of preferences to insiders (which is defined broadly) a preference period of one year applies. The logic behind this is that insiders may have an information advantage (and possibly an advantage in influence) compared to outsiders and could abuse that position by pressing the debtor to prefer them above outside creditors. Benefits of insider-guarantors (such as shareholders or directors) that are created by payments of the principal debtor to the guaranteed creditor can thus in principle be attacked by a preference law action if the benefit was created in the year before bankruptcy.[1421]

Regarding payments between three months and a year before insolvency the bankruptcy administrator can only recover from the insider-guarantor, not from the non-insider creditor. This leads to similar problems as discussed above regarding German law: the might not provide recourse and the benefit of the guarantor may have been much smaller than the payment to the guaranteed creditor.

A very problematic feature of the US system regarding indirect preferences to guarantors is also that it hinges on the status of the guarantor as 'contingent creditor' with a contingent recourse claim. In order to prevent creditor status under the Bankruptcy Code, parties often waive recourse and reimbursement claims in the contract of guarantee, with varying results. Some courts have ruled that this could not affect the application of preference law, whereas others have ruled that it can.[1422] In the latter case, this seriously undermines accurate treatment of indirect preferences to guarantors.

Preferential treatment of guaranteed creditors can be much more subtle than making a payment. Think of transferring assets or granting security rights, for example in the form of lien feeding or

[1419] Of course, the bankruptcy administrator could also try to avoid the payment to the creditor on the basis of the general preference law rules, but the fact that an insider guaranteed the paid debt is not seen as a directly relevant circumstance for that avoidance action.

[1420] See extensively chapter 6, paragraph 4.2.1.

[1421] There are so-called safe harbours, the most important of which is (especially in this context), the ordinary course of business test. Transfers that were made in payment of debts incurred in the ordinary course of business are safe in as far as the transfer was also made in the ordinary course of business (either ordinary in the industry at large or ordinary between this debtor and creditor). The guarantee obligation is, if the guarantor is a shareholder or director of the principal debtor (which is often the case with guarantees in the context of corporate finance), often not incurred at arms-length, which will make it hard to rely on the safe harbour.

[1422] See chapter 5, paragraph 4.2.1.

inefficient bankruptcy filing. Preference law is often not geared towards such behavior. Compared to German and Dutch law, US preference law has the broadest scope and is thus relatively best geared towards policing subtler forms of preferences. Subject to certain conditions, the trustee may avoid any transfer of an interest of the debtor in property. 'Transfer' is defined very broadly in this context.[1423] The definition of 'transfer' is in principle able to capture both indirect transfers and factual behavior such as lien feeding. The application of Dutch preference law is however restricted to legal acts of the debtor, whereas German preference law uses the somewhat broader definition of 'Rechtshandlung'.[1424] To prevent loopholes it would be advisable to use a very broad definition of 'transfer', as US law does.

In short, whereas Dutch law lacks rules on the issue, both German and US law regulate the issue of indirect preferences to insider guarantors to some extent, but with a differing approach and both with some serious shortcomings. The US system in principle has a broad scope, but can (possibly) be undermined by contractual waivers. The German system cannot be undermined in such a way, but is too narrowly focussed on shareholder guarantees. Both systems moreover only allow recovery from the guarantor,[1425] which has serious downsides.

5.2.2 Director liability

Under US law directors generally have relatively little to fear from liability laws in relation to creditors of the company, at least as far as damage cause by preferential payments to other creditors is concerned. Although US law is not completely settled on this point and differs from state to state, the approach often seems to be that directors owe no or only very limited fiduciary duties directly towards creditors of the company. If preferential treatment of certain creditors benefits those creditors in relation to other creditors, the latter have little to expect from director liability law. Creditors do have derivative standing for breach of duties by directors towards the company or shareholders, but the problem here is that preferential payments will generally not do damage to the company or the shareholders.[1426]

German law is famously harsh on directors. The duties of directors are owed to the enterprise and to the stakeholders, including creditors, employees, customers, shareholders and society at large. Directors have a strict duty to timely file for insolvency. If they fail to do so, directors are obliged to compensate for payments that have been made when the corporation was over-indebted or illiquid, unless such payments were consistent with the due care of a prudent businessperson. This also applies to payments that are not detrimental to the company as such, for example because they are made to meet current liabilities, but that are only detrimental to unpaid creditors. 'Payment' should be understood broadly and in a non-technical way, encompassing all benefits from assets of the debtor that reduce the insolvency estate of the debtor. Thus, much of the more subtle opportunistic behavior described in chapter 3 paragraph 3.2.2 will be covered and can lead to director liability if the company was illiquid or overindebted. [1427]

1423 See extensively chapter 5, paragraph 4.2.1.
1424 See chapter 6, paragraph 4.2.1.
1425 At least when the specific system for indirect preferences is used. General preference law would of course allow recovery from the creditor as well, but the insider guarantee, which often gave incentive for the payment, is not considered an important factor in that context.
1426 See extensively chapter 5, paragraph 4.2.2.
1427 See extensively chapter 6, paragraph 4.2.3.

Dutch director liability law is less strict than German law and rather underdeveloped on the issue of indirect preferences through insider guarantees. Directors can be held liable both by the bankruptcy administrator and by creditors for damage to creditors caused by preferential treatment of other creditors, but the starting point is that debtors and by extension directors are free to decide who to pay first, even in times of illiquidity or over-indebtedness. Only when the situation becomes hopeless, this changes. Preferences to insiders however may be suspect at an earlier stage, but the law is still somewhat unsettled on this point and especially unclear on indirect benefits to insiders in this context.[1428]

5.2.3 **Shareholder liability**

Regarding liability of shareholders, the picture is somewhat different. As already discussed above under the heading opaque priority structures (see above, paragraph 4.2.1), US law pays the most attention to the circumstance that shareholders have guaranteed certain corporate debts in veil-piercing (shareholder liability) cases. Thus, when it is the shareholder that guaranteed corporate debts, which is regular practice in the context of corporate finance, that shareholder will more easily be held liable when the company fails. Opportunistic behavior of which a shareholder-guaranteed creditor and thus indirectly the shareholder profited, such as lien feeding or early or late bankruptcy filing, may (further) substantiate a veil-piercing case.

Both German and Dutch law pay far less attention to shareholder guarantees in this context. In both systems shareholder liability towards creditors or the bankruptcy administrator is certainly possible, but often seems an afterthought to director liability.[1429] Simply put, under German law, if it can be shown that certain behavior of the debtor amounted to a one-sided pursuit of the shareholder of his own interests, while insolvency was to be foreseen, the shareholder may be held liable for the damage to creditors of such behavior. The burden of proof is on the claimant. Indirect benefits through shareholder guarantees present a difficult case in this context, as it will be much harder to show that such indirect benefits were the result of one-sided self-interested behavior.[1430] Many insider benefits of the shareholder are however already captured by the particularly strict German rules on payments on (indirect) shareholder loans. Therefore there is generally less necessity for a tort liability system. Under specific circumstances it is however possible that certain transfers escape transaction avoidance rules for technical reasons, in which case a fallback system that has sensitivity to the dynamics created by guarantees should be in place.

Under Dutch law a shareholder can be held liable by creditors or the bankruptcy administrator on the theory of draining value from the estate. Concerning a shareholder that indirectly profits from payments made on a loan guaranteed by him, the creditor prejudiced by this will at least have to show that the shareholder should have seriously taken bankruptcy and the possibility of a shortfall in that bankruptcy of the company into account at the moment of receiving the indirect benefit. Even that may however not prove sufficient, as case law on such indirect benefits in this context is currently absent. The indirect benefit may not always be qualified as a

[1428] See extensively chapter 4, paragraph 4.2.4.
[1429] Except in the case of the applicability of the *Konzernrecht* under German law, as discussed in chapter 6 paragraph 4.1.1. That however applies to a small amount of cases, in which the controlled company is a public company.
[1430] See extensively chapter 6, paragraph 4.2.2.

distribution. The objective fact that a guarantee by a shareholder plays an important role in the dynamics, is not articulated as such.[1431]

5.2.4 Recourse to the guaranteed lender

Dutch[1432], German[1433] and US[1434] law provide very little regarding recourse to the guaranteed lender for opportunistic behavior of the debtor such as lien feeding and inefficient bankruptcy filing that has benefitted that lender. Only in particularly extreme cases, in which lenders took almost complete control of the debtor, recourse to the lender may be possible. Neither of the systems provides clear causes of actions against the lender in the case of subtle and opaque forms of control through guarantees of shareholders or directors of the principal debtor.

5.3 Conclusions on the optimal approach to covert insider dealing through guarantees

Of the three systems, US law offers the best approach to the problem of covert insider dealing incentivized by guarantees and Dutch law the worst. US law however also needs amendment on various points to more adequately address the problems.

US preference law has a very broad scope and can comparatively most easily be applied to subtle and indirect forms of preferential behavior of the debtor. The US preference system also features many objective elements that are relatively easy to apply. Although the US system in principle has a broad scope, it can probably be undermined by contractual waivers. The German system cannot be undermined in such a way, but is too narrowly focussed on shareholder guarantees. Both systems moreover only allow recovery from the guarantor,[1435] which has serious downsides. Easy recovery from the creditor, who often has deeper pockets, should be allowed for as well. Such a possibility has little downsides as long as recourse is limited to the amount by which exposure under the guarantee was diminished by the payment. The guaranteed creditor can, having repaid the bankruptcy administrator, turn to the guarantor. As such, the most important efficient function of the guarantee (preventing opportunistic behavior of the guarantor) is still upheld. This at the same time incentivizes the creditor to be more prudent in taking guarantees, making sure the guarantor does not become overburdened. Because overburdening guarantees are associated with various inefficiencies,[1436] this side-effect further supports efficient outcomes.

The remaining problem is that small guarantees can lead to large preferential payments to the creditor. This problem is however hard to address with preference law. If avoidance of the large transfer is indeed made easier because of the guarantee, creditors will be deterred in taking otherwise efficient guarantees because the guarantee would bring transfers that are normally

[1431] See extensively chapter 4, paragraph 4.2.3.
[1432] See chapter 4, paragraph 4.2.5.
[1433] See chapter 6, paragraph 4.2.4.
[1434] See chapter 5, paragraph 4.2.3.
[1435] At least when the specific system for indirect preferences is used. General preference law would of course allow recovery from the creditor as well, but the insider guarantee, which often gave incentive for the payment, is not considered an important factor in that context.
[1436] (see chapter 3, paragraph 2)

safe from preference attacks into suspected territory, whilst the fact that the guarantee was only for a small amount makes recourse to the guarantor (after paying back the bankruptcy administrator) illusory. This would also incentivize creditors to take larger rather than smaller guarantees, which is the wrong incentive. Therefore easy recovery from the creditor that has received payments that have reduced the exposure of an insider guarantor should be allowed, but only up to the amount that the exposure of the guarantor was reduced by. This makes sure the creditor can turn to the guarantor, which means the guarantee does generally not weaken the position of the creditor under preference law. Moreover, in order to protect the creditor from preference attacks, a safe harbour could apply to the creditor, for example if the creditor can prove that the payment was not unusual.

The advised rule would thus be strongly influenced by US preference law, but with some adjustments. Like in US preference law the rule should extend to all direct and indirect transfers of value. Moreover, like in US preference law, a one-year period should apply in which all direct or indirect transfers to insider guarantors are considered suspect. Other than under US law, the application of preference law should not hinge on the contingent creditor status of the insider guarantor. Also indirect transfers to a guarantor with no recourse claim on the debtor should be included. Other than under current US law, but in line with older US case law (which was amended by Congress after bank lobbying), the long suspect period of one year (the period is 3 months for normal transfers) should also apply in relation to the guaranteed creditor, though recourse to that creditor should be limited to the amount by which the exposure of the guarantor was reduced. Lastly a safe harbour could apply to the creditor in order to protect the creditor from preference attacks. As long as the creditor can prove the transfer (and incurrence of the debt) was in the ordinary course of business, a safe harbour from preference attacks is not problematic. Such a safe harbour should not extend to the insider guarantor in as far as the guarantee was not issued at arm's length. Most insider guarantees are not at arm's length (unrelated persons or entities would not issue such guarantees).

German law and to a lesser extent Dutch law lean heavily on director liability law when things go sour. However in the context of corporate finance it is often the shareholder that guarantees corporate debts. Usually only the shareholder is willing to take such contractual liability risks, as the shareholder is also the one that benefits most from profits of the company. It will often be the shareholder that indirectly benefits from preferential payments or more subtle preferential behavior on the eve of bankruptcy. Holding the directors primarily liable (if at all) for such behavior of the principal debtor is not advisable and may make directors overly anxious. It is the shareholder that set up the opaque priority structure and the shareholder that indirectly benefits from preferential treatment of the guaranteed creditor. Of course, especially in the small business setting the shareholder and the director will often be the same person, in which case the shareholder is automatically also targeted by director liability law. It would however be more precise to target the shareholder directly, as shareholder and director may also be different persons or entities.

In director liability cases, guarantees should play an important role especially if it was the director him- or herself that (indirectly) profited from certain behavior of the debtor in the period before bankruptcy. Preference law should in principle also be formulated in such a way to encompass such indirect wealth transfers. Preference law should however primarily work with objective and easy to apply factors. Cases that fall outside preference law for technical reasons, for example because they were just before the suspect period, could be targeted with more open director liability norms. When filling in such norms, the fact that a director himself indirectly profited from certain transactions should play an important role.

The same applies to shareholder liability cases. Shareholders that indirectly profit from certain behavior should more easily be held liable. US shareholder liability law comparatively has the most attention to shareholder guarantees in veil-piercing cases. Guarantees given by shareholders are often mentioned as a factor in veil-piercing cases.

All three legal systems lack a well-developed system for holding the lender liable on the basis of tort law for preferential treatment of that lender that was induced by the control that a lender often has over a principal debtor through shareholder or director guarantees. Insider guarantors (especially wealthier shareholders) can be strong parties and repeat players, but may also be weak parties that are not able to properly oversee the consequences of certain dynamics.[1437] Legal systems should have clear attention to the evasive problem of lenders using such weak guarantors as marionets for their cause. However, using lender tort liability may not be the best approach here in light of the efficient functions of the guarantee. Insider preferences should be strongly policed but taking guarantees should not be unnecessarily deterred. A lender that is faced by potential tort claims may be deterred in taking otherwise efficient guarantees. Therefore, far-reaching application of preference law offers a better approach towards the lender.

6 Conclusion

In order to answer the question '*How should opportunistic use of the guarantee relationship in the context of corporate finance be regulated?'*, this chapter has compared the approaches of Dutch, US and German law and synthesized the insights gained from the analysis of those approaches with the insights from the economic perspective in chapters 2 and 3, which has led to the formulation of ideal approaches to the problems identified. In order to avoid duplication, reference is made to the 'conclusion & recommendations' of this book for a full summary of the insights gained and recommendations made in this chapter.

[1437] See chapter 3, paragraph 2