A FIRST APPROACH TO CREDITOR MONITORING, THE PARADOXICAL MISSING LEVER OF CORPORATE GOVERNANCE IN SPAIN

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The goal of this paper is to analyze empirically whether debt-holders actually develop a significant role in the corporate governance of distressed companies, as the economic theory would suggest.

Although bankruptcy is still compulsory in Spain, going-concern companies draw on out-of-court workouts primarily, setting aside the petition as the last resort to handle corporate insolvency. Bankruptcy remains thus as a venue for liquidating insolvent companies, which is at odds with the goals of the Spanish Bankruptcy Act. The empirical question that follows is whether this behavior draws on a rational decision grounded on the economics of transaction costs as a reaction against a governance problem.

The data indicates that professional adjusting debt-holders rarely enforce creditor contractual remedies out-of-court, and that the structure of the Spanish bankruptcy proceeding disincentives shareholders filing a petition. Both findings cast doubt on the accuracy of Spanish insolvency law to provide stakeholders with effective tools of corporate governance to manage the agency problem that insolvency poses.

The conclusion of the research is that our legal culture does not take account yet of the role of debt in corporate governance. This unsettling reality may put in jeopardy the ability to refinance going-concern businesses.

1 Introduction[1]

Under Spanish law, corporate insolvency refers to the inability to meet liabilities as they come due.[2] However, an insolvent – a financially distressed – corporation may still be economically viable if it preserves its comparative advantage to compete in the market.[3] In such a case, the business has “going-concern value” because its assets are worth more put together as an operating business unit than if liquidated separately. Hence, an insolvent company may still succeed in the market place if it changes its capital structure through a workout, whether out-of-court or in bankruptcy.[4]

Bankruptcy exists to address insolvency’s collective action problem (the deadly race against the debtor’s assets[5]), by reducing the transactions costs that creditors would otherwise bear. This being said, bankruptcy’s transaction costs may outweigh the potential upsides of filing a petition. The issue is whether or not bankruptcy’s hurdles (such as the automatic stay) are always that worth it for creditors, the new residual claimants of debtor’s assets. For instance, insolvency’s collective action problem may be less severe in the case of going-concern companies with concentrated capital structure, where an out-of-court workout may enable going-concern companies – and their creditors – to minimize

1 While strongly grounded on the economic analysis of corporate and insolvency law, this is an empirical research work based on semi-structures interviews. The paper is updated to the last reforms of Spanish law, but the empirical analysis is restrained to the data available until April 2013 (the date of the last interview): the statistics of 2011. Further empirical research may analyze the impact of the most recent reforms as per the data available for subsequent years.

2 See article 2 of the Spanish Act 22/2003 of July 9, 2003, of Bankruptcy (the “SBA”).

3 Corporate insolvency may be related to financial and/or economic distress. Whereas economic distress may stem from the loss of the debtor’s comparative advantage, financial distress arises when liabilities exceed the company’s assets (or, under Spanish law, when the debtor cannot pay the debts as they come due).

4 A composition agreement is just a judicially sanctioned workout.

5 This is an example of the prisoner’s dilemma. See Adler, Baird, and Jackson (2007).

transaction costs. It may also permit to avoid, for example, the brand prejudice that bankruptcy may encompass and the sure external interference in debtor's corporate governance. An out-of-court workout is thus a contract entered into between a company and its creditors to remove insolvency by restructuring the debtor's capital structure, so that an economically viable company may continue to run its potentially profitable business in the market. From this perspective, bankruptcy may be characterized as an optimal venue to handle corporate insolvency upon the failure of the rest of corporate and negotiated mechanisms (such as an out-of-court workout). In other words, bankruptcy may step in when asymmetric information and stakeholders' different incentives make transaction costs related to the hidden action and the moral hazard problems unmanageable. Thus, going-concern companies, especially those with a high degree of debt concentration, may find it attractive to draw on an out-of-court workout to deal with corporate insolvency. This should be an *ex ante* choice almost exclusively grounded on the economies of transaction costs, though conveniently monitored *ex post* by the residual claimants of debtor's assets (the unsecured creditors).[6]

Under Spanish law, however, bankruptcy petition is compulsory. Filing is a must within two months as from debtor's actual or constructive awareness of its insolvency.[7] As a matter of law, bankruptcy judges must oversee corporate reorganization or the liquidation of insolvent debtors' assets through a bankruptcy proceeding. Hence, the SBA establishes that bankruptcy is the sole venue to deal with corporate insolvency. This is arguably a response to past strategic behavior in detriment of unsecured creditors.[8]

In contrast, the law in action approach shows that bankruptcy is not the first choice for going-concern companies, which usually draw on out-of-court alternatives to handle corporate insolvency.[9] In fact, corporate debtors petition where it is not possible to turn to out-of-court restructuring alternatives. Instead of bankruptcy compositions, going-concern companies draw on out-of-court workouts "in the shadows of bankruptcy" to handle corporate insolvency. First, whilst the SBA formally pursues corporate reorganization through a composition agreement as bankruptcy's "normal" solution to maximize creditor recovery, official statistics show that more than 90 percent of bankrupt companies are liquidated.[10] Moreover, only 7.13 percent of the pending bankruptcy proceedings in 2011 (202 out of 2,835) were aimed at reaching a composition agreement.[11] Official data shows that this figure ultimately stems from the impaired economic and financial condition upon the filing.[12] Most companies filing a bankruptcy

6 Unsecured creditors step in the shoes of the shareholders as the residual claimants of the corporation upon insolvency insofar as they become the stakeholders with best incentives to maximize the assets value. This is due to their pro-rata recovery (they benefit from an efficient management in the margin). They should have standing to file a derivative lawsuit, as well as voice and voting rights as per the solution to remove insolvency, whether it is handled out-of-court or in bankruptcy. This is the shift in the corporate governance of distressed companies that insolvency should trigger.

7 See article 5 of the SBA

8 See preamble to the SBA.

9 Indeed, the SBA's oversight of privately conducted out-of-court schemes never prevented stakeholders from turning to this possibility at all. See Rojo (2003).

10 According to official statistics, the debtor's assets were liquidated in 92.7 percent of 2011 bankruptcy proceedings. Only 287 bankruptcy proceedings out of 2,920 (9.83 percent) concluded in 2011 with the judicial approval of a composition agreement. It is important to note, however, that liquidation may follow if the composition fails. Indeed, 2.8 percent of total liquidations in 2011 followed a previously failed composition agreement. See Van Hemmen (2012).

11 See Van Hemmen (2012). Ninety-two (92.87) percent of 2011 unconcluded bankruptcy proceedings were aimed at liquidating debtor's assets. All the statistical data that follows also stems from Van Hemmen (2012).

12 Without challenging the convenience of further incentivizing post-petition financing as some authors contend, this issue may not have such a direct relationship with the number of companies that are liquidated.

petition have already failed both financially and economically. Sixty-one percent of 2011 bankrupt companies had negative operative margin, whereas 72 percent of 2011 bankrupt companies would not be able to pay back their claims in less than 25 years. Not surprisingly, economic scholars estimate that only 11 percent of companies going bankrupt in 2011 would be able to reach a composition agreement. As a result, the primacy of liquidation over composition is not expected to turn around, at least, for three years.[13] Although, liquidation does not necessarily entail piecemeal liquidation and the shuttering of business units,[14] compositions are far from consisting of the "normal" solution to bankruptcy.

Second, the largest financially troubled companies prefer to turn to out-of-court workouts. The size (total liabilities) of a bankruptcy proceeding in Spain is on average 6.5 million Euros, while the mean is 1.27 million Euros. Only 10.6 percent of companies going bankrupt in 2011 have liabilities over 10 million Euros. Furthermore, the data shows a decreasing size of the companies going bankrupt. On the other hand, companies turning to a bankruptcy-proof out-of-court workout have on average liabilities of 310 million Euros (mean 37 million). Although bankruptcy is formally compulsory to manage insolvency, blue-chips do endeavor in actuality to avoid the petition. In other words, the filing occurs when piecemeal liquidation seems to be the most feasible solution to insolvency's collective action problem. Bankruptcy has also become the residual option to handle corporate insolvency of financially distressed but economically viable flagships.

In sum, insolvent corporate debtors must file a bankruptcy petition under Spanish law, which will most likely lead to their liquidation. As a result, the SBA's twofold goal has arguably failed. Going-concern companies dislike bankruptcy, which, far from being a venue for corporate reorganization, has turned out to be chiefly a liquidation proceeding. The Spanish branches have reactively protected out-of-court workouts subsequently in the four main reforms of the SBA.[15]

Part II comprises the hypothesis and the empirical question. a selected literature review of the public policy considerations that ground the debate between the compulsory judicial oversight of corporate insolvency and out-of-court transactional alternatives. Part III contains a selected literature review of the role of debt in corporate governance from an economic perspective. Part III is concerned with the analysis of the data. It also contains the discussion about the lack of enforcement of financial covenants and events of default. Lastly, part IV contains the conclusions and proposals for further empirical legal scholarly work.

2 Hypothesis, empirical question, and normative background

Statistics show that Spanish going-concern companies avoid the petition where an out-of-court workout (either protected or not) is still feasible. The puzzle that follows is whether or not this is actually a "social stigma," a runaway from liquidation statistics, or an economic decision grounded on the SBA's efficacy and efficiency in reducing agency costs. Hence the significance of analyzing the expectations and concerns of stakeholders

13 No less than three years is the average duration of bankruptcy for companies with liabilities over €10 Million. In addition, only 11 percent of 2011 filing companies are expected to avoid liquidation in light of their financial accounts and accounting ratios upon petition.

14 Liquidation promotes the sale of business units as a going-concern. Yet, this occurs when the business is economically viable, which is not what the statistics suggest. See articles 149 and 191ter of the SBA.

15 See the Royal Decree-law 3/2009 of March 27, 2009, on urgent tax, financial, and insolvency law measures in view of the unfolding economic situation; the acts 38/2011 of October 10, 2011, on partial reform of the SBA, and 14/2013, of September 27, on Support of Entrepreneurs, and the Royal Decree-law 4/2014, of March 7, on urgent measures concerning the refinancing and the restructuring of corporate debt (the "Royal Decree-law 4/2014").

related to out-of-court workouts, the device mostly utilized by going-concern companies to handle corporate reorganization in Spain.[16]

The hypothesis is that creditors avoid bankruptcy because they feel more comfortable to promote a workout that removes insolvency out-of-court. Therefore, the empirical question is whether or not lenders enforce creditor remedies in monitoring activities. The normative perspective is concerned with the consequences of this issue in the corporate governance of distressed companies in Spain. In other words, the following lines address whether or not the "shadow" restructuring arena permits stakeholders to handle the agency problem more appropriately than bankruptcy and how it influences corporate decision-making.

3 The role of debt in corporate governance

3.1 THE AGENCY THEORY OF THE FIRM

Corporate law aims at reducing agency costs by facilitating coordination among participants in the corporate enterprise. Asymmetric information and opportunism, inherent to rational economic agents, give rise to agency problems. An agency problem is basically the acknowledgment of a conflict of interest that takes place within an organization. According to the Berle-Means conventional model, the incorporation of a legal entity and the subsequent separation of property and management give rise to the debate about the corporate governance of the firm.[17] In addition to the agency problem between shareholders and managers, scholarly work has identified two further kinds of agency problems: conflicts among shareholders, and conflicts between the corporations other constituencies, such as creditors.

3.2 ASYMMETRIC INFORMATION, TRANSACTION COSTS, COVENANTS, AND EVENTS OF DEFAULT

When considering whether to grant a loan, a lender is reasonably concerned about the likelihood that it can collect the funds in the agreed date. Lenders cannot know *ex ante* the borrower's information and what the borrower's future behavior will be. This is due to the issue of asymmetric information, which has traditionally been divided by finance scholars into "hidden information" and "hidden action" (moral hazard) problems.[18] The borrower's rational actions during the term of the loan may put at risk the funds' return. Because of shareholders' limited liability, the managers have incentives under distressed scenarios to invest in high-risk projects in order to maximize shareholder's return on equity (ROE), even if the *expected* return on assets (ROA) from the new project (the net present value) is negative.[19] The moral hazard problem triggers a trade-off between the risk of "overinvestment,"[20] which consists of the substitution of low-risk assets or business

16 The data stems from eighteen (18) interviews addressed to leading finance, restructuring, and bankruptcy lawyers from Madrid, who were selected using the most well known Spanish and international rankings: *Best Lawyers, Chambers and Partners* (Global and Europe), *IFLR 1000, PLC Which Lawyer, Expert Guides, The Legal 500,* and *Who's Who Legal.* The interviewees, all of them with over 10 years of experience, are litigators or transactional lawyers. They were also screened according to their different background prior to becoming practitioners (former judges, professors, or bankruptcy trustees). The snowballing strategy led to contacting the restructuring in-house counsel of one of Spain's largest banks. The selection of lawyers from Madrid as the research population seemed sensible for two reasons. First, 35 percent of the 2011 bankruptcy-proof out-of-court workouts, which represented 82.7 percent of claims subject to one of such out-of-court workouts, were concluded in Madrid. Second, reportedly there is no leading finance, restructuring, and bankruptcy law firm in Barcelona without an office in Madrid according to Spanish and international rankings. Yet, further empirical work may extend the research to other cities in light of the statistics of subsequent years. It would be advisable to wait at least until 2016 to observe the data once the SBA's reforms of 2013 and 2014 have settled among legal actors.

17 See Berle and Means (1932); Fama and Jensen (1983); and Triantis and Daniels (1995).

18 See Fama and Miller (1972); Jensen and Meckling (1976). While hidden information is concerned with borrower's better information over the assets' value (including the risk of insolvency), hidden action refers to borrower's control over the assets. The hidden information problem appears before borrowing, whereas the hidden action problem is concerned with *moral hazard,* which appears when a person does not bear the risks of her actions and, therefore, does not have incentives to take care of them.

19 See Brealey, Myers, and Marcus (2007).

20 See Scott and Triantis (2010). Security interests also develop a significant role in addressing the agency problem between shareholders and creditors. See Scott (1986).

projects for high-risk ones, and the risk of "debt overhang or underinvestment"[21], which may thwart profitable business opportunities.[22]

As a result of the hidden information and the moral hazard problems, the corresponding increase in transaction costs is reflected in a higher interest rate or even in the refusal to grant funds. Covenants and events of default anticipate debtor's financial distress and aim at reducing its opportunism in taking advantage of the asymmetric information (hidden action).[23] To the extent that covenants and events of default serve to reduce transaction costs all the parties are better off. The question that follows is how these contractual devices can also develop a further role from a corporate governance perspective. At issue is whether or not banks' monitoring activities may yield net positive externalities for all the stakeholders beyond the protection of their interests.

3.3 HE ROLE OF COVENANTS FROM THE INTERACTIVE CORPORATE GOVERNANCE PERSPECTIVE

Information requirements *(ex ante),* and covenants and events of default, in addition to security interests, *(ex post)* place financial creditors in a privileged position to monitor borrowers' activities. Although creditors rationally seek their own interest (the collection of their claims), their monitoring activities and subsequent decisions may provide valuable information for the rest of the firm's stakeholders.

First, creditors may contribute to reduce managerial slack and contribute in controlling managerial misbehavior. This is an "unintended" consequence of creditors' monitoring role that ultimately stems from the hallmark of corporate law: shareholders' limited liability for business debts.[24] The separation of the corporation and shareholders' estates may increase the value of both types of assets as security because of creditors' specialization in their monitoring activities, yielding a comparative advantage akin to learning economies.[25] Hence, creditors (particularly secured creditors) may succeed in supervising debtor's behavior, indirectly helping to monitor the managers. On this account, creditors react when they spot managerial misbehavior that may put at risk the corporation's assets value.[26] The subsequent "exit" or "voice" action of monitoring creditors may be what yields "signals" and related net positive externalities for the benefit of other stakeholders.[27] Indeed, the monitoring role of other constituencies, mainly creditors,[28] brought scholars

21 Regarding the trade-off between the problems of underinvestment and overinvestment, see Triantis (1992, 2000); and Schwarz (1997).

22 Subsequent lenders will request from the debtor a security interest over the new assets, which prior lenders may anticipate and prevent in a race toward priority in the proceeds.

23 The scholarly literature has classified loan covenants into four typical categories. See Gulati and Triantis (2007): (i) covenants aimed at monitoring the borrower's actions regarding the maintenance of assets' value; (ii) covenants that address the risk of underinvestment and, in general, the moral hazard problem between shareholders and creditors; (iii) covenants that aim at anticipating insolvency or, in general, at monitoring the deterioration of the lender's exit option; and (iv) covenants concerned with transactions costs among creditors, which explain the rationale of syndicated loans. See Triantis (1992); Armour, Cheffins, and Skeel, Jr. (2002); and Baird and Rasmussen (2006).

24 Limited liability and the subsequent "entity shielding" effects shift the business risk from shareholders to the other constituencies, remarkably creditors. See Hansmann *et al.* (2006).

25 See Scott and Triantis (2010).

26 However, their reaction should be reasonably early.

27 See Triantis and Daniels (1995), who, relying on Hirschman (1970), disaggregate the governance activity of any individual stakeholder into monitoring and reaction ("exit"– termination of the contractual relationship with the company – or "voice" option – deliberate attempt to correct, rather than escape from, an objectionable situation). Their theory is based on two premises. First, the existence of net positive externalities from the monitoring activities of each stakeholder, as long as the common interest in reducing managerial slack is not offset by the conflicts of interest among the different stakeholders. Second, through their observable reactions, each stakeholder provides valuable information picked up by the monitoring activities of the other stakeholders. Hence, the system of inter-stakeholders signals permits the information gathered by dispersed stakeholders with concentrated expertise and heterogeneous perspectives on the firm's affairs to be communicated to those stakeholders best able to correct the managerial slack, thereby contributing to the global diminution of transactions costs and the firm's value maximization for the benefit of all stakeholders.

28 See Armour, Cheffins, and Skeel, Jr. (2002) and Baird and Rasmussen (2006).

to describe corporate governance as an interactive system.[29] According to this view, each stakeholder would process corporate information and react to it accordingly, or react to others' actions. Besides interdependences, the interactive element of corporate governance would contribute to the collective interest in controlling managerial slack. Therefore, other stakeholders may benefit from the monitoring role of adjusting creditors according to the "interactive corporate governance theory."[30]

Second, unsecured creditors and other constituencies may also benefit from the monitoring role of banks from the view of the agency problem between shareholders and creditors. Although there is no "legal" agency relationship between shareholders and creditors,[31] there definitely is an agency problem between shareholders and creditors. Creditors do have incentives to control "shareholders' misappropriation" of funds by way of, for instance, imprudent distribution of dividends in view of the financial picture of the company.[32] Creditors of course take for granted that shareholders' and directors' incentives are perfectly aligned.[33] In furtherance of corporate law default rules, adjusting creditors are concerned with stepping in the corporate governance of the firm under certain conditions (the "contractual solution"). This concern stems from the absence of recognition by the law that in distressed scenarios corporate voice should be given to creditors, the new residual claimants from an economic point of view.[34] To the extent that creditor monitoring activities create net positive externalities all the stakeholders are better off. Unsecured creditors may take advantage of the advice of professional creditors as delegated monitors, whose expertise may be valuable under distressed scenarios if they are adequately incentivized.[35]

It is possible just to refer to one account of creditor monitoring. At the end of the day, the second branch (the agency problem between shareholders and creditors) rises at a juncture at which directors should not only turn to shareholders' interest. In other words, creditors' major concerns to address managerial slack occur in financial distress, when they happen to have the best incentives to maximize the value of the assets and to monitor directors.

3.4 DEBT RESTRUCTURING UNDER DISTRESSED SCENARIOS: THE PEAK OF THE AGENCY PROBLEM

The peak of the agency problem between shareholders and creditors arises in fact in the vicinity of insolvency.[36] Insolvency triggers a shift in the residual claimants as creditors do have better incentives than managers to maximize corporate value since they benefit in the margin from a more efficient management. Managers are expected to seek high-risk business projects, whereas creditors do endeavor to avoid the risk of overinvestment that may lead-up to insolvency.[37] The following numerical example shows the distortion of shareholders'

29 See Triantis and Daniels (1995).

30 See Triantis and Daniels (1995).

31 According to Gulati and Triantis (2007), a lender would invest in a business borrower in order to rely on the managers' expertise in carrying out a particular business project.

32 See Kraakman *et al.* (2009). Legal personality protects the firm's assets from the owners' creditors' claims, while limited liability protects the assets of the owners from the claims of the firm's creditors.

33 See Triantis and Daniels (1995).

34 As Kraakman *et al.* (2009) explain, shareholders are a corporation's "residual claimants" in the sense that they are entitled to appropriate all (and only) the net assets and earnings of the corporation after all the contractual claimants (such as employees, suppliers and customers) have been paid in full. This rationale applies to unsecured creditors in distressed scenarios (see footnote 6).

35 See Gulati and Triantis (2007), who contend that the value of banks as delegated monitors is limited by the race against the debtor' assets that insolvency prompts. See in contrast Baird and Rasmussen (2006). See Gilson and Vetsuypens (1994), who set the basis for the empirical analysis of this issue.

36 Leverage maximizes shareholders' ROE provided that new business projects' ROA exceeds the capital cost. Notwithstanding that the net present value may be negative, the level of risk and the expected positive returns are positively correlated. See Brealey, Myers, and Marcus (2007).

37 There may be this a trade-off between the risks of underinvestment and overinvestment in the vicinity of insolvency.

incentives in distressed scenarios. There are three business projects (the price is assumed to be fair[38] and the debtor will not become insolvent or unreasonably undercapitalized as a result of any of the transactions).[39] The first project is a sale of a business unit, which will give rise to a certain consideration (€10,000,000). The second project will produce, with equal probability, either €15,000,000 or €5,000,000 net proceeds. Lastly, the third project will give rise to either €100,000,000 (10 percent probability) or nothing (90 percent probability). Lastly, the company has €10,000,000 liabilities coming due in December. The following table summarizes the example:

CONFLICT OF INTEREST UNDER DISTRESSED SCENARIOS — TABLE 1

Project	Business project	Probability	Net proceeds	Expectancy
1	Sale of business unit	100%	€10,000,000	€10,000,000
2	Purchase of business unit	50%	€15,000,000	€10,000,000
		50%	€5,000,000	
3	Investment in a new venture	10%	€100,000,000	€10,000,000
		90%	€ 0	

SOURCE: Author's elaboration.

Under these assumptions, the three business projects will give rise on average to the same expected proceeds ($10,000,000). Creditors and shareholders will though differ in their preference regarding the managers' final choice. Creditors will want managers to invest in the safer first project. However, shareholders will prefer that managers invest in the riskier third one, because this might allow to a dividends' distribution. Hence the conflict of interests and the resulting agency problem.

Debt restructuring involves a fight for corporate control that may end up in bankruptcy if the contractual solution does not overcome the agency problem. Shareholders prefer engaging in high-risk and potentially more profitable business projects at the expense of refinancing creditors (risk of overinvestment). Adjusting creditors bargain to monitor managers, which may deprive the debtor of risky but potentially profitable business projects (risk of underinvestment).

3.5 BANKRUPTCY AS THE LAST RESORT TO HANDLE THE CORPORATE GOVERNANCE PROBLEM THAT INSOLVENCY POSES

Bankruptcy is in large part a procedure that responds to a collective action problem without distorting creditors' substantive rights. The rules of the bankruptcy proceeding, therefore, reduce transaction costs by preventing unsecured creditors from engaging individually in a costly and unsuccessful race against the debtor's assets. This background may only work provided that bankruptcy actually entails a shift in the corporate governance of the firm. Manager-friendly or excessively bureaucratized legal systems restrict creditors from filing the petition.

According to the role of debt in "interactive corporate governance" account,[40] bankruptcy would be the last resort to address managerial slack when the rest of corporate governance

38 Both the borrower and a third party will receive a consideration of reasonable equivalent value to their performance under the business project. The transaction would not be subject to claw-back under article 71 of the SBA accordingly.

39 Nor will any of the three business projects cause the debtor to incur debts beyond its ability to pay. The transaction, would not be subject to claw-back under the article 71 of the SBA or the state or federal U.S. fraudulent conveyance law.

40 See Triantis and Daniels (1995).

mechanisms fail.[41] Creditors and directors do bargain out-of-court unless asymmetric information increases transaction costs so dramatically that a forced-sale of company's assets to creditors through bankruptcy turns out to be the economically efficient solution. In other words, filing a bankruptcy petition would make economic sense where the transaction costs of handling corporate insolvency out-of-court become unmanageable due to the hidden information and moral hazard problems.[42]

Covenants and events of default reduce transaction costs and may lead the adjusting creditors to develop delegated monitoring and corporate governance activities. Debt instruments thus set the basis for accelerating ("exit") or reaching an out-of-court workout ("voice") upon the signals spotted by professional adjusting creditors. Lenders may step in if the management goes beyond the agreed-upon financial risk. Bargaining consists of threatening to accelerate the loan if management fails to meet creditors' demands (more voice). Negotiations may in turn lead to an out-of-court workout, where creditors may bargain with the petition. The threat is the forced sale of the debtor's assets to creditors that bankruptcy should permit in as much as unsecured creditors become the new residual claimants of the debtor's assets upon insolvency.

From an economic perspective, creditors may thus file a petition provided that bankruptcy's transaction costs do not outweigh this shift in the corporate governance of the firm. While recovery statistics and the time, cost, and bureaucracy of the proceeding are definitely important, creditors' ability to decide whether to propose a plan of reorganization or to prompt the sale of business assets is king in this economic decision. Otherwise creditors do not actually have incentives to file a petition. Nor will their bargaining threat be that credible. Differently put, creditors' standing to file for involuntary bankruptcy may be of little use in their bargaining to influence management in the vicinity of insolvency if the declaration does not entail a clear cut-off in the firm's corporate governance.

3.6 THE PUZZLE OF DIRECTORS' FIDUCIARY DUTIES AND LENDER LIABILITY

The contractual solution bypasses the agency problem by vesting a new constituency (professional adjusting creditors) with corporate voice. However, corporate law does not recognize a takeover in the corporate governance of the firm in distressed scenarios, which triggers lenders' risk of insider subordination or even liability. On the other hand, because insolvency encompasses a shift in the residual claimants, directors may be charged with a breach of their fiduciary duties by two different constituencies if financial distress is handled out-of-court. The question is whether or not insolvency should entail a shift in directors' fiduciary duties in order to protect creditors in the vicinity of insolvency (or when insolvency is handled out-of-court). The pervasive issue is whether or not unsecured creditors may sue directors for their actions in the vicinity of insolvency.[43]

This question was first raised in the United States following Chancellor Allen's famous footnote 55 in *Crédit Lyonnais.*[44] In rejecting shareholders' derivative lawsuit for breach of directors' fiduciary duties, the Court of Chancery contended that directors would not breach their fiduciary duties if they looked at creditors' interest *in the vicinity of insolvency.*[45]

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41 See Triantis and Daniels (1995).

42 Bankruptcy may be the only way to manage corporate insolvency if creditors are for example so dispersed that the common action problem impedes an out-of-court workout.

43 See the United Nations Commission on International Trade Law (2013).

44 See Crédit Lyonnais Bank Netherland, N.V. v. Pathe Communications Corp., 1991 WL 277613 (Del. Ch. Dec. 30, 1991), pp. 1-31, at 25-26.

45 See also section 172.3 of the UK Companies Act of 2006. "The duty imposed by this section has effect subject to any enactment or rule of law requiring directors, in certain circumstances, to consider or act in the interests of creditors of the company".

What the opinion did not clarify, however, is that this assertion was not at all at odds with the business judgment rule,[46] as the Delaware Chancery Court eventually sustained.[47] The unintended consequence was the issue of directors' liability to creditors[48] for "deepening" a corporation's insolvency.[49] This case gave rise to disputes by creditors who filed direct actions[50] ultimately seeking to reach a "deep-pocket" as a last and desperate attempt to collect their claims.[51] In *Production Resources*[52] and *Trenwick America,*[53] the Chancery Court of Delaware further contended the shift of residual claimants' rights that occurs upon corporate insolvency, which was eventually confirmed by the Delaware Supreme Court in *NACEPF.*[54] However, this shift provides standing to file a corporate lawsuit,[55] but not to bring direct actions against the directors.[56] The court further concluded that *Crédit Lyonnais* had just aimed at providing a liability shield against stockholders' derivative lawsuits to directors that turned to creditors' interests in the vicinity of insolvency, rather than a sword for unsatisfied creditors.[57]

In actuality, this hardly meets creditors' needs and expectations because their preferred relief is generally individual (they are concerned about collecting their claims soon and first, especially as insolvency approaches).[58] Besides, squeezed-out unsecured creditors due to preferred payments might hardly try a direct lawsuit against directors for breach of their duty of loyalty.[59] In *Asmussen*[60] and *Pennsylvania Co.,*[61] the Chancery Court of Delaware held that preferred payments do not entail a breach of fiduciary duty, unless the creditor is a stockholder or a director.[62] In other words, unsecured creditors concerned about preferential payments cannot be protected by the "zone of insolvency" doctrine. Instead, they have standing and, indeed, should file a bankruptcy petition to protect their interest.[63]

In short, there is no "shift" in the director's fiduciary duties or in the firm's interest, which remains the same: directors must be loyal to the corporation and pursue the maximization of the corporate assets value. There is just a gradual "shift" in the identity of the residual

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46 See *Gagliardi v. TriFoods Int'l, Inc.,* 683 A.2d 1049, 1052 (Del. Ch.1996).

47 See *Trenwick America Litigation Trust v. Ernst & Young, L.L.P.,* Del. Ch., 906 A.2d 168 (2006), pp. 168-218. The Chancery Court of Delaware rejected the existence of an independent cause of action for "deepening insolvency" and that the "zone of insolvency" could give rise *per se* to a new enhanced standard of judicial review. Chancellor Strine argues that "deepening insolvency" might be a criterion to determine damages caused to unsecured creditors in their condition of new residual claimants (with standing to file a derivative lawsuit).

48 Chancellor Strine sharply argued in *Production Resources,* however, that there would be little room for derivative claims if creditors, as expected, protected their interests contractually. See *Production Resources,* at 790.

49 Whilst Crédit Lyonnais rejected a stockholders' claim for breach of fiduciary duty (the shield), impaired creditors drew on this case to reach out to an additional "deep-pocket" (the sword).

50 *Acción individual de responsabilidad* under Spanish law.

51 See *Trenwick America* or *Production Resources Group L.L.C. v. NCT Group, Inc,* Del. Ch., 863 A.2d 772 (2004), pp. 772-883, and *North American Catholic Educational Programming Foundation, Inc. v. Rob Gheewalla, Gerry Cardinale and Jack Daly,* Del., 930 A.2d 92 (2007), pp. 92-103 ("NACEPF"). See also Veasey (2009).

52 See *Production Resources,* at pp. 790-791.

53 See *Trenwick America,* at pp. 194-195, footnote 75.

54 See *NACEPF,* at 101.

55 This is what the Delaware Supreme Court confirmed in *NACEPF* (see page 101). The "zone of insolvency doctrine" does not give rise, however, to a direct action.

56 This solution is similar to the one provided under article 240 of the Spanish Limited Liability Companies Act.

57 See *Production Resources,* at 788. See also Veasey (2009).

58 Moreover, most Delaware corporations include as a default rule the charter's exculpatory provision under §102(b)7 DGCL (or similar provision in other states), which shields directors' grossly negligent actions if they act with good faith.

59 The protection under §102(b)7 DGCL does not apply to the breach of the fiduciary duty of loyalty.

60 See *Asmussen v. Quaker City Corp.,* 156 A. 180 (Del. Ch.1931), pp. 180-183, holding that the directors of an insolvent corporation may prefer one creditor to another.

61 See *Pennsylvania Co. for Insurances on Lives and Granting Annuities v. South Broad St Theatre Co,* 174 A. 112, pp. 115-116 (Del. Ch.1934), pp. 112-117, carving out an exception of preferred payments made to insiders.

62 However, see the Spanish Supreme Court's order as of November 30, 2001 (RJ 2001, 9854).

63 In *Asmussen,* at 182, the Court of Chancery held that creditors should file a petition to protect them against preferential payments to other creditors. Whether or not the bankruptcy may be too "manager-friendly" is a different issue.

claimants as it approaches the “zone of insolvency”. The U.S. deepening insolvency doctrine may be boiled down to the simple proposition that directors owe a fiduciary duty to the corporation, rather than to the shareholders or any other constituency.[64] In other words, until actual insolvency arises, directors owe fiduciary duties to the corporation and the shareholders act in their capacity as residual claimants and risk bearers. Corporate law provides shareholders with voting rights and standing to file a derivative lawsuit as their interest is aligned with the maximization of the corporation’s value. The other voluntary stakeholders, especially adjusting creditors, are expected to decide rationally whether or not to engage with the firm and to protect their economic interests contractually, which should not give rise to lender liability concern associated to “shadow” or *de facto* direction if they step-in upon financial distress.

4. Analysis of the data and discussion

None of the interviewees was of the opinion that “common market practice” loans or workouts are fully enforceable under Spanish law. Banks’ internal risk committees instruct their lawyers to draft tons of covenants and events of default. This is the “just in case” policy. It consists of including “everything”, unless it actually harms the banks’ interest. However, banks are thereafter extremely cautious to enforce their contractual rights. But for lack of payment or a few – sometimes doubtful – examples of reduction of the guarantees package, the interviewees said, professional adjusting creditors do not enforce covenants and the corresponding events of default to accelerate. There is furthermore a widespread perceived judicial threat of banks being held as “insiders”. Bargaining is regarded suspiciously, particularly in the vicinity of insolvency. Lawyers endeavor to hide the exercise of influence over the debtor’s management in the negotiations of an out-of-court workout.

Assuming that the internationalization of finance and restructuring law has caused loans and workouts to become “boilerplate” to a significant degree, this section is concerned with the unsettling practical consequences of the lack of awareness of the role of debt in corporate governance. It analyzes what might be two of the hottest issues in the Spanish restructuring arena: the risk of professional adjusting creditors being treated as insiders,[65] and the mere formal protection of unsecured creditors by Spanish insolvency law. Lack of express bargaining on enforcement may misbalance stakeholders’ incentives. The Spanish “shadow” out-of-court restructuring arena may hardly provide a more efficient framework than bankruptcy to handle insolvency’s collective action problem.

4.1 LACK OF ENFORCEMENT OF FINANCING CONTRACTS

4.1.1 The “exit option”. Lack of enforcement of covenants and events of default

From the point of view of a Spanish practitioner, the role of debt in corporate governance may be striking, particularly in the vicinity of insolvency. Some of the interviewees were indirectly asked whether or not covenants and events of default might be aimed at influencing debtors’ corporate governance. Whereas most of them answered negatively, especially in light of the insider subordination risk or even the lender liability judicial threat, one of them asserted that “these doctrinal theories are far away from the reality of Spanish law”.

64 See Allen, Kraakman, and Subramanian (2012).

65 The factual consideration of “shadow” or even *“de facto* directors” might be partially grounded on the bargaining to monitor debtor’s management under distressed scenarios. Insider consideration encompasses subordination, the loss of security interests. It might also be challenging if bankruptcy is held “guilty.” See Professor Pulgar (2012a). In addition to being liable for damages and losing their claims, a “guilty” holding may trigger official or *de facto* directors’ liability for the impaired claims for willfully or grossly negligently causing or deepening the debtor’s insolvency. The classification phase opens upon liquidation or when the judicially approved composition agreement is considered “prejudicial” for creditors (discharge of more than a third of the claims or a stay of payment beyond three years under article 167 of the SBA). On a lesser level, third parties may also be judicially declared accomplices for willfully or grossly aiding and abetting negligently in causing or deepening debtor’s insolvency (see articles 166 and 172 of the SBA). Accomplices lose their claims, must give back any payment received from debtor, and may be liable for damages (but not for the impaired claims).

The data shows that acceleration is almost unheard of in practice. True, lack of payment of principal or interests, as well as security interest issues are enforceable in merits of articles 1124 and 1129 of the Spanish Civil Code. However, banks do rarely enforce other kind of covenants and events of default. Some of the most experienced attorneys contended that acceleration for reasons other than non-payment is basically unheard of in Spanish practice. A former judge was not aware of any related case law. Three of the interviewees reported that they were only aware of an extremely isolated acceleration case following the increase of the ratio of loan-to-value. Actually, the event of default that had triggered acceleration was not the breach of the covenant (a predetermined loan-to-value ratio), but the debtor's unwillingness to grant further security interest to restore the ratio. This empirical evidence only confirms the "stare decisis" of the Spanish Supreme Court. It has stated, over and over again, that termination for breach (and thus acceleration) cannot depend on the sole discretion of one of the parties to the contract.[66]

4.1.2 The "voice option". The role of debt in the corporate governance of distressed firms

All in all, the low degree of enforcement of covenants and events of default should not be surprising. Enforcement of covenants (acceleration) through the corresponding events of default, either as breach or acceleration, is concerned with the so-called "exit option".[67] However, the interactive corporate governance theory indicates that the "exit option" may only work as a threat in practice,[68] regardless of the useful information that acceleration may provide to other constituencies of the firm.[69] To be sure, an event of default entitles creditors to accelerate, demand payment, and repossess collateral. However, this option has commercial costs, particularly when professional adjusting creditors have already developed monitoring abilities in specialized economic sectors. In addition, contract termination deprives adjusting creditors of the earnings of a smooth commercial relationship with the defaulting debtor.

Thus, banks and other nontraditional professional adjusting debt-holders[70] primarily include covenants and events of default to bargain with the threat of acceleration. This corporate governance tool enables adjusting creditors to align directors and management decision-making with their interest, and to keep them far from shareholders' incentives, which may diverge from the corporate interest as the debtor approaches the twilight zone (the zone of insolvency). Rather than accelerating, which is rarely followed by collection, adjusting creditors agree to negotiate with the goal of constraining management in exchange of restructuring their debt instruments. This is the so-called "voice option".

Importantly, creditor monitoring, while self-interested, has positive externalities that benefit the rest of stakeholders.[71] In the vicinity of insolvency, directors serving shareholders' interest exclusively may not be maximizing corporate value. Hence, monitoring activities exerted by professional adjusting creditors may effectively address managerial slack or exert influence toward an efficient management of the assets. This contributes to reduce agency costs in the case of atomized unsecured creditors. At least, it bypasses the distorted incentives of the shareholders who may want the directors to invest in high-risk projects at the expense of creditors, while putting at risk the interest of other constituencies. Where bargaining fails, acceleration still provides a valuable monitoring signal to the other

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66 See, Spanish Supreme Court's orders of June 4, 2008 (RJ 2008, 3196), December 12, 2008 (RJ 2009, 152), December 16, 2009 (RJ 2010, 702), and February 17, 2011 (JUR 2011, 3316).
67 See Triantis and Daniels (1995), and Hirschman (1970).
68 See Gulati and Triantis (2007).
69 See Triantis and Daniels (1995).
70 See Baird and Rasmussen (2006).
71 The reason why creditors' monitoring activities may benefit other stakeholders, namely the rest of dispersed and unsecured creditors, is related to the role of delegated monitoring. See Gulati and Triantis (2007).

stakeholders. Yet, this eliminates the net positive externalities from banks' monitoring activities that may benefit other stakeholders, who, nonetheless, may analyze the acceleration signal and react against the slack.[72]

Well, the interviews indicate that adjusting creditors do not bargain that much in the vicinity of insolvency because they are concerned about the risk of insider subordination in subsequent bankruptcy. Moreover, a couple of interviewees noted that a considerable number of "boilerplate" covenants and events of default are unenforceable (and unhelpful in negotiations).

4.1.3 Boilerplate clauses and the "just in case everything" mandate

Lack of enforcement of covenants and events of defaults is puzzling in light of the large contracts that debt instruments constitute. As a result, these interviewees were asked why professional adjusting creditors' legal advisers do endeavor to include "unenforceable" covenants and events of default in debt instruments. The first reason is the "everything, just in case strategy". Some of the interviewees indicated that external counsels are indeed instructed to include "everything." Certain provisions are just included to keep track with previous transactions in order to avoid problems with banks' internal risk committees. Clients request, they explained, not to remove any of those clauses unless their inclusion might be detrimental to the bank for some reason, regardless of whether or not they are actually enforceable. Second, these clauses are maintained in the models just in case the law may change. Certain debt instruments, related to corporate or project finance, are expected to be in force for a long period of time. However, two of the interviewees who specialize in lenders' advice stressed that these clauses have actually become boilerplate. Hence, they said, one should get used to seeing unenforceable or even null provisions, such as *ipso facto* clauses following bankruptcy.[73] All in all, they contended, external counsels advice banks about the unenforceability of those clauses in their legal opinions.

Again, this absence of legal culture of the role of debt in corporate governance may deprive other constituencies from the economies associated to delegated creditor monitoring.

4.1.4 Legal threats akin to the risk of insider subordination

Adjusting creditors do not bargain with the "threat" of acceleration in Spain, particularly in the vicinity of insolvency. The vast majority of interviewees pointed out the risk (and banks' concern) of their treatment as shadow or *de facto* directors, with the associated hazards of insider subordination or even lender liability risk. The view was confirmed by the "in-house" head of restructuring of one of the Spanish largest banks.

Unless the covenant or event of default is perfectly and thoroughly connected to the contract's consideration, they say, the consequences of trying to influence management decision-making may be challenging. First and foremost, as insiders their claims may be subordinated.[74] This moreover deprives lenders from their security interests for the purposes of recovery under bankruptcy. To make things worse, bankruptcy's classification phase[75] might even trigger lender liability. In case of "guilty" bankruptcy, official or *de facto* directors willfully or grossly negligently *causing or deepening* debtor's insolvency may be liable for the impaired claims.[76] At a lower level of lender liability, creditors might also be judicially held to be *accomplices*[77] for willfully or grossly negligently aiding and abetting in causing or

72 See Triantis and Daniels (1995).
73 See article 61.3 of the SBA.
74 See articles 92.5 and 93.2 of the SBA.
75 See footnote 65.
76 See articles 163-175 of the SBA.
77 See article 166 of the SBA.

deepening debtor's insolvency. A complicity holding encompasses the impairment of any claims against the estate, the reimbursement of any "undue" collected amount, and liability for damages.[78]

Notably, the interviewees did not agree with the insider subordination or lender liability risk. They strongly disagreed with it. This makes sense. They nevertheless took it into account, they explained, in light of case law.[79] Moreover, one of the lawyers suggested that the Spanish Supreme Court is currently considering this issue of shadow or *de facto* administration. This lawyer noted rumors and even leaks aimed at banks so that they refrained from joining "steering committees"' during restructuring negotiations. Further, the in-house head of restructuring of one of the largest Spanish banks contended that express bargaining with the threat of enforceability of acceleration is not useful at all. It is rather challenging in light of current case law. For instance, the sale of a controlling shareholder's stake would not trigger the threat of acceleration provided that the debtor did not default in paying its obligations. Nor would the breach of a divestiture plan agreed in an out-of-court workout prompt bargaining with a bankruptcy petition if the debtor was paying punctually.[80]

All in all, a transactional attorney with expertise in advising banks argued that debtors are not indifferent following an event of default. While others, namely litigators, asserted that they do advise borrowers about the extent to which "they can live with events of default", this transactional attorney insisted that debtors do not leverage with the bargain of insider subordination or even lender liability. Borrowers do promptly request a waiver. This attorney furthermore stressed that debtors should either perform or ask for a waiver in order not to be deprived of credit in the future. Yet, this threat depends on whether or not the adjusting creditor is already held-up in its investment on the borrower. To clarify the point, none of the interviewees would feel comfortable with the appointment of a "chief restructuring officer" at the request of the banks. Similarly, creditors are urged not to get involved in the "intellectual authority" of a divestiture plan or even a business plan. Moreover, proceeds should flow directly from the debtor's bank account. Thus, irrevocable powers of attorney to sell a business unit or grant a security interest are examined extremely carefully.

4.1.5 Adjusting creditors do not use their privileged information

The pernicious consequences of missing delegated creditor monitoring rely of course on the assumption that lenders may be willing and definitely would be ready to engage in those governance activities. Quite the opposite, the data shows that banks' degree of carefulness and diligence varies during the commercial relationship. To be sure, the limited judicial culture and the subsequent risk of insider subordination or lender liability regarding acceleration or exercise of the "voice" option, is a hot issue, confirmed by the in-house head of restructuring and bankruptcy of one of the largest Spanish banks. Nonetheless, it turns out that lower level employees with insufficient legal background usually conduct servicing activities, which include creditor monitoring. Therefore, certain professional adjusting creditors, mainly banks, may be charged with a low degree of diligence in monitoring debtor's activity. This is probably more reprehensible than the "just in case" strategy. A lender's attorney who advises banks represented that he becomes aware of financial distress sometimes only upon debtors' request of a waiver. This means that professional adjusting creditors do not control as much as they could. In particular, they do not take advantage of the privileged information they have about borrowers until

78 See article 172 of the SBA.

79 Some of them referred to the order from the commercial court No. 1 of Málaga, of April 7, 2011 (JUR 2011, 329906).

80 One of the interviewees asserted that this breach may nevertheless give rise to either payment or default sooner or later (especially if creditors came up with the divesture plan), which may subsequently entitle creditors to accelerate.

financial distress actually arises. The degree of diligence increases again during the negotiation of a workout. Indeed, as with the initial agreement, the conclusion of an out-of-court workout needs the approval of the committee on internal risks.

In short, Spanish insolvency law does not incentivize professional adjusting creditors to bear corporate governance responsibilities and engage in delegated monitoring roles out-of-court. Instead of an *ex ante* insider subordination or even lender liability risk,[81] it may be more useful to analyze empirically whether appropriately incentivized adjusting creditors may effectively engage out-of-court[82] in delegated monitoring responsibilities to overcome insolvency out-of-court as an alternative to bankruptcy. This work should take account of professional adjusting creditors' incentives towards individual collection or even liquidation. This quantitative research work may not make a lot of sense though if banks do not enforce covenants and events of default in practice. The degree of diligence of banks is at issue. It is regrettable in any event that they do not take advantage of their privileged information.

4.2 THE ECONOMIC DILEMMA BETWEEN BANKRUPTCY AND OUT-OF-COURT WORKOUTS

The data confirms that bankruptcy's transaction costs have prompted economic agents to turn primarily to out-of-court workouts when it comes to dealing with financial distress. No stakeholder has good incentives to petition bankruptcy, where unsecured creditors are far from becoming materially the new residual claimants over the debtor's assets.

4.2.1 The role of bankruptcy in Spain

4.2.2 The choice between filing and handling insolvency "out-of-court"

Handling corporate insolvency out-of-court encompasses notable risks for both unsecured and professional adjusting creditors. First, the lack of legal culture on the role of debt in corporate governance brings about significant risks related to subordination and lender liability. Second, professional adjusting creditors out-of-court may squeeze the unsecured creditors out.[83] Bankruptcy is aimed at protecting unsecured creditors equally according to the absolute priority rule, while out-of-court mechanisms are the result of the negotiations between directors (the shareholders' formal fiduciaries) and the adjusting creditors, who rely upon their contractual bargaining power. As a result, the choice (in-court or out-of-court) may not be neutral for creditors. This is puzzling because the freeze-out and holdout[84] problems may outweigh the economic gains of handling insolvency out-of-court.

Indeed, under the SBA the suspension of the debtor's duty and the creditors' ability to file is only suspended for up to six months. In other words, an out-of-court workout is an alternative to bankruptcy provided that corporate insolvency is removed within six months. As some of the interviewees pointed out, the SBA contains a basic but important inconsistence. Whereas the reforms endeavor to promote out-of-court workouts as an efficient device to address pre-insolvency and, to certain extent, actual corporate insolvency, early petition is also provided with incentives. This may raise strategic behavior that benefits no stakeholder. Whereas adjusting creditors may bargain to impose discharges and/or

81 See Navarro (2011).

82 The goal would be to develop an econometric model aimed at identifying effective tools of creditor governance. The analysis of out-of-court workouts would allow to propose a binary LOGIT model ("1": bankruptcy; "0": success –so far). In addition to certain control independent variables, such as the industry or the amount of the deal, the model would permit analyzing the effects of covenants and events of default in preventing and overcoming corporate insolvency.

83 The debtor would not object to the reduction of its commercial debt provided that the suppliers are enough loyal to (or help-up with) the company. This is just another example of the shareholders' bad incentives in distressed scenarios.

84 Holding-out unsecured creditors may bargain as much as the debtor with the petition and the insider subordination risk.

stays of payments, unsecured non-financial creditors (or even the debtor) may develop greenmailing strategies with the petition after the six months suspension period elapses.

Three of the interviewees suggested, nevertheless, that according to their experience unsecured creditors were totally willing to collect their claims with a significant discount just to avoid bankruptcy. The large majority of the interviewees claimed indeed that Spanish law actually needs a "good copy" of the UK scheme of arrangement. A pre-insolvency proceeding or even an alternative to bankruptcy upon insolvency, with a reasonable degree of judicial overview,[85] would certainly eliminate much of these risks.

4.2.3 Who calls the shots in the Spanish bankruptcy proceeding?

Although the Spanish bankruptcy proceeding is "manager-friendly"[86] (as director keep their role as a default rule), both shareholders and directors escape from bankruptcy to the same extent as creditors do in actuality. Official or *de facto* directors may be held liable to the debtor's creditors for the impaired claims if bankruptcy is classified as guilty. Managers and directors may lose their jobs, while the debtor may end up losing the property of its assets. As per debtors' promoted compositions, the freedom of contract principle is moreover drastically reduced in bankruptcy. A composition cannot include discharges exceeding half of the claims or stays of payment beyond five years.[87] Moreover, discharges exceeding a third of the claims or stays of payment beyond three years will prompt the judge to open the classification phase.[88] In addition, there is no mechanism for a majority of privileged creditors to be able to cramdown a composition over dissenting privileged creditors, which makes undoable a plan of reorganization in special purposed vehicles where all the assets are encumbered.[89] Needless to say, workers do not have any incentive to file for bankruptcy, as they will most likely lose their jobs unless the assets are sold in liquidation as a going-concern business.[90] Until very recently, banks avoided bankruptcy to avoid reporting the corresponding losses in their balance sheets. Now, like any other creditor, they are just unwilling to spend time and money litigating or even waiting for the end of a proceeding that will last on average three years.[91] They may be also deterred by insider subordination and even lender liability considerations.[92]

To be sure, the fact that unsecured creditors *should* be the debtor's assets' new residual claimants it does not mean that they actually call the shots in bankruptcy. True, unsecured creditors are taken into account to validly hold a creditors' general meeting and to approve a proposal of composition.[93] Yet, the legal majority of 50 percent[94] may be distorted with agreements with secured creditors promoted by the debtor. Significantly, a creditor cannot petition liquidation or prompt the sale of business units. In fact, unsecured creditors rarely

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85 The draft bill proposed by Professor Rojo included a pre-insolvency proceeding with a lesser degree of judicial overview. See Rojo (2003). Current scholarship insists, however, on the need to promote out-of-court workouts without judicial intervention. See Pulgar (2012b), who argues that judicial overview entails an undesirable degree of bureaucracy that has jeopardized the social impact of the new pre-insolvency proceedings of France and Italy.

86 Scholars have classified bankruptcy proceedings as "manager-displacing" or "manager-friendly" as a counterbalance to the degree of concentration of capital and debt. See Armour, Cheffins, and Skeel, Jr. (2002), who argue that "manager-friendly" bankruptcy proceedings would make sense in cases of dispersed creditors, whilst "manager-displacing" proceedings would be a useful tool of corporate governance in the presence of a high degree of creditor concentration.

87 See article 100 of the SBA. Yet, companies with "geographic economic relevance" may enjoy more room.

88 See footnote 65.

89 The Royal Decree-law 4/2014, of March 7, enables certain mechanisms that are not yet available in bankruptcy.

90 Except the sale of the business unit as a going-concern.

91 See Van Hemmen (2012).

92 In addition, banks' security interests may not survive the sale of a business unit according to a liquidation plan in accordance with the decisions of March 11, 2013, of the Court of Appeals of Barcelona (No. 36/2013), and July 23, 2013, of the Spanish Supreme Court (No. 491/2013). See articles 148 and 149 of the SBA.

93 See articles 116 and 124 of the SBA.

94 See article 124 of the SBA.

assume the control of debtor's assets in bankruptcy. First, bankruptcy may hardly prompt a "forced sale" of the debtor's assets to creditors in Spain. The petition does not trigger corporate debtor's dissolution, whose legal entity survives until liquidation. The only possibility consists of reaching a composition to sell the debtor's assets to a Newco (incorporated by the creditors) that assumes the claims in consideration for the business unit. This is the so-called *convenio de asunción,*[95] which is almost unheard of in practice. To make things worse, some scholars[96] contend that the debtor should consent to it (which is extremely unlikely), as otherwise it would consist of an expropriation. Second, creditors cannot petition liquidation.[97] The SBA's reform of 2011 just empowered the trustee to petition liquidation if the debtor's business activity is shut down.[98] Moreover, bankruptcy is judicially controlled as a matter of law, which makes it too bureaucratized. For example, the judge must proceed with the composition phase notwithstanding how unlikely it may be to reach a composition.[99] She must summon the creditors' general meeting as a default rule.[100] Further, the judge cannot order liquidation until she confirms that there is no composition proposal, or that no proposal has been accepted in the creditors' general meeting.[101] Quite the opposite, liquidation is the realm of the debtor, who can even leverage with the petition to attempt to avoid a forced sale through a *convenio de asunción* or whatever other sort of composition agreement proposed by creditors.[102] The rationale of the rule is that the debtor may undertake to manage the assets for the benefit of the creditors, or, according to the constitutional principle of freedom of enterprise,[103] to petition liquidation so that creditors are paid with the proceeds of the sale of the assets. Notably, a *convenio de asunción* does not impose a forced management of the assets in the interest of the creditors as a third party undertakes to run the business unit. What is important is that creditors should have the right to petition their "liquidation recovery" where they could prove that liquidation would entail a higher recovery than the proposed composition agreement. However, Spanish law does not provide for a best-interests test.[104] Quite the contrary, common wisdom still refers to the "sovereignty of the debtor" in deciding the solution to insolvency (an early sale of the business unit, a composition agreement, or liquidation).

Besides, the only proposals as per the sale of assets may come from the debtor or the official trustee.[105] This supposedly official representative of creditors supervises or steps in the role of the debtor's directors in making business decisions.[106] Not surprisingly, several of the interviewees asserted that bankruptcy does not attend at all to creditors' interests, despite that this is the SBA's formal goal. A lawyer who has been appointed as the official trustee in more than 150 bankruptcy proceedings confirmed this view. Asked about who

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95 See article 100.2 of the SBA.

96 Significantly, see Pulgar (2007).

97 The creditors may only petition liquidation if the debtor becomes insolvent during the implementation of the composition (see article 142.2 of the SBA).

98 See article 142.3 of the SBA.

99 See article 111.1 of the SBA. The only way to avoid that delay is through the debtor's petition, which is highly unlikely. Sancho (2009) argues that the SBA is too naive in providing for the composition as the default solution in bankruptcy.

100 See article 111.2 of the SBA.

101 See article 143 of the SBA.

102 See article 128.3 of the SBA.

103 See article 38 of the Spanish Constitution.

104 The best-interests test allows each holder of a claim or interest in an impaired class to insist on receiving "property or value, as of the effective date of the plan, that is no less than that amount that such holder would so receive or retain if the debtor were liquidated" under Chapter 7 (see section 1129(a)(7) of Chapter 11 of the U.S. Bankruptcy Code).

105 Certain interviewees raised concerns about the qualification of the official trustees to deal with corporate insolvency.

106 As a default rule, voluntary bankruptcy proceedings give rise to the supervision regime, while non-voluntary proceedings lead to substitution (see articles 21 and 40 of the SBA).

prompted the sale of business units during the "common phase" (the so-called "Spanish 363 sales"), he replied that this was the trustee's business, who usually turns to the debtor's interest.[107] The in-house head of restructuring of one of the Spanish largest banks, in charge of supervising more than 2,000 bankruptcy proceedings, furthermore asserted that bankruptcy "feeds vulture bureaucrats at the expense of creditors". He furthermore criticized how businessmen suffered through bankruptcy and the loss of going-concern value following the petition. The sole exception raised by most of the interviewees was the new distressed M&A market prompted by the sale of the debtor's business units in liquidation. The corporate entity is dissolved and the directors are fired in liquidation. An effective procedure may enable a sale of the business unit that preserves its going-concern value and the workforce to some extent. The price is applied to pay the claims.

4.2.4 The stakeholders' runaway from bankruptcy. Empirical evidence about an economic decision rather than a cultural trait

Rather than being "manager-friendly" or "manager-displacing", the SBA is an overly procedural, bureaucratized, and judicially overseen proceeding. Unsecured creditors do not have in practice material voice to prompt a forced-sale of the assets or to petition liquidation in their purported capacity of new residual claimants. In a way, the legal certainty reactively pursued by the SBA has resulted in both the trustee and the bankruptcy judge acting as "agents" of the creditors' interests in bankruptcy.[108] In other words, the SBA only protects unsecured creditors formally to a great extent.[109] Rather than a last resort to solve a conflict of interest, bankruptcy is generally a poor solution for every stakeholder. No stakeholder is generally willing to file the petition in actuality (and thus the bargaining is not that credible).[110] The only exception consists of dissenting holding-out minor creditors without any likelihood of collection).[111] At most, debtors relying on support from the trustee or even certain judges could have certain incentives, which is absolutely at odds with the rationale of bankruptcy, and which confirms that the SBA's goal of protecting creditors may be at issue due to their limited material voice. Hence, no stakeholder has good incentives to file the petition.

Furthermore, bankruptcy challenges a going-concern business, as some of the interviewees suggested. Five of the interviewees asserted that *ipso facto* clauses are actually enforced in practice despite the formal prohibition under the SBA.[112] While the subordination threat[113] of third parties thwarting the effectiveness of an executory contract[114] is useful, they said, litigation and opportunity costs often prevent active opposition by the debtor or the official trustees. Bankruptcy is pernicious for the debtor's commercial relationships with credit providers, suppliers, administrative agencies, and clients. As a result, the brand value also declines. Thus, beyond a cultural bias against bankruptcy, which may still exist, there are economic reasons that account for a runaway from the use of the petition.

107 Because bankruptcy does not bring about the dissolution of the company, the shareholders maintain indeed a remote residual interest in the assets.

108 The consideration of unsecured creditors as residual claimants is unheard of under the SBA and rare in related legal scholarship. Instead of a committee of unsecured creditors, there is an official trustee supervised by the judge as per the vast majority of significant decisions, which raises concerns about the trustee's and the judges' economic training.

109 It is fair to say that individual creditors may file allegations in different phases of the bankruptcy proceeding.

110 Only 5.04 percent of the bankruptcy proceedings initiated in 2011 were non-voluntary *(i.e.* prompted by a creditor petition). See Van Hemmen (2012).

111 Only 2.4 percent of non-voluntary bankruptcy proceedings (7 out of 287) ended up with a judicially approved composition in 2011. Further, only 17 composition agreements followed a non-voluntary bankruptcy petition between 2006 and 2011. See Van Hemmen (2012).

112 Article 61.3 of the SBA bans clauses that allow third parties to terminate the contract just because of bankruptcy.

113 See article 92.7 of the SBA.

114 The administrative agencies enjoy a privileged regime that enables to terminate a contract under certain circumstances (see article 67 of the SBA). This deters debtors from filing for bankruptcy.

In short, the interviewees suggested hints that might confirm the conclusions drawn from the official statistics of bankruptcy proceedings in 2011. Every single stakeholder endeavors to escape from bankruptcy. Companies try to turn to an out-of-court workout ahead of filing the petition. Only a failure in the negotiations leads to bankruptcy, which explains the unsettling economic outcomes of insolvent companies upon petition's filing. In addition to the culture of the economically failed and socially defeated bankrupt debtor, which may still persist in Spain, the inconsistencies of the SBA (regardless of its good intentions) have confirmed Professor Rojo's warnings over time.[115] The concerns about past fraudulent experiences have turned bankruptcy into a too judicially overseen and perhaps inappropriate way of dealing with insolvency from the standpoint of the unsecured creditors' interest. If insolvency law is aimed at protecting unsecured creditors once they become (or should become) the residual claimants of the insolvent debtor's assets, then Spanish law still has significant room for improvement, as many scholars have already argued. The shift in the residual claimants' rights from shareholders to unsecured creditors is more theoretical than practical. While it seems doubtful in Spanish bankruptcy, it is totally ignored by corporate law when a going-concern company handles insolvency out-of-court.

4.2.5 The reform carried out by Royal Decree-law 4/2014, of March 7

Although the interviewees could not take it into consideration, the brand-new reform of the SBA seems to step in the debate about the identity of the residual claimants and the directors' fiduciary duties in the vicinity of insolvency. While the corporate governance structure in bankruptcy remains unchanged, the new regulation recognizes that shareholders do not have appropriate incentives when insolvency is addressed out-of-court. Under articles 165.4º, 172.2.1º, and 172 *bis* of the SBA, directors and shareholders who thwart a debt-for-equity swap agreed as a result of the conclusion of a bankruptcy-proof out-of-court workout[116] might be liable for the impaired claims where bankruptcy is classified as guilty. In addition, article 93.2.2º of the SBA sets forth that creditors leading the negotiation and conclusion of such a workout shall not be considered *de facto* directors just in view of the covenants and events of default imposed to the debtor as a result of the out-of-court workout. Any person arguing otherwise bears the burden of proof. However, these provisions do not apply to "unprotected" out-of-court workouts. Lastly, article 172 *bis* of the SBA eases the liability to the impaired claims by establishing a more demanding causation relationship.

5 Conclusions

The conclusion of this research is that the abundance of out-of-court workouts to handle corporate insolvency has little to do with a rational behavior grounded on the economics of transactions costs. Stakeholders do not make these contractual solutions over bankruptcy in a pursuit of efficiency. In fact, professional adjusting creditors rarely bargain explicitly with the enforcement of covenants and events of default out-of-court. This is arguably due to certain judicial threats of insider subordination or even lender liability, which shows a misunderstanding of the agency problem that underlies the corporate governance battle that distressed companies undergo. On the other hand, bankruptcy, which is still compulsory under Spanish law, does not trigger an actual shift in the corporate governance over the debtor's assets. As a result, neither bankruptcy nor the "shadow" out-of-court restructuring arena seems to provide stakeholders, particularly unsecured creditors, with an effective legal framework to manage corporate insolvency in order to preserve going-concern value.

Rather than sanctioning the "insider role" *ex ante* with a judicial threat, further empirical research may assess whether banks or other nontraditional professional adjusting creditors may develop

115 See Rojo (2003).

116 An independent expert must produce a report elaborating on the reasonableness of the debt-for-equity swap within the framework of the business plan that grounds the out-of-court workout.

effective delegated creditor monitoring responsibilities to overcome insolvency out-of-court, thereby avoiding bankruptcy's transaction costs. It remains unclear whether there may be a trade-off between handling insolvency out-of-court efficiently and the squeeze-out risk of certain minor unsecured creditors. So far, it is regrettable that professional adjusting creditors do not take advantage of their privileged information in a diligent manner. This casts doubt on whether they might be willing to engage in corporate responsibilities in exchange for avoiding the insider subordination risk. To be sure, this is an exploratory research work that does not attempt to ground any statistically significant conclusion. Based on the data gathered, however, creditor monitoring may be indeed the paradoxical missing lever of corporate governance in Spain. It seems that Spanish insolvency law only protects unsecured creditors formally.

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