Complicating the Comparative Taxonomy: The Dynamic Interaction of Creditors and Shareholders and its Impact on Corporate Governance

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ABSTRACT

Corporate governance literature often focuses on either equity-side or debt-side actors, taking one as a control variable to study the impact of variations in the characteristics of the other. This article considers how the interplay between the nature of debt and equity investments can be analysed through a theoretical framework to further understand differences in governance outcomes across jurisdictions. Therefore, it builds upon existing literature on controlling shareholders, financial intermediation, and creditor governance to analyse the mirroring setup between controlling and non-controlling shareholders on the equity side, as well as private and public lenders on the debt side. It studies the dynamic interaction of these characteristics across jurisdictions where different combinations of debt and equity prevail. It then evaluates how this framework can potently explain cross- and intra-jurisdictional variations in governance outcomes.
INTRODUCTION

The corporate governance legal scholarship is particularly abundant on two of three fundamental agency problems of corporate law, namely the relation between managers and shareholders, and between controlling and minority shareholders. The conflict between non-shareholders and shareholder constituencies has more recently been gaining traction, especially in relation to stakeholderism. Proponents of this movement argue that corporations should not strive for shareholder wealth maximisation but rather serve the interest of a wider array of stakeholders, such as employees, suppliers, and address environmental concerns. More importantly, for the purpose of this article, more attention is dedicated to the creditor agency problem, vis-à-vis both shareholders and managers (understood in the broad sense of directors and officers of the company).

Whilst it is seldom disputed that creditors play an outsized role in corporate governance once a company enters insolvency proceedings, there is an ongoing debate on the extent to which creditors steer their corporate debtors before insolvency proceedings have been started. Likewise, shareholders may...
retain a large influence even in insolvency proceedings. This article builds upon existing literature on controlling shareholders, financial intermediation, and creditor governance (Part II) to analyse the mirroring setup between controlling and non-controlling shareholders on the equity side, and private and public lenders on the debt side (Part III). It studies the dynamic interaction of these characteristics across jurisdictions where different combinations of debt and equity prevail (Part IV). Finally, it reaches the conclusion that this framework can, in many cases, potently explain cross- and intra-jurisdictional variations in governance outcomes (Part V).

**THE MIRRORING SETUP: AN ANALYTICAL FRAMEWORK AT THE CROSSROADS OF THREE LITERATURES**

Equity and debt stakes are fundamentally different and, as such, have often been analysed separately. Besides the explicit governance rights that equity holders may enjoy (e.g. voting or proposing amendments to the charter), equity and debt most saliently differ in the nature of the obligations they give rise to. Whilst creditors have a claim against debtors for a predetermined fixed amount, shareholders gain value from the stock’s appreciation and its dividends (the distribution of which is not a legal obligation). Moreover, in most jurisdictions, such an obligation cannot be incurred if it impairs the firm’s solvency. These two investment instruments attract various types of investors with different incentive structures.

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7 In some rare instances, debt claims can be indexed on profit, but this might lead to a recharacterization of the instrument as equity; see: Mark Roe and Frederick Tung, Bankruptcy and Corporate Reorganization, Legal and Financial Material (4th edn, West Academic 2016) 253.

8 For instance, under §500(a) of the California Corporations Code, the distribution must neither be higher than retained earnings nor render the firm insolvent. In France, the Commercial Code defines ‘distributable benefits’ based on the current financial year profit and distributions can be made from the firm’s reserves but must not render it insolvent (Code de commerce [C. com.] [Commercial Code] L.232-11); John Armour, Gerard Hertig, and Hideki Kanda, ‘Transaction with Creditors’ in Anatomy (n 1) 125.
This article hinges on two notorious subsets of the literature: with respect to equity, the concentration of ownership (I.A), or absence thereof and, in relation to debt, the distinction between private and public debt (I.B). Notwithstanding the usually separate analysis which is made of these forms of funding, they are generally both found within the same company due to the trade-off between the tax benefits of interest deductions and the cost of increased risks of bankruptcy.\(^9\)

This section also presents the strand of literature that engages with the agency problem that can arise from the coexistence of shareholders and debtholders on the company’s balance sheet (I.C). This article aims to study how these different literatures can dynamically interact to explain governance outcomes.

A. Traditional Account of the Concentration of Ownership

1. The Controlling/Non-Controlling Shareholder Distinction

In 2006, Ronald Gilson emphasised the rise to prominence of the distinction between controlling (‘CS’) and non-controlling shareholder (‘NCS’) firms and jurisdictions.\(^10\) For the purpose of this article, a CS may be defined as ‘one who owns or controls sufficient votes to effectively determine vote outcomes and influence corporate decision-making’.\(^11\) The widely accepted account of the concentration of ownership on the shareholder-managers agency problem is that a CS will be better able to exert influence over management.\(^12\) In contrast, shareholders are typically seen as ‘rationally apathetic’ in NCS jurisdictions.\(^13\) This is because the coordination costs of scattered shareholders, paired with an individually small interest in the company, gives NCSs limited incentive and

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\(^9\) Roe and Tung (n 7) 544-548.


\(^12\) Armour, Hertig, and Kanda (n 8) 128.

capacity to monitor management and affect the way the firm is run. Therefore, unaffected by the collective action problem, CSs can use their formal rights at a lower cost and higher efficiency than NCSs. Additionally, they often have an incentive to do so given their high stake in the company. Therefore, CSs can align managers’ behaviour with their personal preferences through methods such as decision and appointment rights, affiliation terms, agent constraints, and incentive alignment.

2. Relevancy of the Shareholder/Creditor Conundrum

The ways in which managers’ behaviours can be aligned with shareholders’ interests are relevant to this Article. This is because the more successful the alignment, the more likely managers are to be obedient to shareholders at the expense of creditors. This observation can be read in conjunction with the impact of ownership concentration on the efficiency of different corporate governance tools. For instance, decision rights are said to be less important in CS jurisdictions than in NCS jurisdictions, as CSs are already capable of exerting significant influence over directors through the appointment and dismissal of directors. This cross-reading of the literature instructs how the role of shareholders could interact differently with creditors, depending on the presence of a CS.

B. Traditional Account of Financial Intermediation

1. The Public/Private Debt Distinction

The financial intermediation literature relies on the distinction between public and private debt. In this Article, public debt refers to the corporate bonds which the public purchasable by the public in registered public offerings. Private

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15 Bebchuk and Hamdani (n 11) 1281.
16 Armour and others, ‘The Basic Governance Structure’ (n 3) 49.
17 Armour, Hertig, and Kanda (n 8) 112.
18 Bebchuk and Hamdani (n 11) 1292-94.
debt, on the other hand, is understood as including both bank loans and bonds privately placed with large institutional investors.\textsuperscript{20}

2. **The Governance of Public and Private Debt**

Private and public debt is, by definition, held by different investors. With this different typology comes a difference in the number of debt investors in every given transaction. In its simplest form, a bank loan often involves a bilateral relationship between a single bank and the debtor. For the largest funding needs, loans may be made by a syndicate, where various banks (rarely exceeding ten) pool their lending.\textsuperscript{21} Likewise, privately placed bonds are held by a limited number of institutional investors with large individual stakes.\textsuperscript{22} By contrast, holders of public bonds for a given issue are more numerous and can number as many as 100.\textsuperscript{23} The financial intermediation literature relies heavily on this difference in headcount to explain an array of debt governance consequences.

First, the fact that an individual bank has larger financial stakes in a company gives it a greater incentive to monitor the debtor.\textsuperscript{24} The idiosyncratic risk associated with large bank loans is difficult to diversify. This is because diversification requires a high number of uncorrelated investments of similar size.\textsuperscript{25} On the other hand, public bondholders generally have a relatively smaller stake in each given bond issue. By holding similar stakes across different sectors, they can also reduce the risk they bear vis-à-vis any single debtor.\textsuperscript{26} An investor who has diversified a firm’s idiosyncratic risk of failure does not have an incentive to invest in monitoring the firm.

\textsuperscript{20} Amihud, Garbade, and Kahan (n 19) 457.
\textsuperscript{21} Amihud, Garbade, and Kahan (n 19) 458. See also: Mark Campbell and Christoph Weaver, *Syndicated Lending: Practice and Documentation* (7th edn, Harriman House 2019) (a guide made by practitioners using mostly examples of syndicated loans with no more than 10 lenders).
\textsuperscript{22} Amihud, Garbade, and Kahan (n 19) 458.
\textsuperscript{23} ibid.
\textsuperscript{24} Amihud, Garbade, and Kahan (n 19) 459.
\textsuperscript{25} Amihud, Garbade, and Kahan (n 19) 461.
\textsuperscript{26} ibid.
Second, private debt is less liquid than public debt. In fact, the illiquidity of bank loans is the origin of a bank’s vulnerability to depositor runs.27 When issuing loans, banks develop specialised knowledge about their borrowers which potential purchasers do not have. This information asymmetry creates an adverse selection problem and drives the price of loans down on secondary markets.28 Scattered public bondholders can also more easily ‘exit’ an investment29 as they hold smaller claims which are traded on deep markets such as organised exchanges or well-developed over-the-counter networks.

Third, as Diamond argues, banks do not face collective action problems which affect dispersed bondholders.30 In his view, financial intermediation is more efficient because dispersed creditors would either have to duplicate monitoring costs or be subject to the free rider problem, whereby each creditor would not invest in monitoring and rely on the investment of other creditors.31 Bondholder dispersion makes it costlier for creditors to negotiate and enforce covenants.32 As a result, creditors may get fewer covenants, covering a narrower range of corporate actions or addressing them in a laxer way.33 One way to mitigate this collective action problem is through the appointment of a bond trustee tasked with representing the interests of scattered bondholders. Although trustees can help reduce coordination costs, this adds another layer of potential principal-agent preference misalignment.34 This Article focuses on the fact that it remains more difficult for public than private lenders to coordinate their action, even if the trustee regime of a given jurisdiction is efficient.

29 Amihud, Garbade, and Kahan (n 19) 461.
31 Diamond (n 30) 410 (‘If there are \( m \) outside security holders in a firm and it costs \( K>0 \) to monitor, the total cost of direct monitoring is \( m.K \). This will either imply a very large expenditure on monitoring or a free rider problem where no securityholder monitors because his share of the benefit is small’).
32 Diamond (n 30) 394-5.
33 Amihud, Garbade, and Kahan (n 19) 462-465.
34 ibid.
Fourth, banks have more political influence than scattered bondholders and can potentially obtain a more creditor-friendly legal framework. Banks, as an interest group, benefit from the same organisational hedge over bondholders as in the agency cost framework; it is easier and less costly for banks to organise in trade organisations and advocate for legal changes that would benefit them, especially where private debt is the dominant form of commercial funding.

3. The Mirroring Setup Between Creditors and Shareholders

This set-up presents an interesting mirror image of the CS-NCS dichotomy, as applied to debt investors. On one hand, private debt creditors and CSs have a high financial stake in the company, which gives them an incentive to monitor. On the other hand, public debt creditors and NCSs are rationally apathetic. The size of one group’s stake makes it more difficult to exit its investment, whilst the other has a comparatively liquid title. Public debt creditors and NCSs are subject to a collective action problem when it comes to defending their interests as a class of claims or interests, whilst private debt creditors and CSs are not numerous enough for this problem to arise to the same extent. The institutional setup also makes it potentially easier for private debt creditors and CSs to have influence over law- and rule-making processes. Although parallels have been drawn in the legal literature, it has scarcely been explored analytically, which this Article purports to do. Whilst this mirroring set-up has garnered little scholarly attention, the interaction between creditors and shareholders has been widely discussed. These insights help elucidate what the mirroring setup entails.

35 Armour, Hertig, and Kanda (n 8) 143 (‘This corresponded with an environment in which banks were fragmented, and consequently posed no real opposition to the passage of the “manager-friendly” bankruptcy code in 1978’). See also: Mark Roe, Strong managers, weak owners: The political roots of American corporate finance (Princeton University Press 1996).


37 Amihud, Garbade, and Kahan (n 19) 450-451 (noting that the collective action problem of dispersed bondholders is ‘familiar from the shareholder context’). An exception is Armour, Hertig, and Kanda (n 8) 129, which is acutely aware that financial intermediation and the concentration of ownership affect creditor governance. The present article seeks to organise this thinking into a cohesive and dynamic framework.

38 In 2002, an article analysed the US and UK bankruptcy regimes through this lens. Both statutes and legal scholarship have since then evolved in significant ways but there has been no comparable work in the last two decades. See: John Armour, Brian Cheffins, and
C. Traditional Account of the Creditor-Shareholder Agency Problem

1. Shareholder-Creditor: Interest (Mis)Alignment

Shareholders and creditors tend to share a common interest in the financial success of the company. Although the nature of the obligation the corporation owes them differs, both groups would rather hold a claim against or have an interest in a valuable entity. As such, both groups seek to avert a diversion of value by managers at their expense.39

However, the interests of these corporate constituencies differ in significant ways. Creditors will typically fear four types of behaviours by shareholders: (1) asset dilution whereby shareholders shift value away from the firm (for example through dividends); (2) asset substitution, as shareholders (who are residual claimants in bankruptcy) benefit from the upside of additional risks whilst the downside risk is borne by creditors; (3) debt dilution, whereby new debt is either senior or ranks pari passu with the prior lender’s debt, whose claim thereby loses value; and (4) underinvestment (or ‘debt overhang’) which consists of managers not making new investments with positive net asset value because their benefits would accrue to creditors.40

2. Creditor Protection and Governance Levers

a. Devices of Creditor Protection

Despite these risks, creditors are given limited attention in corporate law because they are deemed to hold the power to protect themselves via contractual solutions. In fact, private ordering might be more efficient than a one-size-fits-all


statutory rule, which would be difficult to calibrate. In principle, covenants are limited only by the bounds of law and the parties’ imagination. They cover various corporate actions and are classified into different typologies (e.g. negative and positive; financial and non-financial; maintenance and incurrence covenants). However, as mentioned above, this mode of protection is not used to the same extent by private and public debt creditors, which makes the distinction relevant to the analysis of the mirroring setup.

**b. The Active Role of Creditors in Corporate Governance**

More recent literature has also criticised the conventional wisdom that creditors only play a passive role in corporate governance consisting of evaluating the creditworthiness of potential borrowers, receiving fixed payments, and enforcing their rights when borrowers default. This author analogises covenants to ‘trip wires’, which are designed to be triggered well in advance of any financial distress. A covenant violation may be defined as an event of default, which will usually give the lender the right to accelerate the loan and ask for immediate payment. However, rather than resorting to this disruptive option, the lender may want to exert further influence over the borrower as the parties negotiate a waiver of default or a grace period.

As a result, this author posits that creditor influence extends beyond insolvency proceedings, into the ‘vicinity of insolvency’ and the solvent state. In fact, according to Tung, ‘private lender influence is a routine feature of corporate

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41 Armour, Hertig, and Kanda (n 8) 141.
43 The very fact that the firm has committed its free cash flows to debt repayment can also act as a constraint on managers behaviour. As it applies indifferently to private and public debt, this channel is less relevant to this article. See: Michael Jensen ‘Agency costs of free cash flow, corporate finance, and takeovers’ (1986) 76 The American Economic Review 323.
44 Triantis (n 6) 100; Baird and Rasmussen (n 1) 1215.
45 See: Tung (n 5).
46 Tung (n 5) 151; As repeat players in the commercial lending business, they could also suffer from the reputational harm of interfering in the firm’s affairs.
47 See: Armour and others (n 2) 114.
governance even absent financial distress’. 48 Financial literature also provides an empirical basis for these claims, showing that tripped covenants create a ‘mixed region’ in which debt holders play a significant role along with equity holders. 49

It is relevant to emphasise that this literature relies heavily on breach of covenants, which implies the need to negotiate those contractual provisions before monitoring their implementation. This can be read in conjunction with the distinction between public and private debt, according to which public lenders grant funding with fewer covenants, covering a narrower range of corporate actions and providing looser standards. 50 The intersection of these two bodies of literature implies that one can distinguish between ‘weak creditors’, whose contractual protections are weak due to the costs arising from collective action, and ‘strong creditors’, who have both the means and incentive to influence corporate governance, even before debtors become insolvent. This distinction further instructs the analytical interest of the mirroring setup. Thus, a cross-jurisdictional comparative analysis is helpful to analyse how these interactions play out. 51

**RESEARCH DESIGN**

A. The Problem

Similar to NCS and CS jurisdictions, there are jurisdictions in which corporate lending relies more heavily on private debt. One can, therefore, think of each jurisdiction’s positioning on a two-by-two matrix (cf. Table 1) with the degree of financial intermediation (i.e. whether corporations rely mostly on private or public debt) on one axis \((x)\) and the concentration of ownership dichotomy (i.e. whether it is a CS or NCS jurisdiction) on the other axis \((y)\). This yields a \((x, y)\) pairing for each jurisdiction. Combining the insights from the three strands of literature, one would therefore expect each of these jurisdictions to be

48 Tung (n 5) 115.
49 Nini, Smith, and Sufi (n 5) 1715.
50 Part I.B.
51 Part I.B.3.
impacted not only by their degree of ownership concentration or financial intermediation independently, but also by the interaction of these two factors.

*Private Debt; Noncontrolling Shareholders:* a jurisdiction with these coordinates on the matrix may be referred to as a ‘strong creditor, weak owners’ jurisdiction. In this setup, a dispersed body of shareholders is expected to be faced with private lenders, such as banks. If one relied exclusively on the scholarship focused on the shareholder-manager agency problem, then it could be inferred that managers are likely to enjoy greater leeway, lest the methods for mitigating shareholder-creditor agency cost prove effective. In any case, collective action issues make the defence of the dispersed shareholders’ shared interest costlier than it would be to a CS. However, when read in conjunction with works on creditor governance and financial intermediation, one may hypothesise that this free space left out by shareholders is filled by creditors rather than managerial slack. Creditors may attempt to exert influence on aspects of corporate governance more often associated with shareholders than bankers, such as the appointment and dismissals of directors outside of bankruptcy proceedings. However, since creditors only share the same interest as shareholders to a limited extent, this could mean that managers are led to make decisions favouring value-preservation strategies for bank creditors over the maximisation of shareholders wealth.52

The UK is a good, if not unique, example of this configuration.53 It has a low level of ownership concentration, as the top 3 investors represented only 37.4% of total shares of listed companies as of 2020.54 It also relies mostly on private debt with respect to corporate funding; as of 2017, bank loans as a percentage of GDP stood at 80% whilst bonds were at a mere 20% according to the OECD.55

52 Part I.C.1.
53 Armour, Cheffins, and Skeel (n 38).
54 Alejandra Medina, Adriana de la Cruz, and Yun Tang, ‘Corporate ownership and concentration’ OECD Corporate Governance Working Paper 27, 49.
Public Debt; Noncontrolling Shareholders: such a jurisdiction interestingly combines ‘weak creditors’ and ‘weak owners’. This configuration seems to be the most favourable to opportunist managers seeking to extract value from the firm for their own profit. Indeed, the ‘rationally apathetic’ scattered shareholders are less likely to provide a check on managerial abuses than a CS with a large stake in the company. This vacuum does not seem to be exploitable by public lenders. They are subject to the same lack of incentive to monitor and face a similar collective action hurdle in the defence of their common interest.

This configuration is epitomised by the US. This jurisdiction displays a low ownership concentration, where the top 3 investors owned a mere 34.2% of listed firms in 2020.\textsuperscript{56} Whilst the value of bank loans as a share of GDP was still higher than that of bonds, the proportional share of bond issuance to bank loans dwarfs that of other jurisdictions. The bond-to-bank-loans ratio was approximately 40% in the United States in 2017, which is to be contrasted with the 25% ratio in the UK.\textsuperscript{57}

Private Debt; Controlling Shareholders: in this ‘strong creditor, strong owner’ setup, one might expect a balance of power. The question raised by this configuration is whether the corporate governance levers of private lenders can act as a counterweight to the sway of CSs. Conversely, this article will further discuss the extent to which a CS might infringe upon what is seen as the creditor’s ‘turf’ during insolvency proceedings.

France offers a good example of this setup. In 2020, as much as 57.2% of listed firms were owned by the top three investors.\textsuperscript{58} Companies also rely quite heavily on bank lending, as bank loans amounted to 60% of the GDP whilst bonds only amounted to a little over 20% in 2017.\textsuperscript{59}

Public Debt; Controlling Shareholders: this ‘weak creditor, strong owner’ configuration is the friendliest to CSs. This combination of a passive creditor with a CS seemingly gives the latter more latitude to control the company and extract

\textsuperscript{56} Medina, de la Cruz, and Tang (n 54) 1208.
\textsuperscript{57} Antoun de Almeida and Tressel (n 55) 10.
\textsuperscript{58} Medina, de la Cruz, and Tang (n 54) 1206.
\textsuperscript{59} Antoun de Almeida and Tressel (n 55) 10.
value at the expense of the minority and creditors. This passive creditor setting seems to be the implicit assumption behind the studies of controlling shareholders which do not address the issue of creditor governance.

In terms of exemplifying jurisdictions, it seems that no single jurisdiction perfectly fits this ‘ideal type’. Consistent with this article’s thesis, this could potentially be explained by the fact that the agency cost of debt is higher when a controlling shareholder is in place. Nevertheless, it may be found at the margin in jurisdictions which fit other categories. In France, one can imagine a CS choosing to resort to debt capital markets rather than banks, although they are less developed and liquid than in the US. This might be incentivised by the governance power wielded by banks, since CSs might be willing to pay a premium to avoid the non-monetary governance costs associated with bank loans. In line with the idea of a ‘life cycle effect’ in choosing between public and private debt, mature and financially successful firms in CS jurisdictions may be better able to access unmonitored funding through debt capital markets. The lack of any major jurisdiction fitting this configuration shows that CSs are more unlikely to evolve in an environment where unmonitored debt is the most frequent source of funding. Therefore, the relevance of this setup seems limited for the purpose of this comparative endeavour. This is in contrast with how much importance it was implicitly attributed in the CS literature.

B. The Method

This article assesses how this mirroring setup dynamically functions across these three jurisdictions by looking at the different levers of alignment presented in The Anatomy of Corporate Law from a functional perspective. This means looking at whether creditors or shareholders have more control over what these methods seek to achieve (e.g. control of the functions of the board of

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directors). This article places emphasis on appointment and decision rights. This pragmatic and result-oriented method enables this analytical framework to shed new light on how the different control levers available to shareholders and creditors interact with each other. These levers involve dynamics which crystallise the interaction between ownership concentration and financial intermediation. As the relative role each actor is expected to play varies depending on the financial situation of the firm, this article will also distinguish three separate states: (1) solvency, where shareholders are expected to prevail in the governance of the corporation; (2) the vicinity of insolvency, where the role of creditor increases as the likelihood of insolvency does; and (3) insolvency, where creditors effectively become the owners of the corporation and, as a result, exert a higher degree of influence.

These characteristics of creditors and shareholders interact in different legal environments across jurisdictions. Therefore, it is fundamental to account for how public ordering may impact the behaviour and incentive of each actor. Furthermore, to ‘control’ statutory variations across jurisdictions, this comparative project can also be bolstered by looking at the dynamic interactions of shareholders and creditors within a given country. Each jurisdiction has so far been seen as an ideal type but, within the United States, some firms still have controlling shareholders and bank creditors. Indeed, a Senate Judiciary Committee Report was concerned with ‘the natural tendency of a debtor in distress to pacify large creditors […] at the expense of small and scattered public investors’ which aligns more with the UK paradigm.

**Table 1: The financial intermediation-ownership concentration matrix.**

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<th>Noncontrolling shareholders</th>
<th>Controlling Shareholder</th>
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<tr>
<td>Public debt</td>
<td>United States</td>
<td>[none]</td>
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64 See: In re Lionel Corp, 722 F.2d 1063 (2d Cir 1983) in Roe and Tung (n 7) 125 (emphasis added).
THE COMPARISON

A. Appointment Rights: Selection and Removal

Bebchuk and Hamdani have previously painted the picture of what the CS-NCS distinction entails for corporate governance. For instance, in CS jurisdictions control is perceived to be absolute. As a result, management’s fear of being ousted does not act as a bulwark against attempts by insiders to extract an amount of value which is not commensurate with their equity investment. On the other side of the mirroring setup, one would expect creditors to have a larger influence over the appointment and dismissal of those in charge of a bankrupt firm, as shareholders are only residual claimants of the firm. The taxonomy may however explain why creditors may exert influence over the board in a solvent state and shareholders may retain power in insolvency proceedings.

1. Solvency

In the US, the selection and removal of directors remains largely in the hands of shareholders when the firm is solvent, as provided by the statutory framework. This is not surprising considering the ‘weak creditor, weak owner’ configuration detailed above. Since the law defines a default setup and both constituencies are subject to a collective action problem, the constituency benefiting from the default rule is in control. It is noteworthy that even bank lenders rarely get board seats because of §16 of the Glass-Steagall Act, which provides for the separation of commerce and banking, prohibiting banks from getting equity stakes in commercial companies. Thus, even a bank creditor

<table>
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<th>Private debt</th>
<th>United Kingdom</th>
<th>France</th>
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65 Bebchuk and Hamdani (n 11).
66 Bebchuk and Hamdani (n 11)1282, 1285.
67 §16 of the Glass-Steagall Act was codified and is known as 12 USC § 24(Seventh); the Bank Holding Company Act (12 USC § 1843) also prohibits the affiliation with commercial companies which are not ‘closely related to’ the ‘business of banking’ (as
would not be able to get a seat on the basis of an equity stake and would have to exert pressure through its loan agreement.

In the UK, banking and commerce are not legally separated but prudential standards for banks have been interpreted as imposing ‘ring-fencing’ between these two domains.\(^6\) Therefore, the intervention of banks over the choice of managers in solvent companies is minimal too. The same dynamic is at play in France, where bank participation in commercial firms is not forbidden but \textit{de facto} uncommon.\(^6\)

In terms of the normative implications of these observations, it is unclear whether it is desirable that creditors obtain additional influence over a solvent firm. The Law and Economics approach advocates ‘shareholder supremacy’ on the assumption that shareholders have the best incentive structure to maximise firm value, and, therefore, value for all stakeholders.\(^7\) Indeed, as residual claimants, they stand to benefit the most from a marginal increase in firm value, whereas creditors have no incentive to increase it beyond the fixed value of their claim.\(^8\) Hence, despite the monitoring incentive of private debt creditors like banks, any argument for reforming the governance framework to grant them additional powers on solvent firms besides the contractual covenants focused on value-preservation seems inherently limited.

As an alternative to shareholder supremacy, stakeholderism focuses on the interests of a wider array of corporate constituencies, including creditors.\(^9\) However, it seems that its proponents have so far failed to suggest an alternative governance mechanism that would mitigate managerial shirking in the same way

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\(^8\) Easterbrook and Fischel (n 70) 404.

\(^9\) Bebchuk, Kastiel, and Tallarita (n 3) 103-106.
that shareholders do.\textsuperscript{73} Therefore, it would seem warranted that the legislative scale be tipped in favour of the dispersed shareholders of a solvent firm in the US and the UK, rather than give an advantage to bondholders and bank creditors, respectively. There is less of a rationale for this kind of intervention to protect French CSs, which makes the lack of a formal prohibition on equity investments unproblematic.

Hence, the involvement of banks in the management of a solvent firm is limited across these jurisdictions, even in the UK where ‘weak owners’ meet ‘strong creditors’ at least partially due to the legal framework. As demonstrated, the result of this analysis through the lens of this framework is consistent with the conventional Law and Economics approach to corporate governance. The framework is perhaps most informative when considering the blurred situation of firms which are nearing insolvency but have not yet entered formal proceedings.

\textbf{2. Vicinity of Insolvency}

As the debt governance literature makes clear, only private creditors such as banks negotiate the kind of covenant that enables creditors to leverage a breach by the borrower well ahead of actual insolvency, as the indentures negotiated by public creditors in the US usually include less or looser covenants.\textsuperscript{74} Therefore, the vicinity of insolvency does not radically change the public creditors’ leverage over management. Dispersed shareholders will also have a limited reaction to the financial difficulties of the firm, as their monitoring is limited and intervening would be costly. Therefore, besides the harm to their reputation, it seems that managers have little to fear in terms of accountability for the firm’s weak performance. Moreover, although the director’s fiduciary duties shift from the shareholders to the company as a whole when approaching insolvency, creditors cannot directly assert a claim for breach. They have to sue derivatively on behalf of the firm.\textsuperscript{75} This makes appointing directors a lever of

\textsuperscript{74} Triantis and Daniels (n 39); Baird and Rasmussen (n 1); Charles Whitehead, ‘The Evolution of Debt: Covenants, the Credit Market, and Corporate Governance’ (2009) 34 The Journal of Corporation Law 641, 642.
\textsuperscript{75} North American Catholic Educational Programming Foundation v. Gheewalla, 930 A.2d 92 (Del 2007).
limited interest since newly-appointed directors would still be bound to interests broader than those of creditors by legal standards.

In the ‘weak shareholders, strong creditors’ context of the UK, the prevailing bank creditors have typically negotiated loan agreements containing extensive covenants. In fact, syndicated loan agreements are often based on the templates provided by the Loan Market Association and contain a plethora of covenants, the violation of which would be an event of default. This wide range of ‘tripwires’ is consistent with the idea that creditors obtain significant power over the debtor before the company reaches formal insolvency proceedings. Since shareholders are scattered, it is difficult for them to resist lender pressure. As a result, creditors might obtain the replacement of directors and officers more easily. The ‘missing lever of corporate governance’ identified by Baird and Rasmussen reflects such a setup, albeit in an American context. The firing of the CEO and Chairman of the Board of Krispy Kreme was set as a condition by the bank to grant a waiver of default after the firm failed to deliver financial statements under one of its covenants. Such pressure by private creditors also partly explains the high turnover of managers of firms in financial distress. Furthermore, one should bear in mind that the UK context is more favourable to creditors with respect to fiduciary duties, as the Supreme Court recently confirmed that fiduciary duties include the interest of creditors ahead of insolvency when insolvency becomes ‘inevitable’.

In France, the ‘strong creditor, strong owners’ configuration makes it more difficult for creditors to impose their terms on shareholders: a CS is better

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77 Baird and Rasmussen (n 1) 1211.
78 Baird and Rasmussen (n 1) 1211-2.
79 Stuart Gilson, ‘Bankruptcy, boards, banks, and blockholders: Evidence on changes in corporate ownership and control when firms default’ (1990) 27 Journal of Financial Economics 355 (showing that only 46% of incumbent managers are still in office at the end of a Chapter 11 restructuring).
able to resist the pressure of the banking creditor trying to leverage covenant violations. Once again, the dynamic at play in France can be illustrated through a discrete case which occurred in the United States. As the Farah clothing company teetered on the edge of bankruptcy, it was granted an additional loan by its bank creditor.\footnote{See: Roe and Tung (n 7) 294-306.} The new loan included a covenant which defined as a default any change of management which the creditor did not approve. The existence of such a covenant is not innocuous and already demonstrated the significant influence of the bank. This was meant to prevent the former CEO from returning. However, he was part of the family which owned the company. The bank threatened to call the loan and ‘padlock’ the company if he were to return. This lever enabled the bank to get board seats for affiliated people. As they proved to be poor managers, the other members of the controlling family eventually reinstated the former CEO after the change of management clause had been removed during the debt refinancing. He made the company sue the bank for having threatened to declare a default with no intention to do so. This, he alleged, constituted fraud, duress, and interference in business relations.\footnote{Daniel Fischel 'The Economics of Lender Liability' (1989) 99 Yale Law Journal 131,131-132.} Indeed, the testimony of the bank’s president suggests that the bank would not have declared a default on the loan just for a breach of this clause.\footnote{State National Bank of El Paso v Farah Manufacturing Co Inc, 678 SW2d 661 (Tex App 8 Dist 1984) 671, appeal dismissed per stipulation, Mar 6, 1985.} He hints that it could be because of the reputational harm this local bank might have incurred in the local community.\footnote{ibid.} It might, however, also be attributed to the fact that the repayment of the loans to local retail borrowers to the bank depended on their incomes from Farah employment. Roe points out that, in effect, the rest of his family, rather than the bank, kept the former CEO out of the company.\footnote{Roe and Tung (n 7) 305.} This example illustrates well how a CS can have its power contested by a powerful bank creditor claiming, or threatening to claim, a breach of covenant. Importantly, the CS prevailed here because of a judicial intervention into the lending relationship. Even then, Fischel argues that the jury was wrong in deciding against the bank, which was only using the contractual provision it had negotiated in exchange for better loan terms.\footnote{Fischel (n 82) 146.} Likewise, this case study shows how such a creditor can be partially tamed by a
controlling family with the capacity and incentive to control the board. Indeed, this demonstrates the limits of the ‘tripwire’ model of governance for creditors, insofar as, for the bank to even have this level of influence in the first place, it must have obtained the appropriate contractual provision. Here, the bank benefited from its status as one of the prior creditors of a company in the vicinity of bankruptcy, which gave it more leverage than a bank lending to a company that is still in good financial health. This narrows the scope of strong creditor influence in the vicinity of insolvency in the ‘strong shareholder, strong creditor’ jurisdiction. Under French law, this ‘strong creditor, strong owner’ situation is apprehended by the concept of ‘de facto management’ (‘direction de fait’), whereby a bank acting as a de facto manager of the borrower might be liable for its losses. For instance, a bank which had requested the appointment of two members of the board and one head of division, and subsequently used this influence to be paid back earlier than other creditors, was found to be a de facto manager. It seems that even the CS of the company, which was a subsidiary of a larger group, prioritised the banking relationship over retaining tight control of the operations; only a judicial intervention allowed for a mitigation of the advantage the bank had obtained.

The question of the desirability of creditor intervention in corporate governance is arguably the least clear in the vicinity of insolvency. Since the firm is on a downward trajectory, shareholders might anticipate having less sway over its governance as it enters formal insolvency proceedings. This would give shareholders an additional incentive ‘bet the ranch’, that is to say to adopt riskier strategies which would increase the value of their residual equity investment if successful, whilst a failure would decrease the worth of creditors’ claims. External interventions of the legislator or the courts are especially difficult in terms of striking the right balance between preventing shareholders from acting

on their incentive to gamble on the fortunes of the firm at the expense of other stakeholders, and letting them pursue wealth maximisation strategies that would benefit all corporate constituencies. Thus, the use of contractual clauses seems to be most adequate for addressing this conundrum where there is an equilibrium between ‘strong shareholders’ (‘weak shareholders’) and ‘strong creditors’ (‘weak creditors’) like in France (the US). The underlying idea would be that, if the covenants required by a lender are more constraining than is efficient, a company will be able to find another lender willing to offer more flexible terms in a competitive lending market. This is not to say that a perfect balance will be found every time by market participants, but it is more promising than any one-size-fit-all legislative intervention or judicial second-guessing of business decisions as observed in the Farah case. The calibration of such intervention in the UK to address the asymmetry between ‘weak shareholder’ and ‘strong creditors’ is more difficult. Whilst the idea of shifting the benefit of fiduciary duties from the shareholders to the creditors when insolvency becomes likely is appealing, the uncertainty of this standard makes it so unpredictable as to be of little assistance.

In summary, this analytical framework provides an explanation for variations in the corporate governance of across these jurisdictions. ‘Weak owners’ face little interference from the ‘weak creditors’ that are prevalent in the US, but UK banks have both the resources and the incentive required to play a larger role in firms whose financial and economic health is declining. French CSs usually offer a counterweight to such ‘strong creditors’, whose influence is also curbed by judicial review of the extent of their involvement in firm management. This approach provides a sound basis for a more normative discussion of the status quo in each country.

3. Insolvency

In the US, once a company has filed for Chapter 11 bankruptcy, the default rule is that the debtor stays in possession of the firm and the existing management can stay in charge.\textsuperscript{90} If the dispersed shareholders require a change in management, they would have to actively seek its ousting, which implies

\textsuperscript{90} United States Bankruptcy Code §1107 (the statute uses the term of art “Debtor-In-Possession” (or “DIP’)). See: Armour, Cheffins, and Skeel (n 38) 1745 (arguing that the rationale is the incumbent’s detailed knowledge of the firm).
coordination costs. Nonetheless, by the end of a Chapter 11 restructuring, about 50% of firms will have changed management despite this rule.\(^91\) This is partially out of the managers’ own volition. Managers inexperienced with leading distressed firms might prefer to abandon ship, especially if they have better offers available.\(^92\) This explanation is only semi-satisfactory since managers of bankrupt firms tend to fare poorly on the job market.\(^93\) This turnover is also linked to the intervention of funds specialised in distressed firms acquiring the (now) cheap equity and using their appointment rights to oust management.\(^94\) Such a transaction disrupts the equilibrium of power since the firm gets a CS, who is better able to make use of its formal rights than the dispersed bondholders it faces. It is noteworthy that US legislators initially intended creditor committees to act as a ‘shadow board’ of directors, but even private creditors are reluctant to get involved in them since membership prevents them from subsequently trading their debt.\(^95\)

As mentioned above, creditors are expected to effectively become the owners of the firm once it enters bankruptcy.\(^96\) In the traditional account of creditor governance, one would, therefore, expect that they would often oust poorly performing incumbents if it were legally permitted. The US bankruptcy code does provide creditors with the opportunity to move for the appointment of a trustee by the court.\(^97\) The judge must find at the hearing either that there has been gross failure or misconduct by management, or that the appointment is in

\(^92\) Roe and Tung (n 7) 422.
\(^93\) Gilson (n 79) 241.
\(^94\) The sale of equity in bankruptcy is generally done on the basis of 11 U.S.C. §363(b). The equity is ‘cheap’ in the sense that its price is much lower than when the firm was solvent, not necessarily relative to its actual value at the time of the purchase.
\(^95\) Roe and Tung (n 7) 422; France has recently replaced the creditors’ committee system with classes of claims similar to the US system (cf Code de commerce [C. com.] [Commercial Code] art. L626–30 and 11 U.S.C. §§1122 and 1126); in the UK, a creditor committee can also be elected in administration to assist or in Administrative Receivership (Part 17, Insolvency (England and Wales) Rules 2016/1024). Its role is to assist the insolvency practitioner. The coordination benefits of committees for UK private lenders are however less important than for public lenders.
\(^96\) Armour and others (n 3) 109.
\(^97\) 11 U.S.C. §1104 (USA).
the best interests of creditors.\textsuperscript{98} The ‘best interest’ standard does not seem hard to meet for a failing firm whose managers could either work for their own interest or that of shareholders. However, the appointment of a trustee is still largely seen as an exceptional remedy which is rarely resorted to.\textsuperscript{99} This is consistent with the expectation that dispersed bondholders would not have the economic incentive to make use of their formal right to oust incumbents.

In the UK, the default legal rule is that the debtor has to relinquish control of the company when it enters the insolvency regime.\textsuperscript{100} Before 2002, the 1986 Insolvency Act was very favourable to creditors who had a lien over substantially all the assets of the company (i.e. a ‘floating charge’).\textsuperscript{101} Such creditors could get an ‘Administrative Receiver’ appointed without court involvement.\textsuperscript{102} Whilst floating charge creditors could not appoint directors, the right to appoint the administrative receiver is functionally similar because it leads the company in their stead. The power of bank creditors was therefore facilitated by the legal regime, which might have reflected their political influence. Nevertheless, this complete control of one creditor disincentivised the preservation of the residual value for dispersed shareholders.\textsuperscript{103} In 2002, the Insolvency Act was amended by the Enterprise Act to favour recourse to another procedure, namely the administration regime, extending the appointment of an insolvency professional beyond the holder of a floating charge.\textsuperscript{104} Creditors now have both a court and an out-of-court route to obtain the appointment of the firm’s new leadership (i.e. the administrator), without formally displacing directors and officers.\textsuperscript{105} Instead of serving the interest of the floating charge creditor only, the administrator acts for creditors as a whole.\textsuperscript{106} In such a context, the ‘default

\textsuperscript{98} 11 U.S.C. §1104 (a) (USA).
\textsuperscript{99} Roe AND TUNG (n 7) 427.
\textsuperscript{102} Finch (n 100) 381.
\textsuperscript{103} John Armour, Audrey Hsu, and Adrian Walters, ‘The costs and benefits of secured creditor control in bankruptcy: Evidence from the UK’ (2012) 8 Review of Law and Economics 102, 105.
\textsuperscript{104} Armour, Hsu, and Walters (n 103) 105–106.
\textsuperscript{105} ibid; Insolvency Act 1986, sch B1.
\textsuperscript{106} Insolvency Act 1986, sch B1 and s 3(1).
rule’ once insolvency proceedings have begun is that the shareholders are deprived of their influence over those who lead the firm. Whilst this provides protection from shareholder abuses like in the US, this leaves concentrated creditors with an opportunity to exert significant influence. Therefore, the decisive factor is who may trigger the insolvency proceedings. This contrasts with the hurdle which ‘weak creditors’ have to overcome in the US and helps explain why the interests of creditors prevail in the UK.

In France, the counterbalance to the ‘strong owners’ expected from a ‘strong creditor’ is limited by a debtor-friendly statutory framework. A distressed company may enter a form of proceeding known as ‘redressement judiciaire’. In such proceedings, the court shall appoint a judicial administrator (‘administrateur judiciaire’) if the company has more than 20 employees or its after tax revenue exceeds €3 million. Interestingly, the mission of the administrator is defined by the court and can either entirely replace the managers or assist them. However, unlike in the UK, the administrator does not owe a duty of care to creditors. Instead, the interests of creditors are represented by a judicial representative (‘mandataire judiciaire’) appointed by the court when it opens the redressement judiciaire procedure. Its role is much more limited than that of the judicial administrator. In this context, CSs preserve significant leeway over the firm leadership since courts give an assistance mission and only partial control over the firm to the judicial administrator. Creditors, on the other hand, are hamstrung by the statute, which prevents them from leveraging their strength to appoint directors on their own. They would have to rely on the CS’s need for new funds to exert influence. In a recent case, a bank lent new funds with additional collateral and a higher interest rate to repay part of its prior loan, thereby effectively collateralising the prior loan through the new loan (i.e. ‘cross-

107 Finch (n 100) 440-441.
108 Part III. B.
111 Code de commerce [C. com.] [Commercial Code] art. L621-11 (under these thresholds, appointment is possible but not mandatory).
112 Code de commerce art. L631-12.
collateralising’). French judges did not deem this to be an undue interference of
the lender in the management of the company in the absence of proof that the
bank influenced the use of the proceeds.\footnote{Cass com, 21 nov 2018, n°17-21025; Jérôme Lasserre Capdeville, ‘Précisions utiles sur l’immixtion caractérisée dans la gestion du débiteur envisagée par l’article L. 650-1 du Code de commerce’ (2019) 15 La Gazette du Palais 77, 78.} Despite this judicial decision, the
legislative framework seems to clash with the prediction that private lenders
would be politically influential and secure a favourable statute. This might be due
to the significance of the state as a shareholder in France.\footnote{Armour and others, ‘The Basic Governance Structure’ (n 3) 73.} The political influence
of other CSs may also have been a contributing factor.\footnote{Gilson (n 10) 1665.} These departures from
the ideal type associated with one jurisdiction become relevant once again. For
the Private Debt; Controlling Shareholder configuration, one can look to the infamous
case of the Hunt family in the US.\footnote{See: Roe and Tung (n 7) 84-88.} An oil company, controlled by a family,
profited from the ‘Debtor-In-Possession’ default rule that allowed them to
undertake risky projects from which they would then reap the benefits as
shareholders. In case of failure, the bank creditors would have borne the losses
on their claims. In line with the mirroring model’s prediction, the CS was able to
take advantage of its rights. However, the fact that the banks did not move for
the appointment of a trustee left bankruptcy experts surprised.\footnote{Roe and Tung (n 7) 294-305.}

In insolvency proceedings, the Law and Economics rationale for
endowing shareholders with the most control rights shifts to the creditors when
shareholders are not expected to retain value in the company.\footnote{Easterbrook and Fischel (n 70).} Indeed, the
creditors become, in effect, the residual claimants which have the most to earn
from marginal increases in the firm’s value.\footnote{ibid.} Yet, ‘strong creditors’ should not
be given free rein either, to the extent that it may result in the premature
liquidation of a company that enables creditors to recover a large share of their
claims but undervalues the firm. Especially in the UK, where ‘strong creditors’
could abuse ‘weak shareholders’, the balance needs to be struck between these
two conflicting dynamics. The current framework exacerbates this dominance; it
is possible that it decreases the valuation of firms undergoing insolvency
proceedings in a socially inefficient manner. In the US and in France, the relative
debtor-friendliness of legal rules seems at odds with the goal of preventing shareholder gambling the creditor’s money. However, the capacity of scattered shareholders to coordinate such actions is limited for the ‘weak shareholders’ that characterise the US. To the extent that there are CSs in the US, the fact that they often retain some value of the company, even though some senior creditors do not, makes them internalise some of the costs of the riskiest strategies.\(^{122}\) At the impetus of European Union directives, France has recently moved towards a more stringent application of the absolute priority rule, according to which shareholders should not recoup any value until senior creditors have been made full unless they consent to it.\(^{123}\) This has the potential to take away the CSs’ incentive to preserve firm value. This framework suggests that the strengthening of the private creditor’s contractual priority might undermine the policy’s very goal if it is not complemented with a reform of the legal framework allowing ‘strong creditors’ to have greater influence over the firm’s governance.

Thus, default legal rules are primordial to tilting the scale between ‘weak owners’ and ‘weak creditors’ in insolvent firms in the US, because of the relative balance of power. However, in the UK, ‘strong creditors’ enjoy both a strategic advantage due to their resources and incentives, and a favourable legal framework which explains their outsize influence compared to US and French creditors. Indeed, the interference of ‘strong creditors’ in the management of insolvent companies in France is limited both by CSs and more debtor-friendly legal rules.

### B. Decision Rights

Decision rights, meant to reduce the board’s insulation from shareholder preferences, are the core of what Bebchuk and Hamdani call ‘the allocation of power between the board and shareholders’.\(^{124}\) The literature predicts that such rights do not make a real difference in CS jurisdictions since they already have the power to appoint and dismiss directors. These powers are typically seen as potent enough to align a director’s behaviour according to the CS’s interest. As we have seen above however, it may be that creditors intervene in the appointment of

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\(^{122}\) Daigle and Maloney (n 89) 157-158.


\(^{124}\) Bebchuk and Hamdani (n 11) 1292.
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directors, in which case the direct decision rights may become more important. Moreover, in NCS jurisdictions, these rights help to reduce the costs of coordination and the collective action problems that scattered shareholders are plagued with.\textsuperscript{125} Once again however, this literature seems to disregard the role of creditors in such decisions or treats it as a constant variable. This subsection explores how the mirroring setup may affect such rights.

1. Solvency and the Vicinity of Insolvency

In the US, these decision rights give an advantage to shareholders since it limits the agency cost problems and dispersed bondholders are unlikely to interfere with them. However, shareholders in the US are given little direct decision rights compared to other jurisdictions.\textsuperscript{126} This is counterbalanced by the fact that creditors trying to lead the firm may see their claim be ‘equitably subordinated’. This doctrine, which has no equivalence in the UK and France, first emerged in case law and held that creditors treating the debtor as a ‘mere instrumentality’ before entering bankruptcy, should be sent to the end of the distribution line in a Chapter 11 reorganisation.\textsuperscript{127} The case law highlights the difficulty of distinguishing between the legitimate use of power provided for by the loan agreement and abusive interference with the firm’s operations. In fact, according to Roe, the line as it has been set by courts depends mostly on the level of ‘politeness’ of the creditor in its demands.\textsuperscript{128} In line with the expectation arising from financial intermediation theory, these equitable subordination cases arise from private lenders.

In the UK and in France, more extensive decision and initiation rights are granted to shareholders. In addition, both of these jurisdictions have ‘strong creditors’ whose loan agreements contain covenants. As mentioned above in the context of appointment rights, tripped covenants play a major role in giving

\begin{footnotesize}
\textsuperscript{125} Bebchuk and Hamdani (n 11) 1294.
\textsuperscript{126} Armour and others (n 3) 57.
\textsuperscript{127} See: Clark Pipe & Supply Co., Inc., 870 F.2d 1022 (5th Cir. 1989); In Re Am. Lumber Co., 5 B.R. 470 (D. Minn. 1980) (where the bank took every operational decision, such as laying off employees, paying bills, continuing a given project or restricting access to the facilities). See also: US Bankruptcy Code §550(c).
\end{footnotesize}
leverage to bank creditors. Bank creditors in the UK and France are able to obtain maintenance-based covenants, under which some accounting metrics are regularly reported to the lender.\footnote{Block and others (n 42) 19.} Not only can this be used to gain control in the vicinity of insolvency,\footnote{Part IV.A.2.} but it also serves to ensure that the solvent borrower is complying with financial ratios that increase the likelihood of repayment over the duration of the loan rather than on specific occasions. This is especially helpful in France, where the profitable firm could be prone to their assets being drained out of the firm for the benefit of a CS. In the case of 	extit{Krispy Kreme}, the tripped covenant was a failure to deliver financial statements. However, other types of covenants give a veto power to creditors over shareholder decisions. Indeed, bondholders in the US usually negotiate incurrence-based covenants, whereby the debtor has to check its compliance with financial ratios before undertaking certain actions.\footnote{Falk Bräuning, Victoria Ivashina, and Ali Ozdagli, ‘High-Yield Debt Covenants and Their Real Effects’ (2023) Federal Reserve Bank of Dallas Working Paper 2311, 2 \url{https://ssrn.com/abstract=4550495} accessed 20 January 2024.} Otherwise, the lender might block the transaction from being carried through.\footnote{ibid; Block and others (n 42) 20.} Hence, even though creditors do not get the affirmative right to set the agenda, they have a veto right over many decisions, wielding a power over corporations akin to that of constitutional courts, the Kelsenian ‘negative legislators’, with respect to the law.\footnote{Hans Kelsen, ‘La garantie juridictionnelle de la Constitution (La justice constitutionnelle)’ (1928) Revue du Droit public 197.} This makes bank creditors ‘veto players’ whose interests must be considered for decisions.\footnote{See: George Tsebelis, \textit{Veto Players: How Political Institutions Work} (Princeton University Press 2002) (for a description of the role of veto players in political institutions).} The challenge for banks in France is then to obtain such covenants in the first place since they usually must face a CS who will try to retain control in loan negotiations. Directors and officers in the UK may also seek to avoid the monitoring of debtors by restrictive covenants, to the extent that they have access to debt capital markets. This is mostly relevant for firms which are financially successful since data shows that public debt principally goes to the most creditworthy companies with a successful track record under bank monitoring.\footnote{Douglas Diamond, ‘Monitoring and Reputation: The Choice between Bank Loans and Directly Placed Debt’ (1991) 99 Journal of Political Economy 689.} It is unlikely that value-extracting directors would have good access
to public debt, as they do not lead the most creditworthy companies by virtue of their extraction.

Therefore, this framework highlights how decision rights of ‘weak creditors’ in the US are limited by the kind of covenants they are able to negotiate, even with little pushback from ‘weak owners’. In the UK and France, ‘strong creditors’ are better able to obtain more extensive covenant packages, although French CSs will have more negotiation leverage than the scattered UK shareholders.

2. Insolvency Proceedings

Decision rights also matter with respect to formal insolvency proceedings. Key decision points include starting such proceedings, proposing a plan of reorganisation, and converting from reorganisation to liquidation proceedings. Decisions are also impacted by the critical supplier of new funds to the liquidity-starved bankrupt firm.

a. New Money

The supply of new funds necessary to keep the firm running gives significant influence to the creditor, as the firm is in a weak bargaining position. Post-filing lenders to bankrupt firms enjoy a high level of priority in the US and obtain extensive covenants which constitute the ‘principal lever of governance’ in Chapter 11. France provides a similar possibility, to which private lenders resort extensively. No such priority for new loans exists in the UK, as bankers lobby to preserve their pre-insolvency seniority. However, in the US, most of these

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139 John Willock, ‘UK introduces 20-day moratorium - but still no DIP financing’ (European Association of Certified Turnaround Professionals) <https://www.eactp.eu/news-and-events/article/uk-introduces-20-day-moratorium-but-still-no-dip-financing> accessed 8 June 2023 (‘a majority of the UK’s traditional senior lending community continue to resist, claiming they rely on remaining at ‘the top of the waterfall’ in order to lend.’).
new loans are made by pre-bankruptcy private lenders who benefit from their superior knowledge of the firm to win these profitable contracts over external creditors.140 The priority for a new lender is an additional lever over the decisions of both slacking managers in the US and controlling shareholders in France.

b. Opening Insolvency Proceedings

In the US, the debtor can enter Chapter 11 without being insolvent. An involuntary bankruptcy can also be triggered by three unpaid creditors whose claims amount to a minimum of $16,570.141 Since Chapter 11 is so debtor-friendly, it is often used by managers as a shield from creditor pressures.142 Little input from the scattered shareholders is required. Creditors may, therefore, want to enter Chapter 11 to recover preferential payments and fraudulent conveyances made to other stakeholders.143 However, even in the unlikely event that they monitored the company, the above-mentioned number of participants required and dollar amount threshold make it harder for any given dispersed bondholders to use this right.

In the UK, the power to initiate the insolvency proceedings is significant as the insolvency practitioner displaces the incumbent board and executives.144 Since the UK insolvency regime can hardly be seen as a shield from creditor pressure, the focus should be on the ease with which it can be triggered by creditors rather than shareholders.145 Administration proceedings can be opened out-of-court by directors or the holder of a floating charge. It can also be opened in court by shareholders, directors or one or more creditors.146 The fact that a lone creditor can petition for administration makes it quite easy for a large bank creditor to credibly threaten the managers with the opening of a procedure without fearing pushback from the dispersed shareholders. This stands in stark

140 Roe and Tung (n 7) 121.
141 11 U.S.C. §303(b), (h).
142 One cornerstone of Chapter 11 is the automatic stay of proceedings and payment (11 U.S.C. §362).
144 Part IV.A.3.
146 UK Insolvency Act 1986, sch B1, s12(1).
contrast to the US system, in which the managers may seek to opportunistically enter Chapter 11.

In France, the controlling shareholder may attempt to open a ‘safeguard procedure’ (‘procédure de sauvegarde’) to seek protection even before it is unable to make payments.\(^\text{147}\) However, it must demonstrate that it faces difficulties it cannot overcome.\(^\text{148}\) This statutory standard is somewhat broad and CSs have an incentive to try to interpret it broadly since they would retain more control than in other proceedings. In doing so, they face fierce opposition from private lenders. This is exemplified by the Coeur Défense case, in which the private lenders and shareholders entered litigation over whether the failure to replace a hedging arrangement was a difficulty which could not be overcome.\(^\text{149}\) Opening a redressement judiciaire, which at least partly displaces incumbent managers, is contingent upon the inability to make payments. The debtor has little discretion over it, as they must file for it within 45 days.\(^\text{150}\) Even if they do not, a single creditor can move for it.\(^\text{151}\) This makes it relatively easy for private lenders to get a judicial administrator appointed and shift control away from the CS to the judicial administrator.

c. Proposing a Plan of Reorganisation

In the US, the debtor then has the exclusive right to propose a reorganisation plan for the 120 days following the filing.\(^\text{152}\) This, in effect, gives managers significant power over the distribution, although there are safety nets ensuring a minimum compensation to creditors.\(^\text{153}\) For instance, the managers of Texaco profited from this provision by proposing a plan of reorganisation that packaged a very advantageous settlement for shareholders with releases from liability for breaches of their fiduciary duties towards them.\(^\text{154}\) Most shareholders agreed to the plan, except the block acquired by Carl Icahn. This is consistent

\(^\text{148}\) ibid.
\(^\text{149}\) Cass Com 8 March 2011, n°10-13.988.
\(^\text{152}\) 11 U.S.C. §1121(b); this period of exclusivity is often prolonged but may not exceed 18 months (11 U.S.C. §1121(d)(2)(A)).
\(^\text{154}\) In Re Texaco Inc., 92 B.R. 38 (S.D.N.Y. 1988); Roe and Tung (n 7) 429-440.
with the idea that, without a CS, there is a lack of counterbalance necessary for making the managers accountable. This is especially true in the absence of a private creditor.

In the UK, plans of reorganisations in administration are proposed by the administrator, who serves the interests of creditors.\textsuperscript{155} Directors have a significant, albeit non-exclusive, proposal power for plans outside of administration.\textsuperscript{156} However, since creditors can credibly move for administration, they need not concede as much value to shareholders as in the US. Indeed, due to the exclusivity period granted to the debtor in the United States, private lenders have sometimes granted managers additional value (‘gift plans’) in exchange for proposing a favourable plan. Courts have struck down such plans unless they were meant to retain key managers or otherwise justified.\textsuperscript{157} Private lenders in the United Kingdom and in France might resort to similar techniques, although the French context is more prone to shareholder-creditor collusion at the expense of other stakeholders.

Once in \textit{redressement judiciaire}, the reorganisation plan proposal (‘\textit{plan de redressement}’) is elaborated by the judicial administrator, in collaboration with the debtor.\textsuperscript{158} This setup makes creditors mere veto players, and gives the controlling shareholder significant influence over the plan. However, the presence of private lenders makes it more difficult for a CS to exploit this advantage. For instance, a practice has developed in the US where pre-existing shareholders propose a plan involving them acquiring the company’s equity. The risk is that they could purchase the company at a discount relative to its actual value due to their potentially superior knowledge of the firm’s value.\textsuperscript{159} Such an offer generally requires the kind of involvement only seen in CSs. Public lenders of the kind prominent in the US have done little due diligence and minimal monitoring, which

\textsuperscript{155} UK Insolvency Act 1986 c45 sch B1, s49.
\textsuperscript{156} A Company Voluntary Agreement can be proposed by the directors or the administrator and liquidator (Insolvency Act, s1(1), (3) (UK)); an application for a Scheme of Arrangement can be made by the company, any creditor and shareholder, and the liquidator and administrator (Companies Act 2006, s 896(2)); a Plan of Restructuration can be proposed by directors, shareholders or creditors (Companies Act 2006, s 901C(2)).
\textsuperscript{157} Roe and Tung (n 7) 57-59.
\textsuperscript{159} Roe and Tung (n 7) 132-134.
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makes the informational asymmetry significant. A French controlling shareholder would have fewer opportunities to undervalue the firm’s equity since it faces bank creditors whose business relies on thorough monitoring.

d. Converting to Liquidation

Conversion to liquidation seems most favourable to creditors who have a fixed claim and a high priority, because the liquidation value does not offer any upside potential from which shareholders would benefit as the residual claimants, unlike the more uncertain going-concern value. In the US, to convert a case to a Chapter 7 liquidation, creditors have to meet high statutory thresholds so as to demonstrate a ‘cause’. These include ‘gross mismanagement’ and the likelihood that the firm is unsalvageable. Given the lack of coordination and apathy of bondholders, the fact that conversion has been seen as ‘drastic, as a sign of failure’ is not surprising. Should a bank creditor make use of this provision, the onus is on the opponents of conversion to demonstrate that this is not an optimal solution. A bank lender could, therefore, exploit this advantage if it is faced with NCSs. Hence, the conversion to liquidation in the ‘weak shareholders, weak creditors’ US context is a rare occurrence, at least in part because the law imposes costs on the dispersed creditors to obtain it.

In the United Kingdom, liquidation can be voluntarily initiated by a 75% vote of the shareholders or by a petition of any creditor, who generally demonstrates that the firm is not paying matured debt or is insolvent. It is, therefore, rather credible for bank creditors to threaten a conversion to compulsory liquidation since the statute requires no intercreditor coordination. On the other hand, the threshold for shareholders to initiate a liquidation is quite high and makes it an unlikely route, particularly since they would thereby relinquish the going concern value.

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162 Roe and Tung (n 7) 142.
In France, the conversion to liquidation can be requested by the debtor or the court-appointed creditors’ representative.\(^{165}\) Similarly to the US, the statute imposes the high threshold of demonstrating that the firm’s recovery is ‘manifestly impossible’.\(^{166}\) This is to be contrasted with the UK and its looser standard of not being able to pay debt as it matures. Private lenders in the UK can credibly threaten to convert to liquidation, whilst it is an uphill battle for French banks. In turn, this impacts their negotiating power in the conception of a reorganisation plan.

\(\text{e. Exit-Consent Transactions}\)

Whilst creditors can threaten to liquidate the firm, shareholders may also elaborate so-called ‘exit-consent’ offers, whereby the firm offers bondholders to buy back their bonds in exchange for an equity stake, thereby improving the firm’s chances of recovery. Some creditors may refuse the exchange since it amounts to relinquishing their priority as a creditor. Holdouts also benefit from other creditors becoming shareholders rather than sharing equally with them. To prevent such free riding, exit-consent offers to condition the ‘exit’ (i.e. tendering their bonds) upon the ‘consent’ to amendments of the indenture which strip the bonds of their covenant protection. These schemes emerged in the US to circumvent the unanimity requirements for amendments to the maturity, interest, and principal payments of bonds provided for in the Trust Indenture Act.\(^{167}\) Since these core terms could not be changed, the exit-consent targeted covenants. However, because the typical bondholder had few covenants in the first place, the holdout problem persisted.\(^{168}\) The offers are also generally conditional on a certain percentage of bondholders tendering their shares, which effectively gives large lenders in privately placed bonds a veto right over these schemes. The Trust Indenture Act reflected the post-Great Depression \textit{zeitgeist}, in which Democrat-appointed regulators sought to protect small bondholders.\(^{169}\) The appellate court case holding that such offers were not coercive involved private lenders, which

\(^{166}\) ibid.
\(^{168}\) Roe and Tung (n 7) 486.
\(^{169}\) Roe (n 167) 232, 279.
might have influenced the court’s view.\textsuperscript{170} Interestingly, the offer was initiated in this case by a potential purchaser of the firm (i.e. an entity looking to become a CS). Putting together such offers may be costlier in an NCS jurisdiction like the UK, than it is to a CS. Therefore, this seems more relevant to the French ‘strong creditor, strong owners’ paradigm, although the practice has not taken root in France. Such transactions are no longer a threat to UK creditors as they have been struck down by courts because they were seen as coercive for the bondholders.\textsuperscript{171}

A study of corporate governance through the lens of this taxonomy clearly highlights that even actors with resources and incentives to deploy them in a way that benefits the maximisation of firm value might be prevented from doing so by the legal framework. This can be instantiated by the lack of privilege for ‘new money’ in the UK, which would incentivise private lenders to provide new funds to preserve their priority and wield further power over the firm through the negotiation of borrowing terms. Likewise, the framework highlights how one party sometimes has an advantage over the other because of the legal rule in force. For instance, the ease of entering Chapter 11 bankruptcy for the firm gives dispersed US shareholders an advantage over bondholders, over whom this debtor-friendly proceedings hang like the sword of Damocles. Therefore, the taxonomy can serve as the basis for a heuristic of policymaking by bringing to the fore the relative organisational strength of the parties to a financing transaction.

CONCLUSION

Thus, this mirroring setup explains why creditors may exert significant influence over a firm which is solvent and out of formal bankruptcy proceedings, but experiences financial difficulties of varying magnitudes. Little scholarly attention has been dedicated to this interaction between debt and equity investors. This perspective helps surpass monolithic views of corporate governance, which omit the crucial role of creditors. Indeed, private lenders make ample use of the covenants they obtain in loan agreements, both to veto decisions \textit{ex ante} and leverage their power to grant default waivers \textit{ex post}. In the United Kingdom,

\textsuperscript{170} Roe and Tung (n 7) 495.
\textsuperscript{171} Assenagon Asset Management SA v. Irish Bank Resolution Corp Ltd [2012] EWHC 2090 (Ch).
apathetic dispersed shareholders often lack the incentive to resist private creditors pressure, whilst CSs in the French paradigm are better able to resist these pressures. Furthermore, one should not underestimate the role of the statutory frameworks in which these actors evolve. In fact, although the US is often presented as the epitome of a jurisdiction relying on dispersed shareholders and public lenders, many discrete examples involving some other combinations are instructive to the broader framework because they allow to treat the legal environment as a control variable. Policymaking has much to gain from the insights of this taxonomy, as it highlights the relative leverage of each party and their respective incentives. Where a party has welfare-maximising incentives but lacks the coordination capacity, the legal framework should work to make it easier for them to act on these incentives. On the contrary, it should mitigate the perverse incentives that parties with little coordination costs might have. This article has placed emphasis on core aspects of corporate governance, namely decision and appointment rights. Nevertheless, the relevance of this framework extends far beyond these elements and further analysis could highlight new aspects of this interaction. For instance, an interesting avenue for future research could be the mechanisms seeking to overcome the collective action problem of creditors, such as creditor committees, voting procedures allowing the cram-down of reorganisation plans on holdout creditors, or bond trustees tasked with the representation of the bondholders’ interests.