DISTRESSED FIRMS AND CREDITORS' PROTECTION

Distressed corporation = whenever the assets become insufficient to pay creditors

Distress typically emerges before formal insolvency, during a phase in which the firm's assets are still positive but insufficient to satisfy all creditors in full. This "transition period" increases the risk of shareholder opportunism and therefore justifies the early deployment of governance strategies focused on creditor protection.

Creditors are now bearing the risks of the business but without having control or ownership

In bankruptcy creditors receive appointment (crisis manager) and decision rights (plan)

Standard and trusteeship strategies could offer further protection for creditors before and during a bankruptcy proceedings

1. Transition into bankruptcy: conflict shareholders/creditors. The transition into bankruptcy marks a shift from shareholder–creditor conflicts to creditor–creditor conflicts. During this stage, creditor coordination becomes fundamental to avoid inefficient liquidation or value-destructive delay.
2. Bankruptcy: conflict creditor/creditor

Protection of creditors to be sought well in advance through debt structure and renegotiation

A) STANDARD STRATEGIES

- Ex post standard strategies: duties of (i) directors, (ii) controlling shareholders and (iii) favored creditors of distressed firms

A1) v. Directors liability

- Personal liability for negligence/fraud when company is insolvent or nearly insolvent for the net increases in losses to creditors

- Shadow and de facto directors are exposed to like liability

- content of the duty of directors
  - less onerous standard=fraud /knowledge of likely harm
  - more intensive standard=negligently worsening the financial position of a distressed firm
- trigger for duty's imposition
  - greater degree of distress = low intensity (any director can realize the existence of such duty)
  - smaller degree of distress = high intensity (director can be uncertain)

- enforcement
    - by individual creditors = facilitated
    - by the company = not facilitated (usually need bankruptcy)

- directors incentive to pursue shareholders benefit at creditors expenses
    - closely held = high
    - publicly held = low

- key factor of standard strategy against directors is the ownership structure of the firms. The severity of directors' duties varies across jurisdictions. While U.S. law imposes only low-intensity standards—focusing primarily on loyalty to the corporation—most European jurisdictions adopt negligence-based liability triggered well before formal insolvency, reflecting their more concentrated ownership structures.

- US = lowest intensity standards (duty of loyalty is owed to corporation not to creditors)

- UK = like US duty of loyalty only owed to company + liability for “wrongful trading” if directors fail to take reasonable care to protect creditors when the company is insolvent: duty enforceable by liquidator only

- EU states = higher standards (because the more concentrated ownership structure!), negligence based - action to be taken following serious loss of capital

- Japan= duties to creditors are higher but not used apart for closely held corporations

- Brazil = duty of loyalty owed to the company even in the vicinity of insolvency

- PUBLIC ENFORCEMENT

  - directors disqualification (UK, after bankruptcy a public investigation starts)

  - criminal liability: for certain violation of statutory duties. Italy + Germany + France adopt strict rules to hit directors in case of worsening the financial situation

A2) SHAREHOLDERS LIABILITY

- only for controlling or managing shareholders found guilty of abusing of the corporate form

- 3 tools
    1) de facto or shadow directors
    2) equitable subordination
    3) piercing corporate veil
        - blunt tool
        - groups

Equitable subordination and veil piercing serve as corrective mechanisms when controlling shareholders extract private benefits at the expense of creditors. Although applied sparingly in most jurisdictions, these doctrines act as deterrents against opportunistic financing structures in the vicinity of insolvency.

- Law of groups

    Germany = parent company must indemnify its subsidiaries!

    France = equitable cooperation doctrine

- Shareholders' financing may be legitimate and desirable under a feasible restructuring plan

- piercing the corporate veil = disregarding the company's legal personality, used by jurisdictions only in extreme situations apart from Brazil where it is commonly used to protect non adjusting creditors

A3) CREDITORS AND OTHER THIRD PARTIES LIABILITY

a) - actio pauliana (EU-Brazil)/fraudulent conveyance (US-Japan)/undervalue transaction (UK)

- third parties become “gatekeepers”

- role of good faith

Whenever the company enters into disadvantageous transactions in the vicinity of insolvency and third party is aware of insolvency

Transactions concluded in the vicinity of insolvency are often scrutinized under avoidance rules, which allow courts to set aside preferential or undervalued transfers. A creditor’s good faith is crucial: protection is denied when the counterparty knew or should have known of the debtor’s financial distress.

The transaction is set aside

b) insider creditors (banks)

When a creditor becomes involved in the management of the distressed company

c) preferential transactions

Whenever a creditor in bad faith is placed in better position than other creditors

B) GOVERNANCE STRATEGIES

B1) APPOINTMENT RIGHTS

- start of bankruptcy

- removal of board - replaced by administrators. In many jurisdictions, entering bankruptcy automatically displaces managerial authority, replacing the board with a crisis manager or administrator. However, systems differ as to whether the court, creditors, or the debtor retains the initiation right for reorganization procedures.

- supervision by the court or appointment rights granted to court

- reorganization or rescue proceedings: the model chapter 11, US bankruptcy code

- out-of-court pre-packs – workout agreements

B2) DECISION RIGHTS

- initiation and veto rights

- usually crisis manager has the power to initiate an exit from bankruptcy through sale or closure of the business and creditors have a veto right

- in France restructuring plan/or sale - closure of business is decided by the court and creditors have no veto rights

- inter creditors conflicts

- junior = opt for risky plan
- senior = opt for safe plan

Junior and senior creditors frequently diverge in their preferred restructuring outcomes. While senior creditors favor conservative solutions to preserve collateral value, junior creditors prefer high-risk strategies that might restore equity value. Modern bankruptcy systems therefore allocate veto rights only to residual claimants whose interests are most aligned with firm value maximization.

- Jurisdictions allow a *say* only for those creditors who are residual claimants

- the pre-packaged proceedings should offer a better deal for creditors than a formal bankruptcy

B3) INCENTIVE STRATEGIES

- only trusteeship strategy, no reward strategy

- crisis manager as trustee in the interest of creditors

The trusteeship strategy remains central in bankruptcy: crisis managers (or courts) act as trustees of creditor interests by enforcing priority rules and preventing opportunistic transfers. Unlike reward strategies, which play a larger role in shareholder governance, creditor governance depends primarily on strict compliance with contractual and statutory priorities.

- courts principal trustee in France

- courts placed as supervisor in the insolvency proceedings

C) OWNERSHIP STRUCTURE AND CREDITORS PROTECTION

US-JAPAN = debtor friendly

UK-GERMANY = creditor friendly

Concentrated debt structures facilitate creditor coordination and enhance the effectiveness of governance strategies. By contrast, when debt is dispersed across bond markets, collective action problems arise, reducing creditors' ability to exercise meaningful control during distress.

REGULATORY OR CONTRACTUAL CONTROLS FOR SOLVENT FIRMS?

- Germany + Italy have standard terms: creditors oriented accounting principles and legal capital rules

- US made an opposite choice, (accounting left to players)

Germany = concentrated ownership and debt = ok

one size fits all mandatory standard rules

US = contrary

The divergence between the U.S. and European approaches reflects deeper institutional differences: Europe relies on mandatory, creditor-oriented standards due to concentrated ownership, whereas the U.S. favors contractual freedom because ownership is dispersed and markets play a stronger monitoring role.

- Patterns of share ownership are shifting in the core jurisdictions: fragmentation (Germany) and concentration (US)

These ownership shifts significantly affect creditor protection: in Germany, fragmented ownership increases coordination costs among shareholders, reducing their monitoring ability; in the U.S., the rise of institutional investors strengthens shareholder influence, potentially increasing shareholder–creditor agency conflicts.

- Much depends on the debt structure

A concentrated debt structure allows creditors to coordinate more easily and thus to exercise meaningful control in distress situations. Conversely, when debt is dispersed among many bondholders, governance strategies become less effective due to severe collective action problems.

- Credit crunch and capital market finance

The post-crisis(1) shift toward market-based finance has further fragmented creditors, weakening the effectiveness of traditional pro-creditor mechanisms and increasing the need for legal strategies that support coordination among diverse investor classes.

- Pro-creditors tools do not fit any longer when creditors are heterogeneous

Heterogeneity among creditors undermines the functioning of standard creditor-oriented tools such as covenants, priority rules, and legal capital requirements, because each class of creditors may prefer different restructuring paths and risk profiles.

(1)The 2009 financial crisis, triggered by the 2007-2008 subprime mortgage collapse in the U.S., led to a severe credit crunch where banks stopped lending due to massive losses on mortgage-backed securities, creating a freeze in credit markets, a global recession (the Great Recession), high unemployment, and government bailouts, fundamentally shifting financial regulation and economic policy worldwide.

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- The EU Capital Market Union Action Plan

https://ec.europa.eu/commission/presscorner/detail/en/ip_21_6251

The Capital Markets Union aims to deepen European capital markets, broadening access to non-bank finance. While this enhances funding opportunities, it also increases creditor dispersion, making coordination more difficult and pushing EU reforms toward mechanisms that facilitate collective restructuring and harmonized insolvency practices.

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Role of Bankruptcy Law

BL grants creditors governance powers to take on control over the firm

Private workouts are difficult if creditors are dispersed

- US = debtor friendly - chapter11 can be initiated by managers
- UK = creditor friendly = single creditor can enforce its security even against a distressed firm