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Insider guarantees in corporate finance

An economic analysis of Dutch, US and German law

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Conclusion & recommendations

This thesis aims to fundamentally impact the debate on guarantees in corporate finance. Distributional concerns in relation to weak guarantors have been brought forward in the literature and have in some legal systems been addressed by legislation or case law protecting the weak guarantor to some extent, whereas the efficiency of the guarantee relationship in corporate finance has often been assumed, which may also have held back addressing distributional concerns. This thesis has thoroughly reviewed both the efficient functions and the opportunistic uses of the guarantee relationship and has compared Dutch, German and US law on the regulation of opportunistic use of the guarantee relationship in corporate finance. The main question answered is: *How should opportunistic use of the guarantee relationship in the context of corporate finance be regulated?*

This question has been approached using a method of comparative law and economics.¹⁴³⁸ Economic analysis has been used to identify the dynamics involved in the guarantee relationship and to formulate both the beneficial functions and the problems from an efficiency perspective. This economic analysis has served as the basis for the analysis of Dutch, US and German law in relation to the problems identified. This approach has proven to be fruitful. By using economic analysis as a basis, the comparison between Dutch, US and German law has had a clear focus and both the different approaches and the benefits and shortcomings of those approaches have been exposed.¹⁴³⁹

The economic analysis in chapter 2 has shown that the guarantee relationship in the context of corporate finance can indeed often lead to efficiency gains. Those gains can however usually not be ascribed to the relatively uncontroversial functions of specialization in risk bearing, specialization in monitoring or signaling credit quality. The guarantee relationship in corporate finance instead 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.

After discussing the possibly beneficial functions of the guarantee relationship in corporate finance in chapter 2, chapter 3 has focused on possible opportunistic use of the guarantee relationship, first by analyzing opportunistic use towards insiders to the guarantee relationship, then by discussing externalities towards outsiders. Especially the analysis of externalities towards outsiders has broken new ground, as such a comprehensive analysis of the economic effects on outsiders did not yet exist.

The analysis of opportunism towards insiders, most notably a weak guarantor, has shown that such opportunistic use is distributionally suspect, also in the context of corporate finance.

¹⁴³⁸ See for an extensive explanation and defense of the use of this method chapter 1.

¹⁴³⁹ See extensively Chapter 7.

Moreover, opportunistic use towards insiders can also lead to various inefficiencies, including overly cautious business decisions and high bankruptcy costs in case the guarantee is triggered.

The discussion of such opportunistic use under Dutch,¹⁴⁴⁰ German¹⁴⁴¹ and US law¹⁴⁴² has shown that these systems offer too little protection to guarantors in the context of corporate finance. Dutch and German law do have some instruments to protect weak guarantors but these instruments usually do not apply when a business owner guarantees corporate debts. The efficiency analysis has however shown that such protection is warranted and also would do little harm to the core efficient function of guarantees as guarding against moral hazard.

This leads to the following key recommendations:

Recommendation 1: police all guarantees by natural persons on the substance by reducing the liability of the guarantor under the guarantee in case of disproportionality between the amount of the guarantee and the wealth of the guarantor, particularly also in the context of corporate finance.

Recommendation 2: implement an information duty of the creditor towards all guarantors who are natural persons, which should include the duty to inform the guarantor of the risks involved in guaranteeing the particular debt in that instance, particularly also in the context of corporate finance. This duty to warn and inform should extend to the spouse of the guarantor.

After discussing and evaluating opportunistic use of the guarantee relationship towards the guarantor, the analysis in chapter 3, paragraph 3 has focused on opportunistic use towards outsiders to the guarantee relationship. There is relatively little prior research on such opportunistic use of guarantees in corporate finance towards outsiders.

The analysis of the externalities created by guarantees in the context of corporate finance has shown that guarantees, combined with incorporation, can create an opaque priority structure, or in other words lead to 'structural seniority'. The structural seniority that the guaranteed creditor receives 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). The analysis in chapters 2 and 3 has shown that, although guarantees in corporate finance may under circumstances lead to efficient results, deficiency double proof and strong form double proof (the second and third element referred to above) cannot be justified from an economic perspective. The first element of priority referred to above, which comprises the simple fact that the guaranteed creditor can claim from two entities, has been analysed from the perspective of both the literature on the justification of limited liability and the literature on the justification of security rights in general. This analysis concluded that even this element of priority is hard to justify. This has led to the conclusion that the externalities created by guarantees in corporate finance as opaque priority structures should be addressed effectively,

¹⁴⁴⁰ Chapter 4, paragraph 3

¹⁴⁴¹ Chapter 5, paragraph 3

¹⁴⁴² Chapter 6, paragraph 3

whilst ideally not undermining the core efficient function of the guarantee in the corporate finance context as a bonding device.¹⁴⁴³

With the help of a comparison between Dutch, German and US law the optimal technique to address opaque priority structures has been discussed in chapter 7 paragraph 4. The analysis recognized the following regulatory techniques as to some extent able to address opaque priority structures with guarantees: (1) subordinating shareholder guaranteed loans; (2) allow for easier veil-piercing or substantive consolidation when shareholder guarantees are in place; (3) allow for relatively easy transaction avoidance claims against guarantees issued by shareholders; (4) limit double proof. These techniques have distinguishable effects, as further explained below. Limiting double proof is generally the preferable technique, though the other techniques should be used supplementary according to the applicable setting. Dutch, US and German law however do not apply this technique. US law does comparatively have the most attention to opaque priority structures created by incorporation combined with piercing guarantees, as shown by the fact that shareholder guarantees are often considered a factor in veil-piercing cases and by the relatively extensive case law on avoidance of guarantees as fraudulent transfers.

Although subordinating shareholder-guaranteed claims may be warranted in its own right from the perspective of the dynamics involved in shareholder loans (which dynamics have only been discussed concisely in this book¹⁴⁴⁴), it is not an ideal technique to address inefficient effects associated with opaque priority structures created by a combination of incorporation and piercing guarantees because it has a limited effect on such priority structures. At the level of the debtor such a rule would essentially entail that strong form double proof is not allowed, but only deficiency double proof is allowed (if the shareholder does not offer recourse, the claim can be submitted to the debtor). 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. To the opposite, it increases the pressure on the guarantor. In as far as shareholder loans are subordinated, the legal system in place should also scrutinize indirect shareholder loans consisting of a guarantee by a shareholder to an external lender, as such constructions present largely the same problems as direct shareholder loans.¹⁴⁴⁵

Allowing for easy transaction avoidance against guarantees by shareholders is also not an ideal remedy to opaque priority structures, 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. Avoidance also annuls the security function of the guarantee relationship and therefore also the associated beneficial effect of the guarantee relationship of addressing moral hazard. For that reason courts are also likely to (and should) only allow avoidance sparingly. Important to keep in mind is that avoidance of the guarantee can also affect the possibly efficient functions of the guarantee, as discussed in chapter 2. 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 (see further below).

¹⁴⁴³ See chapter 2, paragraph 3

¹⁴⁴⁴ See chapter 3, paragraph 3.1.5

¹⁴⁴⁵ See chapter 3, paragraph 3.1.5

Allowing for easier veil-piercing or substantive consolidation when guarantees by shareholders are in place suffers from the same weaknesses, actually to an even stronger extent, as an approach to opaque priority structures. Although veil-piercing and substantive consolidation would effectively address the opaque priority structure created by a guarantee relationship, these remedies would do much more. Veil-piercing and substantive consolidation are far-reaching measures that have much wider effects than just undoing the opaque priority structure created by a 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. Therefore these measures are only warranted when those further-reaching effects are also warranted, which would apply in a select number of cases only. Courts should use these measures sparingly. Guarantees by shareholders or by group companies should certainly be an important factor in such cases, but certainly by far not the only factor.

In the bulk of the cases in which opaque priority structures have been set up using guarantees, both veil-piercing (or substantive consolidation) and avoidance of the guarantee itself are probably not warranted because of the far-reaching side effects. 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 credit-worthiness 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.

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. 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. 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 function of the guarantee remains 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 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.

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 priority rights discussed that such priority can still be problematic, 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 to only treat such priority with suspicion under aggravating circumstances, such as bad record-keeping or other deceptive or misleading behaviour. In such cases an open norm could be applied that allows courts to take either of the following remedies. The most subsidiary remedy 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 for addressing opaque priority structures with guarantees include annulling the guarantee or annulling limited liability, but these have, as noted above, much wider-ranging effects that are not always warranted. In any case, the existence of the guarantee could and should play an important role in such veil-piercing and consolidation cases, thus supplementing the advised rules on double proof, which may be necessary under particularly aggravating circumstances.

This leads to the following key recommendations:

Recommendation 3a: rule out strong form double proof with guarantees.

Recommendation 3b: limit deficiency double proof to cases in which there is no correlation between the fate of guarantor and debtor (or simpler: to cases where guarantor and debtor are not related parties). In cases where debtor and guarantor are related, a rule of single proof should apply. A rule of 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. In order to leave the efficient functions of guarantees intact, the creditor should get the choice how to allocate the burden over the co-debtors.

Recommendation 4: consider guarantees by shareholders as an important but not the only factor in transaction avoidance cases against the guarantee itself, veil-piercing cases and substantive consolidation cases, especially when the correlation between the fate of the guarantor and the fate of the debtor is high.

Recommendation 5: in as far as shareholder loans are subordinated, the legal system in place should also scrutinize indirect shareholder loans consisting of a guarantee by a shareholder to an external lender.

After discussing and evaluating the externalities created by the guarantee combined with incorporation as an opaque priority structure, the externalities of the guarantee as a vehicle for covert insider dealing have been discussed in chapter 3, paragraph 3.2. The focus here is not on the guarantee itself as giving priority, but on the incentives that a guarantee can create to prefer the guaranteed creditor above others.

Because of the guarantee relationship the guarantor and debtor are likely to succumb to the creditor's interests. The guaranteed creditor could for example use 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. 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.

Such indirect payments to insiders, who often have an information advantage compared to other creditors, do not only lead to redistribution of wealth towards stronger creditors but are 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. 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. Payments on insider-guaranteed loans in the twilight zone should thus be policed strictly.

Transaction avoidance law (or more specifically: preference law) can to some extent address these problems if the rules are sufficiently sensitive to these dynamics. The optimal rule would 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 under US preference law, a one-year period should apply in which all direct or indirect transfers to insider guarantors are considered suspect. Other than in US law the application of preference law should not hinge on 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 in 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 creditor, though recourse to that creditor should be limited to the amount by which the exposure of the guarantor was reduced. Lastly, like under US law, a safe harbor 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 harbor from preference attacks is not problematic. Such a safe harbor should not extend to the insider guarantor 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. In the context of corporate finance it is however especially 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 badly informed 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. 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 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, as was discussed above. 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 took place just before the suspect period, could be targeted with more open director liability norms. When filling in such norms, the fact that a director him- or herself 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 arguably has the most attention for shareholder guarantees in veil-piercing cases. Guarantees given by shareholders are often mentioned as a factor in veil-piercing cases.

It should be noted that it is more common for shareholders to guarantee debts of a corporation than it is for directors. In liability cases, attention should therefore often focus on the shareholder that, through diminished exposure under the guarantee, indirectly profits from certain behavior of the debtor, not on the director that has not profited, even though the director is often more directly responsible for the behavior of the corporation. Holding the director that has not profited liable is a much stronger penalty than forcing the shareholder to repay the unduly received indirect preferences.

This leads to the following key recommendations:

Recommendation 6: all payments by the debtor, understood broadly and in any case also encompassing any value transferred or security given to a creditor, on insider-guaranteed loans in at least the year before insolvency should be easily avoidable with transaction avoidance law, without further conditions. The bankruptcy administrator should be able to choose to either claim from the creditor or from the insider guarantor that indirectly profited, in both cases up to the amount that the insider guarantor profited. A safe harbour can extend to the creditor and insider guarantor, in as far as they can prove the transfer and incurrence of the debt were in the ordinary course of business, which will generally not apply to the insider guarantor.

Recommendation 7: the circumstance that a director or shareholder has guaranteed debts of the debtor and has, through diminished exposure under the guarantee, profited from certain behavior of the debtor, should be an important factor contributing to a successful liability claim on a director or shareholder for damage incurred by creditors because of preferential payments or related behavior by the debtor in the period before insolvency. If shareholder and director are different entities or persons, attention should focus on who profited from the behaviour of the debtor by diminished exposure under a guarantee.

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