TRANSACTIONS WITH CREDITORS

Creditors rely upon certain assets of the corporation but only shareholders have control over them.

Creditors’ exposure is structurally different from that of shareholders. While shareholders enjoy the upside of corporate success but are shielded by limited liability, creditors bear downside risk and must rely on the integrity of the asset pool available to satisfy their claims.

Creditors protection is available in all jurisdictions

Creditors are: banks, bondholders and anyone who accepts a claim on corporate cash flows in exchange of good

dual role of creditors

- ordinarily, contractual counterparties
- default, entitled to seize assets + become owner of the firm

This dual role becomes especially salient at the moment of default: creditors shift from mere contractual counterparties to holders of property-like rights, potentially acquiring control over the firm’s assets once insolvency is triggered.

Whenever the corporation defaults agency conflicts could arise:

(i) Shareholders vs. Creditors

(ii) Creditors vs. Creditors

Protection of creditors requires coordination among them

The debt finance has changed over the years: no longer banks but market!

Accordingly the increase of coordination costs requires a different legal strategy to protect multiple uncoordinated creditors (investors)

The shift from bank-centered finance to dispersed bondholding has dramatically increased coordination costs. As creditors become numerous and heterogeneous, the risk of opportunistic behavior—both by shareholders and by other creditors—intensifies, requiring more sophisticated legal strategies.

ASSETS PARTITIONING

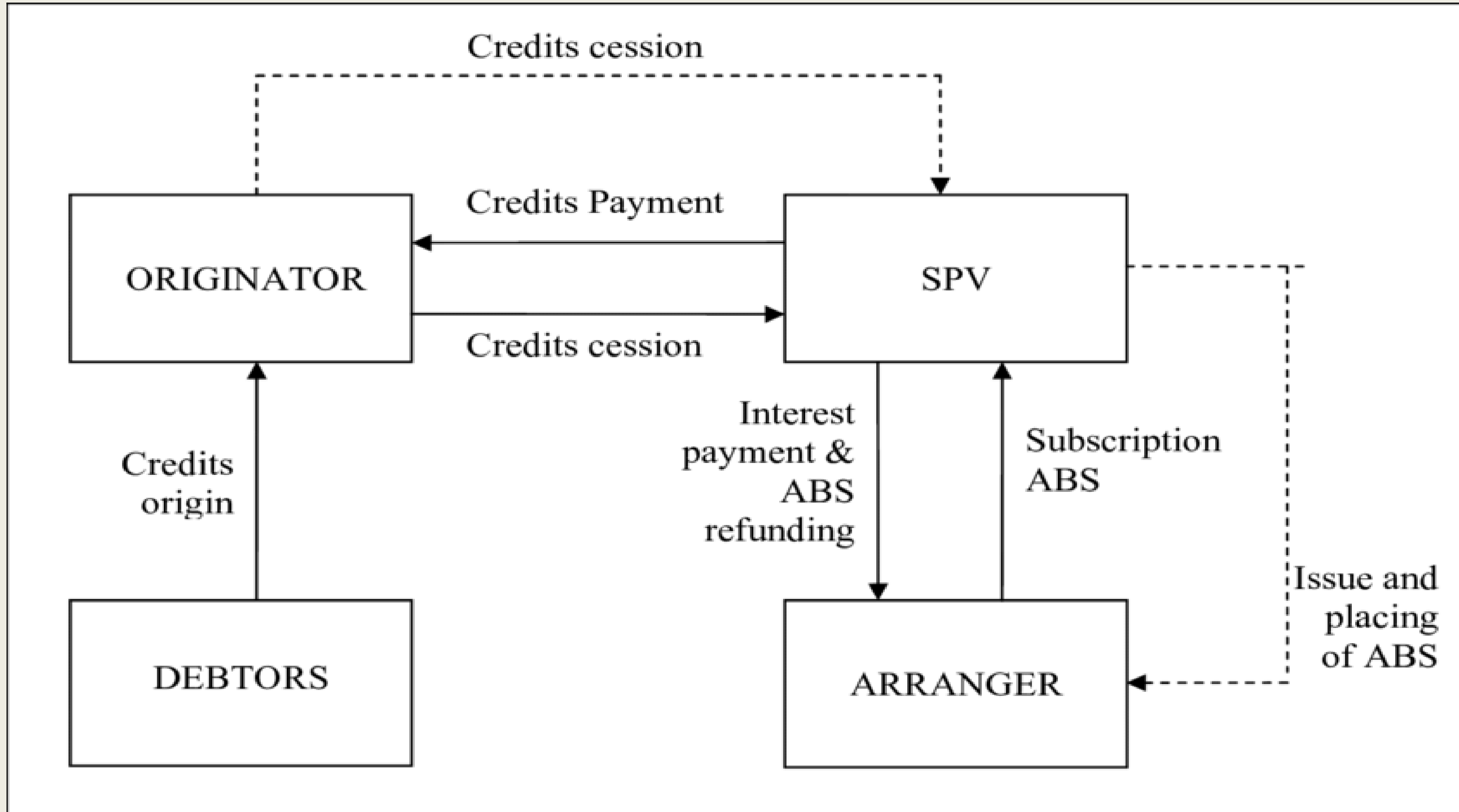
The strategy of assets partitioning allows a corporation to insulate a separate line of business or new venture, though facilitating the monitoring activity by specialized creditors

Asset partitioning operates through "entity shielding," which protects corporate assets from claims on shareholders' personal assets, and "owner shielding," which protects shareholders from corporate liabilities. Together, these features reduce monitoring costs for creditors and enable firms to undertake diversified activities under a single corporate umbrella.

Accordingly such strategy has the effect to reduce the cost of financing the corporation

Whenever creditors are granted right of recourse (so called *credit enhancement*) they have lower incentives to monitor the corporate assets pooled away by their debtor

A usual case of assets partitioning: securitization and asset backed securities (ABS)



SHAREHOLDERS vs. CREDITORS AGENCY PROBLEMS

As contractual counterparts :

- Ex ante assets misrepresentation. Misrepresentation may occur through selective disclosure of the firm's financial condition or by overstating the value of assets that are in fact encumbered or of poor quality. This creates an adverse selection problem for creditors.
- Ex post- alter risk

❖ Assets dilution: assets dilution can harm creditors by reducing the company's assets available to satisfy claims, while asset-based lenders use collateral to protect their specific claims from being diluted

❖ Assets substitution: Assets substitution arises when shareholders induce managers to replace low-risk assets with high-risk ones because the upside accrues to equity while the downside is disproportionately borne by creditors.

❖ Debt dilution: Debt dilution occurs when the firm issues additional debt of equal or higher priority, reducing the expected recovery for existing creditors without their consent.

- Managerial risk aversion depends upon the stakes directors/managers have on the firm! Managers of high-leverage firms may have incentives aligned with shareholders to take excessive risks, particularly when their compensation is tied to equity value rather than firm solvency.

- debt COVENANTS = to protect overall value of the firm and so the creditors. Covenants can restrict asset sales, new borrowings, dividend payments, or investment choices. However, overuse of covenants may hinder efficient firm behavior and requires costly monitoring.

- SECURITY on corporate assets

- corporate law largely denies regulation of transactions with creditors

- Most jurisdictions prefer market-based and contractual mechanisms because legal rules risk being either excessively rigid or too easily manipulated, given the heterogeneity of creditor interests.

- Reasons for reliance on <u>contractual</u> protection rather than legal:

    1) Risk of overkill (balance between incentives of shareholders and creditors can vary upon the model of business)

    2) Heterogeneous interests of creditors

    3) Ease of renegotiation creditors' protection

VICINITY OF INSOLVENCY

- Incentives for shareholders/managers to engage in risky transactions increase whenever the firm's future in doubt As insolvency approaches, equity holders have little to lose but potentially much to gain from high-risk strategies—this is the classic "gambling for resurrection" problem.

- legal restrictions are appropriate in this context

- managers compelled by law to act in the interest of creditors. Many jurisdictions impose intensified duties on directors during financial distress, shifting their focus from shareholder wealth maximization to preservation of firm value for the benefit of creditors.

- rules extended to controlling shareholders (liabilities: shadow- de facto directors, equitable subordination, piercing the corporate veil).These doctrines reflect the idea that controlling shareholders may effectively behave as shadow directors and should therefore bear responsibility when they induce detrimental transactions.

- Managers have to monitor the overall situation, starting to act in the main interest of creditors, directors should start an early restructuring (in order to protect the going concern) or a bankruptcy proceedings

- creditors may trigger bankruptcy proceedings

- Gatekeepers have a fundamental role during time of distress

GROUPS

Controlling shareholders may enter into intra-group transaction to undermine creditors' position

Disclosure of the existence of the group is beneficial to creditors

Intra-group transactions can obscure the real financial position of subsidiaries and may be used to extract value away from creditor-relevant asset pools, especially via transfer pricing, upstream guarantees, or inter-company loans.

NON-ADJUSTING CREDITORS

Definition: creditors unable to adjust the terms of their exposure to reflect the risk they bear (i.e. victims of corporate torts, state)

- shareholders can minimise risks (under capitalization + shifting assets out of risky operation company)

- Non-adjusting creditors need special protection
    - *priority over other creditors*
    - *mandatory insurance*
    - *liability of shareholders (this is the case in Brazil)*

CREDITORS COORDINATION

- individual enforcement vs. collective enforcement

- each creditor has an incentive to enforce his claim individually. This creates a collective action problem: individual enforcement depletes the asset base and reduces the overall recovery for the creditor class as a whole.

- risk of preferential treatment of creditors

- bankruptcy laws provide for the equal treatment of creditors (*par condicio creditorum*)

- from individual rights of attachment to a collective process aimed to the allocation of corporate' s assets among creditors

- restructuring vs. liquidation (early restructuring must be the first option). Restructuring preserves going-concern value, which is often higher than liquidation value. Many modern insolvency systems encourage early filing to avoid value destruction

- the bankruptcy proceedings keep the 5 basic features of corporate form (but shareholders ownership is substituted by creditors ownership)

- laws provide a choice of different insolvency procedures: liquidation / reorganisation

- the legal provisions of insolvency proceedings reassure the creditors about the background against which they are negotiating

- some creditors cannot agree a bankruptcy proceedings at expenses of other creditors

- insolvency proceedings have binding effects for all the creditors

Binding effects prevent opportunistic creditors from opting out of collective procedures and ensure an equitable distribution based on a standardized ranking of claims.