The Corporate Entity as a Bankruptcy Asset

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Topics:

- Company law and insolvency law: from separation to integration
- The importance of history
- Recent developments
- Conclusion: open issues
Company law and insolvency law: from separation to integration
The traditional approach

Company law focuses on the **company**
- Allocation of powers, agency conflicts

Insolvency law focuses on the **company’s assets**
- Seized, sold, proceeds are distributed
- **Going concern value can be preserved through a sale of the business**
The first rift in the traditional approach: Company law as a bankruptcy tool

- Cash sales are often difficult and do not yield sufficient value
- This is particularly true in times of widespread crisis

- Corporate reorganizations emerge
  - History: US Railroad reorganizations of the 19th century
  - Assets are not actually sold
  - They are “sold” to the creditors, in exchange for their claims
Just another way to satisfy creditors...

- **No shareholder consent is required to transfer assets of a bankrupt company**
  - *The “paradigm shift” is on the creditors’ side*
  - *They receive equity of a new company instead of cash*
    - *(Their individual consent may be necessary under the applicable law)*
A second step in overriding the traditional approach: The distressed company as a tool

◆ Transferring assets may destroy value
  ■ Disruption of business, direct costs
    ♦ Employees, clients
  ■ Loss of valuable assets
    ♦ E.g., supplier certifications, tax assets

◆ Bankruptcy may come too late

◆ Incentives for agreements between the company and its creditors
Bending company law to restructuring goals

- In short, efficient insolvency procedures should allow the “use” of the same corporate vehicle.

- The reorganization plan may require, or benefit from, modifications to the corporate structure.
What role for the shareholders?

Should SHs’ consent be necessary to implement a restructuring plan that modifies the structure of the company?

And even before that, should they be entitled to put the insolvent company into liquidation, destroying the value associated with the corporate vehicle?

Under which conditions should they be entitled, or even allowed, to retain an interest in the restructured company?
Everything seems to go down to one simple question:

Is the corporate entity an asset available for creditors?
Shareholders and insolvency: history is important
United States

Dispersed ownership

- Berle-Means (1932)

Shareholders perceived as investors, not as owners

Asset sales vs. corporate reorganizations

Shareholders: “claimants”, participating in the reorganization along with creditors, but at the bottom of the hierarchy
Europe

- Concentrated ownership
- Shareholders perceived as “owners”
- Insolvency procedures focus on asset sales, not on corporate reorganizations
EU Company law: Is it an obstacle?


- Enforced by several ECJ cases:
  - C-19/90 and C-20/90 (Karella [1991])
  - C-381/89 (Syndesmos Melon [1992])
  - C-441/93 (Pafitis-Trapeza [1996])
  - C-367/96 (Kefalas [1998])
ECJ Jurisprudence: The Pafitis Case (C-441/93) [1996]

- The Member States may take “execution measures intended to put an end to the company's existence (...) placing the company under compulsory administration with a view to safeguarding the rights of creditors.”

- “However, the directive continues to apply where ordinary reorganization measures are taken in order to ensure the survival of the company...
The fact that a company is unable to survive as a going concern does not justify a debt-for-equity swap, unless the existing shareholders agree.
The company as a normal debtor

- For centuries, debtors have been allowed to contract with creditors
  - Helped by the majority principle
  - Also with the aim at avoiding liquidation

- Typically, the debtor retains part of the surplus from avoiding liquidation
  - Implicit violation of APR
  - Ours is not an ideal world...

- Why should different rules apply to corporate debtors?
Recent developments
The questionnaires show that convergence is slower on shareholders’ rights

- A veto power may impede efficient restructurings and/or allow the SHs to extract value
  - E.g., Chile, Switzerland, Sweden, Russia, Mexico, Italy (changed 2015)

- Movement towards neutralizing SHs’ veto powers (so-called “shareholders’ cramdown”)
  - E.g., Germany, France, Brazil, Ireland, Nepal, Ukraine, Italy
  - The Netherlands (powers of the Amsterdam Court of Appeal)
Developments (1/3):

*Shareholders’ cramdown*

*Germany 2012 (§ 225a, InsO):*

- Shareholders are just another class of claimants, along with creditors
  - *They can be “crammed down”*

- Modeled after US Chapter 11
Developments (2/3): Shareholders’ disempowerment

France 2014 (Art. L631-9-1, CdC):

- « l'administrateur a qualité pour demander la désignation d'un mandataire en justice chargé de convoquer l'assemblée compétente et de voter sur la reconstitution du capital (...) à la place du (...) actionnaires opposants... »


Company law respected (albeit just formally)
Developments (3/3): Shareholders’ liability

Spain 2014 (Art. 172, Ley concursal):

- May be held liable for “concurso culpable”...
- “los socios que se hubiesen negado sin causa razonable a la capitalización de créditos o una emisión de valores o instrumentos convertibles (...), en función de su grado de contribución a la formación de la mayoría necesaria para el rechazo del acuerdo”
The “sale of business tool” (Art. 38):

Resolution authorities have the power to transfer to a purchaser:

- “(a) ….;

- (b) all or any assets, rights or liabilities of an institution under resolution”.

The “sale of business tool” (Art. 38):

Resolution authorities have the power to transfer to a purchaser:

- “(a) shares or other instruments of ownership issued by an institution under resolution;

- (b) all or any assets, rights or liabilities of an institution under resolution”.

- See also the “bail-in tool ” (Arts. 43-55)
The company is **not** a normal debtor

- There are only financial claims against the company, in a precise ranking
  - *The managers are responsible for respecting such ranking*
  - *While SHs out of the money” have distorted incentives*

- Creditors of a company can reach more than the assets: They can reach the corporate entity
  - *Shareholder consent should no longer been necessary*
“90. (...) If executed correctly, State intervention reduces only the nominal value of the equity and debt instruments affected, because that value no longer corresponds to their real value. The depreciation of those instruments is thus merely formal. **From an economic point of view, the position of the investors should, on the whole, be unchanged:** in the worst-case scenario, they are globally not any worse off than they would have been, had the State not intervened. That would mean, in my view, that the very essence of the right to property of the investors is not affected.”
Conclusion: Towards a generalization of the NCWO principle in insolvency
Issues that appear solved, or in the process of being solved

“Property”
- Also creditors, not only shareholders, have a “right to property”
- Lack of prejudice as the rule ("expanded" NCWO)

Obstacles coming from European directives
- If the process of harmonization of insolvency law delivers the expected results
  - “The Commission will propose a legislative initiative on business insolvency, including early restructuring and second chance (...). The initiative will seek to address the most important barriers to the free flow of capital, building on national regimes that work well”
Issues that are still open

- Cramdown only in insolvency procedures, or also in “preventive” proceedings, upon valuation of the assets?
  - Effect on incentives
  - Sticks and carrots (for the managers?)

- Which safeguards need to be in place?
  - Information/Vote
  - Criteria for valuation/Right to participate in upside value (warrants?)

- Strict APR, or deviations allowed?
  - Allocation of reorganization surplus
  - SHs’ non-monetary contributions to the reorg., pre-emptive rights