



# The Role of Shareholders in the Insolvency of a Company

*Is There Value in an Empty Shell?*

8th European Company and Financial  
Law Review Symposium  
Milan, 27 September 2013

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# Part 1

## ◆ Bankruptcy: The Standard Theory

# Shareholders' call option over the company's assets

## ◆ As long as assets exceed liabilities:

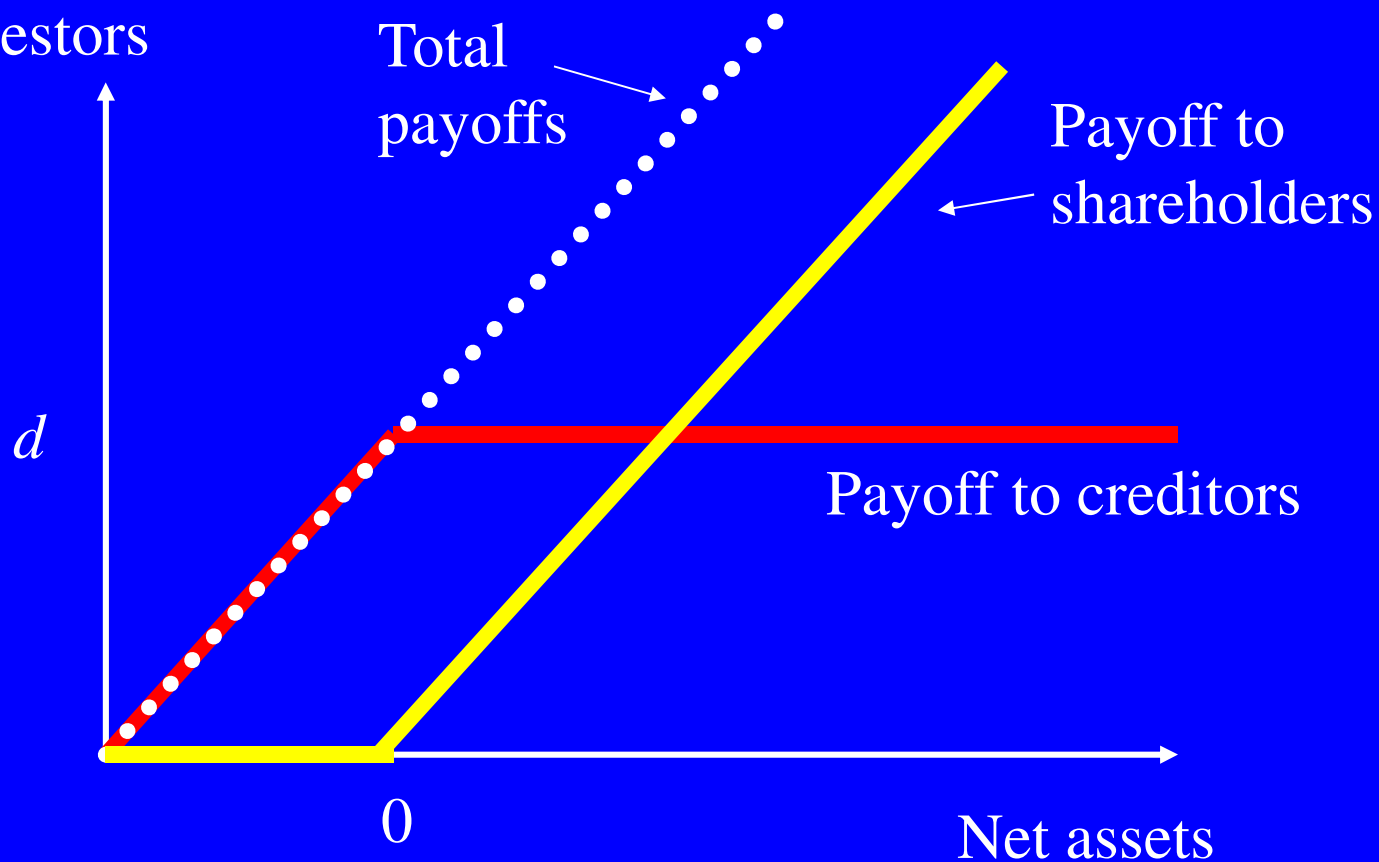
- n *Shareholder control is justified*
  - w Shareholders are the residual claimants
- n *Directors adopt efficient investment decisions*

## ◆ When liabilities exceed assets:

- n *Risk of asset substitution, inefficient investment decisions*
- n **Shareholders enjoy the upside potential, while no longer bearing the downside**

# Insolvent company: payoffs to investors

Total payoffs  
to investors



$d$  = amount repayable to creditors

# Shareholders' call option comes to an end

◆ **In such case, the shareholders' call option expires**

n **Shareholders can always pay off creditors**

n **But they have no incentive to do it, given limited liability**

# The goal of bankruptcy procedures

## ◆ **Displacing sh. of insolvent companies is the goal of bankruptcy procedures**

n *How harshly depends on the applicable bankruptcy law*

w Soft v. hard bktcy procedures

w *[Sometimes, contractual agreements provide for displacement of shareholders and their replacement with lenders]*

◆ Creditors may file a petition for bktcy

# Bankruptcy: the traditional structure

- ◆ **Creditors take control of the company's assets**

- n *Or a court's official, acting in the interests of the creditors, takes control*

- ◆ **The assets are then sold, and the cash distributed among claimants**

- n *Shareholders rank at the bottom*

# Company law and insolvency law in a simplified world

◆ **In this (simplified) world, company law and insolvency law have very limited interactions:**

- n *Company law takes care of the company when it is solvent*
- n *Bankruptcy law takes care of its assets when it is insolvent*



# The problem with cash sales

- ◆ **Cash sales are often difficult and do not yield sufficient value**

- ◆ Particularly so in times of crisis, when bankruptcies are more frequent

- ◆ **Corporate reorganizations emerge**

- n History: US Railroad reorganizations of the 19<sup>th</sup> century

- n *Assets are not actually sold*

- n ***They are "sold" to the creditors, in exchange for their claims***

# Various important issues that shape bankruptcy law

## ◆ Directors' duties in the "twilight period"

- n *Liability for wrongful trading?*

## ◆ The appropriate moment for displacing the shareholders

- n *Balance sheet insolvency?*

- n *Insolvency in the cash flow sense?*

- n *Loss of capital in accounting terms?*  
*["Recapitalize or liquidate" rule]*

- n *No reasonable prospect to continue trading*

# In particular: The treatment of the shareholders

## ◆ If bankruptcy displaces shareholders, they will postpone filing

- n *To the detriment of creditors*
- n *Again: directors' duties are important*

## ◆ A role for the shareholders might be desirable (much debated)

- n *Efficient ex ante?*
- n *Efficient ex post?*

# Corporate reorganizations: The main issues

## ◆ Valuation:

- n *Cash obtained through a sale is certain, valuation never is*

## ◆ Bargaining for the division of value

- n *Among creditors and between creditors and shareholders*
- n *Shareholders may argue that the company is not balance-sheet insolvent*

## ◆ Shareholders' procedural rights

## Part 2

### ◆ Shareholders in insolvency: US v. Europe

# United States (1)

- ◆ Historically many listed companies, with dispersed ownership
- ◆ A shareholder is seen as an investor, not an “owner”
- ◆ Therefore, shareholders have the right to participate in corporate reorganization (Chapter 11), and bargain for value

# United States (2)

## ◆ Shareholders can retain shares in the reorganized company only:

- n If all classes of claimants agree to the plan

- n *OR, when not all classes agree*

- n If the shareholders contribute "new value" to the reorganized company

- n *They can delay the completion of the reorganization*

- w **Evidence of frequent violations of APR**

# Europe:

- ◆ Few listed companies, with concentrated ownership

  - n *UK is a recent exception*

- ◆ A shareholder is seen as an “owner”

- ◆ ***European bankruptcy procedures traditionally focused on asset sales, not corporate reorganizations***



# EU Company Law main constraints to reorganization

## ◆ Who must approve the issue of the shares to the creditors?

n *See 2<sup>nd</sup> Company Law Directive, Art. 25 (now Art. 29 of Directive 2012/30/UE): the (existing) shareholders' general meeting*

w However, shareholders have no incentive to approve

## ◆ Can the law of EU Member States carve out a "crisis exception"?

n *No (ECJ case C-381/89 and combined cases C-19/90 and C-20/90)*

n *The conclusion remains the same even if existing shareh. are given pre-emptive rights (ECJ case C-441/93)*

# ECJ Jurisprudence:

## The *Pafitis Case* (C-441/93) [1996]

- ◆ Trapeza Kentrikis Ellados was a Greek bank lacking sufficient capital
- ◆ The Bank of Greece ordered a capital increase and later appointed a commissioner
- ◆ The commissioner had the power of the shareholders meeting, and he increased the capital, with preemptive rights for the shareholders
- ◆ The existing shareholders sued. The ECJ ruled:
- ◆ *"57 The directive does not, admittedly, preclude the taking of execution measures intended to put an end to the company's existence and, in particular, does not preclude liquidation measures placing the company under compulsory administration with a view to safeguarding the rights of creditors."*

ECJ Jurisprudence:

The *Pafitis Case* (C-441/93) [1996]

◆ **“However, the directive continues to apply where ordinary reorganization measures are taken in order to ensure the survival of the company, even if those measures mean that the shareholders and the normal organs of the company are temporarily divested of their powers.”**

## ECJ Jurisprudence: the *Kefalas* case (C-367/96) [1998]

Karthopiia was a Greek company, unable to survive as a going concern

Greek law allowed the Greek State to recapitalize it

- 15 First, at the time when it was made subject to the scheme provided for by Law No 1386/1983, Khartopiia was heavily indebted to banks and other creditors, it had an acute liquidity problem and it no longer possessed its own capital resources, so that its assets were no longer sufficient to cover its liabilities and its shares were worthless.

# ECJ Jurisprudence: The *Kefalas* case

In addition, the increase in capital effected by the OAE and the subsequent conversion of debt into equity led to the financial recovery of Khartopiia. The economic value of the shareholders' equity was secured, the risk of job losses for thousands of workers was averted and trading with numerous suppliers could continue, all with beneficial effects on the national economy. If, by contrast, the increase in capital had not been effected, Khartopiia would have been declared insolvent and its assets would have been liquidated at the request of the creditors, with the result that all the company's assets would have been lost to the detriment of the shareholders, the workers would have been laid off and the national economy would have been deprived of an important undertaking.

# ECJ Jurisprudence: The *Kefalas* case

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It is settled case-law that the decision-making power of the general meeting provided for in Article 25(1) applies even where the company in question is experiencing serious financial difficulties (see, in particular, Joined Cases C-19/90 and C-20/90 *Karella and Karellas* [1991] ECR I-2691, paragraph 28, and Case C-381/89 *Sindemos Melon tis Eleftheras Evangelikis Ekklesias and Others* [1992] ECR I-2111, paragraph 35). Since an increase in capital is, by its very nature, designed to improve the economic situation of the company, to characterise an action based on Article 25(1) as abusive on the ground mentioned in paragraph 23 of this judgment would be tantamount to a declaration that the mere exercise of the right arising from that provision is improper.

# ECJ Jurisprudence: The *Kefalas* case

- 25 It would mean that, in the event that the company found itself in a financial crisis, a shareholder could never rely on Article 25(1) of the Second Directive. Consequently, the scope of that provision would be altered, whereas, according to the case-law cited above, the provision must remain applicable in such a situation.

# More shareholder rights stand in the way of EU corporate restructurings...

Right to vote on mergers and divisions...

*Third and Sixth Directives*

Rights of consultation

*Directive 2007/36/EC on the exercise of certain rights of shareholders in listed companies*



# Corporate restructuring in the EU at the beginning of 21<sup>st</sup> Century

In Europe, company law was a useful tool in corporate restructurings

*However, it worked from outside insolvency procedures, assisting them in achieving their goals*

Let us see the Parmalat and Eurotunnel cases

# Parmalat restructuring plan (2005)

Plan voted by the large majority of the creditors:

## **Step 1:**

- ◆ Creditors' claims were cut from € 14 bn to € 2.0 bn (as to equalize asset value)
- ◆ A Newco was set up
- ◆ Assets and liabilities were contributed to the Newco (zero net value)

# Parmalat restructuring plan:

## Step 2:

- ◆ Newco issued shares for a total of € 2.0 bn par value
- ◆ Creditors (mandatorily) subscribed the shares swapping their claims
- ◆ In October 2005 the “New” Parmalat was listed
- ◆ ***Result: the creditors have received shares (not in the company, but) in the Newco which owned the assets***

# Eurotunnel restructuring plan (2006-2007)

**Eurotunnel had an incredibly complex capital structure, and was insolvent**

- ◆ A Newco was set up (Groupe Eurotunnel SA)
- ◆ Newco exchanged the old Eurotunnel shares for Newco shares and warrants

*<sup>n</sup> Old shareholders could get up to 67% of the Newco, but subject to dilution down to 13%*

*<sup>w</sup> (Because of notes redeemable in shares in four years)*

# Eurotunnel restructuring plan (2006-2007)

- ◆ 93% shareholders accepted the exchange offer, allowing Newco to become the majority shareholder of old Eurotunnel
- ◆ Old Eurotunnel was recapitalized by its creditors and later merged into the Newco
- ◆ ***Result: the creditors have obtained control of the assets of the old Eurotunnel***
- ◆ (1) A peaceful transition and (2) the objective uncertainty of the values have won the shareholders:
- ◆ the right to a minority stake in the reorganized company and a right to share part of the upside (warrants)

# Part 3

◆ And now let's bring in the financial crisis...

# The effect of the financial crisis

- ◆ Systemic risk from bank failures
- ◆ Recapitalizations had to be made in days, or hours, not weeks
- ◆ Shareholders' rights were impediments towards recapitalizations
  - n *No time to call a meeting*
  - n *No time to let preemptive rights expire*

# The response

- ◆ Recapitalizations done without the shareholders' consent
- ◆ Nationalizations
- ◆ Transfer of assets to third parties or to a bridge institution
- ◆ **Serious problems *ex post*, however**
  - n Huge cost for taxpayers
  - n Litigation sparked



# The nationalization of Northern Rock

- ◆ In September 2007 the ailing Northern Rock received an emergency loan by the Bank of England
- ◆ After no buyer was found, in February 2008 Northern Rock was nationalized
  - n *Shares were transferred to the Treasury*
- ◆ At the time of nationalization shares were trading at positive value
  - n *379 million GBP market capitalization*
  - n *Option value...*

# Northern Rock: shareholders can be expropriated

- ◆ Shareholders were given right to compensation based on NR's asset value
- ◆ **Without taking into consideration the effect of the emergency loan**
- ◆ **Shareholders sued under the European Convention on Human Rights**

# Northern Rock: the ruling of the court

## ◆ Court ruling (Grainger et al v. UK, 2012):

- n **Shares are considered “possession” under Art. 1 Protocol 1 of the Convention**
- n **Public interest can justify expropriation of possession**
- n **No compensation is required if value, in the specific case, is zero**

# Cyprus, March 2013

- ◆ Widespread banking crisis, following (also) the Greek sovereign debt crisis
- ◆ A large bank (Laiki Bank) liquidated
  - n Most assets transferred to Bank of Cyprus, together with insured deposits
  - n Shares cancelled
  - n **Creditors compensated with shares of Laiki Bank up to the expected losses**

# Towards a coherent regime, at least for financial institutions

- ◆ UK Banking Act (2009), US Dodd-Frank Act (2010)
- ◆ Financial Stability Board (2011), “Key Attributes of Effective Resolution Regimes for Financial Institutions”

- n Principles: **Losses must be borne by shareholders and creditors first**

- n *The authorities should then have "the power to:*

- n (i) write down (...) *equity or other instruments of ownership of the firm, unsecured and uninsured creditor claims to the extent necessary to absorb the losses; and to*

- n (ii) convert into equity *or other instruments of ownership of the firm under resolution (...), all or parts of unsecured and uninsured creditor claims”*

# The EU Banking Union: The Single Resolution Mechanism

- ◆ Draft EU Directive (June 2013) and Regulation (July 2013), aiming at establishing a SRM
- ◆ Financial institutions need not be insolvent for resolution tools to be applied
  - n *Likelihood of not being viable in the near future*
- ◆ Such tools may go as far as to restructure the corporate entity
- ◆ **Bail-in tool:** Arts 37-50 Draft Directive and Art. 24 Draft Regulation

# The EU Banking Union: The bail-in tool

## ◆ The principle behind bail-in is intuitive:

- n Losses must be borne by the shareholders, and then by the creditors
- w according to the applicable rank, with exemptions

## ◆ Art. 42 Draft Directive:

- n The existing shares must ordinarily be cancelled
- n **The existing shareholders can remain only when the valuation of the company shows that the company has a positive net value, but they must be “severely” diluted**

# The effect of the financial crisis on general bankruptcy law

## ◆ Update and reform of national bankruptcy laws

- n Some of them were still based on 19<sup>th</sup> Century principles

## ◆ Sterilization of some rules deemed to accelerate the crisis

- n Spanish “recapitalize or liquidate” rule has been watered down (some losses do not count)
- n German *Überschuldung*, i.e., overindebtedness either (*de facto* a going concern test)



# Shareholders in insolvency: UE company law principles are crumbling?

- ◆ German Reform 2011 (effective March 2012): ESUG, 'Act to Facilitate the Reorganization of Companies'

- ◆ § 225a, Shareholders' Rights:

- n The plan can provide for

- w The cancellation of existing shares

- w The issue of shares or financial instruments of the company to creditors

- w The cancellation of preemptive rights and of other compensation to the existing shareholders

## Part 4

◆ Shareholders in insolvency.  
From a “property rule” to a  
“liability rule”?

# A “perfect storm” for shareholders in EU

- ◆ Financial crisis
- ◆ Economic downturn
  - n and increased failures
- ◆ Difficulty in *selling* assets
- ◆ Difficulty in *transferring* assets, even to a Newco

# Result

- ◆ More “friendly” insolvency procedures (e.g., UK, Italy, France, Germany)
- ◆ ***However, no more holdouts impeding potentially efficient solutions***

# Result

- W This means that, if necessary:
- W **Cancelling, diluting, forcibly transferring shares is becoming possible**
- W *Shareholders are claimants, not "owners"*
- W ***They have no right to keep the shares, but merely to be compensated for their loss***

# Conclusion (1)

- w Bankruptcy is extending its reach from the company's assets to the corporate entity itself

- w The position of shareholders is changing from a "property rule" to a "liability rule"

- n *In Calabresi-Melamed (1972) terms*

- n *Only right to be compensated for losses, if any*

# Conclusion (2)

- ◆ An insolvent company is an empty shell

  - n Assets are less than liabilities, i.e., shares are worth zero*

- ◆ An empty shell can have value?

- ◆ **Apparently yes, but it is not the shareholders'**